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US power's leveraged lease dilemma

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When Edison Mission Energy filed for Chapter 11 bankruptcy protection on 17 December 2012, it proved the value of separating utility and unregulated generation for a second time. The filing covers 1,708MW of wind capacity, 4,350MW of coal-fired capacity, and 1,230MW that runs on oil or gas.

Edison International has written down its equity in Edison Mission Energy (EME), and is preparing to transfer ownership to the bondholders. In 2001, it narrowly avoided putting its utility subsidiary, Southern California Edison, into bankruptcy in the wake of the California power crisis.

Edison managed the restructuring of the utility with minimal interruption, and Edison International appears likely to survive the EME bankruptcy. But it will have to retain some retirement obligations, and will delay EMEs transfer until 2014 to retain the tax benefits of owning an unprofitable independent power producer.

Edison Missions critical condition

The holders of Edison Missions $3.7 billion in unsecured bonds will take control, and are already looking to hire advisers to sell the Edison portfolio. The process will come under the supervision of the bankruptcy court, though the filing was part of an agreement between Edison International and Edison Missions bondholders. Moelis & Co is advising Edison International, Perella Weinberg is advising Edison Mission, and Houlihan Lokey is advising the bondholders.

The portfolio includes the large and elderly coal-fired fleet that has caused Edison so much trouble, as well as a more recently developed wind portfolio. According to earnings forecasts that Houlihan Lokey produced for bondholders, the wind assets will produce $178 million in earnings before interest, taxes, depreciation, amortisation and rent this year, compared to a loss of $119 million at Midwest Generation.

Edison International devised Mission Energy Holding as the ring-fenced operating and financing vehicle for the unregulated assets, in a successful attempt to isolate them from the utilitys former woes. The same technique now isolates the wind portfolio, with its own project lenders and tax equity investors, from the sickly remainder of Edison Mission. Bankers who extended loans of between 10 and 16 years to Edison Mission-developed coal projects as their coal-fired affiliates slid towards bankruptcy can rest easily.

The Edison Mission portfolio is lighter than it was in 2001 despite the addition of the wind capacity. With the divestment of its operations in Europe and Asia over the last decade, the International part of Edison International became increasingly anachronistic. And in October 2012, Edison Mission surrendered the 1,884MW Homer City coal-fired plant to its lessor, a GE- and MetLife-owned entity.

Homer Citys problems mirrored those of the Midwest Generation portfolio. It runs old, carbon-intensive capacity whilst the price of gas relative to coal stays low and demand for power remains stubbornly weak all while regulators continue to require the installation of pollution control equipment at these generators.

Edison bought Homer City in 1998 from GPU and New York State Electric & Gas, and Midwest Generation from Commonwealth Edison in 1999. It used leveraged leases to help finance both acquisitions. Edison initially financed the

Homer city acquisition with bank debt from Lehman Brothers, Citi, and Credit Suisse, and then refinanced it with an $830 million lease bond issue in May 1999. Homer City. Midwest was initially subject to a combination of a back-financed leveraged lease ($774 million on the 2,968MW Collins oil and gas-fired plan), and $1.367 billion in structured lease obligation bond debt on its Powerton and Joliet plants.

Lessened leases

Leveraged leases were a common feature of power finance in the period leading up to the fall of Enron in 2002, and even for a short period afterwards. They allowed fast-growing generators with limited ability to benefit from asset depreciation to sell the benefits of this depreciation to third parties that could set off the depreciation against taxable profits. The structures were usually less complicated than the elaborate cross-border structures that eventually attracted scrutiny in the US Congress.

But they did reduce the flexibility of sponsors, now lessees, to respond to problems with assets or the markets in which they operated. Midwest Generations Collins lease was unusual for being financed in the bank, rather than bond, market. In April 2004, Midwest Generation closed a $700 million seven-year term loan B priced at 325bp over Libor, and a $1 billion 30-year note issue, in part to terminate this lease. Then, in 2007, Edison Mission issued $2.7 billion in corporate debt, part of which went towards paying down all of Midwest Generations debt except for a little over $900 million of the lease bonds, and a $500 million working capital facility. This shifted the debt burden associated with Midwest up to the parent. But Edison International did not assume any responsibility for that debt burden.

In 2010, Moodys observed the parents clear position of not providing any direct or indirect credit support for EME and its subsidiaries. That said, we believe that EIX [International] views EME as an important holding that provides long-term option value to the corporation and, as such, we believe that EIX and EME will continue to work through the numerous issues facing EME and its merchant operations.

In the years since the acquisition, Edison Mission has closed the Collins plant (not long after terminating its lease), and closed the Crawford and Fisk plants in September 2012. But Midwest Generation faces substantial capital expenditures on the remaining coal and gas portfolio, including $585 million in environmental compliance spending up until the end of 2015, and another $155 million in other capital expenditure, while Edison Missions gas portfolio faces $90 million in expenditure.

The burden of pollution control expenditures has already led to Edison Mission losing Homer City. Homer City Funding filed for Chapter 11 bankruptcy protection on 6 November 2012, after agreeing with 76% of its bondholders that GE Capital and MetLife, the lessors for the plant, would take it over.

Homer City secedes

Homer City is subject to $174 million in bonds due 2019 and $465.9 million in bonds due 2026. The filing took place after Homer City missed a $47 million rent payment, equivalent to debt service on the senior bonds, though it had already signed a forbearance agreement with bondholders. Homer City had made a $48 million senior rent payment in April 2012, but had missed its $65 million equity rent payment, and asked its lessors for forbearance.

GE Capital had the expertise and the resources to carry out the $750 million in work to install sulphur dioxide scrubbers on two of Homer Citys three units, as required by mercury air toxics standards, which come into force in 2015. In exchange, GE assumed economic as well as nominal ownership of the plant, and swapped the defaulted bonds for new bonds with the same terms, lower leverage, and similarly forbidding fundamentals. Crucially, GE will release Edison Mission from any claims under the tax indemnity agreement in the sale-leaseback agreement. But the US Environmental Protection Agency, environmental group The Sierra Club, and two Pennsylvania residents living near the plant have launched legal actions against the plant.

Edison, in part because of the poor performance of the plant, and in part because of the constraints of the lease structure, had invested little in the plant. In theory, lease structures can take account of future capital expenditure requirements, but only when lessor and lessee are able to anticipate what these might be.

The combination of poor fundamental economics and huge capex requirements means that lessees are much less attached to their assets than they were during the last bout of market weakness. Bankruptcy courts can in theory reject lease obligations as they did during the 1992 bankruptcy of El Paso Electric but a decade ago, bankrupt power producers worked hard to keep control of their assets.

Lessor in the middle

Bankruptcies can leave lessors and lease equity providers in a difficult position: Its not a nice place to be, stuck between lessees and bondholders, says one lawyer who has worked on lease restructurings. Lessors have bought assets to enjoy their tax benefits, and bankruptcy can shift the tax position of lessors drastically. The most obvious complication comes when lease bondholders write off some of their principal, with that debt forgiveness triggering a tax penalty.

CIT, for instance, bought up the lease bonds of the 850MW Broad River and 520MW South Point gas-fired power plants after Calpine, their lessee, entered Chapter 11 bankruptcy protection. It restructured the plants leveraged lease as a single-investor lease, back-levered the lease with a $290 million Barclays-led B loan in 2009, and was able to sell the plants back to Calpine, now out of Chapter 11, in late 2010.

Calpine paid CIT $38 million and assumed the B loan debt, and then refinanced it with an $835 million corporate senior secured first-lien loan in October 2012. Thats a fairly clean exit for a lessor, though youd expect that an outfit with the experience of CIT would be able to pull it off, suggests one adviser.

Dynegy dukes it out

PSEG, the lease equity provider for the sale-leaseback of Dynegys Roseton and Danskammer power plants, had to settle for a slightly less positive outcome when its lease bonds were restructured. Unlike the two Calpine plants, which were barely five years old when they were first restructured (and ran solely on gas), Roseton is almost 40 years old and uses on oil and gas, while Danskammer is a coal-fired facility thats more than 60 years old.

Dynegy bought the plants from Niagara Mohawk, Consolidated Edison and Central Hudson Gas & Electric in 2001, and financed them with a $920 lease bond issue. The rest of Dynegys portfolio has a substantial coal-fired component, though the two leased plants were amongst its oldest plants. Dynegy had a brush with collapse in the aftermath of Enron, but faced a more serious restructuring in 2011.

Its lease obligations were corporate obligations of Dynegy, and as part of Dynegys attempt to restructure its corporate debt it wanted to pare back the two plants debt obligations. Behind its negotiating strategy with PSEG lay its probable ability to reject the leases in bankruptcy. PSEG opposed Dynegys placing the plants in Chapter 11 protection in November 2011, but then settled in December 2011 for a $110 million unsecured claim against Dynegy and $7.5 million in cash. PSEGs initial opposition was in part prompted by Dynegys attempts to split its unprofitable coal operations from its slightly more profitable gas assets. But the two plants were not valuable enough to give PSEG much leverage. In the court-supervised auction of the two plants, Danskammer brought in $3.5 million essentially the value of its land, especially after sustaining damage from Hurricane Sandy last year and has been retired. Roseton recently brought in $19.5 million from Castleton Commodities International.

Dynegy has emerged from the restructuring into credit markets that are comparatively benign for gas-fired merchant generators. In April, it closed on the $1.3 billion in term loan B facilities, which broke down into $800 million and $500 million tranches, priced at 300bp over Libor, with a 1.0% Libor floor, an issue price of 99.5% of par and a 1% prepayment penalty.

End of days

These leased generation assets were as much victims of the vicissitudes of the commodities cycle as the complexities of the US tax code. Lessees, lessors and lenders were able to exercise as much influence during restructurings as the quality of the assets allowed, though thinking through the tax implications of terminating leases kept even more law firms busy than a normal bankruptcy.

But there are very few leveraged leases for independent power producers left to restructure. The $338 million in debt of PPL Montana, a portfolio of coal-fired and hydro assets in the US north-west, remains investment-grade, in large part because of the assets proximity to California. Reliant and Mirant, once distressed merchant power lessees, have gone through their separate restructurings to become the combined GenOn.

There are few signs of a resurgence of interest in power leasing. Some wind assets have been financed using leveraged leases, though most have preferred to use tax equity-based financings. The publicly owned Tennessee Valley Authority (TVA) continues to use leases, but only because it has a ceiling on the amount of debt it can issue limits that do not include lease obligations. The TVA closed a $206 million lease bond financing for Caledonia Generating, an 813MW gas-fired plant that it leases from GE, and a $1 billion lease bond financing for the 880MW John Sevier plant, in 2012.

The TVA is the offtaker for the most recent restructuring of a leased power plant, the 440MW Choctaw plant, which PurEnergy acquired earlier this year. PurEnergy, once the lessee of Caledonia, bought Choctaw from GDF Suez, which had stretched its limits to help fix the lignite-fired plants technical complaints via subordinated debt contributions. Southern Company, as lease equity provider, seems to have survived the restructuring intact.

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