

Articles

"State of the Art: An Analysis of Portfolio Power Project Financing"

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Year five of the US merchant power race and some 12 companies are frontrunners. The goal is to establish a large asset base of strategically located power plants to leverage an annual market estimated at \$250 billion by 2010. In the effort to establish that asset base—where plants are treated as much as trading positions as assets on the ground—independent power producers (IPPs) and the unregulated arms of major utilities have sought unprecedented amounts of bank financing since 1997.

The number and amounts of financings, together with the new merchant risk model that does not provide a long-term power purchase agreement to guarantee revenue streams has, in turn, created a sea-change in the way these projects are financed. The classic project finance template of a single plant financed by a 20-year non-recourse loan secured by the plant and backed by a long-term power purchase agreement has given way to hybrids that mix project finance and corporate finance elements.

Without a long-term contract to support payment obligations, lenders have less of an appetite for long-tenure loans. As a result, bridge and "mini-perm" loans of two to five years with lower amortization requirements are now employed to bring a power plant from construction to initial operation. Once the plant is proven, the loans are taken out with less expensive permanent financing—a bond offering, long-term loan, synthetic lease or other instrument that more closely matches the life of the project.

In effect, the mini-perm provides sponsors with precious time to strengthen and develop the track records of their projects before offering them up for permanent financing. The hybrids will typically unite the corporate finance concepts of shorter-tenure loans and term and revolver features with the project finance concepts of stricter covenants and cash sweeps.

Given the urgent need to develop multiple power projects as rapidly as possible, coupled with the large number of bank financings currently being sought in the marketplace (that is partly the result of the subdued equity and bond markets), the new hybrids have further evolved into the concept of "portfolio financing", which combines multiple projects into a single, cross-collateralized "jumbo" financing of typically \$1 billion or more.

Portfolio financing offers valuable economies of scale, from lower overall transaction costs to uniform loan reporting requirements. This new breed of financing also allows the developer to finance weaker projects by combining them with stronger projects, and to take advantage of lower overall risk through cross-collateralization and diversification of projects of different types and geographic locations.

By 2001, the biggest players in the industry were using portfolio financing to widen the gap between themselves and their competitors. In the first eight months of this year, companies such as American National Power, Mirant, NRG, and TECO/Panda used portfolio financing to raise a total \$8 billion-plus for their projects, and in the last couple of years Calpine (\$1 billion and \$2 billion) and Mirant (\$1.45 billion) also completed one or more portfolio financings. Currently, Sithe Boston (\$1.25 billion), Tractebel (\$1.5 billion), PSEG (US\$850 million) and Cinergy are said to have portfolio deals in the works or close to close.

Portfolio Finance Structure

To date, portfolio financing has been simply the consolidation of a number of project financings under one umbrella. It has not been, as some borrowers had hoped, a throwback to the secured utility financings of the past. Typically, a group of arrangers negotiates a term sheet with a sponsor covering not one, but a group of power plants under different phases of

Articles

construction and agrees to provide financing for the entire portfolio. The sponsor establishes a special purpose financing subsidiary as the borrower, which then owns the individual project companies, which in turn, own the generation facilities.

The financing will characteristically be of short tenure, from two to five years, with step-ups in pricing and perhaps amortization in the later years to encourage a permanent financing take out. The financings are normally rated—which helps when the loans are ready to be refinanced—and may be close-ended (the borrower is not able to add projects to the facility once funded) or open-ended (the borrower may remove projects by paying down debt and then add projects by reborrowing the debt). This year, the American National Power and TECO/Panda portfolio financings were closed-ended construction and term structures, while the NRG and Mirant financings were open-ended revolver structures.

In a portfolio financing, instead of looking at a single project, the entire portfolio is examined as a group to determine its viability. The modeling for these portfolios envisions that the cash flow from anyone project will flow through the borrower and be available to support all costs, not only within its own project but across all of the projects as a whole. Likewise, while there are construction budgets and cost estimates for each project, there usually are provisions for bulk purchasing, cross utilization of equipment, and sharing of a central repository of spare parts that allow the lenders to view the portfolio as a single economic unit. Finally, while not universally true, the major EPC contractors and technology used to generate electricity are often the same or similar across the projects in the portfolio to help facilitate viewing the portfolio as one large project.

Advantages

Instead of financing on a project-by-project basis, the combining of several projects into a single portfolio financing can save significant time and money. For example, only one set of professionals must become familiar with the projects. This means one set of consultants for the sponsor and one set of bankers and their consultants, instead of different bankers and consultants having to get up to speed on different projects at different times under different financings. Moreover, if the portfolio financing is structured as a revolver, the time and cost savings is further magnified with each new project that is added to the portfolio.

Perhaps the single greatest cost savings is that there is only one set of loan documents covering the projects, typically drafted by one law firm for the lenders and reviewed by one law firm for the sponsor. Since all of these costs are both significant and unavoidable in any financing, any meaningful consolidation can result in noticeable cost savings. Another benefit of portfolio financing is possibly better pricing and easier syndication because of a decrease in the overall risk profile through diversification of projects and cross-collateralization. For example, the sponsor may be able to finance certain weaker projects that otherwise would be unfinanceable by combining them in a portfolio with projects that are underpinned by stronger economics, since all of the projects secure the financing. Most portfolios include projects in different stages of development, with some already generating electricity and others just in the early stages of development. Operating projects represent lower risk to the lender both because construction has been successfully completed and because the lender is then able to observe and evaluate the skill level of the borrower's operating personnel and the reliability of the technology used, which will be applied to other projects still in development. This lower risk can then be allocated among the weaker projects in the portfolio.

Similarly, portfolio financings commonly have geographic diversity among the projects. Diversity reduces the parties' exposure to individual markets and power pools, allows the parties to smooth out cash flows by balancing among hot-weather/cold-weather peaking plants, and often provides a more diverse group of suppliers and off-takers spread throughout the country or the world, all of which reduce risk. Moreover, basic risks such as performance failures, fire, explosion, and weather, while generally covered by insurance, can have their impact further minimized by spreading them over a large number of geographically diverse projects. Still another advantage to the borrower comes following the closing of the loan, when the borrower must only deal with one set of reporting requirements to one lender, all having the same standards, the same notice periods, and the same deadlines. What pricing models are used, how costs are estimated, what level of default must be reported, along with an almost infinite number of other similar issues, could be overwhelming if they had to be dealt with differently for each project under a separate financing.

Articles

Further, the conclusion of such a financing results in an improvement, or at least a quasi-improvement, to the balance sheet of the sponsor, and leaves money available for other acquisitions. While project financings, unlike synthetic leases or more exotic structured financings, do not necessarily achieve off-balance sheet treatment, they do usually remove a recourse liability from the sponsor and leave the liability solely with the borrower and entities below the borrower. This may increase the flexibility of the sponsor in dealing with other projects and may result in a more favorable view of the sponsor's financial structure and its ability to engage in subsequent financings, public or private.

Finally, because of the typical size of a portfolio financing, both the sponsor and the lenders often benefit from the increased profile and publicity engendered by a successful financing. While such exposure may have less direct value to the larger players, many of whom do not want to reveal their trading resources, smaller companies seeking to establish themselves in the market or who have been out of the market for a period, may benefit from the publicity of having closed a large dollar financing on a number of projects.

Disadvantages

Portfolio financing, however, does not come without some downside. Due to the size and documentation requirements of the financing, the burden placed on all aspects of a sponsor's resources, including personnel, legal, accounting, financial, engineering, risk management, and marketing, are severe and, in all but the largest companies, preempt a great deal of day-to-day operations. Additional consulting and in-house help is sometimes required both to push the process through and to administer the loan afterwards. Such an undertaking requires a commitment from the sponsor at the highest level and an understanding from management that the financing will place an enormous, albeit temporary, strain on the sponsor's resources.

Certain mechanical and technical problems also arise because of the mere magnitude of the financing, which multiplies by several factors the complexities of a single project financing. For instance, any project financing requires a significant expenditure of time in obtaining consents that recognize the lenders' interests from third parties to all manner of contracts in connection with the projects, from fuel supply and operation and maintenance agreements to interconnection and site services agreements.

In a portfolio financing, since many of the projects are at or near completion, a significant number of these project contracts will typically have been in existence for some time. While these consents are problematic in any project financing, because they are now being requested within the context of a dollar amount and default universe that includes not one, but a multitude of projects, the third parties asked to give them may be more reluctant. In addition, lenders may sometimes require the renegotiation of various contracts to make them more bankable, which can be a painful experience for all parties particularly given the number of contracts involved.

Another disadvantage to portfolio financing is the restrictive nature of the covenants and compliance that can affect a sponsor's operational flexibility for the life of the loan. To support projects' ratings, for example, the covenants typically establish high debt service coverage ratios and penalize the borrower should the projects' rating slip. Limitations on the development of certain projects, such as nuclear or peaking projects, may also be established.

The pricing on portfolio financings typically creeps up in the later years of the facility, with some recent deals going from 160 basis points up to 200 basis points above LIBOR. Further, a market flex provision can cause the negotiated price to spike upward if the arrangers have difficulty syndicating, something that has happened in the current market. For example, according to press reports, the financings of NRG and TECO/Panda this year had their pricing bumped.

Since most portfolio financings have involved merchant plants, they usually require high equity positions of 40 to 50% and employ a rigorous financial supervisory regime. Moreover, harsh cash sweep and cash traps, which prioritize money flows to the lenders, also are used in the later years of a financing or as the result of covenant breaches that may be caused by poor power plant performance, interest rate hikes, regional overbuild or other problems. In fact, to avoid these invasive restrictions on operations, some sponsors elect to pay down debt to take their plants out of the financing once operational.

Articles

Since all of the projects in a portfolio financing are cross-collateralized, a significant default with one project will carry over as a default for all of the projects under the financing, which may not be the case had the sponsor financed each project on a one-off basis. The loan provisions, however, temper this risk somewhat by creating higher default thresholds that keep defaults below the threshold from being deemed a default of the entire portfolio.

Increased Complexity

Many of the issues encountered in portfolio financing are similar to those encountered in an individual project finance, but because of the size and number of projects in a portfolio financing, the complexity of these issues are multiplied. On the financial side, one must develop and update a financial model sufficient to provide comfort to the lenders that the economics of the projects support the capital structure. Since this model will involve a large number of projects, many of which are in different stages of development and have constantly changing cost in revenue projections, modeling becomes significantly more difficult. Add to this that the modeling is no longer typically supported by a long term power purchase or tolling agreement, but instead by the vagaries of merchant risk that includes technology risk, electric pricing risk, fuel risk, regulatory risk and transmission risk, and the modeling has indeed entered new realms of complexity.

Similarly, the mechanics of negotiating how project funds will be accounted for and used increases geometrically in complexity. Almost any project financing involves the negotiation of an account control agreement or depository agreement governing the flow of funds, but in portfolio financing, because multiple projects are involved, the negotiation of this document assumes new significance. Through these agreements, the lenders maintain tight control over all cash and establish a "waterfall" or line of priority for the right to project revenues.

Most portfolio structures envision that cash from all projects flows into a single account from which the cash is then distributed to a series of sub accounts, not on a project-by-project basis, but on a priority basis. The purpose is to ensure that the operation and maintenance reserves, ad valorem taxes and other essential reserve accounts are fully funded and that the lenders receive their interest and principal. Left-over cash is then circulated to other lesser priority sub-accounts, including the account for equity holders.

New Legal Issues

While the legal issues involved in portfolio financings involve a significant overlap with single project undertakings, additional issues do present themselves. First, the corporate structure of the sponsor, borrower and project companies should be carefully reviewed by tax and legal counsel to ensure that the structure is both tax efficient and ring fenced for rating purposes. In addition, since a given sponsor's tax and accounting needs will differ over time, the sponsor should be sure to retain the right to flow funds down to the individual project companies, by either debt or equity infusions, and with minimal documentation and collateral requirements.

In negotiating the borrower structure, the parties should also be sure to comply with all existing FERC filings and requirements to avoid the costly delay of additional applications. Changes in corporate or partnership structure, changes in ownership of assets, moving subsidiaries from one parent to another, significant amendments to transportation and power purchase agreements, may all trigger the need for additional FERC filings. While FERC officials do often attempt to facilitate the tight time requirements of a portfolio financing, notice requirements and scheduling backlogs may cause a delay of several months for anything but the most pro forma of requests. One major goal of portfolio financings is to use the decreased risk profile and decreased transaction costs as a spring board toward an investment grade rating. To achieve this end, most borrowers agree to enhanced sponsor support, fairly severe restrictions on the use of cash, including cash sweeps and traps, restrictions on dividends and fairly high coverage ratios and low debt equity ratios. Quite often an investment grade rating is the sine qua non of a successful syndication.

Also, to the extent that the projects are located in multiple jurisdictions, local counsel will be required to deal with matters of local law, especially concerning permitting, state regulatory, real estate and lien priority matters. Local counsel should be brought in early by both the lenders and the sponsor and carefully briefed on the importance of meeting deadlines, since

Articles

they may, if not kept current, delay the closing.

Individual title problems, and the unique requirements of various states title insurance regulators, can also cause delays in the financing. For example, since many projects in a portfolio financing are already under construction before financing commences, the risk of mechanics liens priming a lender's priority position is great. As a result, the parties typically will have vigorous negotiations on establishing permitted lien baskets on a per project basis and on requiring the sponsor to infuse funds into a defaulting project company. One approach is to strive for a mechanism that allows as much advance notice as possible of a problem and insures that, if funds are infused by a sponsor, the funds constitute some of the required equity for the project, despite constraints normally placed on the definition of equity infusions by the various loan documents.

Portfolio financings also present nuances in a host of other specific documentation issues. For instance, exhausting negotiations can ensue over what constitutes a "material adverse effect" or what the dollar amount and breadth of defaults should be. The negotiations will often center on whether the material adverse effect or default should be on a per project or overall portfolio basis, or at the borrower or sponsor level.

Conclusion and Trends

Some clouds have recently formed over the merchant power industry. The California electricity crisis, which brought rolling black-outs to the state, doubts about deregulation and the bankruptcy of Pacific Gas & Electric, has caused inquietude in the bank markets. After extending more than \$30 billion to the industry over the last couple of years, many credit committees are reassessing their exposure levels at the same time the United States' economy is slowing, energy stock prices are falling, and fears of overbuilding in certain markets, such as Texas and New England, are growing. Part of the uncertainty has been reflected in the difficulty some of the portfolio financings have experienced in coming to market this year. According to press reports, the American National Power, Mirant and NRG jumbos all experienced delays of weeks or months in their closings, as well as adjustments in their pricing or covenants, while the overdue \$1.5 billion Tractebel financing has not yet been able to close.

In the short term, the more aggressive revolver structures, with high hold positions, low fees, broad operational flexibility and low equity positions, may become more difficult to sell. Lenders may also more heavily scrutinize the underlying economics and risk profile of a portfolio, including the geographic diversity, competition and load characteristics within regional power markets, the technology efficiency and reliability, transmission constraints, and fuel risk of the projects underlying the portfolio.

Pricing may also continue to go up, and more of a mix of completion guarantees, offtake guarantees, and long-term tolling agreements may be required to complement the portfolio. In addition, a premium may be placed on sponsors who have strong development skills, utility backgrounds, or established trading arms to help market a portfolio's generation. Finally, sponsors may also find themselves having to spend more time performing one-on-one sit downs and conducting road shows to attract participants.

If the merchant power industry and its lenders are taking a breath, industry experts believe there is still much to be done. The United States government has estimated that the country will need 45% more electricity by the year 2020 and that there is currently 305,000 MW of capacity planned to be installed by 2007 at a cost of \$140 billion. In fact, the current administration has appointed vice president Dick Cheney, an energy industry veteran, to oversee an energy policy, one of whose central tenets is to find a way to develop additional generating capacity on a large scale.

Since enormous amounts of installed capacity are still needed, the great United States merchant race likely is far from being run. Moreover, if Dick Cheney is right and a new power plant needs to be built once a week for the next twenty years, there are not enough bankers, lawyers, and consultants to go around if these projects are developed on a piecemeal basis. Instead, portfolio financing may become the standard of project finance in the United States for years to come.

Articles

Thomas J. Perich, partner, and George Humphrey, associate, are members of Andrews & Kurth, L.L.P.'s energy practice group based in Houston, Texas. In June, Tom closed the US\$1.37 billion American National Power portfolio financing, which covers five natural gas-fired merchant powerplants in Texas and Massachusetts representing over 1,029 MW of generating capacity. Andrews & Kurth's energy group counsels large energy companies, financial institutions, governments, investment funds and other smaller US and non- US companies in virtually every area of energy, including oil and gas, pipelines, oilfield services, refining, LNG, power, transmission, distribution, energy regulatory, renewable energy sources, privatizations, acquisitions, project development and project finance. With regard to finance, Andrews & Kurth has been recognized as one of the world's top law firms in the areas of project and structured finance.