Damhead Creek

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The financial close on 1 June 2004 of ScottishPower's £317 million (US$584 million) acquisition of the 800MW Damhead Creek power station marks another chapter in the short but intriguing life of the Kent plant, writes Max Thompson.

Commissioned in February 2001 by US utility Entergy, the US$700 million state-of-the-art facility rapidly fell victim to the 40 per cent collapse in wholesale electricity prices – the catalyst for which was the introduction of the New Electricity Trading Agreement (NETA) to encourage competition within the sector.

Like its fellow US nationals AES, Edison Mission and NRG, Entergy predicted the UK power market was spiraling into a deep and prolonged depression and, in 2002 it turned its back on a plant on which the paint had barely dried.

Adam Overfield, partner of UK-based power development and ownership company, Greenberry, told IJ that the commissioning of Damhead Creek – a greenfield project –was indicative of the high level of naïvety displayed by US companies which had overestimated the potential of the UK market.

He said: 'The US investors paid premium prices for power generation assets in the UK, many of which were uncontracted and open to the merchant market and also were heavily indebted. This meant they had very large debts to service and had not got a hedge against a turning market.'

A letter to stakeholders written at the end of 2003 by Entergy chairman Robert van der Luft explained the reasoning behind Entergy's decision to hand the keys to the plant back to the banks and withdraw from the UK market.

Luft said: 'Most of Damhead Creek was financed with true non-recourse project debt. To keep the project debt current, and out of default, would have required investing another US$100 million or more – money we would likely never see again. So we reached an agreement with the banks to sell the plant for a nominal amount. When the deal closed in December, we were able to remove over US$450 million of non-recourse project debt from our balance sheet.'

The banks take control

Shortly after the commissioning of Damhead Creek, Entergy's European vice president David Stoner said: 'This is our second major power plant project in the UK, and a sure sign that we are here to stay in this power development market.'

With Stoner's words still echoing forlornly around the cavernous and still gleaming power plant, Entergy had to decide whether to opt for insolvency or whether to execute a consensual transaction with its creditors.

Entergy chose the latter and the syndicate of 28 banks – which included the Royal Bank of Scotland, HBOS and Abbey National – that had backed the project organised the debt into two tranches; a senior debt tranche of around £277 million (US$509 million) and a subordinated debt tranche of around £30 million (US$55 million).

They then rapidly established a special purpose 'warehouse' vehicle to acquire the shares in Damhead Creek, and in doing so challenged the widely held supposition that banks did not run power stations.

For practical reasons, it was decided that the 11 subordinated banks would become the shareholders in Damhead Energy

Limited (DEL) – acquiring unanimous consent from 11 banks is a lot simpler than doing so from 28.

DEL took ownership of the equity from Entergy in December 2002 and the remaining banks from the original syndicate could relax knowing that their senior debt was secure.

DEL then acquired the entire share capital in Damhead Creek Limited which owned and operated the plant through Damhead Creek Operations Limited.

The banks restructure their debt

In June 2003 in response to a market that lacked confidence – but was beginning to show signs of recovery – the banks decided to restructure their debt and in doing so hedged their bets.

Instead of mothballing the new plant – as International Power had done with its 500MW Deeside plant – the restructuring allowed the banks to advertise its wares by running the plant as a going concern.

Speaking of the operation, Allen & Overy partner Nick Williams – who led the team which advised the banks from the plant's conception, during its debt restructuring and during ScottishPower's acquisition – told IJ News: 'It was an exercise in stabilisation. The banks were ensuring that the business had the potential to carry on in the long term which then meant that the banks, shareholders and company could consider offers for the business from a position of strength.'

The restructuring exercise was a success and the bank-backed operation of the plant weathered the wholesale price storm and, at the beginning of this year, the facility became attractive enough to court suitors keen to take advantage of an improving market – among them Centrica and the specially formed acquisition vehicle – CGE.

ScottishPower offer accepted

ScottishPower's £317 million (US$582.7 million) cash offer – which was £30 million (US$55 million) less than CGE's more complicated share-based bid – was accepted by the banks. A move that Susan Reilly – managing director of ScottishPower's strategic transactions group – said 'kiboshed' CGE's plans and led to the collapse of Jim Forbes' enterprise.

Speaking of the deal – which involved the purchase of the share capital of Damhead Creek from DEL – Reilly said: 'We had our eyes on Damhead Creek for three years before we bought it. As a team we've been very strong on knowing when not to buy.'

Charles July, the partner who led the Freshfields Bruckhaus Deringer team which advised ScottishPower, told IJ News: 'This was a particularly interesting transaction due to its hybrid nature, having characteristics of a trade sale and a disposal by creditors. In practice we had to negotiate as if there were two vendors – the management of Damhead Energy Limited and the project finance banks, not all of whom were shareholders of DEL and some of whom were also rival bidders for the plant.'

He added: 'Although the deal is clearly a straight forward M&A, the nature of the asset meant that project finance skills were very relevant and applicable to the transaction.'

Conclusion

Given that the power station is only three-years old and included in the deal is an attractive gas supply contract – details of which ScottishPower would not disclose – the £317 million paid by ScottishPower appears to be a good price.

The banks also seemed pleased with the deal. Williams told IJ News that from his point of view, the fact that ScottishPower saw off other competitors, was testament to the success of the banks' running of the plant during lean times.

He said: 'I think all the banks were delighted with deal. They got almost all their money back which justified their decision to take ownership from Entergy and play a long term game of looking to realise as much value from their asset as possible over a medium term.

Following the acquisitions of Fifoots, Triple F and Killingholme B, the sale of Damhead Creek – which almost doubles the size of ScottishPower's generating capacity in England and Wales to around 1,800MW – is yet more evidence of a resurgence in the UK power sector.