

Hedge funds find joy in energy's distress

Hedge funds are increasingly considering investing in distressed energy assets. However, as McDermott Will & Emery's Greg Lawrence and Terence Healey counsel, lookest before thou leapest

A fast-moving secondary market exists among financial institutions, including hedge funds, trading the debt of distressed power-generation projects and the related equity interests in the holding company structure that owns the generation.

In classic manner, this flowing capital continues to encounter evolving regulatory requirements of the US Federal Energy Regulatory Commission (FERC), and certain state regulatory bodies.

Hedge funds must have a broad understanding of the regulatory and energy market landscape in order to value accurately and close on the equity within a commercially reasonable timeframe.

ALL TO PLAY FOR

From 2003 to 2005, well over 15,000 megawatts (MW), and \$5.5bn of debt were in play for distressed generation assets and this scale continues in 2006. These distressed generation projects generally arose from non-performing loans to merchant plans. Typically, the generation plants were stand-alone, but some include three to four generation plants located in various regions across the US.

For several reasons, including spark-spread collapses and changes in certain capacity and energy market assumptions, the generation plants were unable to service their debt in the form of loans. As part of foreclosure or as an alternative to outright foreclosure, the project companies agreed to transfer all interests (debt and equity) to the lenders.

Thus, the lenders became owners of LLC membership interests in a new holding company that owned an LLC that, in turn, owned the underlying distressed generation asset.

The debt and equity are in most projects 'stapled' together and generally must be traded together. The lenders apparently were (and are) willing to convert the loan debt into equity and take ownership based on the perceived long-term value of the generating assets given projected changes in the applicable energy market as well as the existence of a relatively liquid secondary market for the trading of the debt and equity.

Many of the projects should be familiar to the marketplace by now, including: MACH Gen, LLC, formerly owned by National Energy Group (NEG), including over 2,500MW

located in the New York Independent System Operator (NYISO), ISO New England Inc. (ISO-NE), Midwest ISO (MISO) and the Western Electricity Co-ordinating Council (WECC) control areas; Liberty Electric Power, LLC, formerly owned by Orion/Reliant, a 567MW plant in the Pennsylvania New Jersey Maryland (PJM) control area; Lake Road Generating Co., L.P., formerly owned by NEG, 750 MW of plant in the ISO-NE and NYISO control areas; Milford Power, formerly owned by El Paso, a 544MW facility in ISO-NE; Southaven, formerly owned by Cogentrix, a 810MW facility in the Entergy/TVA control areas; La Paloma Generating Company, LLC, formerly owned by NEG, a 1040MW plant in California; Granite Ridge, a 720MW plant in ISO-NE; Boston Generating, LLC, 3,000MW facilities in ISO-NE; and Gila River Power, LP and Union Power Partners, LP (Entegra), formerly owned by TECO Energy, a combined 4,400MWs located in the Entergy and WECC control areas.

In 2005, the typical distressed plant profile was characterised by a 1,000MW plant with commercial operations usually commencing within the last few years, located in ISO-NE with a combined-cycle-combustion natural gas turbine technology, 7,200 heat rate, with approximately \$450m in debt, a market price of approximately 85% of par loan value, and thus an implied valuation of approximately \$375/KW.

SIGNIFICANT OPPORTUNITY

The opportunity in this market was, and continues to be significant: approximately 20,000MW of combined-cycle generation financed with nearly \$10bn dollars of debt characterised by significant regulatory reorganisation, bankruptcy risk, and apparent discounts for the trading of debt/equity due to these and other risks. Since 2003 more players, both traditional lenders and hedge funds, have entered the secondary market for trading of distressed equity and debt at a relatively quick rate.

The valuation for the equity and debt has surged from approximately \$100/KW to \$500/KW, and more.

This market today continues to be heavily traded. This is true despite, and in some cases because of, the existence of significant regulatory changes to the market structure for

energy, capacity market modifications, rising fuel costs, challenges to reliability must-run (RMR) contracts, and the FERC's continued development of regulatory strictures that influence the ability and timing of purchases of equity in these projects.

IN THE THICK OF IT

Hedge funds are right in the middle of the action as part of either a short-term arbitrage between financial and commodity markets or, possibly, a willing owner of the debt and equity of generation projects over the long term, based on projected valuations for these assets.

A hedge fund that considers purchasing the debt and equity associated with these projects should be aware of several important challenges and potential opportunities.

The holding company that owns the generation asset, and the asset itself, are generally considered as public utilities, authorised by the FERC to sell wholesale power at negotiated rates. As public utilities, the generation asset and the holding

company must seek FERC authorisation to 'dispose' of its equity (but not debt) in the form of LLC member interests pursuant to the Federal Power Act (FPA), Section 203(a)(1).

When considering the grant of authorisation for the disposition, the FERC looks primarily at the impact of the disposition on market competition, but it also considers any potential impact on regulated rates and regulation.

Generally, if there is not a true change of control of the holding company and the underlying generation asset by virtue of a hedge fund acquiring the equity interest, or if the value of that transfer is less than \$10m, the holding company/generation asset would not need to seek FERC authorisation for the transfer of the underlying equity.

This relatively easy road to authorised equity transfers becomes more difficult, however, when there is significant levels of trading of the LLC equity interest – multiple buyers (including hedge funds) purchasing

small levels of interest (generally less than 5%) that add up in the aggregate to, for example, a 20% or more change in the overall equity ownership.

In this scenario, the FERC counsel to the project companies has often sought FERC authorisation based on the theory that a change of control may have occurred in the aggregate, thereby requiring FERC authorisation under FPA Section 203(a)(1).

Of course, seeking regulatory approvals such as this adds risk, primarily as delayed closings of equity assignments to hedge funds.

State energy regulators also may have approval rights when a generator changes its ownership, even if that change is indirect as new players purchase equity in the holding parent.

Many of the projects mentioned have tried to address this regulatory risk and delay, and to encourage capital to trade more freely, by obtaining from the FERC 'blanket authorisations' (sometimes called 'future transfer' authorisation) for certain purchasers of equity, that generally remain valid for a two-year period.

Specifically, if a purchaser is a financial institution, not primarily engaged in the energy business, and it and its affiliates, together, do not own more than 5% of the equity in a generator or power marketer operating in the same area as the target generator

is located, then the purchaser can acquire up to 20% of the equity in the specific target project without further FERC authorisation.

There are after-the-fact compliance filings to the FERC, but the LLC member

interest assignment can be closed by the LLC agent without waiting for further FERC approval.

This may be all well and good, but the hedge fund should keep in mind several factors.

FOR CONSIDERATION

A few hedge funds do have power marketing affiliates that may operate in the same control area as the target generator and, thus, may not qualify for this blanket authorisation. In addition, once a hedge fund purchases 5% or more in a generation asset, it is restricted from purchasing interests in additional generation assets located in the same control area without seeking additional FERC authorisation.

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tion. These factors tend effectively to limit the market liquidity that the blanket authorisations were arguably intended to provide.

Some of the credit documents governing the various project companies have minimum transfer amounts for the debt (stapled to equity), for example, between \$5m and \$10m.

In addition, certain projects require that the transferees be rated entities. Hedge funds often attempt to acquire small amounts of equity (for example, less than 5%).

Such a small assignment may not need FERC authorisation because there is no apparent change in control or the buyer qualifies under the blanket authorisation grant.

However, depending on the capitalisation of the project, the small assignment may not meet the minimum transfer requirements and thus cannot be closed.

These funds might also not be rated, further limiting their ability to take interest by assignment.

If the buyer cannot close, the seller may be 'trapped' with lots of equity that it may have purchased from an existing LLC member.

If the seller's level of equity is high enough, or if enough similarly situated sellers are trying to buy and sell at the same time, FERC authorisation may be triggered, holding up entire chains of interests from closing and reaching their ultimate buyer, often a hedge fund.

A QUESTION OF CLASS

Several generation projects also have both A and B share classes, where class A is considered a passive interest and class B is considered active interests. Some LLC agreements have an automatic conversion to active shares if an entity already holds some active shares.

This conversion could trigger FERC approval requirements of the acquisition – putting the buyer 'over the top' – even though the purchase of the active shares by itself did not

trigger such a requirement. This also may cause FERC approval requirements for the seller – again, the seller may get trapped with more equity than first anticipated, triggering an FERC review.

A hedge fund should be alert as to whether there may be amendments to the LLC agreement that are cir-

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culating among existing members, for example, changing minimum threshold and credit requirements, and such passive/active equity conversion issues.

Hedge funds should also be aware that even risk participations, commonly referred to as “transfers not of record,” whereby economic value is transferred to a buyer, for example, a hedge fund, but not voting rights, may be subject to approval by the agent to the LLC.

Required FERC authorisation is not a death-knell for securing debt stapled to equity rights. It simply means that an FERC application must be drafted detailing the chain of title for each transaction obtained, a profile of the entity acquiring the interest, and a reasoned explanation as to why competition will not be harmed, which may take several months.

Thus, the ability for the ultimate buyer may be delayed, pending FERC authorisation of various upstream intermediary transfers and the ultimate purchase by the hedge fund.

Some have mitigated this regulatory delay and risk through the use of risk participations. Many buyers and sellers use risk participations to allow for the economic interest to be transferred to the hedge funds, pending FERC authorisation.

Another solution has been to address the problem at its source, including encouraging existing members to develop amendments to the LLC and credit documentation to address problems with closing downstream interests, including minimum threshold requirements and credit restrictions.

BUY IN BULK

Another potential solution could be to group together a single hedge fund's purchases from multiple upstream counterparties such that the downstream hedge fund could qualify under any minimum threshold requirements on a net basis. There are other methods to lower the perceived level of interests changing hands, again, all in an effort to reach the legal conclusion that FERC authorisation is not necessary.

This may be a lot of trading regulation to mull over, but there is more.

Hedge funds also should consider whether they are or will become a holding company pursuant to the new Energy Policy Act of 2005 (EP Act) and, in turn, be subject to further regulatory approval requirements by FERC under the FPA, Section 203(a)(2). If an entity owns more than 10% of the outstanding voting security of the holding company (here, the holding company LLCs that own the distressed generators), the holder of that interest could be deemed a holding company if certain exclusions do not apply.

Generally, under current FERC rules, if that entity is a holding company solely because it owns equity in a holding company that in turn owns a generator that is an exempt wholesale generator (EWG) or qualifying facility (QF) – nearly all of the distressed generators are EWGs – then the entity is not subject to certain books and records requirements.

Moreover, such an entity, although a holding company, would not require FERC authorisation under

Section 203(a)(2) to acquire interests of a value greater than \$10m in other similar EWGs or QFs.

Thus, in this limited circumstance, there may not be a regulatory road block to acquiring further equity in distressed generation projects. However, whether or not an entity can avail itself of this exception should be considered.

Hedge funds, as part of their asset valuation due diligence, also should develop a full understanding of the impact of recent FERC pronouncements regarding capacity markets and RMR contracts.

All of the distressed generation assets projects sell capacity and several of the generators have locked-in revenue streams through RMR contracts.

In ISO-NE, for example, FERC recently approved a settlement agreement addressing problems in ISO-NE's generation capacity market, that among other things, sets fixed capacity prices through 2010 for installed capacity resources, and provides for the implementation of a forward procurement capacity auction for capacity to be delivered in 2011.

Any payments received via existing RMR agreements will be netted against these fixed payments and many RMR agreements are set to terminate upon implementation of the forward-capacity auction in 2011. In PJM, settlement talks are ongoing regarding the development of PJM's reliability pricing model (RPM), which will have profound effects on the value and liquidity of PJM's capacity market.

ONE EYE ON THE LAW

It is important to remain focused on these regulatory developments in order to arrive at reasonable valuation projections for the various assets currently being traded in these and other markets. This secondary trading market is not slowing; indeed, it could increase significantly if market conditions, including rising fuel costs, continue to prevent existing merchant generators from being able to service their outstanding loans.

Hedge funds wishing to take part in this market must up-front perform the necessary valuation due diligence and consider the various regulatory and project-specific restrictions related to equity and debt transfers.

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