

Managing Electricity Rates Amidst Increasing Capital Expenditures: Is Securitization the Right Tool? An Update

Overview

A growing number of states, their utilities, and public utility commissions (PUCs) are facing a critical policy dilemma: How to minimize the rate impact of recouping large-scale capital costs? The question isn't easy; whether it's recouping costs associated with natural disasters, retiring outdated nuclear plants, or investing in renewable energy investments, these large expenses can challenge a utility. Traditional financing mechanisms, which include using a combination of traditional equity and borrowing at the utility's cost of capital, inevitably end up increasing rates.

Because investor-owned utilities are generally entitled to returns sufficient to attract investor capital, a risk premium is included in their return on the use of shareholder equity. Utilities generally have little difficulty financing capital plans. However, what happens when their financing needs are unforeseeable or beyond their control or beyond their ability to anticipate and plan? Or, what if the utility is facing economic disruption due to natural disasters, market events, or government-mandated costs?

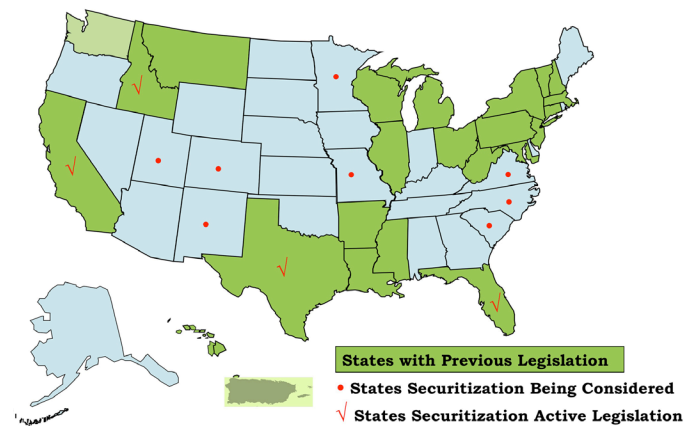
What is the answer? How can a utility finance required expenditures at a minimum cost to customers and even avoid customer rate shock? For more than 21 years, regulators and utilities around the country have found the answer in a financial product known as "securitization." When a utility has an extraordinary cost, for which it is prudent to recover costs from customers (e.g., sunk costs, pollution control equipment, storm recovery costs, remediation of coal ash ponds), it is reasonable to consider securitization as a mechanism to assure cost recovery at a rate below the utility's cost of capital. It is also a unique and valuable tool for regulators and utilities to avoid customer rate shock.

Essentially, securitization is a special form of financing that is specifically designed to lower a utility's borrowing costs, which in turn lowers the amount of money customers will have to repay. Working with their

legislature, utility commissions, and independent financial advisors, utilities can issue high-quality securitized bonds. The bonds receive a "AAA" rating – the highest possible — from Wall Street rating agencies that assess creditworthiness, making them more attractive to investors eager for safe, reliable, long-term returns on their investment. Essentially, it lets utilities and their customers benefit directly from the bond market.

A growing number of utilities have recovered necessary extraordinary costs at the lowest possible financing cost to ratepayers. Think of securitization as akin to a consumer refinancing their credit card debt with a home equity mortgage loan. By refinancing into a secured, higher-quality loan, the consumer can obtain a lower interest rate and significantly lower their borrowing costs over the life of the loan. In much the same way, a utility can replace its existing cost of capital at a lower cost, improving its financial condition in a way that also means less cost to ratepayers over time. Securitization lets them bypass their balance sheet and borrow directly on the broad ratepayer base.

Securitization: 21 States + DC + Puerto Rico



This approach has been successfully used by utilities around the country for a variety of needs. In Florida, securitization was first used after the catastrophic 2004 and 2005 hurricane seasons. More recently, with new legislation, a Florida utility was able to reach an

agreement with consumer groups and regulators to issue nearly \$1.3 billion in securitized bonds to cover the cost of the early retirement of a nuclear plant. The use of securitization in that case ultimately saved ratepayers more than \$680 million in today's dollars.

Securitization can be a dynamic change maker for utilities, their regulators, and customers in the face of rising costs in the capital markets and outsized capital expenditures that can drain resources and increase the burden on ratepayers. It can provide needed financial security to all stakeholders, providing utilities with secure, high-quality financing and customers with the security of knowing they are saving money every month.

Securitization and Utilities: How We Got Here

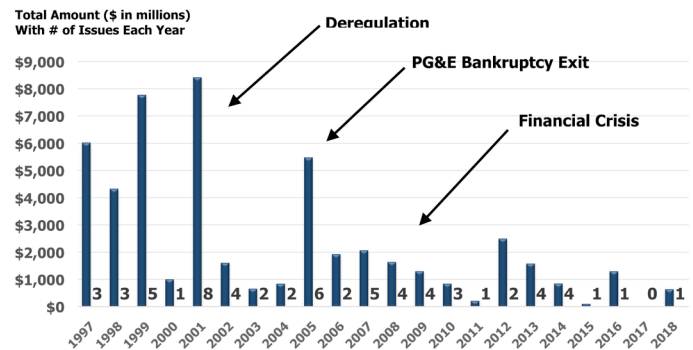
The practice of securitization is not a new concept on Wall Street – railroad-backed bonds date back to the 19th century, and the modern securitization market came of age in the 1970s. The use of securitization by regulators and utilities is of a more recent vintage. It has gained popularity in the last 21 years as states have deregulated their energy markets and utilities have had to deal with the outsized costs of natural disasters and pressure on their capital expenditures.

The approach was first tested in the mid-1990s as California sought to deregulate its energy market. The four investor-owned utilities in the state sold roughly \$6 billion in securitized bonds to finance a 10% rate reduction for their residential and small commercial customers. This earned the bonds the nickname “rate reduction bonds,” or “RRBs.” The technique was later adopted in other states to recover so-called stranded costs of utilities’ electric generation facilities; these refer to generation investments that are “stranded” because of a state breaking up a utility’s monopoly by separating energy generation from transmission and distribution. The bonds helped the utilities recoup those costs while still securing a sizable rate reduction for their customers when compared to traditional financing involving the utility’s cost of capital. Investors offered a new nickname for these securitizations, referring to them as “stranded cost bonds.”

Since those initial forays into securitization, states have used the process to help tackle a range of costs. These bonds have been called “storm recovery bonds” when used to help pay for catastrophic hurricane damage, or “nuclear asset recovery bonds” to help finance the early retirement of nuclear plants. The best description is likely “ratepayer-backed bonds.” Sometimes, these bonds are used to help finance needed improvements utilities must make. In 2007, Allegheny Energy was able to reach

a settlement with consumer groups to use securitization to help finance the construction of newly mandated pollution control equipment at two coal-fired plants in West Virginia. The long-term bond issues were a success, securing the funds while saving customers more than \$130 million in today's dollars over the life of the bonds.

Total ~\$50.9 Billion Issued 1997-2018
64 Investor-Owned Utility Transactions
From \$21.5 Million To \$2.9 Billion In Size



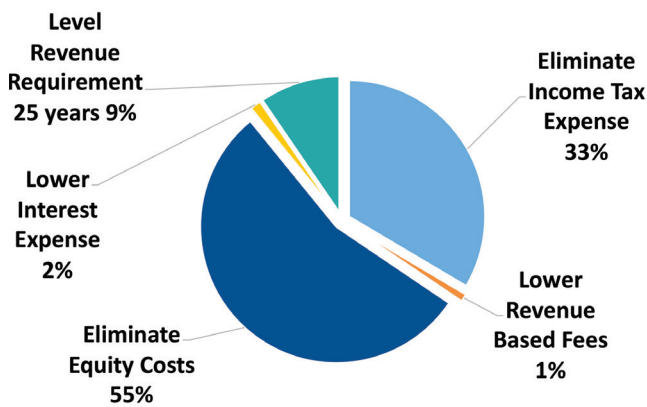
Today, investor-owned and municipal utility securitization bond offerings are authorized in 21 states, the District of Columbia, and Puerto Rico. Since 1997, utility securitization bonds — with the regulator still deciding what prudent costs can be financed — have been used more than 60 times to allow investor-owned utilities to address high-cost events. More recently, legislation proposed in Colorado and Missouri would provide utilities a return of utility capital when certain outdated generation plants are retired early, as well as raise money for transition assistance for affected communities and workers. Both are significant and important innovations.

Utility Securitization: What It Is and How It Works

At its root, although complex, securitization is a special form of bond financing to secure the highest possible rating from credit rating agencies, making the bonds attractive to investors and ensuring that the utility can lower its borrowing costs. Properly structured and implemented, securitization should give a utility additional flexibility to deploy its capital and invest in infrastructure while also benefitting customers. Typically, a properly implemented bond will be sold to investors to replace a corresponding amount of the utility’s existing debt and equity. Because these bonds receive a much higher credit rating, this means the utility’s costs are being reduced through this new bond issue. That benefits both the utility and its ratepayers, who see their monthly bills reduced.

The example noted below, where a utility was able to save its ratepayers more than \$680 million in today's dollars through securitization, provides a good primer on the process. Faced with the early retirement of a nuclear project, Duke Energy Florida worked with customer groups on an agreement allowing the retirement costs to be recouped from ratepayers via the use of long-term securitized bonds that would ultimately lower customers' costs. This agreement significantly altered the equation of traditional utility finance. Working cooperatively with their customers and its PUC, Duke Energy was able to finance the costs in a way that benefited all stakeholders.

Where Securitization Saves Ratepayers in Today's Dollars versus Traditional Utility Cost of Capital



Savings Net of Issuance Costs \$1 Billion Bond 15-Year Average Life 25-Year Maturity

The reason this worked and is attractive to investors goes back to the fundamental structure of securitized utility bonds. Their key characteristic is that they are authorized with special legislation to be issued by a separate legal entity specifically set up for the transaction. These “limited purpose entities” as they are known receive revenues from a dedicated tariff rate on utility customers’ monthly bill. Direct recovery from customers provides special legal protections that make them more secure in the eyes of credit rating agencies and investors. The legislation allows the utility to have the PUC adjust the rates at least semi-annually to ensure payment of principal, interest, and associated costs when due without further regulatory review.

Under securitization, a newly created property right authorized by the legislation and approved by the PUC is assigned to a limited purpose entity that pledges the property right as collateral for the securitized utility bonds sold to investors. The utility is considered repaid for the investment, and any related rate base or other regulatory asset is removed from the utility’s books. Customers stop paying the utility’s cost of capital with respect to that item, and instead begin paying the special

charge which repays the bondholders. This works to the customers’ benefit because the utility’s base rates go down significantly more than the securitized charges go up. Over the period of repayment, this means that securitization can save customers a very large amount of money while giving the utility additional flexibility and certainty in its operations.

Making Securitization a Reality

Achieving a successful securitization offering requires a number of steps to be taken before an offering. Buy-in at the state, PUC, and customer levels is crucial to ensure broad-based support, and to help clear legislative and regulatory hurdles to proceed with an offering.

The following elements are critical to ensure a utility and its customers can take advantage of securitization:

- The state legislature passes legislation specifically authorizing the use of securitization by utilities, declaring the right to impose, adjust, bill, collect a dedicated rate component to be a presently existing property right, and granting special authority to the regulators with a “lowest cost” to consumers standard.
- The PUC issues a financing order that allows the utility to charge its customers a dedicated amount per month over the life of the bonds. The charge applies to all, or substantially all, customers and cannot be bypassed.
- The PUC approves an adjustment mechanism that permits and requires the adjustment of the monthly charge to customers over time to make sure that the payments fulfill the obligations of the bonds.
- The PUC orders are irrevocable and the state agrees never to impair the right of the bondholders to the special charge as it is adjusted to repay the bonds in full.

These four elements are what allow the new securitization bonds to receive the highest possible credit ratings from rating agencies such as Moody’s, Standard & Poor’s, and Fitch. Achieving the highest possible credit ratings allows the bonds to achieve the lowest cost financing with the active oversight of the regulator in the public debt markets, which ultimately help create savings enjoyed by a utility’s ratepayers.

The critical piece of the puzzle for a successful securitization hinges on actions by the PUC. Ultimately, the PUC’s role in the financing process is three-fold:

- 1) issuing an irrevocable financing order laying out the parameters of the bond offering and the standard of “lowest cost” to customers;

2) establishing the regular adjustment mechanism; and, finally,

3) actively engaging and negotiating with investors and Wall Street to ensure the bonds are considered of the highest credit quality with the greatest competition among investors for the bonds.

An active, engaged commission (aided by independent financial advisors with a duty to the ratepayers) throughout the process is vital because of the unique nature of securitization; the special legal protections make the bonds an attractive investment, but also bind subsequent PUC's from future oversight. Typically, the necessary up-front PUC costs are paid from the proceeds of the bond sale — as are the utility's advisors/underwriters.

Foregoing future regulatory oversight make the bonds very different from typical utility bonds. There, the utility has a strong incentive to negotiate for the lowest possible interest rates and other costs. Between rate cases, the utility and its shareholders benefit. With securitization, these same ongoing checks and balances do not exist and must be done up-front. Whatever the bond's costs at the time of sale, the utility receives the same amount of pre-approved funds but every dollar of costs is a ratepayer dollar.

That's why it is important to send a clear signal to independent third-party evaluators and investors that the securitization is credible, fully supported and vetted at the regulatory level; promoting confidence and helping underscore the efficacy of the offering. This means ensuring the structuring, marketing, and pricing of the bonds are done properly. Active PUCs (like the models of Florida, West Virginia, New Jersey, and Texas) are also more likely to secure better terms for ratepayers than those that take a passive approach. Ultimately, it's critical that the PUC require full transparency during the financing process, effectively represent the interest of the ratepayers and be active at every step of the securitization process. Nothing is automatic in the capital markets; securitization only provides the opportunity to achieve the lowest cost to consumers.

Conclusion

At its core, securitization gives regulators and utilities unsurpassed flexibility in minimizing the cost of infrastructure investment, service, and financial stability goals. The design of securitized utility bonds is explicitly intended to create a win-win scenario for the utility and its customers; a sharp step away from traditional capital-raising approaches that have led to blowback for utilities who were forced to take on debt and earmark scarce equity for such costs.

The Benefits of Securitization

FOR UTILITIES:

- Allows access to lower borrowing costs
- Provides greater balance sheet flexibility, increasing headroom for rate management
- Grants utilities certainty for funding important infrastructure goals

FOR CONSUMERS:

- Provides security to ratepayers, lowering long-term costs
- Eliminates responsibility for covering utility debt costs, income taxes, return on equity costs
- Saves consumers money while allowing utility to improve balance sheet

FOR REGULATORS:

- Provides an effective tool to mitigate rate shocks and lower ratepayer bills

Joseph S. Fichera is an NRRI Fellow and CEO of [Saber Partners, LLC](#), a financial advisory firm specializing in securitization. Since 2000, Mr. Fichera has served as an advisor to public utility commissions in a number of states including Florida, Texas, West Virginia, Wisconsin, and New Jersey on 13 securitization offerings with an aggregate value of \$9,020,000,000.00. The opinions expressed in this NRRI publication are the author's and do not necessarily reflect those of NRRI or NARUC.

About NRRI

The National Regulatory Research Institute (NRRI) was established in 1976 as the research arm of the National Association of Regulatory Utility Commissioners (NARUC). NRRI provides research, training, and technical support to State Public Utility Commissions. NRRI and NARUC are co-located in Washington, D.C.



1101 Vermont Ave., NW • Suite 200 •
Washington, DC 20005 • (202) 222-0390 •
nrri.org

Copyright NRRI 2019