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If it works...

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The received wisdom about the European power industry is that the most successful players will be those that can become integrated generators, marketers and distributors. AES in western Europe is gleefully setting about proving this wrong, building up a strong portfolio of generating assets with the potential to add earnings fast. It is a strategy, if it can be called that, formed from the highly decentralised corporate structure of the AES beast itself.

Mike Armstrong, Group Head of AES Electric, responsible for AES' assets in western Europe, is not one for setting out its future direction: ?We often get asked what our strategy is, and I guess that the strategy is that we try lots of things and see what works ? there aren't any long term strategy objectives. Nothing's done centrally ? we invest in each project on its own basis.?

It is an ethos that saw AES net 8% of the UK's generating capacity with the Drax acquisition, the £1.86 billion ($2.96 billion) deal that saw off Edison Mission's Fiddler's Ferry and Ferrybridge acquisition to become the largest deals in UK power of the last year. Drax set new benchmarks for deal complexity and size, with the £1.3 billion senior secured bank loan, lead arranged by Industrial Bank of Japan, Chase and Deutsche, just part of the intricate financial structure.

The ownership structure involves at least three intermediate holding entities, AES Drax Ltd, AES Drax Holdings and InPower, with Drax Holdings issuing bonds subscribed to by InPower. AES is understandably coy about how this tax-efficient structure works but was impressed by the roles played by the lead banks, in particular long-standing relationship bank IBJ as advisor, and Chase's strong showing in syndications and ratings advisory.

For AES it was the ease with which the financing could be absorbed into the London bank market that was paramount. Whilst AES did the structuring work from its UK base, John Turner, Project Manager for Drax, adds, ?We decided from the start that it was important to get an investment grade rating, simply because of the size of the financing and the capacity of the Sterling bank market.? The debt was rated BBB- by Standard & Poor's and BBB by Duff & Phelps Credit Rating, despite an uncertain regulatory future and a fire (with, as it turned out, no lasting damage) at Drax' number 3 unit.

The leads are still in the process of selling down the debt, but the underwriting phase closed November 30, following quickly from the sale agreement in mid-August. This was not, however, a deal assembled on the hop since National Power, the seller, had made its intention to divest known from late 1998, anticipating regulatory concerns. The regulators made it clear that the deal had to be closed by year-end.

AES has examined opportunities for acquiring distribution companies, but has been wary of what has come to the markets so far. Armstrong explains: ?There are two reasons for not building up a distribution presence, first, there haven't been that many distribution companies up for sale, and secondly we felt that the UK distribution companies were too expensive.? Nevertheless, AES has established distribution businesses in the US, and even in Georgia (Caucasus), where its Telasi affiliate received $60 million in funding from the IFC and EBRD to upgrade distribution networks.

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A number of AES' successes have come from less obvious directions, a case in point being the £123.75 million ($204.2 million) Fifoots Deal. Fifoots was a combination of acquisition and refurbishment of a coal-fired plant in south Wales destined for decommissioning. AES bought the development from the company charged by former owner Celtic Energy (a Welsh mining group) with the demolition of the 3x120MW facility. Fifoots closed at the end of December 1999, competing with both Drax and the Edison Mission acquisition for lenders.

Initial reaction to Fifoots was subdued: the pricing (between 125bps and 175bps) was aggressive and the tenor, at a minimum of 16 years, was lengthy. But sole lead arranger Deutsche pointed out that the deal was the UK's first mid-merit plant financing, has a flexible number of units and is well placed with regard both to supply and to offtake agreements.

The most significant aspect, at least for AES, is that Fifoots is a merchant facility serving an attractive grid location in Wales. Says Armstrong: ?Fifoots was very much a one-off opportunity ? the refurbishment meant that we could install Flue-gas desulphurisation and particulate capture to increase the plant's capacity factor.?

Armstrong is keen to point out that the majority of AES' output globally is under contract ? by 2004 only around 9% of their earnings are likely to come from merchant generation. The generator believes that partially hedged and semi-contracted structures that were used with Drax offer more solid earnings potential. At least 50% of the term loan principal on Drax will be hedged on a 5-year rolling term basis. It is the predictability of earnings that could endear AES to investors at a time when the share values of other large US electricity firms, some of them with heavy merchant exposure, are being buffeted.

AES, in common with other global energy players, is awaiting the expansion in deregulation in mainland European electricity markets, a situation where it believes that it can thrive. But, again, the reality of finding a killer asset that can dominate its market takes precedence over exploiting market types. ?Our belief is that pricing is more dependent on competition than on market structure. Which isn't to say that the structure of pricing won't be different ? there may be more volatility?, says Armstrong.

However, Armstrong will be looking carefully at the Italian asset privatizations, as soon as a definitive structure for the sell-off emerges. He's confident that a bid will be assembled whatever shape the sales take, but adds that a genco style deal would make it harder to ascertain exactly what has been taken on. It was no surprise that CIP6, the grandfathering of power tariffs that was controversially challenged by the Italian authorities, was affirmed: ?We would expect that the government would live by them. It's not a situation that we'd expect in a country like Italy?.

Yet it is differences such as this that caution sponsors against any wholesale export of deal templates. ?There will be no identikit deals?, says Armstrong ?and in the UK we've seen a steady process of re-regulation, but there are certain fundamentals there?. What we can confirm is that the structural features that characterise recent deals will be all present and correct ?we'll use the hedge agreements, partial contracts and PPA's that we've used successfully over here?.

Elsewhere in Europe much depends on the attitude of the incumbents to competition. Markets in Spain and Germany are undergoing a process of transformation most clearly evidenced by the merger and take-over activity swirling around the incumbents. Amstrong is positive about the prospects for meaningful foreign penetration of these markets, but in common with most observers remains sceptical about the French market opening up. Electricite de France (EdF), the state-owned incumbent generator and distributor, has had its monopoly formally ended (in part under threat of European litigation), but big-ticket power deals, as opposed to the smaller cogen projects, are still likely to be thin on the ground. It is a galling situation in which to be when AES and EdF are often sparring in foreign markets, although the two are both substantial shareholders in Brazilian distributor LIGHT.

AES is now proceeding with a 1200MW combined-cycle gas turbine project in Spain, having achieved the necessary approvals and with an EPC announcement due imminently. Turner adds this warning: ?companies with a strong domestic franchise have seen that growth has got to come internationally, but this has happened with mixed results. What we are

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now seeing is a process of retrenchment back into their core markets?.

Armstrong echoes this sentiment, and implicitly contradicts the received wisdom that integrated players will be the ones to watch. ?I think that the specialists will be the winners in the long run. In this market we're primarily generators, but some energy traders may use generating assets either to manage risk or for branding reasons?, he says. The ultimate aim will be to act as the most efficient player in a pan-European single market for electricity, although the nearest equivalents at the moment are countries with a high degree of interconnectivity, such as Austria or the Netherlands.

AES operates the Elsta plant in the Netherlands, a 405MW gas-fired facility in which it has a 50% stake, alongside Destec Energy. Says Turner, who has been watching the Dutch market closely, ?We did look at the generating assets in the Netherlands, although we found prices very high. It's deregulated and does have opportunities, not least because it has a high level of interconnectivity with neighbouring countries.?

Nevertheless, whilst always having to assume a market that is changing very fast, AES are still forced to play the waiting game. As with another US IPP titan, NRG Energy, currently waiting for Section 36 approval for its Plymouth gas-fired facility, there is not a great deal that AES can do whilst waiting for the Partington project to get off the ground. At stake here is the relationship between politics and the declining UK coal industry, and despite subtle hints of an end to the gas-fired moratorium there has still been no alteration to the official line that exceptional circumstances have to be cited to gain approval.

Partington as planned would be a merchant gas-fired facility and the UK government has made it clear that it would look more favourably on inside the fence combined heat and power deals. From AES' point of view these small-scale plants offer few attractions, although Partington, located in an industrial area near Manchester, might be able to muster the necessary chemical plants as off-takers. There have been attempts to look at renewables as well, including a waste-to-energy project under the auspices of NiGen, the Northern Irish joint venture with Tractebel. However, the support usually required for these projects sits uncomfortably with the competition-fixated mindset of the generator.

The other regulatory issues on the horizon are certain to be more fundamental. The current bone of contention is the so-called ?good behaviour? clause that has been proposed by UK regulator Ofgem in an attempt to avoid a repeat of the high pool prices of July 1999. Ofgem has included the seven generators owning the majority of the country's coal-fired assets ? only TXU Europe and Magnox accepted the conditions in February. AES, along with British Energy, PowerGen, National Power and Edison Mission Energy, rejected the clause, although Edison has since submitted.

Ofgem argues that the coal generators set prices in the pool around 80% of the time and that the new clause is designed to prevent price spikes and market abuse rather than simply cap prices. There has been a great deal of disquiet, however, about the beefed up regulatory powers to which Ofgem has laid claim. The matter is now in the hands of the competition commission.

It is in its dealings with Ofgem that AES manages to convince in its claim that it really is a decentralised organisation. It takes the non-recourse structure to its logical conclusion, carrying out nearly all operations on-site. In demonstration, Armstrong brandishes a letter from Ofgem asking for a central address for their correspondence: ?that's really a matter for the men on the ground?, he says.

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