Project Finance

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TIME TO CUT

Turkey's upgrade sparks hopes of lower pricing /29

Is there room for the UK's Green Investment Bank to grow? /31

Non-bank brakes on GCC mega-projects /34

US wind roundtable – beyond the PTC /36

Inside: Deals of the Year 2012 – Americas – /41

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DEALS OF THE YEAR 2012

North American Water
Deal of the Year 2012

Carlsbad Desal: Revived

ProjectFinance
Deals of the Year 2012

The $733.56 million issue of bonds for Poseidon Resources' Carlsbad reverse osmosis desalination project took ten years to come to market. But it could serve as a useful template for applying PPP structures to water assets, particularly in ocean water desalination.

The project, located in Carlsbad, California, had a long gestation because of the highly public nature of the project and what it will produce. Poseidon ultimately came to work with the San Diego County Water Authority, whose role as offtaker was the key to bringing the deal to close. Poseidon will own the plant, which will sell output to the water authority under a 30-year water purchase agreement (WPA), and the agency will own an associated pipeline, though the sponsor will be responsible for building it.

At the end of the WPA, the authority will buy the plant for $1. "So the partnership has many levels," says Sandy Kerl, the water authority's deputy general manager. Together, the projects will cost $900 million, with bond proceeds and equity from Stonepeak Infrastructure Partners funding the desalination plant.

The water authority hosted more than 40 public meetings for the first large-scale ocean-water desalination project in California – a state that relies too much on the overstretched Colorado River – and the largest desalination project in the Western Hemisphere. "Project finance is usually best developed in private," says David Moore, managing director at Clean Energy Capital, the financial adviser to Poseidon and the water authority. "But there was a need to be transparent here."

"If you get caught up in an IPP (independent power project) mindset," adds Carlos Riva, chief executive officer of Poseidon, "it won't work." Riva is a former CEO of InterGen, a prominent independent power producer.

As far back as the 1990s, Poseidon scouted for sites that could host California-based desalination projects. It targeted sites that already housed power plants, under the theory that obtaining permits would be easier. "Not so much," says a reflective Riva, who joined Poseidon in August 2011. Poseidon eventually selected land next to NRG's 965MW Encina power plant, which it had an option on.

By 2010, Poseidon had expected to sell water to specific municipalities in San Diego county, including Carlsbad. But the water authority decided that it couldn't put its credit behind a few members, prompting some municipalities to ask the authority to step in as purchaser. The water authority ultimately agreed, but in negotiating commercial terms outside a competitive bidding process, essentially made the project a bilateral agreement between the two.

Poseidon and the water authority then began to draft the WPA, which resembles a power purchase agreement. Poseidon would bear construction and operating risk, such that the water authority would only pay for water that is produced, but the authority was required to buy the desalinated water and assume fuel cost risk. Indeed, the WPA features a cost pass-through to the authority.

Poseidon, the water authority and Clean Energy contemplated a bank deal, which would have featured lower capitalised interest but a vastly shorter tenor. Bonds also lacked exposure to mid-year loan resetting and refinancing risk. "So the cost of funds and the duration of funding in the municipal (bond) market just blew away those terms from bank lenders," Moore explains. JPMorgan was chosen as senior underwriter of the bonds, issued by the California Pollution Control Financing Authority, with Barclays, Bank of America Merrill Lynch, Goldman Sachs and Stone & Youngberg participating as managers.

The bonds were issued in two tranches: a $530.35 million piece for the desalination plant priced for yields of between 4-4.78% and subject to the alternative minimum tax, and $203.22 million tranche for the pipeline priced between 3.18-4.37% that isn't subject to the AMT but is callable after five years at par. Both tranches are fixed-rate current-interest bonds with 5% coupons and maturities between 2027 and 2045. The bonds were sold in a limited offering to qualified institutional buyers in minimum denominations of $250,000. Moody's Investors Service has estimated the debt service coverage ratio at 1.5x. The financing features a 12-month cash-funded debt service reserve, project-level reserves for working capital and a minimum 1.25x DSCR.

Moody's assigned a provisional Baa3 rating, which benefited from San Diego County's sterling AA rating. So, bond funds, insurance companies and investment advisers eagerly bought in. The municipal market is "so safe and secure that there's no yield," Moore explains. "This has risk – the delivery of water – and thus yield." Yet, the rates were attractive for the issuer, too, as the spread between AAA and BBB credits was among their lowest in the past decade.

The water authority expects the Carlsbad plant to eventually meet 7% of the county's water and process 50 million gallons daily. A joint venture of Kiewit Corporation and JF Shea is the engineering, procurement and construction contractor. The agency has begun preliminary plans on a separate desalination project at Camp Pendleton, just north of Carlsbad, in the northwest corner of the county, while Poseidon is prepping a project in Orange county, California, that could reach financial close in 2014. PF

Poseidon Resources (Channelside) LP

STATUS
Priced 13 December, closed 24 December 2012

SIZE
$900 million

DESCRIPTION
Desalination plant located in Carlsbad, California

GRANTOR
San Diego County Water Authority

SPONSORS
Poseidon Resources, Stonepeak Infrastructure Partners

DEBT
$733.56 million

MATURITY
2027-2045

COUPON
5%

BOOKRUNNERS
JPMorgan, Barclays, Bank of America Merrill Lynch, Goldman Sachs and Stone & Youngberg

EQUITY PLACEMENT AGENT
Barclays

PROJECT FINANCIAL ADVISER
Clean Energy Capital

EQUITY INVESTOR'S ADVISER
Simpson Thacher & Bartlett

BOND LEGAL COUNSEL
Orrick Herrington & Sutcliffe

ISSUER LEGAL COUNSEL
Nixon Peabody

POSEIDON LEGAL COUNSEL
Dickstein Shapiro and Latham Watkins

WATER AUTHORITY LEGAL COUNSEL
Hawkins Delafield & Wood

BOOKRUNNER LEGAL COUNSEL
Drinker Biddle & Reath

RESERVE OSMOSIS PROCESS PROVIDER AND PLANT OPERATOR
IDE Technologies

INDEPENDENT ENGINEER
Black & Veatch

CONSULTING ENGINEER TO WATER AUTHORITY
SAIC

GENERAL FINANCIAL ADVISER TO WATER AUTHORITY
Montague DeRose and Associates

EPC CONTRACTOR
Kiewit/JF Shea joint venture