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SECTOR IN-DEPTH
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Regulated utilities - US

Utility cost recovery through securitization is credit positive

Utility cost recovery charge (UCRC) securitization, a financing technique used to recover stranded costs, storm costs and other expenses, can be a credit positive tool for regulated utilities. UCRC securitization, whereby utilities issue bonds with lower financing costs that are paid back through a special customer charge, is typically underpinned by state legislation and in recent years has become more versatile and widespread. The ability to use securitization as a tool to recover, often significant, costs related to large or unforeseen developments allows utilities to avoid potentially credit negative events. However, though the mechanism typically benefits utilities and their customers, too much securitization can have negative consequences.

» **Securitization typically benefits utilities and their current customers.** Utilities benefit because they receive an immediate source of cash from the securitization proceeds and are ensured recovery of large costs in a timely manner that may, otherwise, be recovered over a lengthy period of time or denied recovery altogether. Current utility customers benefit because the cost of the securitized debt is lower than the utility's cost of debt, which reduces the impact on their monthly bills.

» **UCRC securitization has become more versatile and prevalent.** Utility securitization became widespread for the recovery of stranded costs following deregulation of the sector in the late 1990s. It is now used to recover costs associated with storm restoration and environmental costs, utility restructuring, deferred fuel costs and renewable energy projects.

» **State law and financing orders strongly protect securitization assets.** There are three major components of a UCRC securitization—state legislation, a financing order and a true-up mechanism—which ultimately protect the assets backing the bonds.

» **Too much securitization can have negative consequences.** The use of securitization removes the utility's opportunity to include the corresponding asset in its rate base and the ability to earn a return on that asset. A significant amount of securitization debt could impact customer bills substantially while hurting the utility's financial flexibility and ability to raise rates for other reasons, such as to recover future costs and investments.

Securitization typically benefits utilities and their current customers

UCRC securitization was widely used after the deregulation of the utility sector in the late 1990s as a way to finance so-called stranded costs—the shortfall between the market value of utilities' generation assets and their book value when certain states switched to competitive electric supply markets and utilities sold their generation assets. In UCRC securitization, utilities issue bonds with lower financing costs that are paid back through a discrete customer charge. We typically view use of the technique as credit positive for utilities.

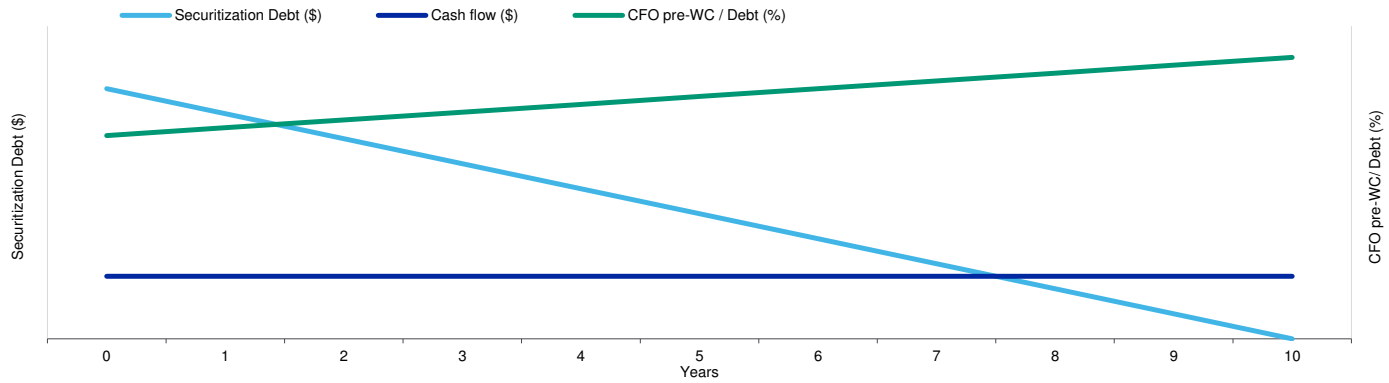
A utility benefits from the securitization because it receives an immediate source of cash. The ability to use securitization generally means the utility is allowed to recover all or most of the costs in question in a timely manner. The ability to use securitization as a tool to recover costs related to large or unforeseen developments allows utilities to avoid potentially credit negative events. The utility's ratepayers benefit because customer rates are lower than if the securitization was not utilized and in many cases avert the need for a substantial rate increase. Under state legislation, the utility must show that the savings to its customers on a net present value basis will be higher than they would have been without securitization.

The savings result from the cost of the securitized debt being lower than the utility's unsecuritized cost of debt and much lower than its all-in cost of capital, which reduces the revenue requirement associated with the cost recovery. The special surcharges involved are also spread out over a long period, typically corresponding to the maturity of the securitization bonds. This eases the impact on customer bills when compared with requesting cost recovery from customers through a one-time payment.

Exhibit 1 shows an illustrative example of the potential impact over time on a utility's ratio of cash flow from operations pre-working capital changes (CFO pre-W/C) to debt, all else being equal. Depending on the size of the securitization debt as a proportion of total debt, the impact on a utility's financial metrics can vary. If the securitization is a significant component of total debt then a utility's ratio of CFO pre-W/C to debt could be severely negatively affected.

Exhibit 1

Illustrative example of the impact UCRC securitization can have on a utility's ratio of CFO pre-W/C to debt



Source: Moody's Investors Service

In the presentation of securitization debt in our published financial ratios, we make our own assessment of the appropriate credit representation, but in most cases we follow the accounting in audited statements under US Generally Accepted Accounting Principles (GAAP), which in turn considers the terms of enabling legislation. As a result, accounting treatment may vary. In most cases, utilities have been required to consolidate securitization debt under GAAP, even though it is technically non-recourse.

We typically view securitization debt of utilities as on-credit debt, in part because the rates associated with it reduce the utility's headroom to increase rates for other purposes while keeping all-in rates affordable to customers. Thus, where accounting treatment is off balance sheet, we seek to adjust the company's financial ratios by including the securitization debt and related revenues in our analysis. Where the securitized debt is on balance sheet, our credit analysis also considers the significance of financial ratios that

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exclude securitization debt and related revenues to ensure that the benefits of securitization are not ignored. Since securitization debt amortizes mortgage-style, including it makes financial ratios look worse in early years, when most of the revenue collected goes to pay interest, and better in later years, when most of the revenue collected goes to pay principal.

CenterPoint Energy Houston Electric has a long history of issuing securitization bonds

In 1999, the Texas legislature adopted the Texas Electric Choice Plan, under which integrated utilities operating within the Electric Reliability Council of Texas, Inc. (ERCOT, Aa3 stable) were required to unbundle their operations into separate retail sales, power generation, and transmission and distribution companies. The legislation provided for a transition period and a true-up mechanism for the utilities to recover stranded and certain other costs resulting from the transition. Those costs were recoverable, after approval by the Public Utility Commission of Texas (PUCT), either through the issuance of securitization bonds or through the implementation of a competition transition charge as a rider to the utility's tariff.

In the early 2000s, CenterPoint Energy Houston Electric, LLC (CEHE, A3 stable) restructured its business in accordance with the new law and its generating stations were sold to third parties. Over the years that followed, CEHE has worked with regulators to obtain recovery of most its stranded assets and associated costs through the use of securitization bonds and other regulatory mechanisms.

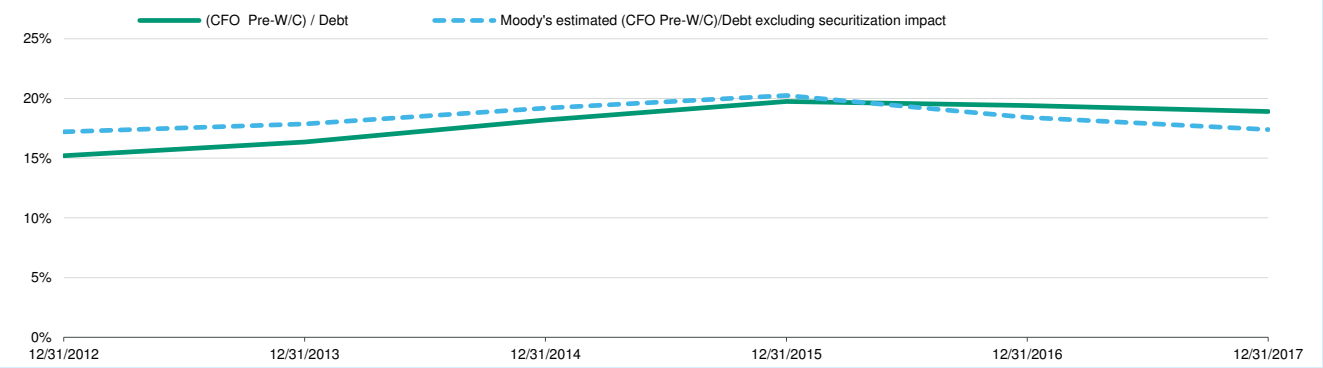
In October 2011, PUCT approved a final order that allowed CEHE to recover an additional $1.695 billion of stranded costs through the use of securitization bonds. In January 2012, CEHE created a new special purpose subsidiary, CenterPoint Energy Transition Bond Company IV, LLC, which issued $1.695 billion of securitization bonds in three tranches with interest rates ranging from 0.9012% to 3.0282% and final maturity dates ranging from April 15, 2018 to October 15, 2025. The securitization bonds will be repaid over time through a charge imposed on customers in CEHE's service territory.

The overall time-weighted interest rate of approximately 2.5% for the securitization bonds was substantially lower than the average rate on CEHE's unsecuritized debt of about 7.66% at that time. The PUCT estimated that the reduced interest charges from the securitization of the stranded costs resulted in savings for CEHE's customers of more than $700 million over the life of the bonds.

Exhibit 2 shows our estimate of the impact on CEHE's ratio of CFO pre-W/C to debt from 2012 through 2017 due to the impact of the $1.695 billion securitization debt. We estimate that the securitization debt had at most a 200-basis-point impact on CEHE's ratio of CFO pre-W/C to debt either positive or negative, depending on the year.

Exhibit 2

How CEHE's ratio of CFO pre-W/C to debt was impacted by securitization debt from 2012 through 2017



Source: company's filings, Moody's Investors Service

UCRC securitization has become more versatile and widespread

UCRC bonds were created after the deregulation of utilities in the late 1990s as a way to finance stranded costs. To date, more than 20 states have used this model to recover not only stranded costs but also costs associated with storm recovery and to a lesser degree environmental restoration, utility restructuring, deferred fuel costs and renewable energy projects.

In June 2005, for example, Section 366.8260 of the Florida Statutes was enacted through Senate Bill 1366, allowing the Florida Public Service Commission to authorize the state's utilities to securitize storm recovery costs. Following Hurricanes Katrina, Rita and Wilma in 2005, Arkansas, Louisiana, Mississippi and Texas joined Florida by passing special legislation giving utilities operating in their jurisdictions the option of utilizing securitization for recovery of storm costs. Recently in California, legislators are considering an amended version of Assembly Bill 33 which, as amended, would allow securitization to be used for prudently incurred costs arising from wildfires, a credit positive step for utilities dealing with potentially significant wildfire-related liabilities. Exhibit 3 shows a list of securitizations completed by utilities in recent years.

In each case, with the exception of the Entergy New Orleans LLC's (ENO, Ba1 stable) bond issuance (Aa1 (sf)) in 2015, we rated the securitization bonds Aaa (sf) owing to the strength of the state legislation, including the state's non-impairment pledge, the irrevocable financing order typically from the state public utility commission, credit enhancement consisting of a statutory uncapped true-up adjustment mechanism, the manageable size of the cost recovery charge and the remote likelihood of a successful legal, political or regulatory challenge, among other factors.

The Aa1 (sf) rating on ENO's securitization bond issuance, which is one-notch lower than the typical Aaa (sf) rating, reflects the relative small size and concentration of the ratepayer base from whom the storm recovery charge will be collected. The bonds are exposed to the risk of declines in the rate payer base in the service area of ENO in case of severe events, such as anther severe hurricane.

Exhibit 3

Moody's rated UCRC securitizations issued since 2012

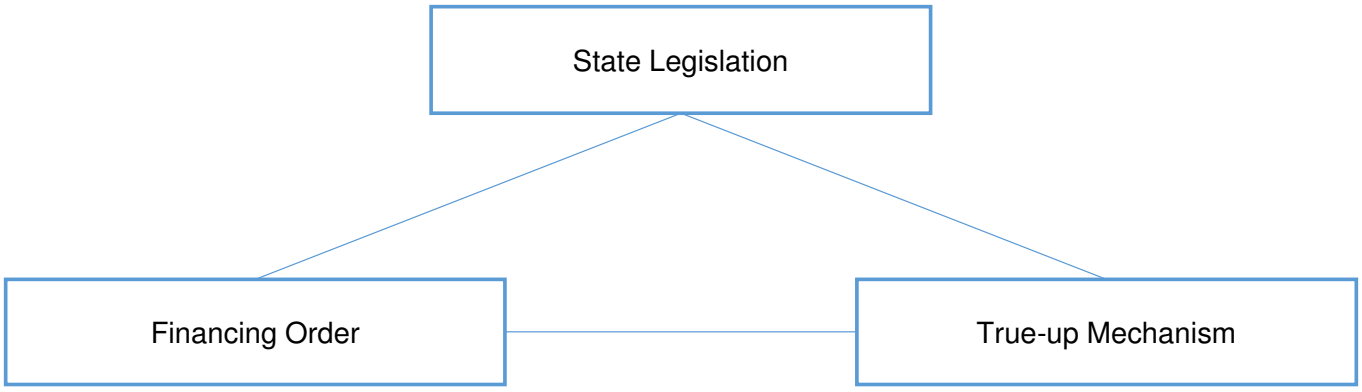
Deal Name	Servicer	Issuance ($ millions)	Year Completed	Rating (sf)	State
PSNH Funding LLC 3, Series 2018-1	Public Service Co. of New Hampshire	$636	2018	Aaa	New Hampshire
Utility Debt Securitization Authority Restructuring Bonds, Series 2017	Long Island Power Authority	369	2017	Aaa	New York
Utility Debt Securitization Authority Restructuring Bonds, Series 2016B	Long Island Power Authority	469	2016	Aaa	New York
Duke Energy Florida Project Finance, LLC	Duke Energy Florida LLC	1294	2016	Aaa	Florida
Utility Debt Securitization Authority Restructuring Bonds, Series 2016A	Long Island Power Authority	637	2016	Aaa	New York
Utility Debt Securitization Authority Restructuring Bonds, Series 2015	Long Island Power Authority	1002	2015	Aaa	New York
Entergy New Orleans Storm Recovery Funding I, L.L.C.	Entergy New Orleans LLC	99	2015	Aa1	Louisiana
State of Hawaii Department of Business, Economic Development, and Tourism - Green Energy Market Securitization Bonds, 2014 Ser. A	Hawaii Electric Light Company, Inc. and Maui Electric Company, Limited	150	2014	Aaa	Hawaii
Louisiana Local Government Environmental Facilities and Community Development Authority - System Restoration Bonds (Louisiana Utilities Restoration Corporation Project/EGSL), Ser. 2014 (Federally Taxable)	Entergy Gulf States Louisiana, L.L.C.	71	2014	Aaa	Louisiana
Louisiana Local Government Environmental Facilities and Community Development Authority - System Restoration Bonds (Louisiana Utilities Restoration Corporation Project/ELL), Ser. 2014 (Federal Taxable)	EL Investment Company, LLC	244	2014	Aaa	Louisiana
Consumer 2014 Securitization Funding LLC - Senior Secured Securitization Bonds, Series 2014-A	Consumers Energy Company	378	2014	Aaa	Michigan
Utility Debt Securitization Authority Restructuring Bonds Series 2013T and Series 2013TE	Long Island Power Authority	2022	2013	Aaa	New York
Appalachian Consumer Rate Relief Funding LLC - Senior Secured Consumer Rate Relief Bonds	Appalachian Power Company	380	2013	Aaa	West Virginia
Ohio Phase-In-Recovery Funding LLC	Ohio Power Company	267	2013	Aaa	Ohio
FirstEnergy Ohio PIRB Special Purpose Trust 2013	Cleveland Electric Illuminating Company (The), Ohio Edison Company, Toledo Edison Company	445	2013	Aaa	Ohio
AEP Texas Central Transition Funding III LLC, Senior Secured Transition Bonds	AEP Texas Central Company	800	2012	Aaa	Texas
CenterPoint Energy Transition Bond Company IV, LLC, Series 2012 Senior Secured Transition Bonds	CenterPoint Energy Houston Electric, LLC	1695	2012	Aaa	Texas

Source: Moody's Investor Service

State law and financing order strongly protect the securitization assets

There are three major components of a UCRC securitization: state legislation, a financing order and a true-up mechanism, as shown in Exhibit 4. The securitization law and financing order legally protect the assets backing the bonds.

Exhibit 4
UCRC securitization has three major components



Source: Moody's Investors Service

The state legislature typically passes a law authorizing the utility to finance the recovery of certain costs through the issuance of securitization bonds. The legislation authorizes the creation of a property right allowing the issuer to collect special charges from customers which are used to repay the bonds. Bondholders receive protection through a non-impairment pledge, under which the state pledges that it will not take any actions that alter the charges or the law until the bonds have been repaid in full.

The legislation also mandates an irrevocable financing order, typically issued by the state public utility commission, which means the state cannot change or revoke the financing order once it is issued. The order authorizes the transaction servicer, typically the utility, on behalf of the issuer of the debt, to charge and collect the special surcharges from the utility's ratepayer base.

The securitization law and the financing order mandate a true-up adjustment mechanism under which the servicer must adjust the charges at least annually to ensure the collection of adequate funds to provide for timely payments on the securitization bonds. The securitization law also establishes the issuer of the debt as a bankruptcy-remote special purpose entity (SPE), and the utility sells the securitized asset (the property right) to the SPE via a true sale transaction. The assets are thus legally isolated from the utility. The SPE issues the bonds and uses the proceeds to acquire the asset. The SPE then uses the charge collected from the utility's customers to pay debt service until the bonds are repaid in full. The utility receives the proceeds from the bond issuance.

Too much securitization can also have negative consequences

While the use of securitization does provide more timely recovery of costs for the utility, there can be some downside. In cases where utilities use securitization to recover stranded costs, the mechanism requires utilities to give up the opportunity to include the corresponding asset in its rate base as well as the ability to earn a return on that asset. This diminishes the utility's future earnings power and cash flow generation.

A significant amount of securitization debt could represent a substantial portion of the utility's customer bills. This would not only raise customer rates but could also prevent regulators from approving rate increases in the future, out of concern that rates are rising too much. This could in turn affect the utility's capital investments and the ability to add any such investments to rate base and earn on a return on them.

In addition, since the surcharge on customer bills used to pay off the securitization bonds will typically exist for several years, any new customers in the utility's service territory will be subject to this surcharge. As a result, future customers will be paying for costs related to historical occurrences, which may deter new commercial and industrial businesses from moving into the service territory if rates become less competitive.

Further, customer rates or cash flow used to service securitization debt is senior and has a higher legal priority to the utility's remaining cash flow generation. As such, securitization bondholders would have a senior claim in a liability waterfall during times of financial distress. So a significant amount of securitization debt within a capital structure could put secured and unsecured debt holders at risk of less than full recovery in a bankruptcy filing.

Pacific Gas & Electric's securitization during bankruptcy in the early 2000's demonstrates the enforceability and resiliency of the legal structure

In 1997, Pacific Gas & Electric Company (PG&E, A3 negative) issued $2.9 billion of securitization bonds after obtaining approval by the California Public Utility Commission to recover stranded asset costs associated with the state's utility deregulation. When PG&E filed for bankruptcy on 6 April 2001, both the company and bankruptcy court respected the bankruptcy-remote structure of the securitization that the parties had established in order to isolate the assets of PG&E's securitization from PG&E's bankruptcy estate. PG&E remained the servicer of the transaction and continued to collect and remit the securitization payment. The securitization cash flows were not affected by the bankruptcy due to a build-up in the reserve fund and the base level of customer consumption used to calculate the 2001 tariff remained relatively stable. For these reasons among others, the Aaa (sf) rating on PG&E's stranded costs recovery securitization bonds was maintained throughout the company's bankruptcy.

The bankruptcy remoteness of securitization transactions is stronger than that of other, purely corporate asset-backed securities for several reasons including the explicit recognition, by state legislation, of the right to collect the special surcharge from customers as well as the first lien on the asset that is often granted by statute upon its transfer. The consumption-based fee is imposed on ratepayers and is not dependent on a particular electrical supplier. The fee is not affected if the servicer becomes bankrupt. The underlying legislation usually requires that any successor to the original utility (due to bankruptcy, reorganization, merger, or acquisition) must satisfy all obligations of the original utility, including the collection of the special surcharge. The right to collect the special surcharge is irrevocable and cannot be altered by either the state utility commission or the state.

In January 2005, PG&E issued $1.9 billion of securitization known as energy recovery bonds (ERBs). The securitization financing accelerated the company's collection of the regulatory asset that was created as part of PG&E's bankruptcy. A second securitization financing was completed in late 2005 which enabled PG&E to largely recover the entire regulatory asset. This was another example where securitization was used as a tool to significantly reduce the uncertainty and length of time in the recovery of significant costs, a credit positive, while also reducing costs for customers by keeping rates lower over the long-term.

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Rating Methodologies:

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- Regulated Electric and Gas Networks 16 March 2017
- U.S. Electric Generation & Transmission 15 April 2013
- Natural Gas Pipelines 6 July 2018
- Moody's Global Approach to Rating Securities Backed by Utility Cost Recovery Charges 22 June 2015

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