

# The Market for Overseas Energy Projects Commences a Major Shift.

## Where To? The U.S.

*Michael J. Zimmer, Partner*

*Samir S. Desai, Infrastructure Development and Finance*

*Thelen, Reid & Priest LLP (Washington Office)*

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Informal discussions with various sources in the banking, legal and investment communities regarding energy project financing continue to underscore a critical market shift this past year. While there has been strong interest in emerging markets, the regulatory, legal and contractual support mechanisms for many infrastructure projects are not necessarily in place in a number of major international arenas. Recent fiscal, currency and market developments in Asia have served to heighten those concerns for international energy project developers at least for the next several years.

### TURBULENT INTERNATIONAL CONDITIONS.

Recently, these market conditions were exacerbated by announcements regarding reexamination of pricing in power purchase contracts by the governments of India, Malaysia and Pakistan. While more international transactions appeared to close this past year, particularly in Latin America, Africa, and Asia, several key distinctions are arising. A number of financial closings are occurring, but they are subject to post-closing conditions that must be satisfied before funds actually transfer. We were recently involved in a similar transaction on an international acquisition which closed in July of one year, but actual funding itself did not occur until the following year. Post-closing condition precedents, consents, bank refinancings and completions of project construction fre-

quently are imposed to satisfy the business interests of the panics before funds are actually disbursed.

Several countries represent these market attributes, including India, Pakistan, China, Brazil, Peru, Vietnam, and even Turkey. With recent market developments in Asia, one might add Korea, Indonesia, Malaysia, Thailand, and the Philippines to the mix of international markets facing major uncertainties. While many project development companies have substantial interests in these emerging markets and are exhibiting a widespread optimism that the political, financing, and regulatory environment will be improved, many factors are unstable awaiting resolution. As well, a number of countries such as India and Pakistan, in denying requests for sovereign guarantees, continue to maintain that additional project finance experience has evolved that does not sustain the requirement for further sovereign support in the future.

## U.S. PROSPECTS BRIGHTEN IN RESPONSE

Why has the U.S. market for new energy investment in this same period been such a well-kept secret? How can such a huge, stable, attractive market be so inconspicuous? This has occurred because in recent years demand for new U.S. electric capacity has been slow and the perceived potential for the highest returns has been in the emerging markets. In addition, while actual barriers to foreign investment in the industry have been eroding, perceptions of the difficulty of those barriers lags behind reality.

There are a few companies to whom the appeal of the U.S. market is no secret. Tractebel S.A., Compagnie Generale des Eaux, Marubeni, and National Power have been active players in the U.S. energy industry for some years. These companies are well-positioned to expand their U.S. success and take advantage of the coming demand for new projects, new products, and the altered state of the industry. For example, British Energy just announced a joint venture with PECO (Philadelphia Electric) to buy U.S. nuclear plants, and Marubeni is expanding into power marketing in the Northeast.

During the past year, 44% of all new power transactions worldwide were U.S.-based deals. Deregulation of the U.S. electricity market is creating opportunities for independent power and foreign companies not seen since the passage of PURPA in 1978. New domestic generation

capacity is projected to significantly increase over the next decade. During the same period, ownership of a significant number of existing power plants and generation companies will transfer. Independent power producers (IPPs), utilities, financial entities, fuel suppliers and regulators are now focused on the burgeoning domestic potential created by these major market shifts in preparation for escalating levels of activity into the next century.

#### NEW U.S. DEMAND

The U.S. market is huge, and by some measures the largest in the world. Total consolidated assets of all investor-owned electric systems are approximately \$572 billion according to the Securities and Exchange Commission. Investor-owned gas and electric systems combined have assets of more than \$710 trillion. In 1994, investor-owned electric systems' operating revenues totaled more than \$170 billion, while combined revenues for gas and electric topped \$235 billion.

Because of changes beginning with the enactment of PURPA, which forced traditional investor-owned utilities to purchase power from non-utility generators, and the subsequent phenomenal growth of IPPs, recent construction has been sluggish in the U.S. Domestic companies have been focusing their investment attention outside the U.S., seeing only slow growth, delay, regulatory barriers, and confusion at home since 1992. But, this assessment is changing.

New financing techniques will have to be established to finance these transactions and meet increased demand in the U.S. marketplace, especially for the new, more efficient merchant plants. There will be decreased reliance on long-term contract revenues and increased exposure to market and commodity risks. Historical long-term contracts for power projects are at risk or subject to pending expiration. These realities will require sponsors and lenders to structure financing for merchant plants that allocates risks in new ways. Investors' perceptions of IPPs as inherently risky may limit their ability to finance merchant plants using traditional project financing. Also, looming efforts to renegotiate or abate historical PURPA power supply agreements in many states will not provide a stable investment environment for new merchant plants.

On the other hand, with increased asset redispositions, the wider

deployment of securitization, Rule 144A financing and roll-ups will occur in the power generation industry in the U.S. These initiatives will support needs for debt, subdebt and equity to replace traditional project financings on a non-recourse basis and to maintain leverage, attractive rates of interest and access to more widespread capital sources.

## PROJECT FINANCE MARKET IMPACTS

The financial markets will impose:

- Increasing use of the capital markets for debt financing,
- Higher equity requirements,
- More sophisticated assessments of market and regulatory risks and their relationship to pricing projections,
- New roles for pension and insurance company investment, and
- Financing for portfolios of projects to promote risk diversification.

What this means in the future are several important developments for project finance markets.

1. While opportunities are widespread, future international transactions may shift to the smaller sized and industrial-based facilities in certain emerging markets in response to these current risks. This would be consistent with the emerging PURPA experience in the United States in the early 1980s.
2. The success factor for greenfield project development worldwide is running at a current level of 15%. This yield has not been attractive compared with other prior international experiences and in recognition of marketing and development costs for such projects. This has prompted the shift to other strategies based on acquisitions, privatizations and market diversification into fuels and energy distribution assets.
3. Worldwide interest will shift to distribution, transmission, fuels infrastructure, and privatizations where access to existing facilities and assets can occur, presenting rehabilitation and repowering opportunities, and accelerating net income improvements to company financial statements in the near term. This shift will postpone the delays and financial impacts of over-reliance on greenfield development.

4. Additional sources of debt will need to be developed, accessing public debt markets, pension funds, insurance companies, specialty funds, and local capital markets in the host country and world public debt markets in Europe and the U.S. This is essential for emerging market potential to be achieved and to bridge the almost \$90 billion/year debt market shortfall that exists between the multi-laterals and commercial lending sources.

5. The number of companies in emerging markets will shrink directly in response to these challenges, including utility affiliates and subsidiaries. While almost 300 companies are currently competing worldwide, that number will shrink to less than 100 effective players by 2000.

6. The emerging markets focus accelerated by the instabilities in Asian markets will ultimately shift as the North American markets will accelerate within the next two years. Many of these companies ultimately will return to the U.S. to participate in the asset divestiture, restructuring, and merchant power markets. Deliveries commencing for facilities in the 2000-2005 time frame will require material asset repositionings, development, regulatory review, and permitting in 1998-99 to meet these performance goals and objectives.

A variety of factors stimulating change in the U.S. market are creating conditions favorable to the development of new products and services. These factors—increased competition, technological advances, consumer demand for more choice, and shareholder and institutional pressure—are precursors of significant market opportunities for a strategic and foresighted domestic and international energy company.

The risk/reward profile is significantly better in the U.S. now than anywhere else, and is not limited to historic players or utilities.

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#### ABOUT THE AUTHORS

**Michael J. Zimmer** is a partner in the Washington, DC, office of Thelen, Reid & Priest. He is a *cum laude* graduate of the University of Maryland/Baltimore School of Law in 1975 and a *cum laude* graduate of Providence College, receiving his bachelor of arts degree in political science in 1971, while also attending Brown University.

Mr. Zimmer has represented energy concerns for over 17 years in

matters before the Department of Energy, the FERC, and Congress. He has represented domestic and international industrial and manufacturing companies, electric utilities and their unregulated subsidiaries, energy project developers, natural gas pipeline and distribution companies, trade associations, financial institutions universities and embassies. He has been an invited witness on various energy and energy tax proposals before Congressional committees, various federal departments and agencies, and state commissions since 1977. He has also practiced before state public service commissions in Connecticut, Massachusetts, New York, New Jersey, Pennsylvania, Maryland, Virginia, North Carolina, Florida, Ohio, Illinois, Iowa, Missouri, New Mexico, and California. He has energy regulatory, contracting and project finance experience in successful support of over 12,000 MW of power generation in facilities in 25 states, and 3 foreign countries.

**Samir S. Desai** is a member of the firm's infrastructure development and finance department. He serves in the India, Utility Services, Telecommunications and Environmental Practice Groups, and assists in advising U.S. clients seeking to invest in various markets in India on taxation, corporate structuring and other issues. He writes regularly on diverse sectors in India, including electricity, automobiles, telecommunications, transportation infrastructure and oil refining. In cooperation with Thelen, Reid & Priest affiliate, the Singhanian & Company law firm, Mr. Desai researches and keeps abreast of the latest legal, financial and regulatory issues as they arise in India.

Mr. Desai also advises clients on many issues of U.S. federal and state energy, telecommunications and environmental regulation. He assisted in drafting a comprehensive, year-long review and analysis of developments in the electric industry in North America during 1995-1996.

Mr. Desai has been published in *Independent Energy*; *Water, Environment & Technology*; *Octane Week* and *Fuel Reformulation* on India and environmental matters.

Michael J. Zimmer, Samir S. Desai, Thelen, Reid & Priest LLP, 701 Pennsylvania Avenue, NW, Suite 800, Washington, DC 20004; (202) 508-4000.