Asset-Backed
Special Report

Outlook for Utility Tariff Bonds in Recessionary Times

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Related Research

- *Rating Criteria for U.S. Utility Tariff Bonds, Aug. 30, 2007*
- *U.S. Utilities, Power and Gas 2009 Outlook, Dec. 22, 2008*

Summary

Despite softening demand growth for electricity and a rising customer delinquency trend driven by the deepening U.S. recession, Fitch's rating outlook for U.S. utility tariff bonds (tariff bonds) will remain stable throughout 2009. To date, Fitch-rated tariff bonds are performing within expectations due to the structural and regulatory protections available to tariff bondholders such as the mandated periodic reset, or true-up, of the dedicated utility tariff component intended to preserve interest payments and expected debt amortization.

Of the 34 Fitch-rated deals currently outstanding, 24 experienced an upward adjustment in tariff during the last 12 months compared to 10 for the preceding 12-month period. Further, three interim and two non-standard true-up applications were filed with utility regulatory commissions during the past year. Interim true-up revisions may be made more frequently than mandated to correct undercollections relative to forecasts, replenish any shortfalls in overcollateralization and/or capital subaccounts, and ensure that collections are sufficient to make full scheduled payments during the next payment date. Non-standard true-ups refer to filings where forecast billing determinants for any customer class for an upcoming period decrease by more than 10% compared to the forecasts at inception.

2009 Outlook

Fitch anticipates the frequency of true-ups and capital subaccount withdrawals to increase in 2009 as recessionary impacts persist and consumption falls below forecasts, commercial and industrial loads decline, and collection timing curves lengthen. Nevertheless, no negative rating actions are expected in 2009 for tariff bonds as the true-up mechanism continues to support existing ratings and the prospect of widespread downgrades in the utility segment remains remote.

While Fitch views the business climate for U.S. investor-owned electric utilities as negative both in 2009 and in the longer term, no regulated electric utilities are expected to default or even be downgraded from investment-grade status, barring unforeseen events. Utilities benefit from investor perceptions as a defensive group and are holding up fairly well relative to most other U.S. industries.

Recessionary Impact on Key Rating Drivers

While tariff bonds continue to perform well, the current economic downturn has raised questions among investors regarding the recessionary impact of the following rating drivers on the performance of tariff bonds:

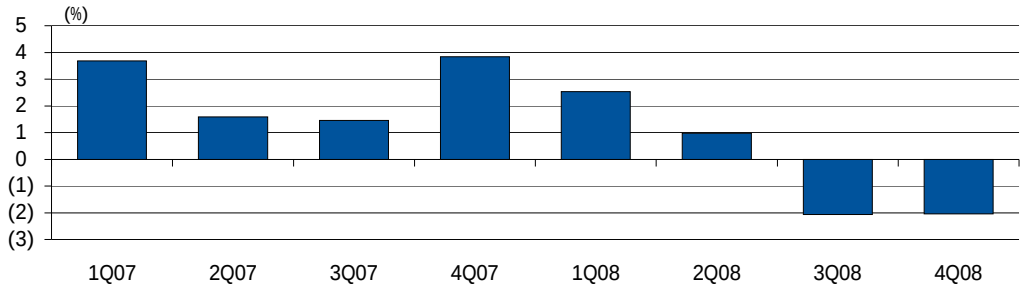
- Demand reduction.
- Rising delinquencies and chargeoffs.
- Bankruptcy of the industrial customer base and/or the servicing utilities.
- Elevated regulatory risk associated with rate increases and rising service disconnections.

Fitch's view regarding the potential for each of these factors to impact tariff bonds ratings is discussed below.

Demand Reduction

U.S. electricity sales continued to increase in the first half of 2008, and then declined in the second half of the year as recessionary pressures were felt by businesses and households. Electric power sales volume rose by 2.5% in the first quarter of 2008 and 1.0% in the second quarter relative to the same quarters in the prior year, but declined by 2.0% in each of the third and fourth quarters. Electric sales were down 0.2% as of year-end 2008; by contrast, sales grew by 2.6% in 2007 versus 2006's levels. The chart below illustrates the trend in the volume of U.S. electric power sales in 2007–2008.

Change in U.S. Electric Sales Volume by Quarter



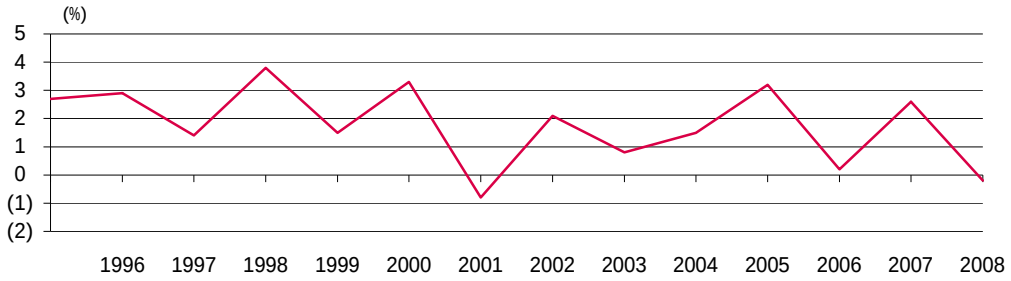
Source: U.S. Energy Information Agency.

Demand during the second half of 2008 was weak due to a variety of factors, including recessionary impacts affecting commercial and industrial loads, voluntary consumer reaction to rising electricity rates, pressures on household budgets and rising unemployment levels, and the spread of policy-driven programs that encouraged energy conservation.

Fitch forecasts that total electric power sales will decline by roughly 2% in 2009. While a slow economy is expected to stifle demand growth in 2009, it is also possible that the U.S. will experience a systematic downward shift in forecasted demand. The chart on page 3 shows the longer term annual sales trend from 1994–2008. According to Fitch, per capita electricity demand growth is likely to be flat over the next three to four years due to increased political support for and public adoption of energy efficiency programs.

When analyzing utility tariff bond transactions, Fitch assumes a permanent and appreciable decline in consumption attributable to economic recessions, demographic shifts, co-generation, energy conservation, and forecasting errors. Fitch's 'AAA' cash flow stress methodology aggregates these multiple contributory factors and applies a single-variance percentage to cash collections to determine if revenue declines from adverse volume variances are offset in subsequent periods by the application of the true-up mechanism. Under Fitch's break-the-bond stress scenario, transactions can typically withstand a permanent decline in demand (relative to forecast levels) in excess of 50%.

Annual Change in U.S. Electric Sales Volume



Source: U.S. Energy Information Agency.

Rising Delinquencies and Chargeoffs

Bad debt expense has been creeping higher in recent quarters for utilities, although it still remains within historical ranges. As reflected in several of the recent true-up filings, upward revisions in tariffs were driven by, among other things, higher expected chargeoffs and weighted average days sales outstanding projections. Despite this increase, tariff bonds remain well-protected as established by Fitch's 'AAA' stress case that tests the ability of deals to withstand 5x peak historical chargeoff experience and extended collection cycles.

Heightened Bankruptcy Risk

Industrial Customer Base

Bankruptcy of industrial customers has assumed greater prominence during the current crisis. As an additional cash flow stress scenario, Fitch tests the ability of transactions to withstand the complete loss of consumption from the industrial class (and its impact on the utility tariff) for service territories with high industrial concentrations.

Stress tests are further customized for specific jurisdictions. For instance, in the case of Detroit Edison tariff bonds, where auto and auto-related customers represent the largest segment by revenue, Fitch stressed the deal structure to analyze if it could withstand the complete loss of consumption from the auto industry concentration within Detroit Edison's service territory under a bankruptcy scenario and its concomitant effect on manufacturing employment. The stress results indicated that the tariff bonds can withstand the loss of consumption from the entire auto industry concentration and approximately 40% of residential customers, occurring as early as year 1 of the transaction and continuing to be un-remedied through the end of the transaction, and still pay out by the legal final maturity date.

Servicing Utility

Despite a challenging credit environment in 2008, there were no bankruptcy filings by utilities that have issued tariff bonds, and Fitch does not foresee any prospect for such filings in 2009. Historically, three tariff bond transactions have experienced the insolvency or bankruptcy of the sponsor utilities without affecting ongoing receipt of cash flows by the bond trustees or any adverse effect on the bond payments. Tariff bond issuers were never included in the bankruptcy proceedings, and there was no motion by the bankrupt utility or any creditor thereof to consolidate the issuer in the bankruptcy case. Specific orders in each bankruptcy resulted in remittance of the cash collected by the utility pre-petition to the trustee in the early days of the bankruptcy case and the regular transfer of cash flows thereafter. These events confirm that the bankruptcy-remote structure and true sale are effective and that bankrupt or insolvent utilities can perform capably as servicers without having to utilize a substitute servicer.

Elevated Regulatory Risk

During recessionary times, regulatory risk remains elevated for utilities as the pressure of a weak economic backdrop could result in regulatory and political push-back to requests for rate increases even when targeted at cost recovery and reasonable return on investments. The higher incidence of service disconnections to counter rising delinquencies, as witnessed in several states, further exacerbates the risk of resistance from consumer advocacy groups and regulators.

In contrast, tariff bondholders are better protected against changing political agendas in the legislative or executive branches of government and the prospect of a jurisdiction's rate-setting climate turning confiscatory or capricious during periods of extreme economic distress. Because the special tariffs are established as irrevocable charges pursuant to authorizing legislation and commission order, they are not subject to reduction or impairment by regulators or the legislature. Further, since the current reset utility tariffs continue to represent a small percentage of an average customer bill, the potential for political or regulatory challenge is substantially diminished.

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