Illuminating the Opportunities in Rate Reduction Bonds

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Takeaway

Rate reduction bonds ("RRBs") are securitization instruments issued by utilities, with increasing popularity since the mid-2000s. RRBs have features benefiting utilities and credit investors alike, and our findings show these bonds have produced better risk-adjusted returns than a number of similarly rated as well as lower rated areas of the investment grade fixed income universe.

Background

Traditionally, utilities have a monopoly in their service area. In exchange for this advantage, state regulators set prices high enough to recover their costs and earn a reasonable rate of return. In 1992, the National Energy Policy Act allowed for private market competition and a series of events in the ensuing years led to deregulation[1]. Several states restructured electric generation markets in an effort to lower energy prices for customers. An order issued by the Federal Energy Regulatory Commission in 1996 sought more compromises, and states passed legislation forcing some regulated utilities to divest generation assets before their costs were fully recovered (e.g., separate T&D business from power plants). This resulted in "stranded assets" and "stranded costs" because the market value was less than book value. Moreover, the property could no longer earn a return because it had to be removed from the utility's rate base[2]. States allowed utilities to recoup stranded costs by issuing securitized debt. Securitization provided lower borrowing costs than issuing corporate debt or equity.

The market for this securitized debt is evolving due to the frequency and severity of natural disasters, significant investments to transition to cleaner sources of generation, and higher energy prices straining balance sheets and pressuring affordability for its ratepayers. In recent years, securitization has been used to fund energy conservation programs, environmental control facilities, electric power purchase costs, storm damages, and even refinancing bankruptcy-related regulatory assets[3,4]. There have been 25 securitization deals between 2018 and mid-2023 to recover storm damage costs, according to Structured Finance Association[5].

The common approach to recovering costs is through a rate case with state utility commissions. If approved, it can take several years to recoup costs because rate increases are usually modest. According to the U.S. Energy Information Administration, electricity prices increased approximately 2.4% annually between 1997 and 2022 or 2.9% since 1960[4].

Ratepayer and Servicer Benefits

The ability to securitize cash flows and transfer the property to a special purpose entity ("SPE") not only provides an immediate cash infusion to the utility (i.e., servicer in these transactions), but can lower the cost of capital which benefits ratepayers and shareholders while improving its own financial health. To reiterate, it can take years for utilities to recoup costs because regulators review proposed increases at subsequent rate cases. For some projects, utilities can only recover costs once a project is complete, and there have been instances were cost recoveries were denied.

RRBs are a form of off-balance sheet financing that take the place of conventional debt and equity funding. Cost reductions are achieved through various legal/credit enhancements, allowing RRBs to receive the highest rating from nationally recognized statistical rating organizations ("NRSROs"). For comparison, utilities traditionally issue debentures in the corporate bond market, where the average rating on these instruments is A-/BBB+ or 6-7 notches lower than RRBs. We reference the Bloomberg Investment Grade Electric Bond Index, which is comprised of corporate debt. According to an Energy Innovation report from 2020, securitized bonds provided the lowest average cost to customers at 3.5%, compared to 5.5% for corporate debt financing and 9.5% returns to utility shareholders[6]. Ratepayer savings can vary but tend to be greater if their utility has a higher level of equity in its capital structure – average mix was 60% debt and 40% equity in 2023[7].

Another benefit of securitization is that the bonds are non-recourse debt to the utility. Default and bankruptcy risks are transferred to the issuer through the SPE which protects the servicer's credit quality. The utility sells the securitized asset, known as the property right, to the SPE via a true sale transaction. Securitization property can either be a tangible asset such as a power plant or intangible asset such as the right to a particular revenue stream.

Those in favor of securitization say it protects equity holders from dilution and bondholders from the politics of larger rate base increases[8]. Moreover, financing costs tend to be lower because RRBs can earn AAA ratings. It's prudent for regulators and servicers to limit the impact on ratepayers by choosing economical sources to fund projects, and state legislation can obligate the commission to seek the lowest possible costs.

Credit Investor Benefits

Up to this point, RRBs may not sound alluring to credit investors, but there are several features we find attractive. The three major components of RRBs are state legislation, the financing order, and the true-up mechanism. State legislatures must first pass a law authorizing utilities to finance the recovery of certain costs through securitization bonds. Since 1997, 27 states as well as Washington D.C. and Puerto Rico have enacted securitization laws/statutes, and 21 states have issued securitized debt[5,9]. The legislation authorizes the creation of a property right, enabling servicers and issuers to collect charges from customers to repay the bonds. Bondholders receive protection through a non-impairment pledge or state pledge. In the prospectuses we've analyzed, states and their agencies agree not to alter or limit the provisions set forth to servicers, impair the value of securitization property until all bonds and associated costs are paid in full, nor impair the rights and remedies of bondholders.

The second critical feature is the financing order, which has multiple attributes that are bondholder-friendly. Financing orders are authorized by securitization statutes and issued by state utility commissions. In the deals we've reviewed, state legislatures issued irrevocable financing orders, which are final and non-appealable, giving servicers the right to impose non-bypassable charges on all existing and future customers. Non-bypassable simply means that all retail customers, with a few exceptions, are required to pay the full charge on a regular basis (i.e., monthly). Customers cannot avoid paying the surcharge by switching service providers or through self-generation[3].

Securitization laws and financing orders mandate servicers to adjust rates to ensure that revenues are sufficient for timely debt service payments. This process is known as the true-up mechanism. True-up adjustments are uncapped, and servicers are authorized to make interim changes at any time. Servicers are required to file reports with state utility commissions, at least annually, to ensure cash flows will satisfy debt service payments.

Establishing the SPE also benefits credit investors because it forms a bankruptcy-remote entity to isolate from the servicer. In the event a servicer files for bankruptcy protection, the securitization property should be protected if the transfer from the utility to the SPE was completed as a true sale. This is because the property is no longer an asset of the utility nor part of its estate. A true sale is a legal and accounting concept that documents the transfer of securitization property as a sales transaction, not a financing arrangement (i.e., a loan). The bankruptcy remoteness of utility securitization deals is stronger than that of purely corporate asset-backed securities because 1) the right to impose a surcharge on ratepayers is irrevocable, 2) a surcharge cannot be altered or impaired by the state, 3) it includes a true-up adjustment mechanism, and 4) it is not affected if the servicer becomes bankrupt (*see the PG&E case study below*).

A simple and perhaps obvious attraction to these bonds is the high likelihood that customers are going to pay their electricity bills each month – demand is inelastic. Electric utilities provide an essential service, and electricity is a fundamental need.

Many advisors invest in conventional corporate debt given the essential service utilities provide, their monopolistic advantages, and large service areas. However, the average quality of the sector has weakened a bit due to substantial capital spending programs aimed at addressing environmental concerns. These concerns include reducing greenhouse gas emissions and hardening assets in light of the increased frequency and severity of natural disasters. Utilities are prioritizing corporate debt to fund their investments, but this has weighed on important financial metrics to the rating agencies, such as FFO/debt, triggering credit downgrades. S&P reported that downgrades outpaced upgrades for four consecutive years from 2019-2022, and the median rating for the industry fell to BBB+ from A- [10]. RRBs are another way to invest in the sector while maintaining a higher average quality.

Bankruptcy Case Study

In 1997, Pacific Gas & Electric Company ("PG&E") issued $2.9 billion in securitization bonds to recover stranded asset costs. When PG&E filed for bankruptcy in April 2001, both PG&E and the bankruptcy court respected the true sale to the SPE, isolating the securitization assets from the bankruptcy estate. PG&E remained the servicer on the RRBs and continued to collect and remit the securitization payments. In 2005, PG&E issued more securitization bonds to reduce uncertainty pertaining to the recovery time for an asset that was created as part of its bankruptcy.

In January 2019, PG&E filed for bankruptcy again after being found guilty of starting deadly wildfires in California two years prior. As fire liabilities mounted, PG&E issued more securitization debt in 2021 and 2022 to recover the costs. To date, there have been no interruptions in collections or remittances to securitization debtholders. Throughout the company's bankruptcy filings, Moody's maintained AAA ratings on the RRBs, and its outstanding securitization bonds remain AAA-rated to this day.

Limitations on Securitization

Even though RRBs provide timely recovery of costs for the utility and can lower charges imposed on ratepayers, the economic benefit of issuing securitized debt has limitations. There's still a cost passed along to retail customers; thus, affordability is a critical factor to state utility commissions and requests may be revised or even rejected. Additionally, rating agencies require that imposed charges remain below 20% of the bundled rate in order to earn AAA ratings[3]. Although securitized debt is technically off-balance sheet and non-recourse to the utility, rating agencies still account for the bonds when computing leverage metrics.

When securitization is used to recover stranded asset costs, it lowers the utility's future earnings and cash flow generation because the asset is no longer included in the rate base.

Investment Risks

Investors need to be aware of the risks associated with RRBs. One risk is legal challenges to securitization statutes in order to weaken the protections afforded to bondholders. However, state pledges and financing orders set a high bar for success. Some states with laws similar to securitization statues have been challenged in the past, but no challenges succeeded. Nevertheless, future challenges could be made. One bond prospectus we reviewed highlighted a bankruptcy case for LTV Steel Company, Inc. The company had previously entered into financing arrangements with respect to its inventory and accounts receivables. The court issued an interim order that LTV Steel Company (the debtor) may have "at least some equitable interest in the inventory and receivables, and that this interest is property of the Debtor's estate". Ultimately, the company and investors settled their dispute, and the court issued a final order declaring the arrangements to be true sales.

Events such as unfavorable weather patterns, natural disasters, attacks on infrastructure, or economic downturns could delay debt service payments, although, the true-up mechanism allows for timely adjustments to rates. Another risk is the limited market for the securitization property where the underlying asset is merely the right to receive revenues collected by a utility. Other risks include servicers having limited experience with property securitization, but this is offset by utilities having decades of experience forecasting, implementing, and collecting charges from customers.

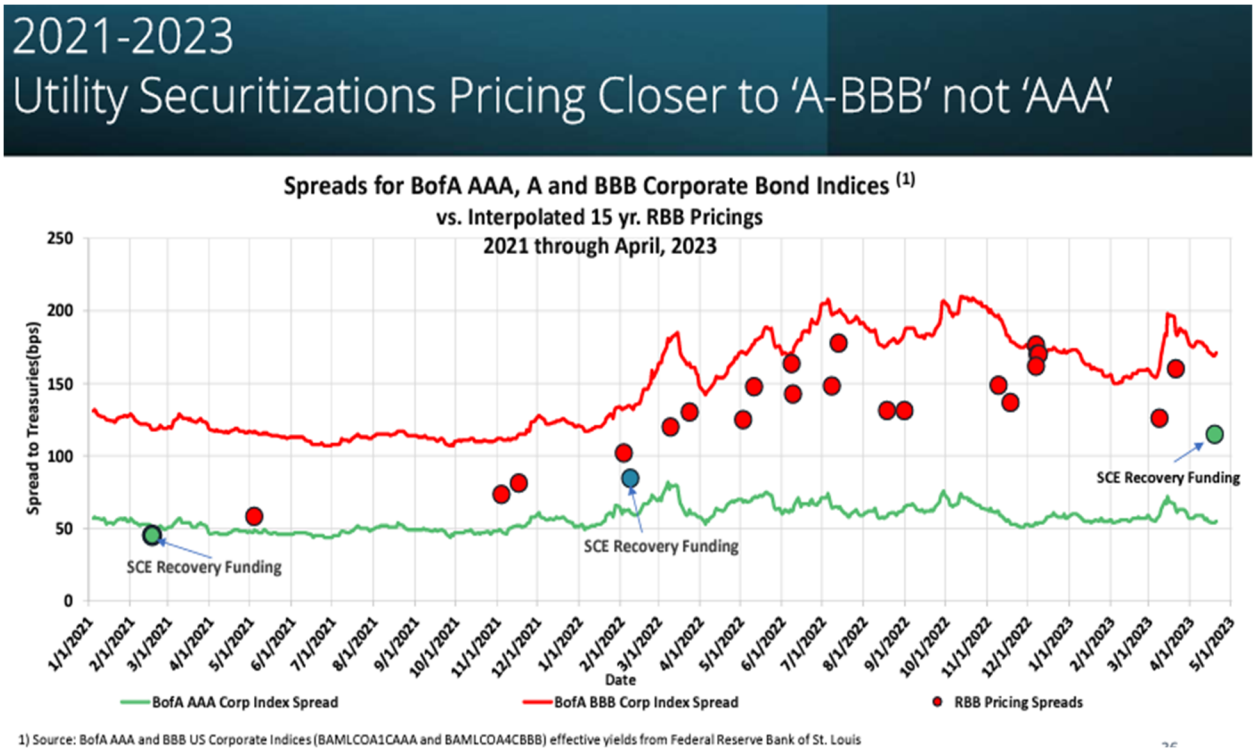
Ratings

Moody's has assigned AAA ratings to every securitization bond offering it has reviewed except for the Entergy New Orleans LLC's ("ENO") 2015 securitized deal. ENO's issuance earned a rating one notch below the typical securitization bond due to its small ratepayer base and continued risk of severe hurricanes[11]. S&P has reviewed 190 securitization bond tranches, and all were assigned AAA ratings[5].

Valuations[12]

Securitization bond spreads have risen in recent years, and one explanation for this may be a function of rating trends for the industry. There have been four consecutive years of downgrades outpacing upgrades, causing the average quality for conventional debt to fall to BBB+[13]. Securitization bond structures are more complex than conventional corporate debt issued by utilities, and Saber Partners suggests investor education is needed on this "unique" securitization on an "essential commodity." Saber Partners also pointed to varying opinions on relative value when underwriters price securitization bonds because AAA-rated securities have a wide range of spread levels (e.g., corporates, mortgage-backed securities, U.S. agencies, municipals).

The first chart on the next page compares AAA-rated and BBB-rated corporate bond spreads to RRBs when they were issued. Despite their AAA ratings and legal protections, RRBs often priced closer to single-A and BBB-rated corporate bonds.



We also compared historical excess returns of the Bloomberg Stranded Cost Utilities Index to other indices to assess performance consistency over time. The excess return measures performance relative to duration-matched Treasuries. When returns were negative, investors were better off owning Treasuries. We purposely used long time horizons to capture full economic cycles and a typical investment horizon of our clients. When possible, we selected an intermediate maturity profile (e.g., 1-10 years) to better align returns between the Stranded Cost Utilities Index and the comparable index.

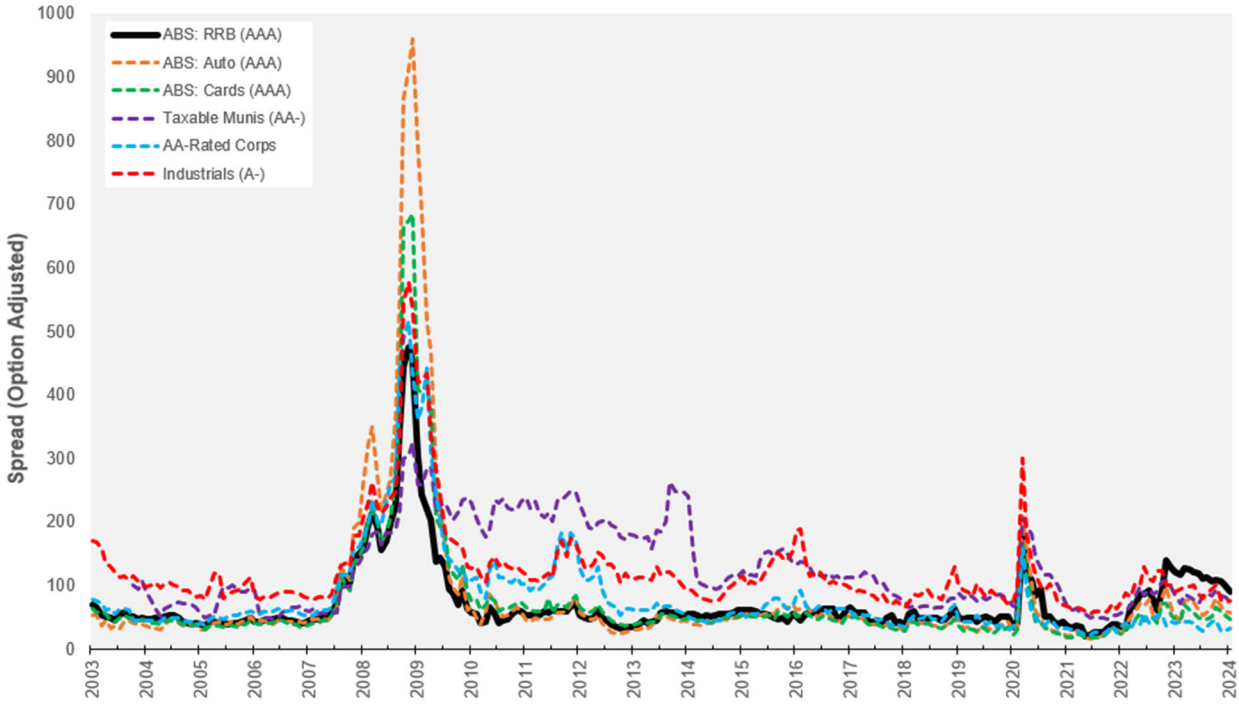
Our findings show that RRBs have produced better annualized returns and lower volatility than a number of similarly rated as well as lower rated areas of the investment grade fixed income universe. These include AAA-rated automotive and credit card asset-backed securities, AA-rated corporate bonds, and even high grade industrial corporate bonds where the index quality is rated 6-7 notches lower, with an average rating of A-/BBB+.

ABS - Automotive (AAA) Annualized Return: 0.71% Annualized Volatility: 4.59% Performance Consistency: 0.15	ABS - Credit Cards (AAA) Annualized Return: 0.65% Annualized Volatility: 5.70% Performance Consistency: 0.11	Intermediate Corps: AA-Rated Annualized Return: 0.54% Annualized Volatility: 3.51% Performance Consistency: 0.16	Intermediate Corps: Industrials Annualized Return: 0.76% Annualized Volatility: 5.19% Performance Consistency: 0.15
ABS - Utilities, Cost Recovery Annualized Return: 0.79% Annualized Volatility: 3.94% Performance Consistency: 0.20	ABS - Utilities, Cost Recovery Annualized Return: 0.93% Annualized Volatility: 3.91% Performance Consistency: 0.24	ABS - Utilities, Cost Recovery Annualized Return: 0.97% Annualized Volatility: 3.99% Performance Consistency: 0.24	ABS - Utilities, Cost Recovery Annualized Return: 0.85% Annualized Volatility: 3.78% Performance Consistency: 0.22

Note: computed from annual returns since at least 2001, and as early as 1998 depending on inception dates, through Dec 2023

Finally, the chart below looks at historical spreads for RRBs and other areas of the fixed income universe. Again, we chose the intermediate index for corporates and municipals to better align with the average maturity of the RRB Index. In risk-off environments, RRBs have widened less than other major asset-backed bond indices as well as investment grade corporates. Taxable municipal bonds widened less than RRBs during the financial crisis, but RRB spreads were often more contained in risk-off periods.

Historical Spread Trends Across Various Asset Classes and/or Sectors



Sources: Bloomberg, WEDGE Capital Management

Note: The RRB spread jumped in late 2022 because of new, long dated bonds entering the index; using intermediate indices, when available, to ensure duration profiles are similar across asset classes

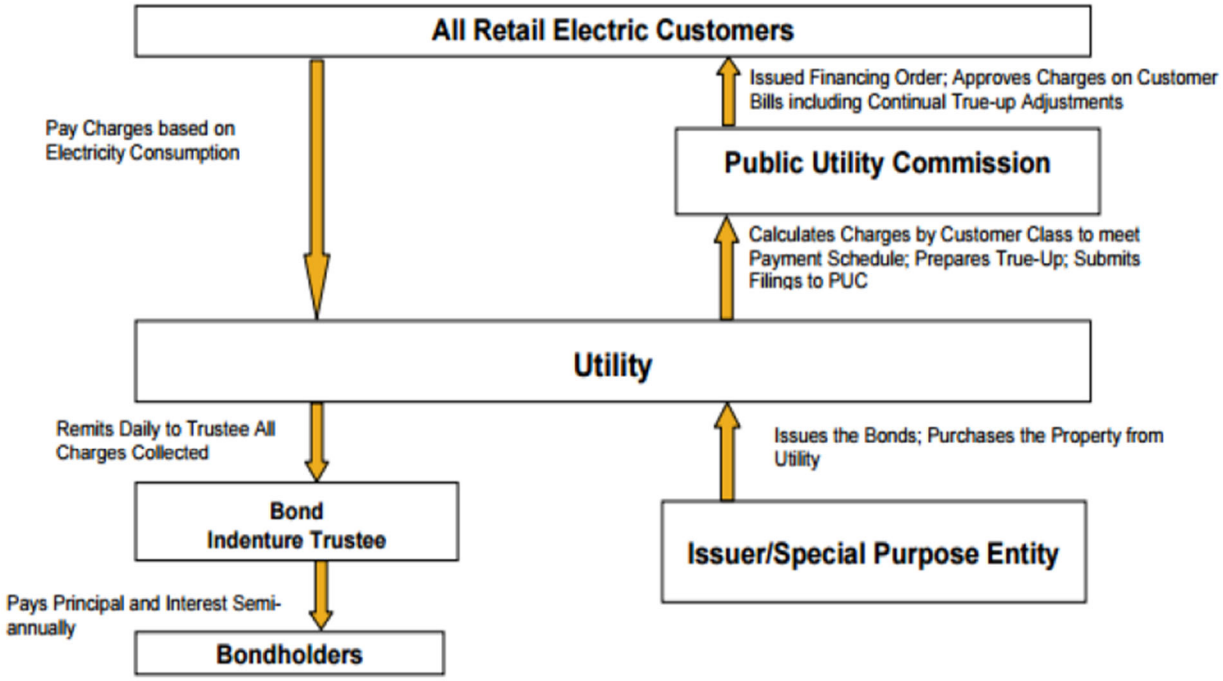
The information presented above is based on the following indices: Bloomberg ABS Stranded Cost Utilities Total Return Unhedged USD, Bloomberg US ABS Auto Aaa Total Return Index Unhedged USD, Bloomberg ABS Credit Card AAA TR Index, Bloomberg US Intermediate Corporate Aa Total Return Unhedged USD, Bloomberg Invest Grade Industrial Interm Total Return Unhedged USD, Bloomberg Intermediate Taxable Municipal: US Agg Eligible TR Unh USD

Conclusion

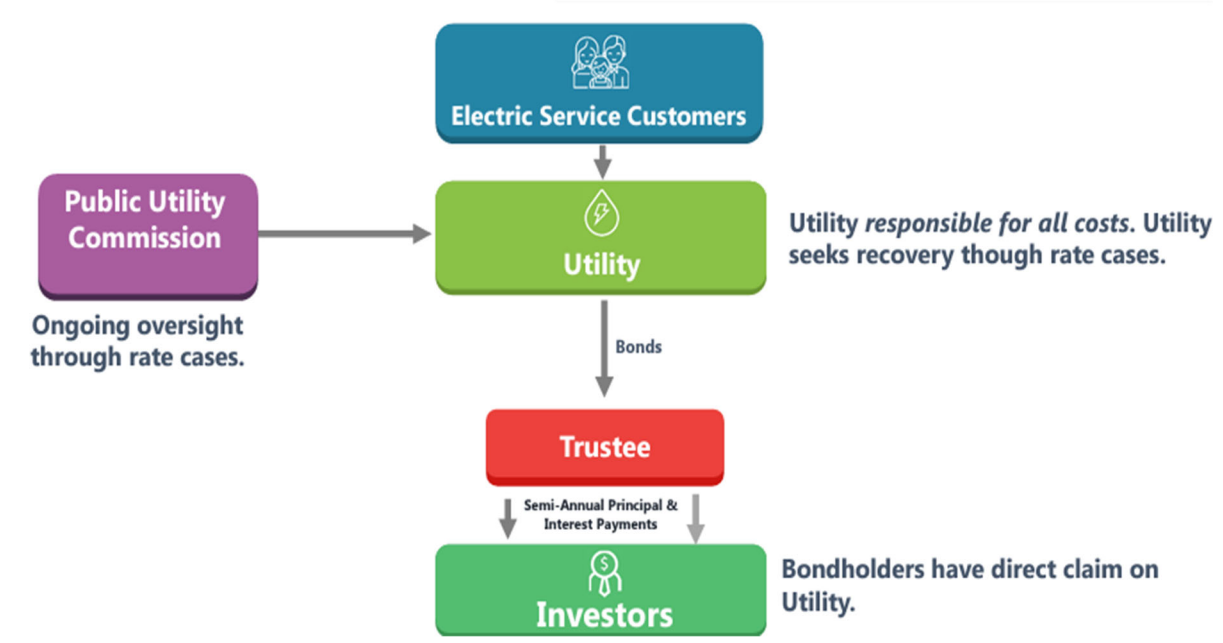
Rate reduction bonds have features that benefit both utilities and bondholders. For bondholders, irrevocable financing orders and true-up mechanisms are key provisions that distinguish RRBs from corporate asset-backed securities. Furthermore, PG&E's two bankruptcy filings demonstrate that servicer challenges have not interrupted payments to securitized bondholders. In terms of performance, RRBs have generated higher risk-adjusted returns than similarly rated asset-backed securities and conventional corporate debt. Taken together, these attributes are reasons to consider RRBs as part of a diversified portfolio of high-quality investment securities.

Appendix

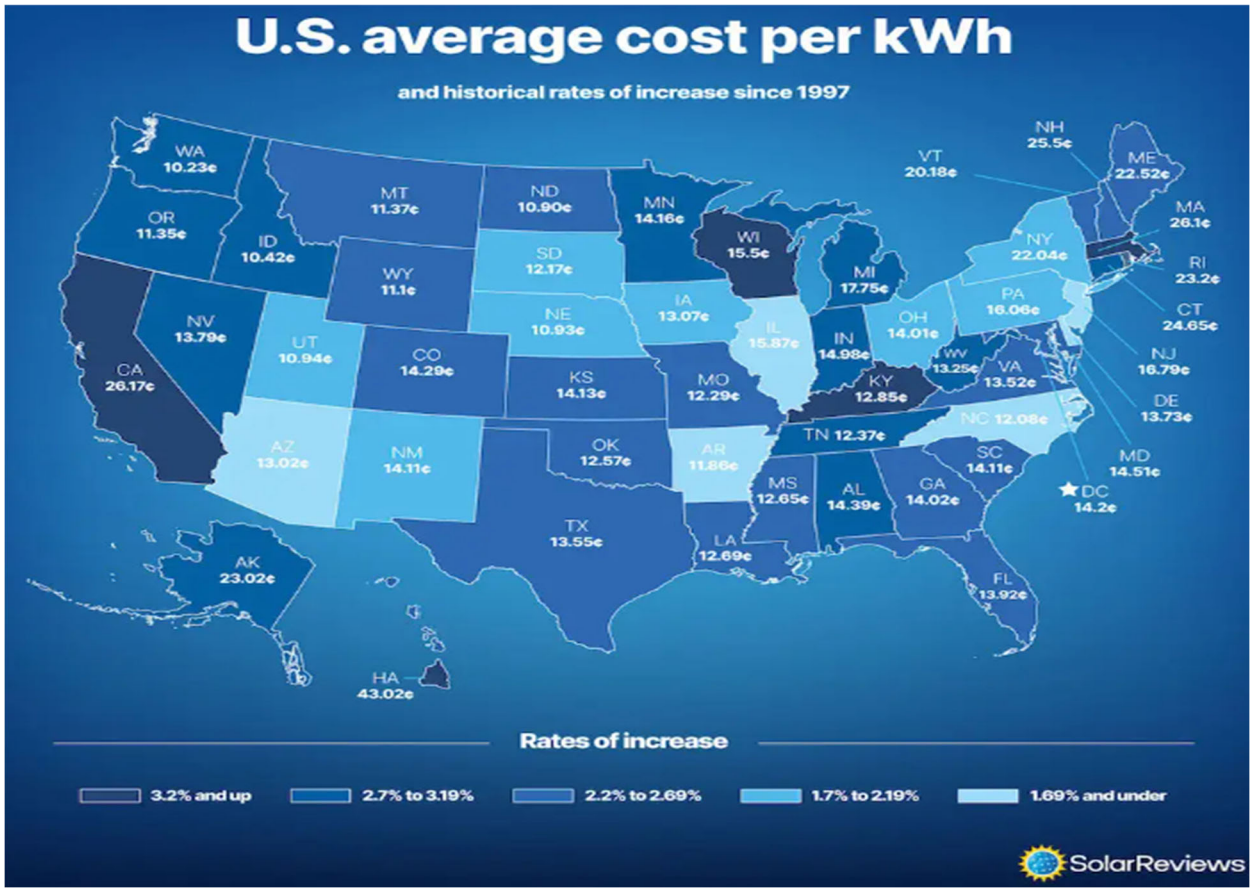
Flow of Funds – Typical RRB Structure (more complex than traditional utility bond issuance)[3]



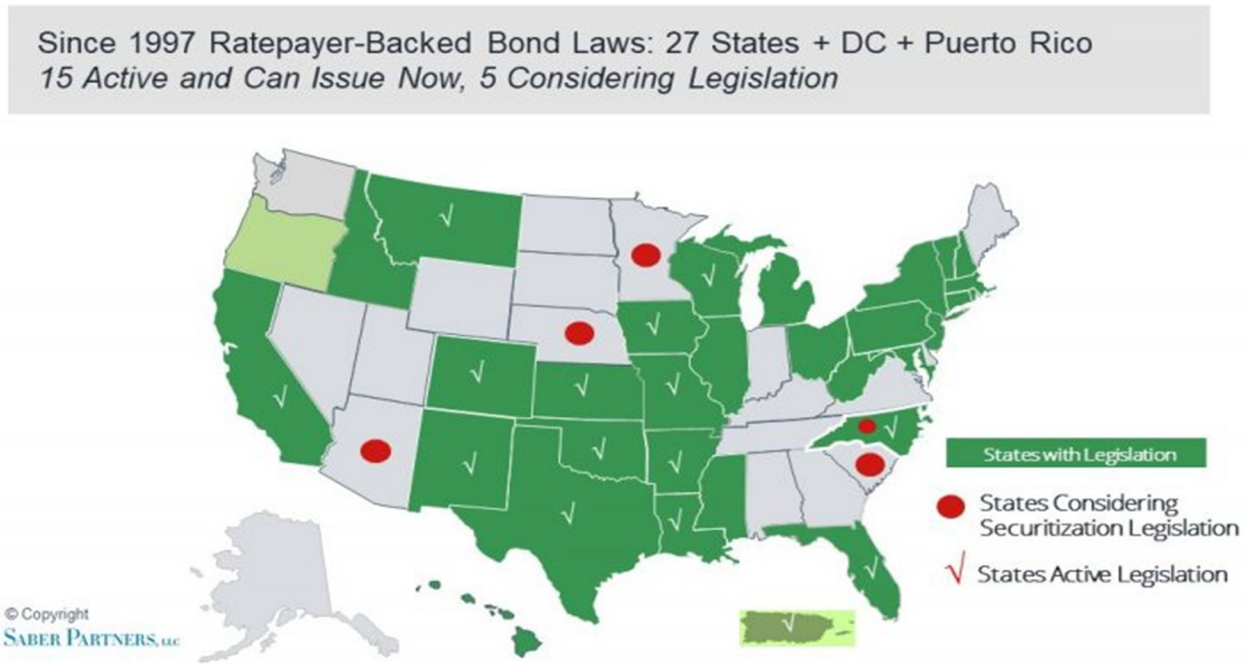
Flow of Funds – Traditional Utility Bond Structure[14]



Electricity Price Changes by State[15]

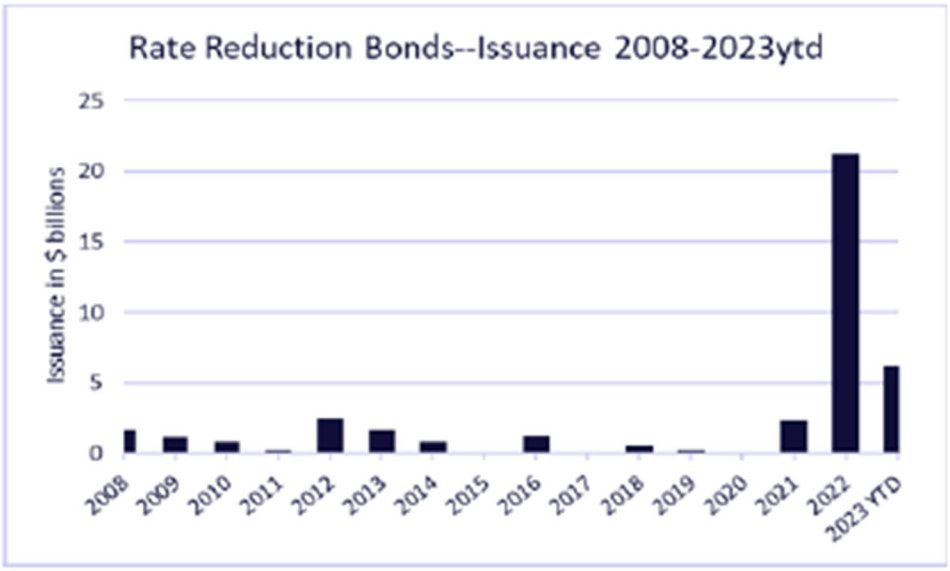


Utility Securitization Map[9] – June 2021



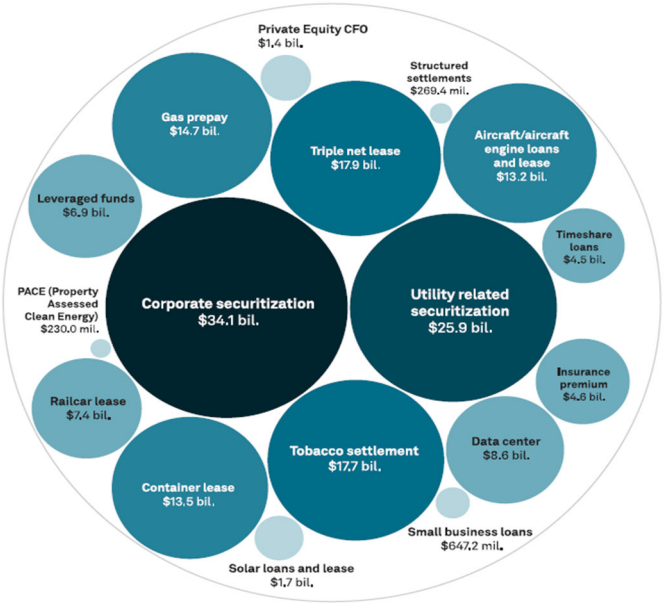
21 States Where RRB Securitizations Have Been Issued 1997-2022 (By Purpose)			
Disposing of Stranded Costs	Retiring Nuclear/Coal Plants or Clean Energy Investments	Storm Damage and Wildfire Costs	Deferred Balances*/Other
California, Montana, Illinois, Pennsylvania, Massachusetts, Michigan, Texas, New Jersey, Louisiana, New Hampshire	Wisconsin, West Virginia, Florida, Michigan, Indiana	Texas, Louisiana, Kansas, Oklahoma, Arkansas, North Carolina, and Florida	New Jersey, Maryland, Ohio, West Virginia

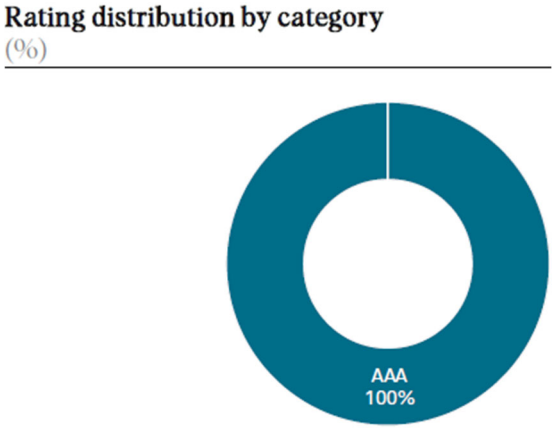
Source: Structured Finance Association, "Rate Reduction Bonds", August 2023[5]



Source: Structured Finance Association, "Rate Reduction Bonds", August 2023[5]

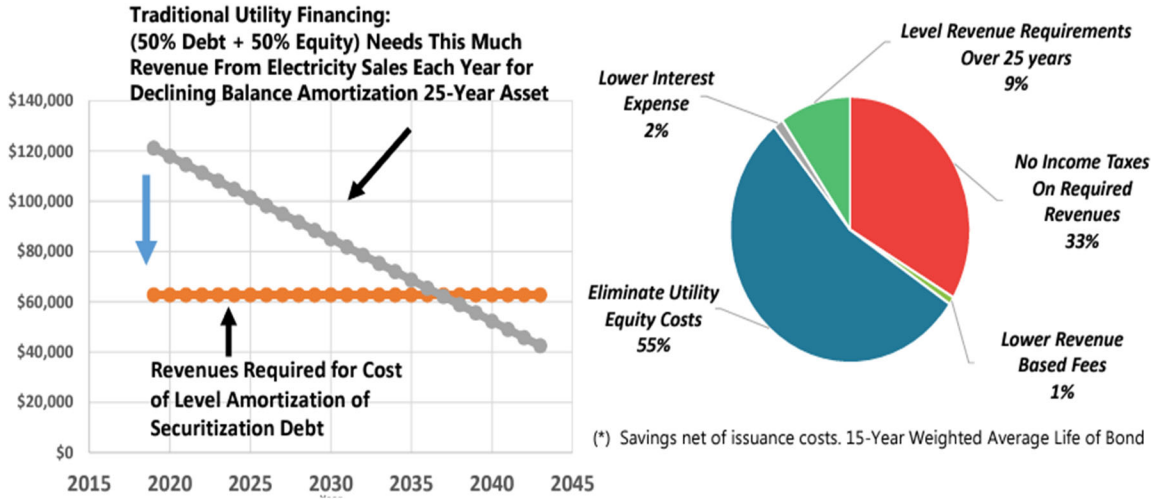
S&P: Non-Traditional ABS, Current Outstanding Balance by Sector (as of March 31, 2023)[16]





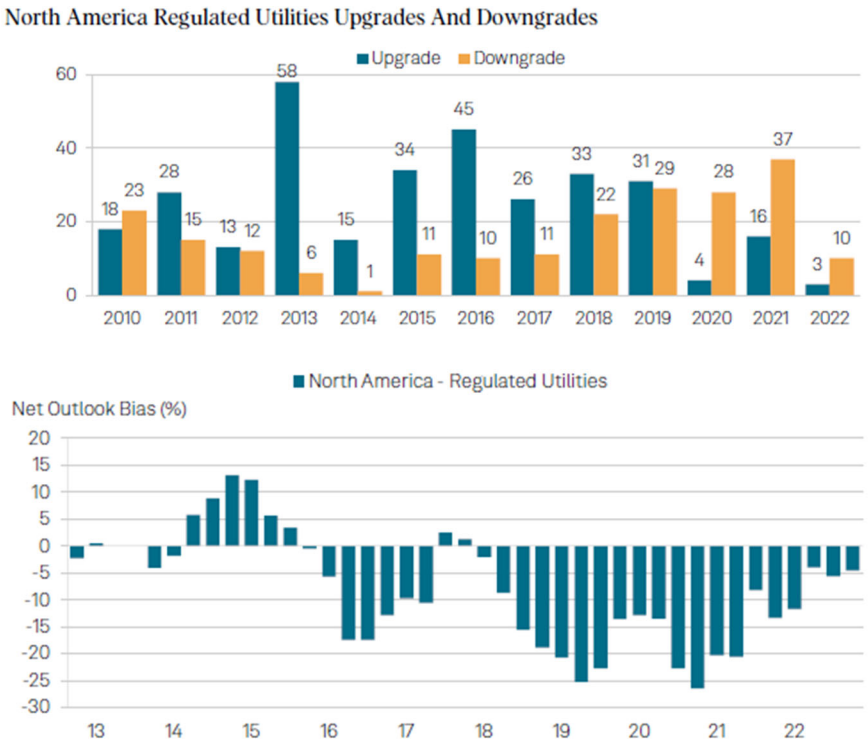
Source: S&P Global, May 2023

Sources of Utility Securitization Ratepayer NPV Savings[14]

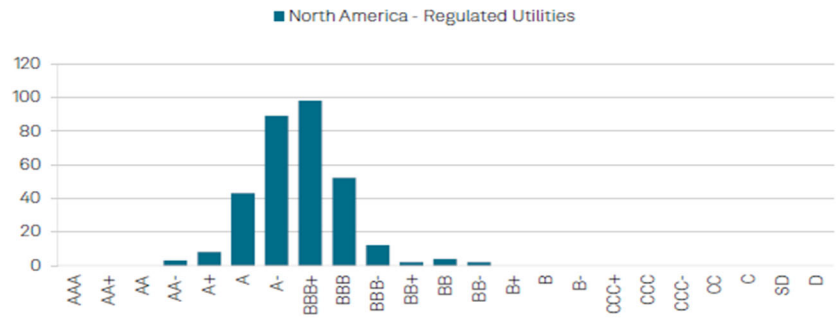


Source: Saber Partners

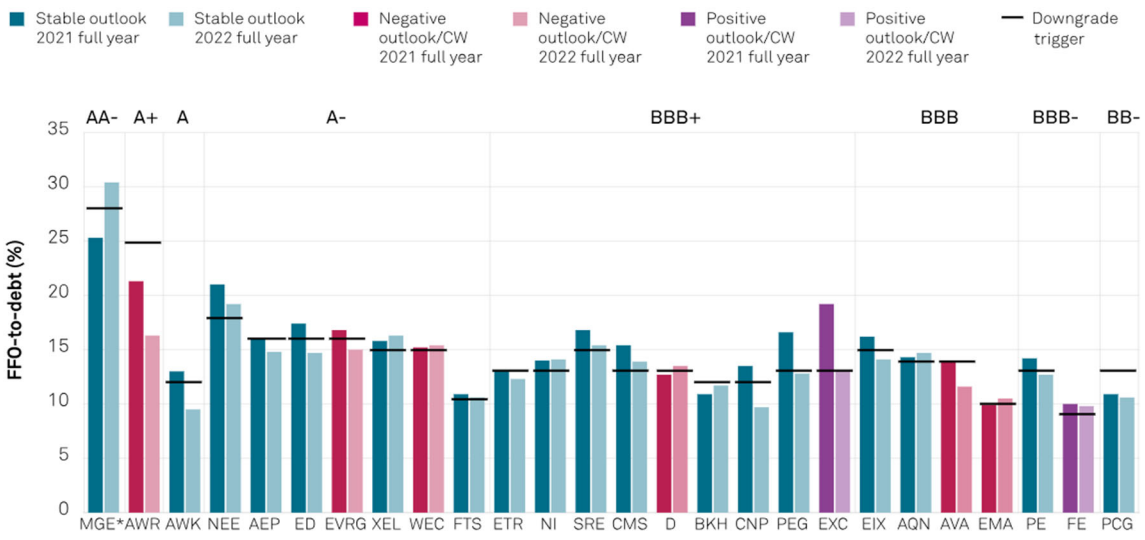
Rating Statistics – S&P[13]



Ratings distribution

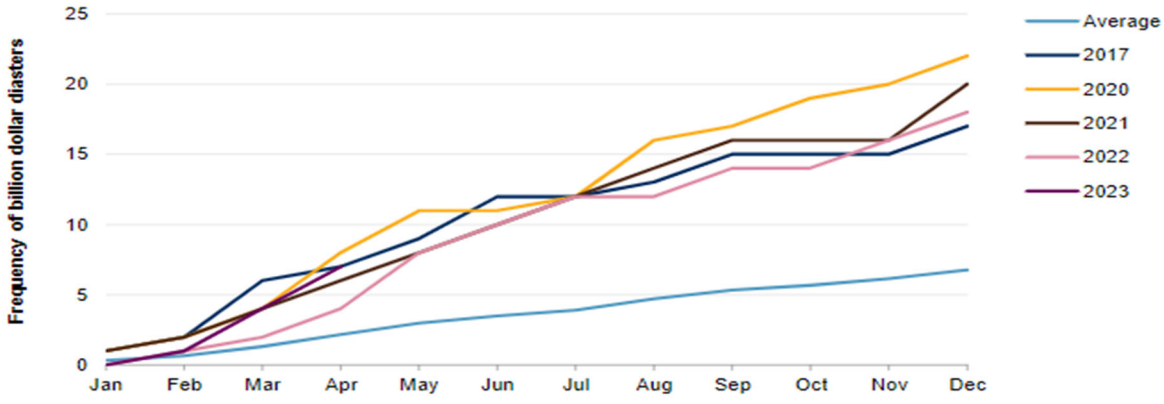


Minimal Financial Cushion[13]



*MGEE (MGE Energy Inc) is parent company of Madison Gas & Electric, this rating relates to Madison Gas & Electric.
As of May 15, 2023. Source: S&P Global Ratings.

Frequency of U.S. weather disasters > $ 1 billion[12]



Average is 1980-2023. Source: National Oceanic and Atmospheric Administration.

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10. S&P, "North America Regulated Utilities – The Industry's Outlook Remains Negative", January 2023
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Links

https://saberpartners.com/roc-map/

https://saberpartners.com/list-of-investor-owned-utility-securitization-rocrrb-bond-transactions-1997-present/

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