NA PF trends

Trends in NA project finance

The global project finance market rebounded in 2004 with an overall volume of US$144bn, according to Thomson Financial. By **Ramesh Raman**, director, and **Scott Flippen**, associate, **Taylor de Jongh**.

Loans represented US$116bn of that total and bonds made up a further US$28bn. In North America, project finance volume was up 75% to US$29bn, and activity for the first half of 2005 indicates a continued robust market. Transportation PPPs are blossoming in more than a dozen states, and projected activity shows volumes rapidly approaching the activity levels in European markets.

In the energy sector, strong demand in the US gas market is driving the rush to develop LNG import terminals as well as pipelines from Alaska and Canada to bring natural gas to markets in the US. Project finance is playing a critical role in funding the projects being developed to meet the rising demand. In the power sector, several notable deals in the first half of the year indicate that the commercial banks are returning to the US power market. In all, the North American project finance market is rebounding with renewed vigour.

Financing opportunities in LNG

LNG has been the buzz in the industry over the past few years, as the US seeks to satisfy growing demand for natural gas. Higher energy prices and declining domestic natural gas production have strengthened LNG's role in the energy equation. The growing importance of LNG has given rise to a flurry of activity among firms vying to get LNG import terminals in place to meet the new demand. Much of this new terminal development in North America will follow one of three types of structures:

- An integrated strategy where an international oil company (IOC) constructs the terminal, imports LNG from its own liquefaction facility and markets the resulting gas to existing customers at affiliated companies. Although the majority of these projects are likely to be funded using the corporate balance sheet, this model can lead to non-recourse project financing when the sponsor is a joint venture.
- Push tolling. An LNG producer needs regasification capacity to access customers contracts for capacity at an LNG terminal, for regas services and capacity on a tolling basis.
- Pull tolling. A utility or trader purchases LNG to market to its customers and buys regas capacity on a tolling basis.

In both tolling models the terminal owner is paid a capacity charge for converting LNG to natural gas. Such a contract structure mitigates the terminal owner's exposure to commodity risk and provides a reliable revenue stream. Tolling models put a priority on signing agreements with strong counterparties. If creditworthy suppliers and off-takers are involved, the stable cashflows from the tolling agreement make the project suitable for non-recourse financing.

Many of the current developers of import terminals are independent developers or entities that will seek to utilise non-recourse or limited recourse project financing, and thus structure their terminal use agreements (TUAs) as tolling facilities in order to maximise the leverage.

Cheniere's Sabine Pass facility provides an example of the push-tolling concept. Total signed a 20-year capacity agreement with Cheniere for 1bn cubic feet per day, or about 40% of the terminal's expected capacity. This structure allowed Cheniere to achieve a US$741m project financing. Following this success, Cheniere added a second capacity agreement, this time with Chevron, for 700m cu ft per day and was able to increase the project debt to US$822m. The transaction was successfully syndicated to 47 financial institutions.

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Natural gas distribution

Transmission constraints in the gas pipeline system in North America have arisen from a nearly five year hiatus in major capital investments in the system. With new points of supply arising from the LNG terminals that are being added, the gas transmission system is in need of some significant new investment.

Multiple ownership changes and restructuring activities have taken place within the pipeline sector over the past several years. US companies have sold assets to pay down debt and improve their financial standings by monetising the high values of their pipeline operations. Prior to 2002, the vast majority of US pipelines were owned by energy companies.

After Enron filed for bankruptcy in 2001, many energy companies examined the state of their own financial affairs and began selling assets to improve their balance sheets. As a result, financial buyers with minimal experience in the industry began buying up pipeline assets.

For example, in April 2005, Philadelphia based Atlas Pipeline Partners (APP) purchased Elk City system in Oklahoma from Energy Transfer Partners (ETP) for US$192m. The proceeds of the sale will go towards repaying ETP's US$825m of outstanding debt, which was incurred in its acquisition of Houston Pipeline System.

Traditional pipeline operators have also been consolidating. In November 2004, TransCanada Corp acquired Gas Transmission Northwest Corp from National Energy & Gas Transmission for US$1.7bn. The key assets in this transaction were the Gas Transmission Northwest Pipeline, which is essentially an extension of its existing BC and Foothills pipeline systems, and Baja Pipelines, which provided a new market growth opportunity for the corporation.

In January 2005, Enbridge acquired Shell Gas Transmission for US$613m. The acquisition included ownership interests in 11 natural gas transmission and gathering pipelines in five major offshore Gulf of Mexico corridors that transport approximately 3bn cu ft per day.

With respect to new projects, in May El Paso completed a US$435m deal for the 380-mile, 36-inch Cheyenne Plains Natural Gas Pipeline. Around US$278m of debt was arranged to replace equity that El Paso has already spent on the project's construction, which began in 2004.

This type of long-dated financing was the first for an onshore pipeline in the US since the Kern River expansion deal in June 2002 and is exemplary of the new appetite in the bank market. The debt was broken down into a US$266m senior secured term loan and a US$12m senior secured letter of credit. It has a tenor of 10 years, an amortisation schedule of 15 years and a balloon payment at maturity. The project's financing consists of 30% equity and 70% debt. Bond financing was considered in the initial financing strategy but not utilised.

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TransCanada was awarded a US$181m contract by Mexican state-owned public utility Comisión Federal de Electricidad to build, own, and operate a 36-inch, 125km gas pipeline running from Pemex Gas facilities near Veracruz in east-central Mexico to a power plant near Tamazunchale, San Luis Potosi.

Projects such as this one, the Alaska pipeline, and the Mackenzie Valley pipeline represent a trend where many of the large pipeline projects in North America consist of public-private partnerships. The State of Alaska is contemplating taking an equity stake in the US$20bn Alaska gas pipeline and the project has financing options that include federal loan guarantees and access to tax exempt bonds.

Power market participants - New approaches

An emerging trend in financing power projects in 2004 was the greater utilisation of Term B loans. The collapse of the merchant power market had resulted in commercial banks limiting their exposures to the power sector, particularly deals involving market driven pricing mechanisms that lacked long-term off-take commitments. But subsequently, the economic recovery provided high yield investors with greater liquidity, resulting in Term B investments flowing into the energy sector in place of traditional project finance debt.

One of the first major recipients of Term B loans was the Astoria plant in Queens, New York. The US$690m financing was priced at 525bp over Libor for the first tranche and 825bp over Libor for the second. The larger spreads were due to a variety of factors that included an off-take agreement structured to take advantage of volatility in the market pricing, albeit with a floor price that satisfied debt service requirements. Timing of the financing also played a key role in the need to close financing promptly, resulting in an additional premium.

Astoria's initial Term B financing was successfully refinanced at the beginning of this year in the traditional project finance commercial banking sector, which has been showing signs of recovery for well structured projects. The first half of 2005 has seen a number of generation and transmission projects close project financings and refinancings, including the following:

- Calpine closed US$503m in debt for two generation plants, the 375MW Mankato plant in Minnesota and the 250MW Freeport plant in Texas. The facility was priced at 1.75% over Libor, matures in December 2011 and was backed by a 20-year PPA with Northern States Power at Mankato and a 25-year PPA with Dow Chemical at Freeport.
- Crockett Cogeneration refinanced the debt at its 240MW cogeneration facility with a US$295m issue of senior secured notes at an interest rate of 5.869%. The issue's tenor is 20 years, matching the life of the PPA.

NA PF trends

▶A US$550m project finance facility for Neptune Regional Transmission System to construct its 660MW undersea transmission cable from New Jersey to Long Island, New York. Development and equity financing thus far have been provided by Energy Investors Funds (EIF) and Starwood Capital Group Global LLC.

High energy prices will also drive more power development to coal-fired generation plants. Clean coal development will lead the way in states with strict environmental regulations and the development of lower cost waste-coal plants will also increase.

Alternative energies such as wind are also providing more opportunities for project finance. The growth of wind-powered generation plants has mainly been spurred by regulatory policy. Many states have adopted Renewable Portfolio Standards (RPS), mandating that a certain percentage of energy generation be derived from renewable resources.

The key driver for renewables is the federal Production Tax Credit (PTC). Without the PTC, wind projects would find it difficult to provide an economically attractive energy resource. The Energy Bill, currently in Conference Committee, contains provisions that would extend the PTC for three years. If this provision is included in a final bill that passes the House and the Senate, then a surge in wind projects requiring project financing can be expected.

While banks have returned to the market, they are taking smaller chunks of debt.

One trend that runs through the majority of the project financings mentioned above is the tendency for project debt to be distributed across larger syndicates. While banks have returned to the market, they are taking smaller chunks of individual project debt. This means that more banks are needed to complete deals, as demonstrated by the 47 institutions that participated in the Cheniere financing described above.

The economic recovery and the stabilisation of power markets have increased the level of bank comfort in energy project financings. The rapid increase in number and size of the transportation financings, combined with the resurgence of build-out in energy infrastructure will require 'big tickets' for total debt in these transactions.

With most North American banks sporting healthy balance sheets and rather urgently seeking assets, they will become more comfortable in increasing their participation in individual deals, thus reducing the number of institutions per transaction. The demand for projects and the return of commercial banks to the market offer a strong outlook for project finance in North America.

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