

Bright Idea

States may offer U.S. utilities new ABS route

by Marc Hochstein

Joe Fichera thinks he's got a better mousetrap. And he'll talk your ear off trying to sell it. Since late last year, Mr. Fichera, an investment banker at Prudential Securities, has been telling utility treasurers and CFOs, as well as bond rating agencies, that many U. S. utilities can sell debt in the asset-backed market without the need for new state-by-state legislation.

Until now, it had been assumed that securitization required passage of new laws in each of the 50 states. But Mr. Fichera argues that in at least six states, local regulators already have sufficient authority under existing law to sanction asset-backed deals. He specifically cites New Jersey, Maine, Texas, Michigan, New Mexico and Arizona. These states, he insists, have legal precedents and constitutional safeguards in place that can make the utilities' deals triple-A investments. As a result, he says, the issuance of utility asset-backed—expected to total \$75 billion to \$100 billion in the next few years—could materialize faster than anticipated.

Utilities around the U.S. want to use securitization to ease the transition to a competitive power market by refinancing the costs of infrastructure built in a regulated environment. The companies would replace high-cost debt and equity with low-cost, triple-A asset-backed securities (ABS), which would be paid off by special tariffs on customers' bills. Par-



ing down balance sheets would allow the companies to become more nimble now that electricity customers are being given the chance to choose their own power producers.

The so-called "rate reduction" bonds were one of the hottest new fixed-income products of 1997. Investors, attracted by the stable cash flows, practically fell over each other to buy \$6 billion of the securities from three California utilities in late November and early December. Since then, those bonds have so appreciated in value that their yields relative to U.S. Treasury securities tightened as much as 15 basis points. Still, the market was disappointed by the slower-than-expected pace of utility ABS issuance.

"After what seemed like the longest pre-marketing period of any asset class, ABS investors eagerly swept up the three California deals," recalls Goldman Sachs analyst Anthony Thomsson. "And since then? Nothing."

The delays are largely due to political opposition and litigation. In Pennsylvania, PECO Energy Co., which plans to sell some \$4 billion of bonds, saw its program temporarily derailed—first by a gadfly state senator, then by competitor Enron Corp. In May, however, PECO announced a tentative settlement. In New York, the first securitization bill ever drafted is still in limbo, two years after its introduction. Even in California, a consumer group called TURN (The Utility Reform Network) tried to block ABS bond sales, though it ultimately failed.

“Utilities are being held hostage to an adversarial political process,” contends Mr. Fichera. In addition, he says, the assumption that legislation is always needed is “forcing more and more controversy and making it more difficult.” The fact is, he continues, “there is no template” when it comes to the leeway of the states in such matters. “Most people

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haven’t thoroughly examined the existing authority of the [state public utility] commissions,” he insists. Under Arizona’s Constitution, for example, the Public Service Commission is considered a separate branch of government that doesn’t have to answer to the legislature.

California’s ABS deals attracted strong investor interest. It helped that the customer surcharge—known as the fixed transition amount, or FTA—providing the cash flow for the bonds was irrevocable. According to the offerings’ prospectus, the California statute explicitly says that the state will “neither limit nor alter the FTAs... until all obligations under the Certificates are fully met and discharged.”

Mr. Fichera further asserts that such bondholder protections are already contained in the “takings” clause of the Fifth Amendment to the U.S. Constitution, which prohibits the federal government from reneging on a contract without making just compensation. Under the Fourteenth Amendment, he adds, this prohibition applies to the states as well. Most state constitutions also echo the federal takings clause. “At the end of the day, the legal protection for bondholders is essentially the same,” says Michael Parish, a partner at Reid & Priest.

Mr. Parish cites a New Jersey State Supreme Court ruling that barred the Board of Public Utilities from raising water rates because the commission had already committed not to do so in a settlement agreement. Despite a statute expressly permitting the BPU to change its mind on rate orders, the court ruled that the board had no such leeway in this case because of the prior settlement accord. Therefore, say Messrs. Parish and Fichera, the authority to issue irrevocable orders can be used to make stranded-cost ABS deals bulletproof.

Skeptics Cite Legal Pitfalls

Still, this idea has met with skepticism. “For every lawyer that says you have a constitutional right, you have another bunch of lawyers saying you don’t,” notes Frank Delany, vice president and corporate rate counsel at New Jersey utility Public Service Electric & Gas. PSE&G wants to securitize about \$2.5 billion of its estimated \$3.3 billion of stranded costs and has retained Lehman Brothers as its advisor. “The protection of a law passed by the legislature gives you and gives purchasers of the bonds sufficient comfort and guarantees that promise will be honored without hiring more lawyers,” Mr. Delany says.

Ratings agencies, meanwhile, are open-minded yet skeptical. “Legally, [Mr. Fichera and others] make a good case. But it’s a question of how it’s going to stand up in this contentious climate,” says James Penrose, assistant general counsel at Standard & Poor’s. Recalling the controversies in Pennsylvania and California last year, he points out that “those were two good states with nice statutes and [the utilities there] were still on the receiving end of litigation. It’s hard enough to do when you have a statute. The good thing about the statute is that it goes through the blast furnace of the political process. You have slow consensus building.”

Aside from California and Pennsylvania, utility deregulation laws providing for securitization have been passed in Connecticut, Illinois, Massachusetts, Montana and Rhode Island. Similar legislation is now pending in Missouri, New Hampshire and Ohio, and new bills also may be introduced in Michigan and New Jersey this year.

As for his critics, Mr. Fichera scoffs: “I’m amazed that I’ve been turned into a radical in this market by saying the law is sufficient.”

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