

New Uses for Utility Securitization Bonds in the Absence of Traditional Rate Recovery

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Introduction

Since the 1990s, utility companies have used securitizations as a financing technique to recover costs that may not be includable in rate base. Initially, securitizations were used as a vehicle to allow utilities to recover their “stranded” costs (generation-related costs incurred historically by vertically integrated utilities that were no longer recoverable through regulated rates after certain states opened the market for energy generation to competition). More recently, securitizations have been used to finance the construction and installation of environmental equipment on existing generation plants in states where generation is still a regulated part of the business,¹ to recover costs resulting from storm damage,² and to recover deferred power procurement costs.³ While most utilities may prefer to finance their capital investments in traditional ways so as to increase rate base, as capital needs in the utility industry rise, it may become more difficult to raise sufficient capital through traditional means, particularly without jeopardizing credit ratings. Utilities may also wish to avoid the regulatory risk associated with certain types of investments or rate proceedings. Therefore, as discussed more fully below, securitization should be considered as an alternative means to finance costs incurred as a result of climate change legislation or regulation, smart grid projects, smart meters, and renewable portfolio standards.

Structure

There are three key components in the structure of a utility securitization: (1) state legislation that authorizes the utility to finance the recovery of certain costs through the issuance of securitization bonds and contains a pledge that the state will not interfere with the utility’s right to recover from customers the amounts necessary to service the securitization bonds; (2) a financing order issued by the state utility commission pursuant to the state legislation which, among other things, creates the right to impose certain nonbypassable charges on utility customers in the utility’s service territory; and (3) a bankruptcy-

1. *See, e.g.*, December 2009 offerings by affiliates of two regulated utility subsidiaries of Allegheny Energy, Inc. of Senior Secured ROC Bonds, Environmental Control Series B, pursuant to a West Virginia statute.

2. *See, e.g.*, November 2009 offering by an affiliate of a regulated utility subsidiary of Entergy Corp. of Senior Secured Transition Bonds, pursuant to a Texas statute.

3. *See, e.g.*, June 2007 offering by an affiliate of a regulated utility subsidiary of Constellation Energy Group, Inc. of Rate Stabilization Bonds, pursuant to a Maryland statute.

remote, special-purpose entity, created by the utility, to issue the securitization bonds. The nonbypassable charges are collected from ratepayers and used to make payments when due on the securitization bonds. The state legislation specifically provides that the charges are subject to adjustment to ensure the collection of adequate funds to provide for timely payments on the securitization bonds. The financing order is generally irrevocable.

As a result of this strong legislative structure supporting utility securitizations, these bonds have historically been rated in the top categories by the rating agencies. In fact, despite concerns with securitizations in recent years given the problems in the mortgage-backed securities market, securitization bonds issued by special-purpose entity affiliates of utilities have not been impacted by the market disruptions of 2008/2009.

Benefits of Securitization

Securitization provides benefits for both the utility and its customers. For the utility, all costs are recovered upfront through the sale of the bonds, eliminating any recovery risk. In addition, this type of financing preserves credit metrics and lessens the pressure to issue additional equity. Even though the securitization will appear on the utility's consolidated balance sheet, rating agencies generally ignore the debt for credit analysis purposes because it is an obligation of the special-purpose entity issuer, not the utility. As noted, though, the utility loses the ability to include the investment in rate base and earn a regulated return on it.

At the same time, securitization results in lower costs to be recovered from customers, both because the higher credit ratings on securitization debt result in lower interest rates than traditional utility debt and because the investment is funded 100% by the securitization bonds and, therefore, the customer pays for only this debt cost, without the typical, more expensive equity component of a traditional rate base return. A reduced burden on customers for these investments may take pressure off other rate elements.

Securitization and New Initiatives

There are many international, federal, and state legislative and regulatory initiatives implemented or pending that attempt to measure, control, or limit the effects of global warming and overall climate change, including limitations on greenhouse gas emissions such as carbon dioxide. The adoption of current or future proposed legislation or related regulations by federal or state regulatory bodies such as the Environmental Protection Agency could have far-reaching and costly impacts on the utility industry. Such current or future legislation or regulation would likely require additional capital expenditures resulting in increased capital needs. Securitization should be considered as an alternative financing mechanism for capital costs incurred in connection with climate change initiatives.

Smart meters provide communication between the meters attached to ratepayers' homes and the energy providers and are intended to facilitate real-time pricing options; allow better monitoring for power outages; provide accurate, up-to-date meter readings; and control demand response systems. Smart meter projects being implemented across the country will also require significant financing. Securitization should be considered as an alternative financing mechanism for costs incurred in connection with smart meters and related smart grid infrastructure projects.

As of July 2009, 30 states and the District of Columbia had adopted renewable portfolio standards (RPS).⁴ Renewable portfolio standards set deadlines by which utilities must acquire a certain percentage of their power supply from renewable sources, such as wind, solar, geothermal, biomass and hydro-electric sources. Achieving compliance with applicable renewable portfolio standards is expected to be costly for utilities and, therefore, for ratepayers. In October 2009, the Staff of the New York State Department of Public Service (the Staff) issued a report summarizing the results of the state’s renewable portfolio standards program so far.⁵ In that report, the Staff stated, “Recognizing that the overall costs associated with RPS are large and that price suppression does not fully offset these costs, it is important to control the costs and minimize the bill impacts of RPS. The use of hedges, variable or capped bids and/or legislated securitization to fund RPS (or perhaps an even broader clean energy charge) are all possibilities that [this Report] recommends be analyzed by Staff and NYSERDA in the near future.”⁶

Conclusion

With pending legislation to address the effects of climate change on the horizon, the development of the smart grid, and the passage of renewable portfolio standards in the majority of states, the utility industry will soon require even more access to capital. Addressing climate change, developing the smart grid, and complying with renewable portfolio standards will be costly. Finding innovative ways to finance these expenditures will be crucial to the success of these initiatives. Securitization is a proven, low-cost financing technique that should be considered, along with other alternatives, as utilities face ever-increasing capital needs. It may be possible to combine securitization with more traditional financing techniques, allowing utilities to earn a rate of return on a portion of their costs, while financing the other portion through securitization.

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4. Edison Electric Institute, *see* Database of State Incentives for Renewables and Efficiency, *available at* <http://www.dsireusa.org/>.

5. N.Y. State Dept. of Public Service Staff, *The Renewable Portfolio Standard: Mid Course Report*, October 26, 2009.

6. *Id.* at 8.

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