

Lowering Environmental and Capital Costs with Ratepayer-Backed Bonds

Joseph S. Fichera and Rebecca Klein

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Major investments for plants, transmission and distribution, and even “rainy day” funds (also known as reserve funds) for unforeseeable energy “events” are a growing burden for electricity ratepayers in many states across the country. Since 1995, ratepayer securitization (also known as ratepayer obligation bonds, securitization bonds, and utility tariff bonds) has been used with increasing frequency among state utility commissions to pay for the heavy investments necessary for these statewide energy benefits.

Securitization is the process of selling to investors high-quality, highly rated securities through special purpose, bankruptcy-remote entities. Typically, a company transfers property with a dependable cash flow to a special purpose entity (SPE) through a “true sale.” For purposes

of achieving the necessary legal protections under federal bankruptcy law, a true sale is achieved through an absolute transfer of the company’s entire right, title, and interest in the property to the SPE, a legally distinct party, for fair market value, with the company retaining no residual ownership interest in the property.

The SPE then issues bonds and pledges the transferred property to secure the payment of debt service on the bonds. The transferred property can be either tangible or intangible. For example, the transferred property might be a physical asset (e.g., a plant), an intellectual asset (e.g., a patent), or an intangible asset (e.g., the right to a particular revenue stream), which is the property at issue in ratepayer-backed bonds.

Securitization therefore creates a separate and independent credit based on the risk associated with the cash flows from the pledged property that supports the payment of principal and interest to investors. As a result, securitized debt instruments do not burden the assets or revenues of the company and instead are payable solely from the pledged property. The bonds are not a charge against the credit of the parent company, but the parent company gets full use of the proceeds.

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State legislatures, public utility commissions, and investor-owned utilities have used securitization to raise funds for several different purposes in the public interest. To date, securitization has been used or is pending to fund energy

conservation programs, environmental control facilities, electric power purchase costs, hurricane-related damage, and stranded costs arising from deregulation.

A defining and common feature of these securitization transactions is that they all have been made possible by specific enabling state legislation that establishes a legal framework for the creation of a new type of intangible property right under state law. This includes an irrevocable regulatory guarantee to always adjust rates to whatever level is necessary to ensure timely payment of debt service on the bonds known as the true-up adjustment process. In general, this new, intangible property will initially be owned by the utility. Like any other property owned by the utility, this new property can be pledged as collateral in a financing. In this case, the property created is the right to bill, charge, and collect a specific charge on some or all retail electricity consumers in a given electricity transmission and distribution service territory.

The enabling legislation also allows utility commissions to issue irrevocable financing orders that segregate a component of the retail rate charged to consumers throughout the territory; cause the right to receive this rate component to be treated as a present interest in property that can be bought, sold, and pledged; authorize the utility to sell this property to a bankruptcy-remote SPE; authorize the SPE to issue debt instruments secured by a first priority lien on this property, including the right to the true-up adjustment process; and require the utility to use net proceeds from the transaction for specified purposes.

There have been 37 issues of securitized utility bonds since 1994 totaling more than \$38 billion. In none of these transactions has the utility or its shareholders been responsible for any portion of the costs or charges associated with securitized bonds. Consequently, the financing is unlike any of the utility's other obligations. The economic burden of repaying these securitized bonds falls squarely on the ratepayers in the service territory; hence, the securities are aptly referred to as "ratepayer-backed" bonds.

Initially, ratepayer-backed bonds were issued primarily for the recovery of stranded costs in states that had deregulated their electricity markets. In 2004–06, ratepayer-backed bonds began to be used for purposes other than the re-

covery of stranded costs. Certain state governments and their regulators authorized their use for refinancing of a bankruptcy-related regulatory asset (California), unrecovered electric power purchase costs (New Jersey), environmental facilities (Wisconsin and West Virginia), buy-downs from contracts with independent power producers (Vermont), storm cost recovery (Florida, Louisiana, and Mississippi), and any corporate purpose (Idaho).

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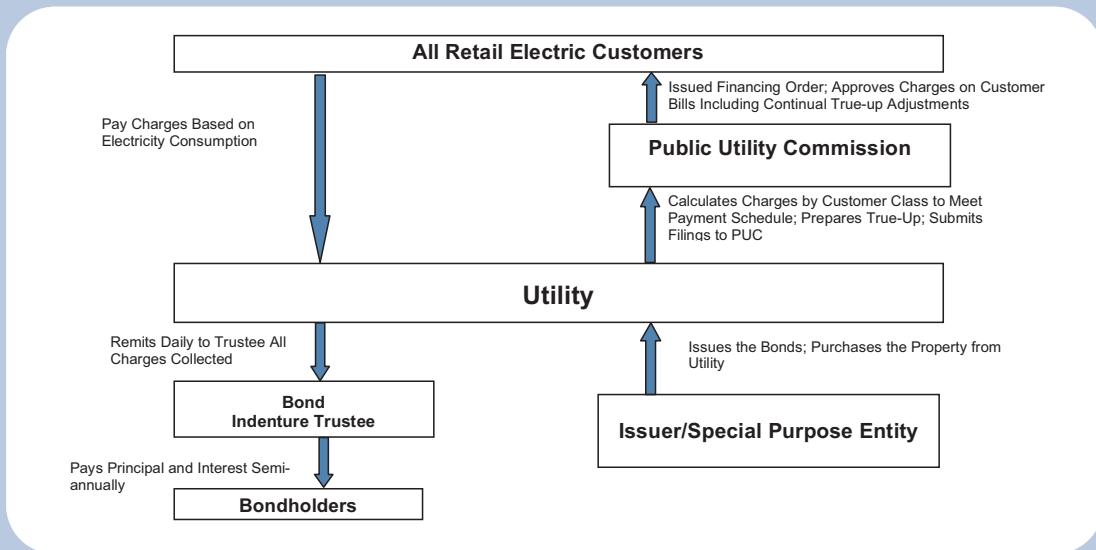
A utility fee securitization is therefore a unique form of utility corporate debt financing. A significant advantage of securitization is that the credit quality of the future revenue stream will be much higher (generally triple-A) than that of parties associated with the transaction, thereby obtaining significantly lower interest rates than would otherwise be available because of the better credit rating.

Another significant advantage of securitization is that it is nonrecourse to the parent and protects the credit quality of the parent. Shareholders get an improved balance sheet and more headroom in rates for other financings that may earn an equity return. Thus, securitization is an efficient form of off-balance-sheet financing that has the potential of gaining the most favorable cost of funds from the capital markets with benefits for ratepayers and shareholders.

A typical utility tariff securitization program is simple and straightforward and, because of its structure, is not an "asset-backed security" but a unique government-sponsored credit. Fundamentally, a utility tariff bond program does the following:

- Imposes a nonbypassable charge (based on electricity consumption) on the electric bill of all retail electric consumers in a utility's transmission and distribution service territory
- Collects the charge and turns it over to a special purpose, bankruptcy-remote entity to pay principal and interest on the bonds
- Guarantees that the government will adjust the charge at least annually to guarantee suf-

Exhibit 1. Parties to Transactions



efficient funds to pay principal and interest and all expenses of the transaction on time

The charge is termed nonbypassable in that customers cannot avoid paying it by switching service providers or through self-generation. The charge is required by law or regulation to be set and continually adjusted to a level to guarantee the payment of principal and interest on the bonds and all expenses of the transaction. The state and the commission also give bondholders a specific pledge never to interfere with their rights to receive payments on the bonds.

PARTIES TO TRANSACTION

Exhibit 1 represents the parties to the transactions underlying the offering of a typical utility tariff securitization. It describes their roles and relationships to the other parties. There are a number of different variations on this structure that utilities and their regulators could employ depending on the needs of the parties.

Precedents Are Many

Exhibit 2 is a list of state and utility issues involving tariff-backed debt.

RATEPAYER SAVINGS AND SHAREHOLDER BENEFITS

There are two basic sources of economic benefits (see **Exhibit 3** for an example). First, significant savings occur when utilities use

ratepayer-backed bonds to replace conventional utility debt and equity financing. It is effectively off-balance-sheet and nonrecourse to the utility. The utility and its shareholders are fully protected. This means that the utility can finance the asset or expense in question with nearly 100 percent debt rather than its normal capital mix of about 50 percent debt and 50 percent equity without any impairment of its credit structure.

The ratepayer savings are even greater for a utility that has a high equity level in its capital structure. The cost of equity is much higher than the cost of debt. A 5 percent cost of debt and an 11 percent cost of equity are typical values in today's environment. In addition, savings occur by the avoidance of income taxes that would otherwise have to be paid on the equity return. These savings accrue directly to the ratepayers in the form of lower overall rates than would otherwise be levied.

Second, these ratepayer-backed bonds save in the capital markets commensurate with their extremely high credit quality. In general, the better the credit rating, the lower the interest cost. By separating the operating utility from the issuer of the bonds (a so-called bankruptcy-remote entity) and isolating the cash flow with the guarantee of the commission to always adjust the charge to repay the bonds, the credit-rating agencies associated with ratepayer-backed investors will evaluate the bonds as independent of the utility and independent of the traditional

Exhibit 2. Tariff-Backed Debt Outstanding

Date	Issue	State	Ratings	Size (\$mm)
Nov-97	PG&E, Ser. 1997-1	California	Aaa/AAA/AAA	2,901.0
Dec-97	SCE, Ser. 1997-1	California	Aaa/AAA/AAA	2,463.0
Dec-97	SDG&E, Ser. 1997-1	California	Aaa/AAA/AAA	658.0
Dec-98	Montana Power	Montana	Aaa/AAA/AAA	64.0
Dec-98	ComEd, Ser. 1998	Illinois	Aaa/AAA/AAA	3,400.0
Dec-98	Illinois Power, Ser. 1998-1	Illinois	Aaa/AAA/AAA	864.0
Mar-99	PECO, Ser. 1999-A	Pennsylvania	Aaa/AAA/AAA	4,000.0
Apr-99	Sierra Pacific	California	Aaa/AAA/AAA	24.0
Jul-99	Boston Edison	Massachusetts	Aaa/AAA/AAA	725.0
Jul-99	PP&L, Ser. 1999-1	Pennsylvania	Aaa/AAA/AAA	2,420.0
Nov-99	West Penn Power, Ser. 1999-A	Pennsylvania	Aaa/AAA/AAA	600.0
Apr-00	PECO, Ser. 2000-A	Pennsylvania	Aaa/AAA/AAA	1,000.0
Jan-01	PSE&G, Ser. 2001-1	New Jersey	Aaa/AAA/AAA	2,525.0
Feb-01	PECO, Ser. 2001-A	Pennsylvania	Aaa/AAA/AAA	805.5
Mar-01	Detroit Edison, Ser. 2001-1	Michigan	Aaa/AAA/AAA	1,750.0
Mar-01	CL&P, Ser. 2001-1	Connecticut	Aaa/AAA/AAA	1,438.4
Apr-01	PSNH, Ser. 2001-1	New Hampshire	Aaa/AAA/AAA	525.0
May-01	WMECO, Ser. 2001-1	Massachusetts	Aaa/AAA/AAA	155.0
Oct-01	CenterPoint Energy, Ser. 2001-1	Texas	Aaa/AAA/AAA	748.9
Oct-01	Consumers Funding, Ser. 2001-1	Michigan	Aaa/AAA/AAA	468.6
Jan-02	PSNH, Ser. 2002-1	New Hampshire	Aaa/AAA/AAA	50.0
Jan-02	CPL, Ser. 2002-1	Texas	Aaa/AAA/AAA	797.3
Jun-02	JCP&L 2002-1	New Jersey	Aaa/AAA/AAA	320.0
Dec-02	Atlantic City Electric 2002-1	New Jersey	Aaa/AAA/AAA	440.0
Aug-03	Oncor Electric 2003-1	Texas	Aaa/AAA/AAA	500.0
Dec-03	Atlantic City Electric 2003-1	New Jersey	Aaa/AAA/AAA	152.0
May-04	Oncor/TXU Electric 2004-1	Texas	Aaa/AAA/AAA	789.8
Feb-05	Pacific Gas and Electric	California	Aaa/AAA/AAA	1,887.9
Feb-05	Massachusetts Special Purpose RRB Trust	Massachusetts	Aaa/AAA	674.5
Jul-05	Rockland Electric	New Jersey	Aaa/AAA/AAA	46.5
Sep-05	Public Service Electric & Gas	New Jersey	Aaa/AAA/AAA	102.7
Sep-05	West Penn Power, Ser. 2005-A	Pennsylvania	Aaa/AAA/AAA	115.0
Nov-05	Pacific Gas and Electric	California	Aaa/AAA/AAA	844.5
Dec-05	CenterPoint Energy	Texas	Aaa/AAA/AAA	1,851.0
Aug-06	JCP&L	New Jersey	Aaa/AAA/AAA	182.0
Oct-06	AEP Texas Central	Texas	Aaa/AAA/AAA	1,740.0
Pending	Wisconsin Electric Power	Wisconsin	Pending	450.0
Pending	Allegheny Power	West Virginia	Pending	466.0
Pending	Florida Power & Light	Florida	Pending	708.0
Pending	Baltimore Gas & Electric	Maryland	Pending	632.0

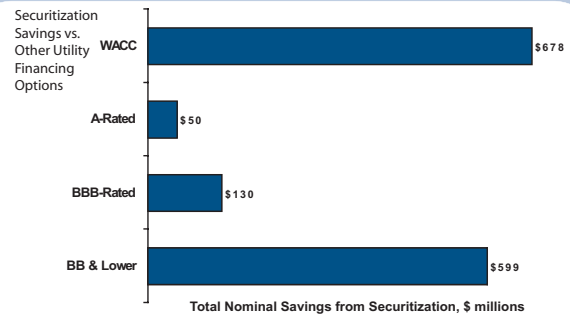
debt of the utility. Conventional utility debt has numerous risks associated with its repayment. Those risks will not be present in connection with ratepayer-backed bonds.

Furthermore, and most important, the broad-based charge will be imposed on substantially all retail electric consumers in a utility's service area, and the charge will be automatically adjusted periodically to whatever level is necessary to repay the bonds on time over the life of the bonds, as required by the enabling statute and a commission order. Thus, so long as the charge does not exceed 20 percent of the bundled rate to consumers, the bonds will be rated "AAA." This category is the top in the credit-rating system.

The savings commensurate with this top-quality credit in the capital markets are not automatic. Not all AAA-rated bonds price or trade at the same yield. There are a number of steps that are required at the time ratepayer-backed bonds are structured, marketed, and priced. These steps will achieve the lowest cost available consistent with market conditions at the time of pricing and capture the full economic value of the unique government guarantees embodied in the legislation and the irrevocable nature of the financing order.

Because the bonds require more structuring than traditional corporate bonds, transaction costs are higher. This need not be an obstacle to the issuance of the bonds. Rather, it requires more

Exhibit 3. Expected Savings from Securitization on a \$1 Billion Ten-Year Average Life Financing



Based on Citigroup utility bonds spreads versus securitization spread 2001–2006.

diligence and work on the part of regulators and companies to identify cost savings and economies of scale during the transaction process. Regulators and companies need to think about statewide initiatives and coordination of efforts to reduce burdens on all ratepayers. **Exhibit 4** is a map of states with enabling legislation.

Finally, in approaching the structure, marketing, and pricing of the bonds, utilities and regulators should see it as an active partnership. Each side brings an important perspective to the negotiation and each side needs to be empowered to cooperate in making decisions that serve the economic interests of each of their constituencies. A joint decision-making process will preserve the integrity of the ultimate outcome for shareholders and ratepayers.

Exhibit 4. States with Enabling Legislation for Utility Tariff Securitization/Ratepayer-Backed Bonds

