North American Merchant Power Deal of the Year 2012: Sherman and Temple

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The twin financings for the Sherman and Temple merchant power projects mark a return to market for the former management of Panda Energy, one of the older names in independent power project development. The two deals asked debt markets to absorb more greenfield merchant risk than since Pandas 2001 heyday.

The Panda Energy managers decided in 2007 to launch a private equity firm that would specialise in power development. The new venture, Panda Power Funds, would develop and finance power projects in US markets that were short of generating capacity or soon would be and then sell the facilities soon after they start operations.

For its first two projects, Panda Power Funds did not stray too far from its Dallas headquarters, though not purely for the convenience. Panda began developing 758MW gas-fired projects in the Texas cities of Temple and Sherman, and soon won air permits for the projects, as well as generous local subsidies. A consortium of Siemens and Bechtel would hold the fixed-price engineering, procurement and construction contracts for the projects, which would use Siemens turbines with quick-start capabilities.

But Panda was unable to find suitable long-term power purchase agreements (PPAs) for the projects. Commercial and institutional lenders to greenfield projects rarely lend against merchant credits, at least not for the last ten years. The absence of PPAs would have discouraged most sponsors from moving forward.

Still, Panda was intent on financing and building the Temple and Sherman projects, despite their lack of PPAs, and for the same reason that it had developed the projects to begin with: The Electric Reliability Council of Texas (ERCOT) appears short of new baseload power, especially in the expanding Dallas-Fort Worth corridor. Old, dirty coal-fired generators are close to retirement, while the proportion of ERCOTs capacity coming from wind, a volatile resource, is increasing.

Panda hoped that ERCOT would move to a capacity market to encourage the construction of reliable baseload capacity, because the council expects its reserve margins to slip to 9.8% in 2014 and 6.9% in 2015. But regulators in Texas have yet to act, and may not do so. If Panda can bring its two plants into operations, this inaction may help those capacity additions.

While ERCOTs lack of a capacity market may have limited Pandas chances of signing suitable power purchase agreements, the looming crunch offers the prospect of high power prices and spark spreads for flexible merchant facilities. Temples first phase and Sherman are expected to be operational in 2014, possibly in time for the peak summer period of demand. There is a complete disconnect between the market and reality, says Robert Simmons, Panda chief financial officer. Whenever there is disconnect, theres volatility. And where theres volatility, theres opportunity.

Panda management understood that financing the two plants would require some revenue certainty. Pure merchant deals have been scarce since the meltdown of the California power market in 2000. Projects with limited merchant exposure, including the ArcLight- and Hess-sponsored 512MW gas-fired peaker in Bayonne, New Jersey, are also rare, though they can be financed with conservative enough gearing.

Panda looked for financial hedges, in the form of four-year revenue put options, which would cushion Temple 1 and Sherman against adverse movements in gas prices by setting floors on the projects gross margins. Investment banks have long offered hedges to merchant plants typically brownfield assets but restrictions on banks trading activities mean that there are fewer players with slimmer product offerings.

Panda ultimately signed its hedges with the 3M Employee Retirement Income Plan, a creditworthy counterparty and an equity investor in the sponsor, for 600MW of the projects output. Other Panda Power Funds investors include the Employees Retirement System of Texas, Ohio Teachers Pension Plan and duPont Testamentary Trust. Sherman has a higher revenue strike price than Temple, $45 million to $41 million, respectively.

At this point, Temple 1 and Sherman offered some revenue certainty, but their risk profiles were not conservative enough for most traditional project finance banks. The institutional markets tend to accept riskier deals, including occasional financings supporting merchant plants. But the last financing in the institutional market with a big merchant component was Longview Powers 769MW coal-fired project in West Virginia. And that project has suffered from a series of technical mishaps.

Panda, nevertheless, opted for first-lien institutional deals, backed by equity contributions equivalent to roughly 50% of construction costs, for Temple I and Sherman. It mandated Morgan Stanley as joint lead arranger to finance Temple, alongside Ares Capital. Morgan Stanley launched a $305 million six-year (non-call for two years) financing, split between a term loan A and a term loan B; the A loan was larger than the B loan. The tranches are pari passu and include cross-acceleration provisions.

At closing on 17 July 2012, the Temple financing had risen to $330 million and the sizes of the respective tranches had essentially flipped, with a $75 million term loan A priced at 700bp over Libor and a $255 million term loan B priced at 1,000bp with a payment-in-kind feature. Both loans had 1.5% Libor floors and original issue discounts that priced them at 98.5% of par. The financing has a debt service coverage ratio (DSCR) between 1x-1.15x, the product, according to Standard & Poors, of higher than expected interest rates. The financing package also included a $10.16 million letter of credit facility from Union Bank and $5 million in working capital. Lenders will benefit from a sweep of excess cash flow of at least 75% for Temple and 100% for Sherman.

While Temple 1 established Pandas merchant credentials, the structure and marketing of its immediate successor, Sherman, is more likely to be the template for future deals. Whereas just six participants principally hedge funds financed Temple, Sherman was marketed to a wider audience and featured a single tranche. Sherman brought in 30 lenders, including Fidelity and Siemens, as well as collateralised loan obligations and business development companies.

Sherman benefited from lower upfront fees and the financing priced at 750bp over Libor, lower than Temples blended rate, with a 1.5% floor and an original issue discount. But market observers insist that Shermans margin would have been even lower had Temple not been so narrowly marketed. Temple, they explain, had set the market price for greenfield merchant and Sherman closed just two months later, on 18 September 2012.

Goldman Sachs and Credit Suisse led the $372 million six-year (non-call for two years) financing package for Sherman, increased from $353 million, which consists of a $342 million term loan B priced at 750bp and a $30 million letter of credit. Sherman has a tight DSCR of 1x-1.1x, again according to S&P. Goldman and Credit Suisse are strong contenders to lead a single-tranche financing for the 758MW Temple 2, which should launch in March 2013.

Sherman had some advantages over Temple. Sherman will procure gas from multiple receipt points, essentially allowing it to lock in a price at or below the Waha Hub index price, which is lower than Temples Katy benchmark. Sherman also benefits from lower pipeline and water supply costs, saving millions over Temple, will be subject to less transmission congestion risk, and has a more favourable and longer-term tax abatement program. Its construction costs are $10 million cheaper than Temples, but both financings have the same B rating (S&P).

Panda Temple Power LLC
STATUS

Closed 18 July 2012
SIZE
$745 million
DESCRIPTION
758MW merchant gas-fired project in Temple, Texas, dispatching into the ERCOT market.
SPONSOR
Panda Power Funds
JOINT LEAD ARRANGERS
Morgan Stanley (documentation agent) and Ares Capital
COLLATERAL AGENT
Union Bank
SPONSOR LEGAL COUNSEL
Latham & Watkins
LENDER LEGAL COUNSEL
White & Case; Bingham
ADVISERS
Moore-McNeil (lender insurance), AON (borrowers insurance), Navigant (market), SAIC (independent engineer), Marshall & Stevens (valuation)
Panda Sherman Power LLC
STATUS
Closed 18 September 2012
SIZE
$732 million
DESCRIPTION
758MW merchant gas-fired project in Sherman, Texas, dispatching into the ERCOT market.
SPONSOR
Panda Power Funds
LEAD ARRANGERS
Goldman Sachs and Credit Suisse
DOCUMENTATION AGENT
Ares Capital
SPONSOR LEGAL COUNSEL
Haynes and Boone
LENDER LEGAL COUNSEL
White & Case, Haynes and Boone
ADVISERS
Moore-McNeil (lender insurance), AON (borrowers insurance), Navigant (market), SAIC (independent engineer), Marshall & Stevens (valuation)