Saber Partners Sees Strong Demand for FirstEnergy Pass-Through Certificates

Very Low Coupons But Will High Quality Get Credit Spreads They Deserves

According to a Securities and Exchange Commission filing, three Ohio subsidiaries of FirstEnergy Corp. - The Cleveland Electric Illuminating Company, Ohio Edison Company and The Toledo Edison Company - are planning to offer up to $505 million of Pass-Through Certificates. The certificates represent undivided interests in a trust that includes debt instruments issued by three separate special purpose vehicles formed to facilitate the transaction. See "FirstEnergy Ohio PIRB Special Purpose Trust 2013" http://www.sec.gov/Archives/edgar/data/20947/000119312513138701/d511777ds3.htm

Traditional but Complex

Though the new offering is complex, it is a form of "utility securitization" first introduced to the market in 1997. In 2011 ,the Ohio legislature passed special legislation to allow First Energy's Ohio subsidiaries to sell bonds to reimburse for specific costs that those utilities incurred in providing electric services to customers.

While the structure is more complex than almost all previous utility securitizations, it follows basic rules for these types of offerings:

1. a special ratepayer obligation charge ("ROC") is imposed on consumer electric bills; the ROC can't be avoided by consumers;
2. a mechanism to adjust that ROC periodically as needed to ensure payments of interest and principal when due; and
3. special legal protections to make the adjustment mechanism irrevocable and enforceable for the benefit of bondholders.

High Credit Quality

The certificates will likely receive the highest investment grade ratings from the rating agencies. With strong demand among investors for high-quality, fixed-rate investments as shown in the recent Apple Corp. debt offering (only AA rated), this offering should be well received..

Credit spreads or the interest rate premiums above U.S. treasury benchmarks that investors require to own a security are how market participants judge the success of any offering. Current credit spreads for both corporate and utility debt offerings which are the best comparables to this bond are historically narrow. Institutional investors are looking for high-quality investments, and there is a limit to the amount of US treasuries and U.S. Agency debt that they want to buy.

In the lower rated Apple offering, credit spreads were particularly narrow. The multi-tranche offering, investors accepted only 0.20% percent higher than three-year U.S. treasuries and 0.75 percent higher than 10-year U.S. treasuries…and the bonds were three times oversubscribed suggesting that the spreads could have been even lower.

West Virginia Utility Comparables Show the Possibilities

Besides Apple, Johnson & Johnson (AAA), excellent comparables for the FirstEnergy offering are the 2009 and 2007 AAA-rated utility securitizations in neighboring West Virginia. About $600 million in AAA/Aaa rated bonds were issued by Potomac Edison (through "PE Funding") and Monongahela Power (through "MP Funding"), subsidiaries of Allegheny Energy at the time. (First Energy owns these subsidiaries now.)

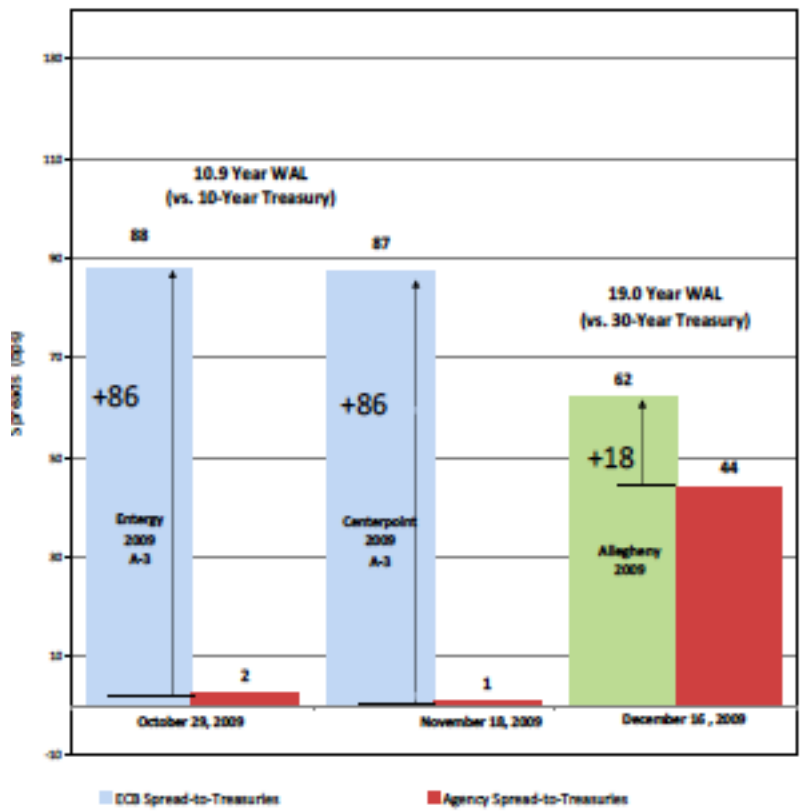
The two West Virginia issuers each sold ROC bonds to investors directly rather than use the more complex pass-through certificates .,. FirstEnergy may be trying to increase tranche sizes.. Sometimes smaller tranches require higher credit spreads, though that was not the experience of the West Virginia transactions.

Furthermore, unlike the pending FirstEnergy certificates, MP and PE Funding did not sell their ROC bonds not as "asset-backed securities" as defined by the SEC. This helped expand the market for the 2007/2009 MP and PE Funding bonds because some investors compare utility securitizations to transactions backed by receivables like credit cards.

Long-Dated Utility Securitizations in Demand

The Allegheny Energy MP and PE Funding offerings received the narrowest credit spreads ever for a utility securitization of similar maturities. The 2009 offerings were also the longest maturity of any utility securitization (19 year weighted average life), and credit spreads were similar to where AAA-rated Johnson & Johnson bonds were trading at the time or 0.62% above 30-year US Treasuries. The spread to AAA US Agency debt was even tighter...only 0.18% above comparable US Agency bonds and much narrower than shorter term utility securitizations sold in Texas around the same time.

AAA ROC Bonds, AAA US Agency vs. US Treasuries (2009 Transactions)



The FirstEnergy Ohio structure is more complex, and its description and disclosure of the various components comprising the securitization are different from the MP and PE Funding transactions. How investors react to this is an open question.

Higher Cost for Electricity Customers on Some Items Don't Affect Bondholders

A possible indication of the complexity of the upcoming transaction is that FirstEnergy as the servicer of the debt will receive two times the normal servicing fee associated with previous utility securitizations. It will receive 10 basis points on the principal amount per year vs. 5 basis points per year for the MP and PE Funding ROC bond transactions. (There also does not seem to be a corresponding offset above actual cost associated with other customer rates that were a part of the MP and Funding transactions.)

Coupons on the FirstEnergy pass through certificates should be historically low for utility securitizations given the historic low general rates for benchmark U.S. Treasury and U.S. Agency debt. Whether credit spreads will match the historical lows the West Virginia transaction achieved will be the key point to watch.

Future Good for More Supply of Utility Securitizations

However, for investors looking for high-quality. stable cash flow investments, these bonds are hard to compete with and aren't offered frequently. They will be "museum pieces" in the parlance of the bond trade.

Saber expects more utility securitizations to occur over time. Utilities, their regulators and state legislators want to lower electricity costs to consumers. It can apply to storm recovery costs from Sandy as well as environmental and other costs. When properly structured and marketed, this is the best financing vehicle available for utilities and their customers.

For further information, mailto:contact@saberpartners.com