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# The Recession Hasn't Been Hard On "Ratepayer Obligation Charge" Bonds

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# The Recession Hasn't Been Hard On "Ratepayer Obligation Charge" Bonds

Some investors may know them as stranded-cost bonds or rate-reduction bonds. These days, Standard & Poor's Ratings Services is calling them ratepayer obligation charge (ROC) bonds, and they're gaining market attention again because of their strong performance during this recession. ROC bonds are backed by usage-based charges that, pursuant to state statutes, electric utilities may assess and collect from their customers. To date, utilities have issued approximately \$40 billion of these bonds, all of which have retained their 'AAA' ratings. Over the past 15 years, many of them have performed through severe natural disasters, an energy market crisis, one major utility bankruptcy, and now, the worst U.S. recession in 50 years.

The strong performance of these bonds, along with the funding efficiency they've given utilities and ratepayers, has, in our view, encouraged market participants to find new uses for them. Originally, ROC bonds were associated with stranded costs from the late 1990s and early 2000s--costs that utility companies incurred that they weren't able to recoup because of industry deregulation. Standard & Poor's believes that the ROC bond sector may be poised to play a larger role in funding prospective investments in the U.S. energy sector, such as construction of nuclear power plants or environmental remediation.

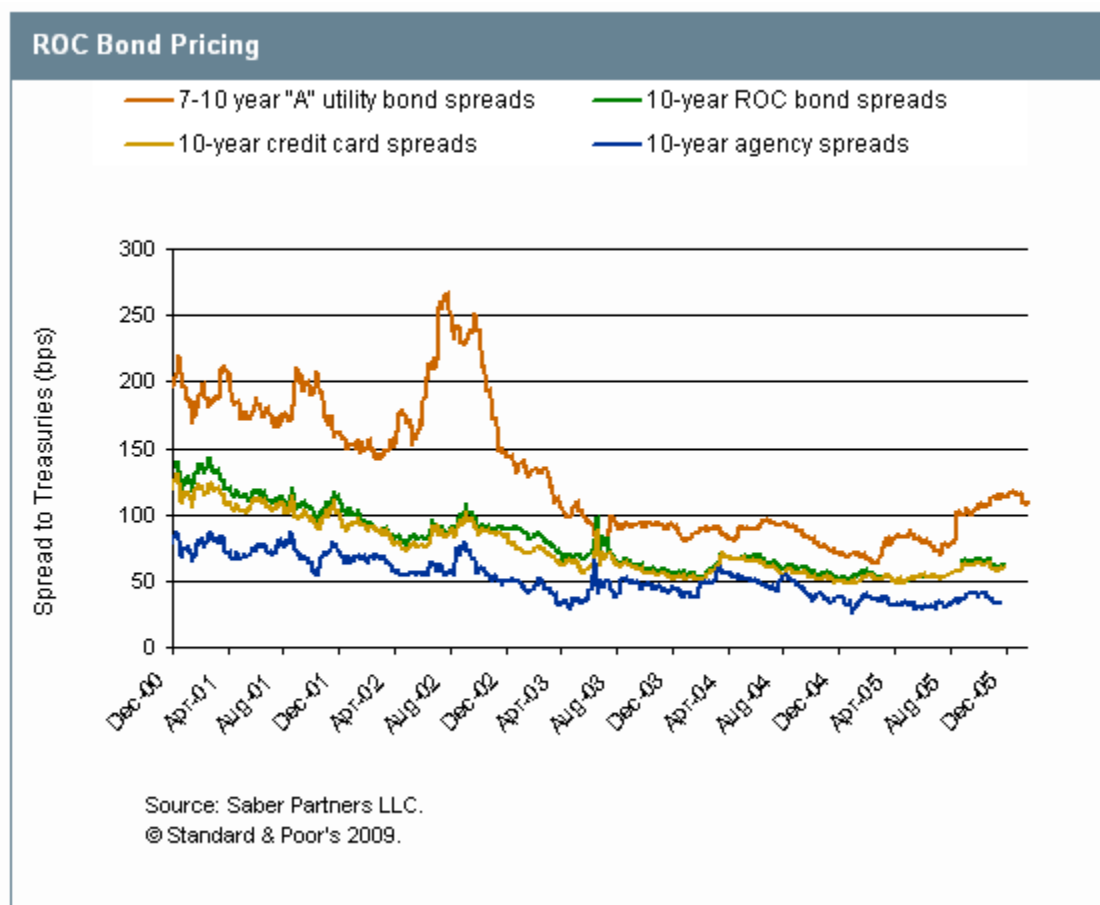
## ROC Bonds Are Outperforming Other ABS Asset Classes

This recession has led to downgrades of some asset-backed securities (ABS) backed by consumer assets--such as auto loans, auto leases, and credit cards--due to poor collateral performance. According to our data, however, ROC bonds have shown no material weakness in performance to date.

Current spread levels for ROC bonds, when compared with those for other benchmark ABS bonds, appear to us to reflect this credit stability. According to secondary-market participants, as of the end of May, some five-year "stranded-utility" bonds were trading around 75 basis points (bps) inside the spreads of 'AAA' credit card ABS of the same tenor (duration). And some 10-year ROC bonds were trading closer to Small Business Administration (SBA) guaranteed pooled certificates, which we understand many market participants consider to be benchmark government-sponsored-entity (GSE) securities due to their government guarantee. Although we believe the secondary market is fairly thin, most supplies are trading at a premium, according to market sources.

ROC bonds' general immunity to prepayment risk may be another positive factor behind their currently strong pricing, in our opinion. It wasn't always this way, though. Before 2007, many ROC transactions attempted to achieve pricing parity with benchmark credit card ABS or GSE debt (see chart 1). According to one industry source, Saber Partners LLC, new-issue pricing spreads of ROC bond issues in five states closely tracked those of comparable 'AAA' credit card ABS, but, for the most part, remained higher until the beginning of the current credit market dislocation.

Chart 1



## We Expect The Stable Performance To Continue

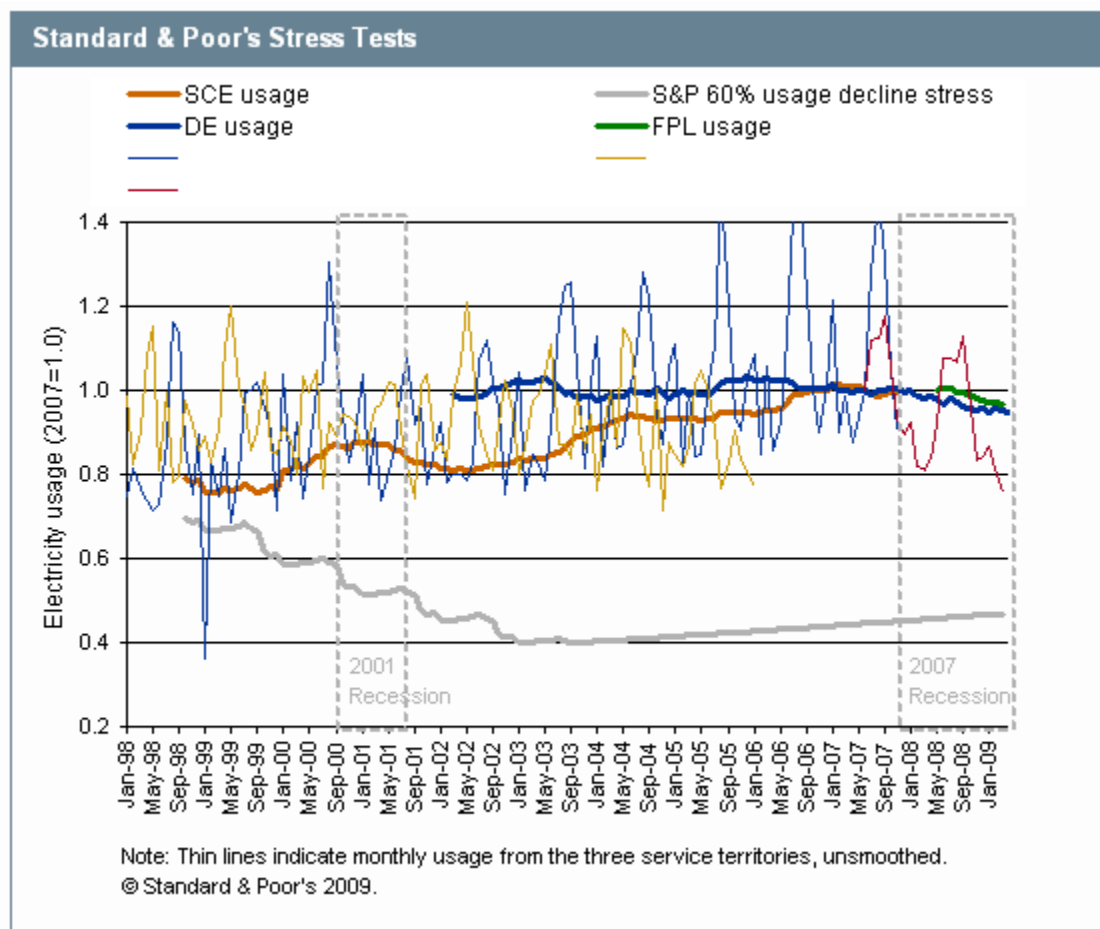
Over the past 15 years, the ROC bond sector has faced--and, we believe, withstood--several shocks, including the 2001 California energy crisis, which brought Pacific Gas and Electric Co. (PG&E), a ROC-bond issuer and servicer, to bankruptcy. Natural disasters have struck as well. Hurricane Rita, for example, shut down the Houston metropolitan area (a major ROC service territory) for days, yet failed to result in a material reduction in collections.

The current recession has had disproportionate effects on the country geographically, hitting some states, such as Michigan and Florida, the hardest. Both of these states fall in service territories whose utilities have issued ROC bonds. Such territories include Southern California Edison (SCE), Detroit Edison (DE), and Florida Power & Light (FPL). Usage trends have shown modest declines, consistent with the 2001 recession (and the California energy crisis) for SCE and with the 2007 recession for Detroit Edison and FPL. In contrast, in our 'AAA' stress tests, we assume a usage decline of between 60% and 80% (see chart 2).

Our 'AAA' stress test for the SCE service territory contains five consecutive usage declines of 12% for each of the first five years of the transaction's life. The scenario further assumes an increase in usage at the long-term growth rate of 2%-3% following the initial five-year annual decrease of 12%. In our view, the magnitude of this stressed usage decline scenario reflects the combination of population decline, migration of commercial and industrial users

out of the service territory, and the increased use of onsite generation, which may entitle customers to bypass the related usage charge.

**Chart 2**



Our usage patterns show that use of electricity in regions suffering from double-digit unemployment in recent years (Michigan and Florida), devastating natural disasters (Texas), and rolling blackouts (California) remained within our 'AAA' stress factors for the ROC bonds that we rate.

## The Statutory True-Up Mechanism Supports The 'AAA' Ratings

State statutes require the utilities to perform and the regulators to implement a periodic true-up, which is a reassessment of the level of the charge to electricity users for the purpose of satisfying debt service in full and on time. In its simplest form, this feature essentially makes a service territory's ratepayers (including residential, commercial, industrial, and governmental) into "joint and several" obligors, allowing, for example, a 10% drop in industrial electricity usage in one period to be mitigated (i.e., made whole) by an increase in charges to all other ratepayers in the next collection period.

Once the related legislation passes, this statutory true-up mechanism is irrevocable until the ROC bonds are paid off. Unlike the general obligations of state and local governments, ROC bonds are insulated from the periodic

budgetary process, generally allowing the bonds to have higher ratings than those backed by the general obligations of state and local governments.

We believe the political environment may be shifting in favor of ROC bonds as ratepayers recognize the projected lower funding costs associated with the bonds' 'AAA' ratings. ROC bonds also tend to allocate a lower amount of collections for debt service than do the bonds that utilities issue. This "dollar-revenue-for-dollar-debt," or 1x debt service coverage, can be a highly efficient financing feature.

## **Their Names May Have Changed, But Their Versatility Keeps Growing**

In recent years, ROC bonds have gone by a variety of names as market participants tried to capture their uses, including:

- Stranded-cost bonds.
- Rate-reduction bonds. (Although bond issuance generally causes a slight increase in the ratepayers' all-in utility bill, the relatively cheaper financing costs result in a relatively lower charge increase on the ratepayers.)
- Energy or storm-recovery bonds.
- Environmental trust bonds.

We believe this "identity crisis" is actually a testament to the versatility of this financing alternative as utility regulators and ratepayer advocacy groups look to expand its applications. It's no longer just about the historical "stranded costs," because the assets and service territories now go beyond the states that were deregulated. Right now, based on our observations, utilities are focusing on funding their future investments and mandated costs.

Standard & Poor's expects this financing technique will play a larger role in the funding of future energy-related and other public projects. We're now seeing the application of ROC securitizations for renewable portfolio standards and carbon emissions credits. Progress Energy Florida also recently attempted to use ROC bonds to fund the construction of a nuclear power plant. As interest in the ROC bond sector expands, we will continue to update the market on its developments.

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