IssuesLetter

Securitization:
In Search of the Proverbial Free Lunch

Securitization is a new concept for most involved in regulated electric utilities. It has appeared in the last year in state restructuring legislation adopted in California, Pennsylvania and Montana as a mechanism to deal with utilities' stranded (uneconomic) cost and, perhaps, to lower rates. Other state legislatures have also received securitization proposals from their utilities. As presented, securitization would allow utilities to receive full or partial stranded cost recovery by being paid off, up-front with a lump sum cash payment. Sometimes called "transition bonds," securitization involves issuing a debt instrument in which payback comes from future revenues generated by the electric utility.

Securitization is not a free lunch. For customers, its overall benefits are marginal at best. Perhaps its greatest potential is as a mechanism to protect stockholders' interests as part of a larger package which benefits customers in other ways. This *Issuesletter* provides an overview of securitization and presents some issues that require attention when evaluating securitization proposals.

Q: What is securitization?

A: Securitization proposals are a permutation of asset-backed securities (ABS). The ABS market has developed rapidly over the past few years largely to service the credit card and automobile loan industries. The operating principle is that a firm packages loans it has issued and sells them on the bond market. Generally, the firm continues to service the loan and act as agent by collecting payments and forwarding them to the security holders. This concept is similar to the common practice of reselling home mortgages on the secondary market.

Over the past five years, the market for asset-backed securities has expanded rapidly. In 1996, asset-backed securities totaling almost $150 billion were issued. Of these, about three quarters were for credit card, auto and home equity loans.

Q: How would a utility securitization bond differ from other common types of asset-backed securities?

A: Electric utilities are not in the business of making loans and as a result do not have a large portfolio of customer loans to sell off in the financial markets. Instead, the idea is to earmark some portion of the utilities' future revenues to support an ABS. For example, a utility might designate its first $100 million per year in revenues over the next ten years as the asset it wishes to sell off. If the market interest rate for such an offering were seven percent, this future cash stream would be worth approximately $700 million to investors. After issuing the loan, the first $100 million per year in revenues would go to an independent trust which, in turn, would make principal and interest payments.

Q: Would a securitization bond carry a relatively low interest rate?

A: Depending upon the "credit enhancement" features built into the bond, securitization could carry a low interest rate. On the other hand, without some form of "credit enhancement," it might be impossible to issue securitization bonds at all.

Q: What forms of "credit enhancement" would be necessary?

A: Utility securitization "credit enhancements" generally require legislation to provide a high level of security to lenders. This legislation creates an intangible property right -- the right to the portion of the utility's future revenue that is designated to pay principal and interest on the loan. In addition, the legislation typically requires that the state PUC issue a qualified rate order (QRO) -- a statement saying that the appropriate portion of revenue will be allowed in rates and dedicated to debt service. There is generally language barring a PUC from withdrawing or substantially modifying a QRO once it is issued, as well as language which attempts to influence, if not bind, future legislatures from enacting changes to the statute which would materially harm the interest of creditors. Finally, there is often a legislative attempt to "bankruptcy proof" the revenues supporting the bonds so those supporting securitization will not be available to other creditors should there be a bankruptcy proceeding.

Q: What is the relationship between securitization and stranded costs?

A: There are many ways securitization financing could be structured. A simple way is to pledge some amount of future revenues and use that as the asset to be securitized. More commonly, utilities have proposed the revenue stream associated with stranded cost recovery be converted to an intangible asset and used as the basis for the loan. Presumably, this approach is attractive to utilities because it effectively locks in stranded cost recovery and allows no further consideration as to whether these costs are properly recoverable. Once the revenues to pay for stranded costs are legally declared to be an "intangible property right," any future action to reduce those revenues could more easily be challenged as an unconstitutional "taking."

Thus, the effect of securitization is to substantially eliminate any future uncertainty about recoverability by shifting recoverable stranded costs from items that a utility has a reasonable opportunity to recover to items where recovery is practically guaranteed. No doubt, utilities' nervousness about stranded cost recovery has played a significant role in the decision to structure securitized offerings around stranded cost as opposed to other elements of the utilities' cost structure.

Securitization and Divestiture

Stranded costs are probably best measured by requiring the sale of generating assets and letting the market determine the value. Interested purchasers are not only in a much better position than regulators to determine the value of things, such as existing plant sites or the ability to enter a particular regional market but may in fact find additional value in features not immediately obvious to regulators. Market determinations of value can be wrong too, but the sale of generation assets will certainly include consideration of value that administrative determination has never attempted to quantify. Selling generation will also benefit customers by correcting market power problems. The downside of selling generation is that it amounts to a one-time determination of stranded cost. On balance, though, this drawback is more than offset by the benefits.

Securitization could complicate future efforts to divest assets. Even though securitized bondholders do not take a security interest in the physical assets of the utility, they become another party with an interest in major shifts in business activity, such as a sale of assets. For this reason alone it makes sense to divest first, then saturates stranded costs rather than the other way around.

Q: Does securitizing stranded cost create risks for utility customers?

A: Yes. Depending upon the specific situation, securitization can be extremely risky for consumers, particularly where a utility's stranded costs are primarily related to expensive, utility-owned generation or purchased power contracts. Customers may end up paying too much for costs that do not actually turn out to be stranded. Regulators need to compare securitization with other methods that allow for recovery of stranded costs.

If stranded cost recovery is allowed, the first step is to estimate the magnitude. In general, stranded costs are estimated as the difference between the accounting costs of a particular asset and the market price of the asset combined with the power the asset will produce over the remainder of its operating life. Estimating the future market price is difficult, and errors can have huge effects on the total stranded costs. Estimating the value of the power plant asset, including the value of the site, is equally difficult. For these reasons, it is generally desirable to avoid relying on a single point, administrative estimate of stranded costs made at the time of the transition to competition and make, instead, periodic adjustments to stranded cost estimates to reflect new information, particularly with regard to the market price of power.

Because securitization requires a one-time estimate of stranded costs, the ability to adjust for any errors in the future is, for the most part, eliminated. For example, suppose stranded costs for a utility were estimated at $1 billion, and $1 billion in securitization bonds were issued. If it turned out that electricity market prices were higher than forecasted and actual stranded costs were only $0.5 billion, stranded cost recovery would be reduced, and sufficient funds would not be collected to repay the securitization bonds.

This suggests that securitization amounts be limited to the lowest possible estimate of future stranded costs. Of course, it must be borne in mind that for many utilities, a one cent per kilowatt-hour error in estimating future market prices of power could reduce stranded costs to zero or result in negative stranded costs.

Securitization should be viewed in a positive light only where the benefits outweigh the risks and costs of a one-time determination. Combining securitization with divestiture or other initiatives which favor consumers is one way to help assure that benefits outweigh the risks.

Q: Does securitization create an obligation on the full faith and credit of the state?

A: Securitized bonds are not explicitly an obligation of the state. They are an obligation of the monopoly utility and its customers, backed up by a revenue stream guaranteed by state law. It is not clear what would happen if a future legislature changed or removed the law creating the revenue scheme. Because future legislatures cannot be bound by the acts of today's legislature, would bondholders have recourse against the state if it decided to repeal the law permitting securitization? The lack of legal precedent for securitized schemes which rely on state *guaranteed* revenue streams limits the ability to predict future liabilities for the state.

Certainly any state which chooses to use securitization would be well advised to seek the opinion of its Attorney General with regard to state liability.

Q: Proponents of securitization argue that securitization would produce substantial cost savings for ratepayers. Is this likely?

A: The short answer to is no. While the details differ from one proposal to another, proponents of securitization point to three ways for ratepayers to save money. The first is to use the securitization bonds as a mechanism to spread stranded cost payments over a longer period of time. This is much like reducing a home mortgage payment by refinancing an existing 15 year mortgage to a 30 year payoff. The effect is to reduce current payments by stretching out the repayment period and to increase total interest costs. While this may be desirable in some cases, lengthening the time span for cost recovery shifts costs in time but does not reduce these costs. If the repayment period stretches too long, concerns of inter-generational customer equity arise. It can be a means of simply pushing costs onto future ratepayers.

The second path relies on the expectation that securitized debt offerings will carry a lower interest rate than other, more traditional utility loans. There is potential for some savings here (although the precise magnitude of the savings must await at least the issuance of the first round of utility securitization bonds). But any savings from lower interest rates will be modest. For example, if securitization bonds carry an interest rate of one-half to one percent less than traditional utility bonds, the utility's rates are likely to be reduced by only a fraction of one percent.

Where securitization claims to provide substantial savings -- in the range of five to ten percent -- there is generally the assumption that such offerings would allow a utility to carry a more heavily debt-laden capital structure. Imagine a utility that carries a typical utility capital structure of 50 percent debt and 50 percent equity (ignoring preferred stock for the purposes of this discussion). If securitization allowed a portion of the utility's capital to be 100 percent debt financed by the securitization bond while the remaining capital of the utility continued to be supported by the traditional 50:50 equity to capital structure, there is a potential for significant cost savings.

These savings would occur as the overall capital structure of the utility (including the securitized portion) substituted debt for equity financing. First, debt costs are significantly less than the return which stockholders demand (for example, if debt costs seven percent, common stockholders might demand 11 percent return on their investment). In addition, the interest payments to debt holders are not taxable on utility's corporate income taxes, but returns to stockholders are taxable. If bondholders require seven percent interest, all a utility need do is collect seven percent. But to give stockholders 11 percent, the utility must collect 18 percent to pay income taxes and still have 11 percent available after taxes.

Q: Will financial markets accept this change of capital structure?

A: Securitization will not lower costs if future financial markets require a utility that has securitized to carry more equity and less debt on the remainder of its capital. This issue is closely analogous to the financial situation of utilities with substantial purchased power obligations. Here, the rating agencies have taken the view that the existence of large purchase power obligations are fixed-cost obligations to the utility, much like the utility's own debt. Because of them, utilities have been downgraded and/or required to carry higher amounts of common equity to compensate for these obligations. If the rating agencies adopt

the same view of utilities that have made substantial securitization offerings, the purported rate benefits of securitization will be reduced or eliminated.

Q: Could securitization have undesirable effects on the competitiveness of the generation market?

A: Yes. For restructuring to work, there needs to be reasonable competition among suppliers.

Already at the starting line, one supplier has effectively 100 percent of sales. The effect of securitization is to give this dominant player a large cash infusion just as the competitive game is beginning. It is possible that this large cash infusion could be used to further skew the market in favor of the incumbency. For example, were the incumbent to invest this cash in acquiring additional generation sources or in taking over neighboring companies, securitization might exacerbate existing market power problems. Of course, there may be other cash rich competitors waiting in the wings, but as with all restructuring decisions, it is critical for policy makers not to err on the side of creating market conditions that clearly advantage the existing utility or any other single supplier.

Securitization may also have the unintended effect of relieving the pressure restructuring creates to reduce costs and improve efficiencies. Many states have already benefitted from the belt tightening undertaken by their utilities in the face of potential competition.

Q: What experience have states had with securitization so far?

A: Historically, securitization had only been used by one electric utility, and then only for the limited purpose of financing some demand-side management expenditures. Puget Sound Power and Light Company used this device in the early 1990s when it securitized the revenue stream associated with approximately $200 million in demand-side management investments.

In May of this year, the Pennsylvania PUC approved the securitization of $1.098 billion of uneconomic costs for PECO from a requested $3.773 billion. This included $607 million of generating assets, $373 million of regulatory assets, $96 million of deferred fuel costs and $22 million in issuance and use of proceeds costs.

Conclusion

Not surprisingly, securitization does not come without a price. It may offer modest cost savings to ratepayers, but these cost savings do not come free. In the worst case, securitization could result in exposing customers to substantial new risks, far beyond those justified by fairly modest reductions in costs. Its potential advantage is to get the stranded cost issue behind us once a fair and reliable means of measuring stranded cost has been adopted. One effective policy combination would require the sale of generation assets to solve inherent market power problems and then, if desired, any remaining cost could be securitized.

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