

# SECURITIZATION AND STRANDED COST RECOVERY

by  
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## I. INTRODUCTION

Securitization is a financing tool which has been employed for many years to expand the availability and reduce the cost of consumer and business credit. Securitization achieves this purpose by obtaining funds from the securities markets by means of specially developed securities whose attributes are carefully shaped to minimize investment risk and thereby to obtain a high investment rating with corresponding reduced interest cost. Were a business or financial intermediary to raise these funds by issuing its own securities, the securities' investment risk and associated cost would typically be greater due to the business and financial risk of that business or intermediary. Such risks are avoided through securitization because return of and return on investors' capital is obtained from dedicated assets (thus the name "asset-backed securities") rather than the business fortunes of the securities' issuer.<sup>1</sup>

For the past two years, state legislators and Public Utility Commissions (PUCs) have debated whether this tool can effectively be employed to assist in the transition from a regulated to a competitive market for electricity. In 1996, two states, California and Pennsylvania, adopted legislation designed to make this tool available in their states. In May and June 1997, despite growing opposition to its use by certain electric market participants, two additional states, Montana and Rhode Island, enacted similar legislation.<sup>2</sup> Supporters of securitization argue that it is an "eloquent" solution to one of the more difficult problems (stranded cost recovery) of the transition from a regulated to a competitive electricity market and provides a solution which is "win-win" for both utilities and ratepayers. For the utility, it provides stranded cost recovery while preserving financial

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1. See Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J.L. BUS. & FIN. 133 (1994); Joan Barmat, *Securitization: An Overview*, in THE HANDBOOK OF ASSET-BACKED SECURITIES 3 (Jess Lederman ed., 1990)[hereinafter ASSET-BACKED SECURITIES].

2. See CAL. PUB. UTIL. CODE, § 840 (West Supp. 1997); 66 PA. CONS. STAT. ANN. §§ 2808, 2812 (West Supp. 1997); S.B. 390, 55th Leg., Reg. Sess. (Mont. 1997)(enacted); H.B. 7003, Gen. Ass., Reg. Sess. (R.I. 1997)(enacted). Also, in August 1997, California Senate Bill 477 was signed into law modifying the definitions of "special purpose trust," "transition property," and "financing entities" in the 1996 legislation to permit additional flexibility in transaction form, and to authorize and establish the terms of a consensual security interest. S.B. 477, Reg. Sess. (Cal. 1997).

integrity, while for the ratepayer it produces rate reductions from existing PUC-determined just and reasonable rates.<sup>3</sup>

Various published analyses, however, have expressed concern that the securitization process may be unfair to ratepayers and may create insurmountable competitive advantages for existing utilities in the new electric marketplace. Indeed, some opponents of securitization have termed it a "swindle" and refer to the proposed securities as "nuclear mistake bonds." They argue that, while providing ratepayers with only "minuscule" rate reductions, securitization provides utilities with legislatively guaranteed recovery of their stranded costs, which costs are by definition uneconomic and of little or no value to ratepayers. Opponents object to utilities' entitlement to recovery of stranded costs in the amounts proposed to be securitized and assert 1) that stranded costs cannot be accurately measured and the inaccuracy would both be confiscatory to ratepayers and injurious to utility competitors; 2) that the up-front capital infusion from stranded cost recovery provided by securitization permits utilities a substantial competitive advantage in the new marketplace; and 3) that securitization will, at a minimum, substantially delay ratepayer receipt of the benefits of competition and may actually increase, rather than decrease, ratepayer-borne costs.<sup>4</sup>

3. In Docket No. R-00973877 et al., the Pennsylvania P.U.C. authorized PECO Energy Company to issue \$1.1 billion of "transition" or "rate reduction" bonds, the names given to these securities by their authorizing legislation. See *Application of PECO Energy Company for Issuance of a Qualified Rate Order under Sections 2808 and 2812 of the Public Utility Code*, 177 Pub. Util. Rep. 4<sup>th</sup> 417 (Pa. P.U.C., May 22, 1997)[hereinafter PAPUC Order]. In Docket No. R-00973953, PECO's electric restructuring case under the Pennsylvania statute, as part of a settlement of the contested issues of that case, PECO Energy is proposed to be granted the authority to securitize \$4 billion of its claimed \$7.5 billion stranded costs (i.e. inclusive of the \$1.1 billion described above), but only after writing off \$2 billion of such costs. See *Joint Petition for Partial Settlement of PECO Energy Company's Proposed Restructuring Plan and Application for a Qualified Rate Order*, Docket No. R-00973953 (Pa. P.U.C., August 26, 1997). The three largest California utilities filed applications on May 6, 1997, for authority to issue \$7.4 billion of rate reduction bonds to securitize a portion of their claimed stranded costs in excess of \$28 billion. The California P.U.C. has approved issuance of the bonds, noting that they are expected to produce net present value savings for ratepayers of up to \$970 million over their approximate ten year maturity. See *Application of Pacific Gas & Electric Co./Southern California Edison Co./San Diego Gas & Electric Co. For Authority to Reduce Rates Effective January 1998 etc.*, Application Dockets A9705006, A9705018 & A9705022, Interim Order-Decision No. 97-09-054, Financing Orders-Decision Nos. 97-09-055, 97-09-056 & 97-09-057 (Ca. P.U.C., September 3, 1997). Issuance of the California bonds is expected to begin in the fourth quarter of 1997.

4. See IPALCO, *White Paper Critical of "Securitization" Swindle-High Cost Utilities Use Scheme to Charge Customers for Future Losses* (May 5, 1997) <http://www.ipalco.com/COMPETITION/swindle/swindlewp.html>; New York State Assembly, *Shedding Light on Securitization: A Briefing Paper on Moving to Competition in the Electric Industry* (March 1997) <<http://www.dps.state.ny.us/>>; Kenneth Rose, *Securitization of Uneconomic Costs: Whom Does It Secure?*, PUB. UTIL. FORT., June 1, 1997, at 32-37. On August 15, 1997, the Illinois Commerce Commission, at the request of the President of the Illinois Senate, issued a Report evaluating Illinois Senate Bill 55. ILL. COMMERCE COMM'N, REP. TO THE SENATE PRESIDENT: ANALYSIS OF ELECTRIC RESTRUCTURING WITH PARTICULAR EMPHASIS ON SENATE BILL 55 (1997)[hereinafter Report]. This bill restructures the electric industry, and permits securitization of stranded costs. The Report recommends substantial revision to the restructuring legislation, asserting that, in its existing form, Senate Bill 55 "favors electric utilities at the expense of lower prices, economic development and job creation". *Id.*, Executive Summary at 1. The Report's principal objections to Senate Bill 55 relate to its method of computing stranded cost charges to be

This article examines the securitization "tool" and seeks to define circumstances where its use is beneficial. Its thesis is that securitization, where properly applied, is but a financing tool which can achieve savings for ratepayers. To be effective, however, this tool requires that certain underlying cost recovery patterns and industry restructuring conditions be present. By improving utility financial integrity, securitization also increases share value and thereby benefits shareholders. Where these conditions exist, securitization should be employed by legislators and regulators. Disadvantages asserted by opponents can be avoided or acceptably mitigated by careful crafting of the regulatory decision, the legislation permitting securitization, or both.

This conclusion is supported in four sections below. Section II describes recent FERC and PUC orders establishing transition or restructuring plans to move from regulation to a competitive electric market. The roles of stranded cost recovery and of securitization, a method to achieve such recovery, are explained. Section III describes the securitization process, including the existing market for asset-backed securities (of which rate reduction bonds will be a new class), the process by which stranded costs are securitized into rate reduction bonds, and the means by which such bonds produce both rate reductions for ratepayers and corporate value increases for shareholders. Section IV discusses objections to securitization which have been raised and concludes that certain of these objections are overstated or may be avoided entirely by care in formulation of the legislation or regulatory decision authorizing the securitization. Other concerns, however, cannot be avoided totally but are present whether securitization is employed in the transition process or not and may be acceptably mitigated by several available methods. Section V provides a brief conclusion.

## II. SECURITIZATION'S ROLE IN ELECTRIC MARKET RESTRUCTURING

### A. *The Movement Toward Electric Market Restructuring*

Electric market restructuring is a process being driven and shaped by orders issued by the Federal Energy Regulatory Commission (FERC) and state PUCs, to date, primarily in states where electricity rates significantly exceed the national average. Formal consideration of electric industry restructuring began in the early 1990s with the opening of investigations in California and New York, and in 1995 with the FERC's issuance of two notices of proposed rulemaking. On December 20, 1995, the California Public Utility Commission issued its initial roadmap decision outlining its proposal for restructuring California's electric utilities. Additional state

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recovered from ratepayers, which it asserts produce recoveries in excess of actual stranded costs which will stifle competition, and to the fact that the 15% rate reduction for residential and small commercial customers mandated in Senate Bill 55 nevertheless leaves Illinois ratepayers paying rates 10 to 25% in excess of the Midwest regional average. The Report, however, also proposes the elimination of Senate Bill 55's securitization provisions because it is asserted they will increase utility cost of capital and provide inadequate limitations upon the use of the capital raised, thereby permitting that capital to be used in a manner that will harm the development of competition. See further discussion, *infra* note 84.

orders followed throughout 1996 in Massachusetts, New York, Pennsylvania and a number of New England states.<sup>5</sup> On September 23, 1996, Governor Wilson of California signed Assembly Bill 1890, the first legislation to authorize the recovery of utility stranded costs through the use of securitization.<sup>6</sup>

### 1. FERC's Approval of Stranded Cost Recovery

In Order 888, the FERC expanded its prior mandate of open-access transmission applicable to jurisdictional utilities, defining non-rate terms and conditions under which service must be provided and in what manner this requirement will apply to power pools and non-jurisdictional entities operating in the wholesale power market.<sup>7</sup> Appended to Order 888 is a

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5. See Notice of Proposed Rulemaking and Supplemental Notice of Proposed Rulemaking, *Promoting Wholesale Competition Through Open-Access Non-Discriminatory Transmission Service by Public Utilities and Recovery of Stranded Costs by Public Utilities and Transmitting Utilities*, 60 Fed. Reg. 17,662 (1995); *Re Proposed Policies Governing Restructuring California's Electric Services Industry and Reforming Regulation*, 166 Pub. Util. Rep. 4th 1 (Cal. P.U.C. 1995); *Re Electric Industry Restructuring*, Docket D.P.U. 96-00 (Mass. D.P.U. 1996) [hereinafter Mass. Res. Order]; *Re Competitive Opportunities Regarding Electric Service*, 168 Pub. Util. Rep. 4th 515 (N.Y.P.S.C. 1996). Within the past six months, a number of additional states have initiated electric industry restructuring investigations and several lower cost states are now actively evaluating restructuring alternatives. Published studies state that some action to consider or advance electric market restructuring has been taken in over 40 states. See John C. Hoag, *Updated Summary of State Electric Industry Restructuring Activities*, NRRI QUARTERLY BULLETIN, Summer 1997, at 205-09. Electric industry restructuring is also being examined in workshops before the Senate Committee on Energy and Natural Resources and in hearings before the House Commerce Committee in connection with national electric restructuring legislation. Evidence presented to the Senate indicates that prior restructuring efforts in formerly regulated industries have produced early rate savings of 15-20% with long-term savings that have reached 50%. *Electric Utility Industry Restructuring: Why Shouldn't All Consumers Have a Choice? Workshop Before the Senate Committee on Energy and Natural Resources*, 105th Cong. (1997) [hereinafter Workshop] (statement of Mr. Jeffery Skilling, President & Chief Operating Officer, Enron Corp., quoting a Joint Study by the Brookings Institute and the Center for Market Processes at George Mason University). That evidence also shows, however, that electric rates have been declining under regulation, and have declined by as much as 27% nationwide over the past fifteen years and continue on a downward trend. *Id.*, statement of Allen Franklin, President and Chief Executive Officer, Georgia Power Company.

6. Pennsylvania's legislation, the Electricity Generation Customer Choice and Competition Act, was signed into law on December 3, 1996. See 66 PA. CONS. STAT. ANN. §§ 2802 et. seq. (West Supp. 1997). Montana's legislation, the Electric Utility Industry Restructuring and Customer Choice Act, was signed into law in May 1997. See S.B. 390, 55th Leg., Reg. Sess. (Mont. 1997). The Rhode Island statute, An Act Relating to Public Utility Securitization, was enacted in July 1997. See H.R. 7003, Gen. Ass., Reg. Sess. (R.I. 1997).

7. Order No. 888, *Promoting Wholesale Competition Through Open Access Non-Discriminatory Transmission Services by Public Utilities; Recovery of Stranded Costs by Public Utilities and Transmitting Utilities*, 61 Fed. Reg. 21,540 (1996) (to be codified at 18 C.F.R. pts. 35, 385) [hereinafter Order 888]. Utilities were required to make open-access tariff filings in early July 1996. A series of FERC orders has been issued adjudicating utility-proposed departures from Order 888's generic tariff, the scope of the reciprocity requirement of non-jurisdictional utilities and proper cost based rate levels for this service. Order 888 establishes rules for additional matters not relevant to stranded cost recovery or securitization, including the division between state and federal jurisdiction, unbundling or divestiture of electric operating system functions and assets, transmission rate structure and the comparability doctrine, provision and pricing of ancillary services, environmental effects analysis, and oasis/standard of conduct requirements. The requirement to provide non-discriminatory and comparable open-access

generic tariff for use by jurisdictional utilities as a model in making the required filings to provide open-access transmission service. Power pools were also required to develop and file proposals for new governance structures, operating procedures, and other matters, to render their operations consistent with and supportive of the new competitive market. These filings included proposals for independent system operators, power exchange markets, marginal cost-based transmission pricing and other matters, and are presently being reviewed by the FERC.<sup>8</sup>

Order 888 permits stranded cost recovery from customers who terminate their wholesale service where the costs are "legitimate, verifiable and prudent."<sup>9</sup> To obtain such recovery, jurisdictional utilities must satisfy a "heavy burden" that they had a "reasonable expectation" of continuing to provide service to departing customers for some period beyond the termination date and must further show that the claimed stranded costs were directly and proximately caused by FERC's open-access directive.<sup>10</sup> Stranded costs are measured as the difference between revenues received during the prior three years of service under the contract (or during the prior most recent year if contract rates have changed) and the estimated market value of the capacity and energy involved. The latter may be estimated on the basis of pricing studies, a brokered sale by the customer of its former supply or by employing the customer's new power supply as a proxy for this value. The cost may be recovered either through an exit fee or by means of a surcharge imposed on future transmission service provided to the customer.

Order 888 does not authorize securitization as a means of recovery of wholesale stranded costs. No federal legislation exists or has been proposed to grant the FERC authority to issue "irrevocable financing orders" creating the property right whose existence, as will be explained below, is neces-

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transmission service was established and initially defined by the FERC in a series of case adjudications in 1992-1994. The more significant of these adjudications and a discussion of technical factors which contributed to the change from a regulated to a competitive electric industry are described in Order 888. *Id.* at 21,543-50.

8. See, e.g., *Re Pacific Gas & Elec. Co.*, 77 F.E.R.C. ¶ 61,265 (1996); *Re Pacific Gas & Elec. Co.*, 77 F.E.R.C. ¶ 61,204 (1996); *Re Atlantic City Electric Company*, 77 F.E.R.C. ¶ 61,148 (1996); *Re PECO Energy Company*, 77 F.E.R.C. ¶ 61,148 (1996); *Mid Continent Area Power Pool et al.*, 78 F.E.R.C. ¶ 61,203 (1997); *Re New England Power Pool*, 79 F.E.R.C. ¶ 61,374 (1997).

9. Order 888 does not mandate blanket abrogation of contracts as was done in the restructuring of the natural gas industry. However, customers are permitted to force revision or abrogation of their contracts where they can demonstrate that the contract terms are "unjust and unreasonable" in the context of the new competitive marketplace. Utilities are also permitted to seek contract revision to obtain recovery of stranded costs. See Order 888, *supra* note 7, at 21,556-58.

10. Order 888, *supra* note 7, at 21,629-62. A notice of termination term in the customer's service agreement gives rise to a rebuttable presumption that no "reasonable expectation" could exist. The FERC has ordered hearings to permit application of its stranded cost recovery standard in several cases. See, e.g., *Re Duquesne Light Co.*, 79 F.E.R.C. ¶ 61,116 (1997); *Re Duke Power Co.*, 79 F.E.R.C. ¶ 61,161 (1997). In these orders, the FERC rejected the availability of alternative entitlements to employ a utility's transmission system (because of NRC license conditions) and concluded that factual hearings were required to determine a utility's "reasonable service expectation," especially where the contract included a notice of termination provision.

sary for statute-based securitization to proceed.<sup>11</sup> Moreover, the contractual basis of electric service provided under FERC jurisdiction and the limited magnitude of wholesale service costs which the FERC regulates under a specific contract for a specific utility, with some exceptions, make securitization an impractical recovery mechanism (because of transaction expenses) unless such costs are combined across a number of contracts and also with the typically much larger retail stranded costs of the utility. Wholesale stranded costs arise only where and when individual service contracts are terminated and require contract by contract evaluations for their quantification. For these reasons, it is not surprising that securitization has yet to develop as an option for stranded cost recovery at the FERC level.

However, this does not mean that the FERC's jurisdictional costs will never be recovered through securitization. For example, the Rhode Island statute permits securitization of "qualified transition expenditures." Such expenditures are defined to include "all of the contract termination fees owed by an electric distribution company to its wholesale power supplier."<sup>12</sup> In New England and elsewhere, where integrated company systems with wholesale supply subsidiaries operate, the system may well be able to recover its FERC jurisdictional stranded costs through the "intangible transition charges" which its retail subsidiary is permitted to impose under state securitization statutes.

It is more difficult to visualize how securitization might be applied to the many finite wholesale contracts between primarily retail utilities and municipals or coops which the FERC regulates. There are three primary impediments to the application of securitization to stranded costs arising under these contracts. First, Congress may be unwilling to adopt legislation permitting the FERC to issue irrevocable orders authorizing stranded cost recovery and impose the necessary charges upon wholesale customers. Congress may not be willing to include in that legislation the promise made by state legislatures (as described further below) that Congress will not act to interfere with bond amortization and interest recovery. Second, it may be difficult to quantify the savings which securitization achieves in the wholesale market. As explained in the next section, securitization of retail costs produces defined savings on the basis of replacement of existing higher cost capital with lower cost asset-backed securities and by "stretching out" stranded cost recovery over a longer time period than would occur otherwise.

Wholesale contracts are often only indirectly based upon cost of service, with rate levels being one of several negotiated terms. Moreover, arguments could develop over the proper allocation of capital cost savings between retail and wholesale service operations. Although securitization might produce savings by stretching out wholesale stranded cost recovery (as compared to recovery through a contract exit fee), both customers and the rating agencies might view such a stretch-out with concern. Customers

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11. See discussion *infra* Section III.C.

12. See H.R. 7003, Gen. Ass., Reg. Sess. (R.I. 1997).

may prefer to pay off the old contract promptly, rather than having it contribute to costs over the period normally employed to amortize rate reduction bonds. Rating agencies would be concerned with an extended cost recovery period absent the statutory and irrevocable guarantees provided in state legislation and financing orders.<sup>13</sup>

However, it is not improbable that securitization of wholesale costs can be achieved even absent federal legislation containing the promises made by state legislatures, if the FERC states strongly its commitment to permitting recovery of bond interest and principal, and permits such recovery over a reasonably short period, and where it would be unlikely that FERC Commissioners and policy on the securitization issue would substantially change.<sup>14</sup> Alternatively, specific wholesale customers could sign agreements obligating themselves to payment of securitization supporting transition charges as settlement of utility-claimed stranded cost obligations. Securitization of this repayment obligation would then be based upon private contract, as is the case with most securitizations (including mortgage and credit card debt), but with the significant difference that only a finite number of payees would be providing obligations employed as security for the bonds. As described in Section IIIA, securitizations are normally backed by numerous small obligations.

This difference might impact the credit rating assigned the bonds, unless the wholesale costs were included in a larger primarily retail cost securitization. Moreover, it might be possible through over-collateralization, maintenance of a reserve fund, or some other standard credit practice, to create assurance of wholesale cost recovery equal to that provided by the statutory guarantees at the state level. However, each of these latter mechanisms increases transaction costs. State commissions and retail customer groups would clearly require that these additional costs be allocated to the wholesale transaction. The net result of these additional costs and of the allocation process might well be the conclusion that securitization for wholesale, individual contract stranded costs is not cost-effective and should not be pursued. Only analysis based on FERC-approved stranded cost levels and specific securitization-related costs will provide an answer to this question. Nevertheless, the basic thesis of this paper remains valid as to wholesale stranded costs. If securitization can produce measurable savings for ratepayers, then Congress and the FERC should take the actions necessary to assure its availability.

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13. The importance to producing a high credit rating of these factors is described below. See discussion *infra* Section III.D.2. A high credit rating is substantially responsible for the savings which can be achieved through securitization.

14. For example, the capital markets have, in past years, reacted favorably to FERC and state PUC decisions permitting major, disputed cost-recovery, such as recovery of major plant construction costs or abandoned plant expenditures amortized over a multi-year period, though such orders and the policies adopted were not protected by a statutory grant of irrevocability and thus were subject to change. See, e.g., *Re Northeast Utilities Service Co. (Re Public Service of New Hampshire)*, 50 F.E.R.C. ¶ 61,266, 51 F.E.R.C. ¶ 61,481 & 51 F.E.R.C. ¶ 61,177 (1990)(Recovery of Seabrook investment); *New England Power Co.*, 51 F.E.R.C. ¶ 61,225 (1990)(abandoned Nuclear Power Plant construction expenditures).

## 2. The States' Approval of Stranded Cost Recovery

State legislation and PUC orders address a number of issues important to the success of electric industry restructuring which are unique to retail electric service.<sup>15</sup> With the exception of California, each state which has adopted a definitive restructuring plan has provided for a phase-in of competition typically over a three to five year period ending prior to 2005. The state legislature or the PUC concludes that competition is more effective than regulation in reducing electric rate levels and in protecting the public, and that a principal purpose of electric restructuring is to reduce rates for the benefit of state citizens and its business environment, as well as to provide citizens and businesses with a choice of electric supplier.<sup>16</sup>

One of the more contentious issues faced is the recovery of stranded costs. Utilities argue that such recovery is required by constitutional and

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15. These issues include establishing licensure and qualification procedures for non-utility competitive energy suppliers; authorizing and implementing open retail access pilot programs; establishing performance based regulation of the remaining monopoly distribution function; assuring maintenance and funding for universal service, low income assistance, reliability of service and conservation, and renewable energy programs; establishing procedures to achieve an ordered transition between a regulated and competitive marketplace, including a fair and full opportunity for stranded cost recovery; establishing protections against the exercise of undue market power, including the establishment of codes of conduct and the functional or corporate unbundling of generation assets; and the effects of a competitive marketplace upon environmental quality and state tax revenues. These issues are discussed in the decisions cited in *supra* note 5.

16. For example, the California Legislature states, in A.B. 1890 (Section 1), that it intends to provide, during a "limited transition period" extending from January 1, 1998 to March 31, 2002, "[a]ccelerated, equitable, nonbypassable recovery of transition costs associated with uneconomic utility investments and contractual obligations," "[a]n immediate rate reduction of no less than 10 percent for residential and small commercial ratepayers" with that reduction financed through "rate reduction bonds" and with "[a]n anticipated result through implementation of this act of a subsequent cumulative rate reduction for residential and small commercial customers of no less than 20 percent by April 1, 2002." 1996 Cal. Legis. Serv. 854 § 1(b)(1)-(4) (West). The Legislature further notes that the California PUC has found that:

[T]he interests of ratepayers and the state as a whole will be best served by moving from the regulatory framework existing on January 1, 1997, in which retail electricity service is provided principally by electrical corporations subject to an obligation to provide ultimate consumers in exclusive service territories with reliable electric service at regulated rates, to a framework under which competition would be allowed in the supply of electric power and customers would be allowed to have the right to choose their supplier of electric power.

*Id.* § 10(d). It further stated that "[c]ompetition in the electric generation market will encourage innovation, efficiency and better service from all market participants, and will permit the reduction of costly regulatory oversight." *Id.* § 10(c). Unlike other states, California has concluded that there is no technical or other reason for a formal phase-in of competition. *Re Proposed Policies Governing Restructuring California's Electric Services Industry and Reforming Regulation*, 177 Pub. Util. Rep. 4<sup>th</sup> 1 (Cal. P.U.C. 1997). All customers are eligible to select an alternative supplier beginning January 1, 1998. CAL. PUB. UTIL. CODE § 330(l)(4) (West 1996). However, it is expected that customers will move to competition gradually, thus producing a de facto phase-in. Should this expectation prove erroneous, emergency short-term phase-in procedures have been adopted. *Re Proposed Policies Governing Restructuring California's Electric Services Industry and Reforming Regulation*, 177 Pub. Util. Rep. 4<sup>th</sup> 1 (Cal. P.U.C. 1997). See also 66 PA. CONS. STAT. ANN. § 2802 (West Supp. 1997); R.I. GEN. LAWS § 39-1-1(d) (Supp. 1996); *Restructuring the Electric Power Industry in New Jersey*, Docket No. EX94120585y, 1, 118-121 (N.J.B.P.U., April 30, 1997) [hereinafter N.J. Res. Order].

statutory protections.<sup>17</sup> In addition, utilities point out that denial of stranded cost recovery would seriously impair their financial integrity and thereby render them less able to ensure electric service reliability, to provide future transmission and distribution service at reasonable cost, or to timely take the actions needed to facilitate the transition to competitive markets. Utilities argue that denial of recovery of stranded costs incurred to provide service and recognized as just and reasonable under regulated rates, merely to permit movement to a competitive market structure now believed to be more beneficial, is highly unfair to utility investors who furnished capital under regulation with the expectation of obtaining a just and reasonable return thereon. Such shareholders are individuals of limited means who rely upon their share dividends for needed income supplementation.<sup>18</sup> All states, with one possible exception, which have defined a stranded cost recovery standard as part of electric industry restructuring, permit a "fair" opportunity, at least comparable to that existing under regulation, for recovery of stranded costs.<sup>19</sup>

### **B** *State PUCs Permit an Opportunity for Fair and Full Stranded Cost Recovery*

Stranded costs are defined in state legislation and regulatory decisions as costs which would be recovered under regulation but which will not be recovered under the reduced price level which is expected to result from competition.<sup>20</sup> Most statutes and PUC orders provide a specific listing of

17. Evaluation of this position is beyond the scope of this article. The federal and state constitutional, statutory, federal preemption and regulatory compact bases of this position may be reviewed by examining the decisions cited in footnote 19 *infra*.

18. In a May 22, 1997 session of the Senate Energy and Natural Resources Committee Workshop on proposed federal restructuring legislation, representatives of the financial community testified that electric utility stocks would suffer severe loss of value if substantial stranded cost recovery were not permitted. Further, witnesses testified that 62% of electric utility stocks are held by individual Americans (i.e. not counting ownership through mutual funds and other institutional investors) often as a part of retirement programs or for dividend income to supplement retirement pensions. The average profile of this shareholder is middle income and with an average age nearing retirement. See Workshop, *supra* note 5 (testimony of Kit Konolige, Equity Research Analyst, Morgan Stanley and of Bill Steinmeier, National Chairman of the Electric Utility Shareholders Alliance). The potential effect of electric restructuring on the market value of the electric utility securities held by these investors was also addressed at the workshop where it was noted that certain restructuring orders issued by the California and Texas Commissions had resulted in \$4 to \$5 billion dollar market value losses or more than 20% of total value in the shares of electric utilities located in those states. Workshop, *supra* note 5.

19. See, e.g., *Re Proposed Policies Governing Restructuring California's Electric Services Industry and Reforming Regulation*, 166 Pub. Util. Rep. 4th 1, 48-57 (Cal. P.U.C. 1996); *Re Electric Industry Restructuring*, Docket D.P.U. 96-100, 224-67 (Mass. D.P.U. 1996); *Re Restructuring New Hampshire's Electric Utility Industry*, 175 Pub. Util. Rep. 4th 193, 238-43 (N.H.P.U.C. 1997) [hereinafter N.H. Res. Order]; *Re Competitive Opportunities Regarding Electric Service*, 168 Pub. Util. Rep. 4th 515, 537-40 (N.Y.P.S.C. 1996).

20. See, e.g., Act of May 29, 1997, ch. 316, sec. 3, § 32, 1997 Me. Legis. Serv. 316 (West); 66 PA. CONS. STAT. ANN. § 2803 (West. Supp. 1997) (transition of stranded costs); *In Re Restructuring of the Electric Utility Industry*, 177 Pub. Util. Rep. 4th 201 (Mich. P.S.C. 1997) [hereinafter Mich. Res. Order]; N.J. Res. Order, *supra* note 16, at 93-107. Nuclear plant decommissioning costs and employee retraining and severance costs are excluded or are requested to be excluded from treatment as stranded costs in certain states. Instead, to provide greater assurance of their recovery, to maintain greater regulatory

the classes of utility assets which are to be included as "stranded costs." Principal among these are the difference between book cost and market value of generation assets, regulatory assets which are related to the generation function, power purchase contracts entered into under PURPA or which otherwise obligate the utility to pay prices in excess of market value, plant decommissioning and spent nuclear fuel cost, and employee retraining and severance costs.

State legislation and PUC orders seek to provide a "fair" or "reasonable" opportunity for, but not a guarantee of, stranded cost recovery during a transition period prior to full implementation of market competition. For example, in California, A.B. 1890 (Sections 10(s) and (t)) mandates that rates be frozen at their level on June 10, 1996, for up to a 51 month period (i.e. January 1, 1998, to March 31, 2002).<sup>21</sup> During this period, generation plant related and certain other stranded costs are to be recovered from the "headroom" which exists between the frozen 1996 rate levels and California utilities' declining cost of service. Should energy cost levels exceed those presently existing or should additional non-energy costs be

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control over their collection and the use of the funds collected, and because of their perceived importance to the public health and safety, these costs are often viewed as a regulated cost to be collected through the rates of the regulated distribution company. Such treatment avoids subjecting such costs to the possibility of non-recovery under the "opportunity" recovery mechanisms described in the text and satisfies NRC requirements that licensees classed as "electric utilities" for purposes of satisfying financial responsibility requirements in NRC regulations recover decommissioning and facility operating costs through cost of service rates. See, e.g., N.J. Res. Order, *supra* note 16, at 107-08; George A. Avery, *Selling Off Your Nuclear? Here's What the NRC Has in Store*, PUB. UTIL. FORT., June 15, 1997, at 34.

21. The California Legislature states:

It is proper to allow electrical corporations an opportunity to recover, over a reasonable transition period, those costs and categories of costs for generation-related assets and obligations, including costs associated with any subsequent renegotiation or buy-outs of existing generation-related contracts, that the Commission, prior to December 20, 1995, had authorized for collection in rates and that may not be recoverable in market prices in a competitive generation market . . . . The transition to a competitive generation market should be orderly, protect electric system reliability, provide the investors in these electrical corporations with a fair opportunity to fully recover the costs associated with commission approved generation-related assets and obligations, and be completed as expeditiously as possible.

CAL. PUB. UTIL. CODE § 330(s) (West 1996). Recent electric restructuring orders have rejected retail access phase-ins which did not provide for approximately equal access throughout the phase-in to all customer classes. See, e.g. Mich. Res. Order, *supra* note 20, at 4-5; N.J. Res. Order, *supra* note 16, at 7; *Re Competition in the Provision of Electric Services*, 175 Pub. Util. Rep. 4th 1 (Ariz. C.C. 1997). Finally, several states are considering, but none have yet adopted, stranded cost recovery procedures which include a "true-up" mechanism which assures intended or at least substantial stranded cost recovery. Although a true-up mechanism could negate the "opportunity" feature of regulatory cost recovery which stranded cost recovery procedures have to date maintained, employment of recovery "ranges" prior to true-up adjustment or equity cost adjustments such as that described, *infra* note 67, can appropriately rebalance ratepayer and shareholder interests. See *Delaware P.S.C. Staff Draft Report, In Re Report by the PSC to the House of Representatives Concerning Possible Alternative Approaches to the Restructuring of the Electric Utility Industry Delaware*, Docket No. 97-229 (issued August 8, 1997). As discussed in Section IV.B.1., *infra*, employment of a true-up procedure can be an important protection against inaccurate estimation of the market price component of stranded cost determination.

incurred, the "headroom" for stranded cost recovery will be reduced and California utilities may be unable to recover their stranded costs.<sup>22</sup> Although the transition period and the specific stranded costs to be recovered will differ in other states, this basic concept of freezing or providing a stated rate reduction which is less than that which cost of service reductions would permit, employing the "headroom" between the permitted rate level and lesser actual cost levels to provide an "opportunity" for stranded cost recovery, is employed in most state restructuring plans.<sup>23</sup>

Stranded cost recovery poses a balancing judgment for state legislators and regulators. As noted above, implementation of a competitive marketplace is expected and intended to produce electric service price reductions for all customers.<sup>24</sup> Permitting recovery of stranded costs delays or reduces the expected price reduction to be provided ratepayers to the extent that headroom is devoted to recovery of stranded costs. Nevertheless, the magnitude of stranded costs, estimated in some public studies to exceed \$150 billion nationwide and 100% of equity investment for many utilities, raises

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22. California has established different periods for recovery of different classes of stranded costs. The 51 month period described in the text applies to generation asset-related stranded costs and costs associated with the implementation of the ISO and PX. Employee severance and transition costs may be collected through 2006. Purchase power contract and PURPA related costs are to be recovered over the life of the original contracts. Declining cost levels in California are occurring because of the expiration of the guaranteed price term on certain PURPA contracts, previously ordered accelerated depreciation of nuclear power plants, and the availability of lower cost power from other states. *See Re Restructuring California's Electric Services Industry*, 175 Pub. Util. Rep. 4th 65 (Cal. P.U.C. 1996).

23. Pennsylvania mandates a 54 month rate freeze from December 3, 1996, for all costs and for non-generation costs, and a 9 year rate freeze also from December 3, 1996, for the energy supply component (including competitive transition charges (CTC) and intangible transition charges (ITC)). Such freezes are subject to lengthening or shortening depending upon how quickly the utility recovers approved stranded costs and provides full retail access. Transition costs must be collected during these rate freeze periods. *See* 66 PA. CONS. STAT. ANN. § 2804 (West Supp. 1997). New Jersey proposes to mandate a 10 to 15% rate decrease from existing rates to apply beginning October 1998, with utilities permitted to recover their stranded costs during the remaining "headroom" permitted after this decrease is effected. *See* N.J. Res. Order, *supra* note 16 at 1, 115-120. The Montana statute mandates a total rate freeze (i.e. entire charge) from July 1, 1998 to June 30, 2000, and a further freeze in the energy supply component of electric utility rates during the additional period of July 1, 2000 to June 30, 2002. *See* S.B. 390, 55<sup>th</sup> Leg., Reg. Sess. § 12(6) (Mont. 1997). This statute also mandates that all stranded costs as approved by the Commission be recovered during this four year period. Montana requires that "[P]ublic utilities shall apply savings [resulting from the issuance of transition bonds] toward the rate moratorium" which is a partial or full rate moratorium for 2 years during the four year transition period specified by § 12(6) of the statute for recovery of transition costs, and "must benefit customers". *Id.* §§ 12(9), 31(1). In both Montana and Pennsylvania, utilities may obtain relief from the mandated rate caps under specified circumstances to preserve financial integrity or to recover uncontrollable costs.

24. In A.B. 1890, the California legislature states its intention that, upon conclusion of the stranded cost recovery transition period in 2002, a 20% reduction in electricity costs be achieved. *See* 1996 Cal. Legis. Serv. 854 § 1(b)(1)-(4) (West). This rate reduction for residential and small commercial customers is to be measured as of April 1, 2002, by excluding any price reductions achieved in energy supply and costs being paid to retire rate reduction bonds. *See* CAL. Pub. Util. Code § 330 (West Supp. 1997). In his letter of February 24, 1997, proposing electric restructuring legislation in Massachusetts, then-Governor Weld states that the proposed legislation is intended to provide an immediate 10% electric cost reduction. The New Jersey Board of Public Utility Commissioners proposes a 10 to 15% immediate electric rate reduction, with 5% of this amount to come from reduced state taxes. *See supra* note 23.

practical, fairness, and legal considerations which necessitate their recovery.<sup>25</sup> For this reason, each definitive PUC Order issued to date, with the possible exception of that of the New Hampshire Public Utility Commission, has provided an opportunity for (but not a guarantee) of full stranded cost recovery over a five year or greater period.<sup>26</sup> Such recovery is to occur under a "non-bypassable" charge, a charge which must be paid even though a customer chooses to purchase its energy supply from another supplier. This charge is typically called the "competitive transition charge" (CTC).

Prior to obtaining stranded cost recovery, electric utilities are required to demonstrate that they have undertaken "all practicable" steps to mitigate such costs, and the PUC must find that their recovery is "just and reasonable" and "in the public interest". Recovery is further limited in some states, as at the FERC, to costs whose stranding can be shown to be caused by open access wheeling and not some other cause, such as rate discounting to maintain industrial accounts, movement of production out of the service territory, or self-generation.<sup>27</sup> Only "net" costs are to be recovered, i.e. an asset with a market value which exceeds its book cost is to have that value netted against stranded costs prior to allowance of recov-

25. Various studies have estimated net total electric utility stranded costs at between \$72 and \$169 billion, of which only a small portion is estimated as being subject to FERC wholesale jurisdiction. For many utilities, stranded costs represent more than 50% of equity investment. See Workshop, *supra* note 5 (statement of Ronald L. McMahan, President of Resource Data International, Inc.); ENERGY INFO. ADMIN., DEP'T OF ENERGY, ELECTRICITY PRICE IN A COMPETITIVE ENVIRONMENT (1997); *New Moody's Survey Shows Many Changes in Estimated Stranded Costs and Prices*, ELEC. UTIL. WK., January 27, 1997, at 11. *possibly* *Estimate?* *nuclear assets?*

26. See Workshop *supra* note 5 (testimony of Kit Konolige, Equity Research Analyst, Morgan Stanley). The New Hampshire Commission initially adopted the New England regional average price as a benchmark to contribute to its decision of the appropriate level of stranded cost recovery. This benchmark was employed in developing interim stranded cost recovery charges which were intended to remain in effect for two years (from July 1, 1997, to July 1, 1999) during a portion of the transition to a fully competitive electric market. The Commission planned to hold hearings during this two year period to permit individual utilities to establish that extenuating circumstances, reasonable special expectations of their shareholders respecting cost recovery, or impairment of their financial integrity justified or necessitated a higher recovery level. If permitted to stand, this benchmark would result in non-recovery of approximately 40% of Public Service of New Hampshire's (PSNH) stranded costs and of substantial percentages of the stranded cost of other New Hampshire utilities. *Re Restructuring New Hampshire's Electric Utility Industry*, 175 Pub. Util. Rep. 4th 193 (N.H.P.U.C. 1997). PSNH has sought and obtained a preliminary restraining order against enforcement of this tentative disallowance from the Federal District Court in Rhode Island, as well as against enforcement of a provision which prohibits utility-owned generation companies from making sales in the distribution affiliate's service territory. PSNH has sought and obtained rehearing of the Order before the NHPUC. PSNH and the State, acting through the Governor's Office, had agreed to the mediation of this dispute, but the mediation concluded without achieving agreement in early September. The most recent reports indicate that, in the rehearing proceeding before the NHPSC, interim rate reductions of between 10 and 20% are now being considered. See, e.g., *Amended Complaint for Preliminary and Permanent Injunctive Relief and for Declaratory Judgment*, N.H. Action No. 97-97-JD, R.I. Action No. CA97-121L (filed March 18, 1997); *Public Serv. Co. v. Patch*, N.H. Action No. 97-97-JD, R.I. Action No. CA97-1216 (D. N.H., May 22, 1997); *Re Statewide Electric Utility Restructuring Plan*, Order No. 22,548 (N.H.P.U.C. 1997).

27. See, e.g., CAL. PUB. UTIL. CODE § 372 (West Supp.1997); S.B. 390, 55th Leg., Reg. Sess. §12 (Mont. 1997) (enacted); N.J. Res. Order, *supra* note 16, at 101-103.

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Prior to obtaining stranded cost recovery, electric utilities are required to demonstrate that they have undertaken "all practicable" steps to mitigate such costs, and the PUC must find that their recovery is "just and reasonable" and "in the public interest". Recovery is further limited in some states, as at the FERC, to costs whose stranding can be shown to be caused by open access wheeling and not some other cause, such as rate discounting to maintain industrial accounts, movement of production out of the service territory, or self-generation.<sup>27</sup> Only "net" costs are to be recovered, i.e. an asset with a market value which exceeds its book cost is to have that value netted against stranded costs prior to allowance of recov-

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ery. Recovery may also be permitted only from revenues remaining after a specified rate reduction is provided to some or all customer classes. Incentives, in addition to the possibility of non-recovery under the cost cap, are provided to encourage stranded cost mitigation where such mitigation involves negotiations with third parties to obtain relief from contract pricing terms. Incentives include the ability to retain for shareholders 10% or more of any savings over non-mitigated costs.<sup>28</sup>

### C. *Securitization is an Alternative with Unique Advantages for Permitting Stranded Cost Recovery*

Securitization is one alternative available to permit recovery of utility stranded costs. This section will describe how securitization is employed in existing and proposed electric market restructuring plans. Securitization's unique advantage, the fact that its application also reduces the level of stranded costs while providing for their recovery, is explained in Section III.

In the Pennsylvania legislation, securitization is explicitly identified as a stranded cost mitigation measure available for use in satisfying a utility's duty to mitigate.<sup>29</sup> Other such measures include accelerated depreciation of stranded assets, transfer of depreciation reserves from transmission and distribution accounts to generation accounts contributing to stranded cost levels, buyouts and buydowns of PURPA or other uneconomic purchased power contracts, sale of assets and application of the proceeds to reduce stranded costs, and maximization of revenues from non-jurisdictional sales of generation from stranded assets.<sup>30</sup> Proposed legislation in certain states provides for the use of securitization to mitigate only certain stranded costs, particularly uneconomic PURPA or purchased power contracts.<sup>31</sup>

In California, securitization is employed as a vehicle to permit an immediate rate decrease for residential and commercial ratepayers during the transition period while stranded costs are being recovered.<sup>32</sup> As noted

28. See, e.g., R.I. GEN. LAWS § 39-1-27.3(f) (Supp. 1996) (retention of 10% of the savings from power supply contracts permitted); H.B. 6774, Gen. Ass., Reg. Sess. § 9 (Conn. 1997) (DPU directed to develop and adopt incentives for stranded cost mitigation). Massachusetts is considering "incentives" to be imposed on PURPA and other owners of non-utility generation, specifically that they agree to reduce PURPA contract costs by 10% or be prohibited from selling in the retail market place. See S.B. 1714, 181st Gen. Ct., Reg. Sess. § 5G(7) (Mass. 1997).

29. See 66 PA. CONS. STAT. ANN. §§ 2808, 2812 (West Supp. 1997).

30. See, e.g., 66 PA. CONS. STAT. ANN. §§ 2808, 2812 (West Supp. 1997); Act of May 29, 1997, ch. 316, sec. 3, § 3208(4), 1997 Me. Legis. Serv. 316 (West); N.J. Res. Order, *supra* note 16, at 112-15.

31. See, e.g., H.B. 4311, 181st Gen. Ct. § 30 (Mass. 1997). For an explanation of a proposed basis for so limiting the application of securitization, see discussion *infra* pages 391-93. Certain PUCs have held that they have no authority to limit recovery of PURPA contract stranded costs absent supporting federal legislation due to federal preemption, or that utility recovery of such costs should be favored because of past governmental support of such contract initiation. See, e.g., Mass. Res. Order, *supra* note 5, at 273-80; N.J. Res. Order, *supra* note 16, at 112-15; *Re Electric Industry Restructuring*, 175 Pub. Util. Rep. 4th 193, 239-40 (N.H.P.U.C. 1997).

32. 1996 Cal. Legis. Serv. 854 § 1(e), 10 (West). In their briefs in support of their Applications to issue the new securities, California utilities assert that approval of their requests and the associated deferral of a portion of stranded cost recovery will not result in any improvement or detriment to the

above, generation asset-related stranded costs are to be recovered during the four year period January 1, 1998 to March 31, 2002. However, AB 1890 permits a sufficient portion of these costs to be recovered through securitization to produce a 10% reduction in rates from otherwise frozen levels for residential and small commercial customers (i.e. demand of 20 kw or less). This rate reduction is achieved through replacement of existing utility debt and equity capital with lower cost "asset-backed securities" issued during the securitization process, and because recovery of the securitized stranded costs is extended from the four year transition period to the ten year term of the new securities. When employed in this fashion, securitization becomes one factor in the balance achieved between ratepayer and shareholder interests described above. It operates as one element of the "fair" and "reasonable" opportunity provided shareholders for stranded cost recovery. This opportunity necessarily delays and reduces for a time the anticipated benefits to ratepayers of a competitive electric market place. Although residential and small commercial customers receive the benefit of an early 10% rate decrease over a four year period, their rates are increased by one to two cents per kwh thereafter and through December 31, 2007, to permit retirement of the rate reduction bonds.<sup>33</sup>

A final restructuring issue which affects but is not part of the debate over securitization is whether and to what extent generation asset divestiture is required of electric utilities. Several states have recently encouraged voluntary divestiture of generation assets which contribute to stranded costs in return for increased assurance of stranded cost recovery.<sup>34</sup> For

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opportunity provided for them to achieve stranded cost recovery under the otherwise applicable rate freeze. See *Application of Pacific Gas & Electric Company Rate Reduction Financing*, No. 97-05-006, at 5-9 to 5-10 (May 6, 1997) [hereinafter PG&E Application]; *Application of Southern California Edison Rate Reduction Bonds and 10 Percent Rate Reduction*, No. 97-05-018, at I-5 to I-7 (Cal. P.U.C., 1997) [hereinafter SCE Application]. This result is achieved by careful accounting of both the reduction in revenues due to the elimination of securitized transition costs from otherwise frozen base rates and of funds collected for repayment of the "transition bonds" to assure that the two are equal. Revenues collected under other unbundled rate components are therefore the same as if securitization had not occurred. Thus, the opportunity for overall stranded cost recovery has not been enhanced. New Jersey also proposes to employ securitization savings to achieve near term rate reductions, and further characterizes it as an approach for general mitigation of stranded costs. See N.J. Res. Order, *supra* note 16, at 115-20.

33. See Interim Opinion, *In the Matter of the Application of PG&E, SCE and SDG&E for Authority to Reduce Rates Effective January 1, 1998*, etc., Applications 97-05-006, 97-05-018, 97-05-022, Decision 97-09-054, at 19, note 13.

34. See, e.g., *Re Application of Pacific Gas & Electric Co. for Authorization to Sell Certain Generating Plants and Related Assets Pursuant to Public Utility Code Section 851*, Application 96-11-020, Interim Order, Decision No. 97-09-046 (Cal. P.U.C., September 3, 1997); *Re Application of Southern California Edison Co. for Authorization to Sell Certain Generating Plants and Related Assets Pursuant to Public Utility Code Section 851*, Application 96-11-046, Interim Order, Decision No. 97-09-049 (Ca. P.U.C., September 3, 1997); R.I. GEN. LAWS § 39-1-27.3 (Supp. 1996) (sale, lease or other disposition of at least 15% of generation assets to obtain market valuation data to be used in adjusting CTC charge); Act of May 29, 1997, ch. 316, sec. 3, § 3204, 1997 Me. Legis. Serv. 316 (West)(corporate unbundling or divestiture required and limitations placed upon the ability of generation affiliates to market electric supply in the distribution affiliates service territory); *Massachusetts Electric Co. & Nantucket Electric Co. Restructuring Settlement Agreement*, Docket Nos. 96-100 & 96-25 (Mass. D.P.U.), <<http://www.nees.com/news/settlement.html>>; *Re Consolidated Edison Co. of New York, Inc.*

Benefits  
of Restructuring

example, utilities in Massachusetts, Maine, and California have announced or are presently pursuing bidding procedures to sell all or substantial portions of their fossil generation (primarily hydro, oil and natural gas plants) to non-utility parties. These sales serve two purposes. First, they offer the possibility of "jump-starting the competitive market place" by placing significant generation assets in the hands of parties unaffiliated with the transmission and distribution utility. Second, the sales provide a market basis for valuing stranded costs which does not depend upon regulators adjudicating competing valuations presented by utility, consumer or non-utility supplier interests during evidentiary hearings. This "market" valuation, however, would be derived from the estimates made by market participants of the same factors which contribute to administrative market valuations presented in regulatory hearings.

Finally, not all utilities have proposed securitization as a method for stranded cost recovery. Several utilities have proposed restructuring plans which at present do not employ the securitization process. Typically, these plans call for recovery of stranded costs over a specified period or periods employing the same "headroom" concept described above in connection with the California plan (i.e. existing rate levels are maintained or rate reductions are provided which are less than anticipated cost reductions in the absence of stranded cost recovery). Stranded costs, after mitigation, are then collected from the difference between cost and maintained rate levels over a specified period of time.<sup>35</sup> Mechanically, returns in excess of the PUC-determined "just and reasonable" level are either retained by the utility, or shared between ratepayers and shareholders, with the shareholders' share being used to pay down stranded cost levels.

### III. HOW SECURITIZATION WORKS

This section describes 1) the characteristics of asset-backed securities, the market in which they are sold, and the methods by which they achieve a high investment rating and low interest cost; 2) their prior use in electric

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*Plans For (1) Electric Rate/Restructuring Pursuant To Opinion*, No. 96-12 etc., Restructuring and Rate Settlement Agreement dated September 19, 1997, approved by Order Adopting Terms of Settlement Subject to Conditions and Understandings (N.Y.P.S.C., September 23, 1997) (Agreement provides for divestiture of 50% of Con Ed's generation located within New York City by the year 2002, which constitutes a load "pocket" not accessible to non-Con Ed generation due to transmission constraints). New Hampshire, concluding that it lacks jurisdiction to order divestiture of generation plant the majority of which is located outside the state, prohibits utility generation affiliates from selling power to their distribution affiliates. See NHPUC Res. Order, *supra* note 19, at 221-23. An agreement to effect one such generation plant sale has recently been executed. See *infra* note 77.

35. See *New Entergy Plan Offers Bigger Rate Cut But Would Delay Competition until 2004*, SOUTHEAST POWER REPORT, May 16, 1997, at 1; Order, Notice & Hearing, *Ex Parte Investigation of Electric Utility Restructuring & Application of Virginia Electric & Power Co.*, Case No. PUE960036 (Va. S.C.C. 1997); *Re Consolidated Edison Company of New York, Inc.'s Plans For (1) Electric Rate/Restructuring Pursuant to Opinion*, No. 96-12 etc., Restructuring and Rate Settlement Agreement dated September 19, 1997, approved by Order Adopting Terms of Settlement Subject to Conditions and Understandings (N.Y.P.S.C., September 23, 1997). (Con. Ed. agreed as part of the settlement to a mitigation target (either mitigate or non-recovery) of several hundred million of generation-related costs).

generation and conservation asset financing; 3) typical terms of state legislation enacted to authorize their use in the financing of electric stranded costs; and 4) certain issues which arose in California and Pennsylvania proceedings held to authorize their issuance. Included in this discussion will be a review of security rating agency pronouncements respecting the needed structure and likely rating of such securities.

A. *Characteristics of an Asset-Backed Security and of the Market for Such Securities*

The earliest asset backed securities were based upon mortgage obligations and employ large pools of mortgage loans to "collateralize" the securities being issued. Development of these securities permitted mortgage lenders to access the security markets and thereby obtain greater capital available for mortgage loans at lesser cost. Examination of the payment history of like mortgage loans was performed which employed statistical methods to identify the expected magnitude of defaults and late or early payments. Sufficient loans were then included in the collateral pool to provide assurance of recovery of the security's face value and interest, and to obtain thereby a desired AAA or AA credit rating and associated lower interest cost. The interest and principal repayment terms of the CMO were then established to match the anticipated cash flow from repayment of the mortgage loans.<sup>36</sup>

In the mid 1980s, use of this financing process expanded to include other forms of consumer and business credit which have predictable cash flows. In 1985, the first securities backed by a financial asset other than mortgage debt were issued. In recent years, securities backed by credit card receivables, auto loans, home equity loans, student loans, tax liens, equipment leases, trade receivables, and even taxicab medallions or other unusual money payment rights have been issued. The same forms and credit enhancement techniques as employed with mortgage debt were applied to achieve high credit ratings for these securities, though each ABS product requires transaction structure and credit enhancement customization based on the characteristics and credit quality of the collateral being securitized.

Since the late 1980s, the value of asset-backed security issuances has expanded greatly from \$42 billion in 1990 to \$148 billion in 1996. The latter amount is approximately 80% of the total dollar volume of traditional corporate bond issuances during that year, a fact which demonstrates the growing importance of this market. Major purchasers of asset-backed

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36. See, e.g., Christine Pavel, *Structures and Cash Flows*, and Barbara J. Moss, *The Benefits and Risks of Asset Securitization*, in *ASSET SECURITIZATION: PRINCIPLES AND PRACTICE* (David M. Morris ed., 1990) [hereinafter *ASSET SECURITIZATION*]; JOAN BARMAT, *Securitization: An Overview in ASSET-BACKED SECURITIES*, *supra* note 1, at 41; RODNEY S. DAYAN, ET AL., *Legal Overview of Asset-Backed Securities*, in *ASSET-BACKED SECURITIES*, *supra* note 1; Pennsylvania Public Utility Commission v. PECO Energy Corp., Docket No. R-00973877, (Pa. P.U.C.), Direct Testimony of Howard Hiller, Vice President, Fixed Income Capital Markets Group, Saloman Brothers, at 3-4, 20-21 [hereinafter *Hiller*]; *PG&E Application*, *supra* note 32, at 2-7 to 2-9; *SCE Application*, *supra* note 32, at III-1 to III-3.

securities include insurance companies, mutual funds, banks, investment advisors, and other fixed income institutional investors who find their relatively short maturities (two to ten years) and interest rates attractive.<sup>37</sup> Individual issues can be quite large, often exceeding \$1 billion dollars and with one large recent issue exceeding \$4 billion.

Asset-backed securities differ from traditional corporate bonds in two principal respects. First, the credit quality of the bond and its specific terms are dependent upon the character of the underlying financial asset and the extent to which credit enhancement is employed. Credit analysis of an asset-backed security focuses upon the legal structure supporting the security, particularly the degree to which the underlying asset is protected from the bankruptcy creditors of its originator and servicer; the timing and certainty of cash flow from the underlying asset; historical evidence of the credit quality of that underlying asset, particularly the magnitude of charge-offs, delinquencies and pre-payments; and the financial strength and operating reliability of the servicer of the underlying financial asset. This difference arises because in asset-backed securities the payment of principal and interest of the security derives from the dedicated asset, whereas with corporate securities such payments are made from the earnings and cash flow of the corporation. The legal structure supporting an asset-backed security will often vary depending upon the accounting and tax objectives of the securities' originator and issuer.<sup>38</sup>

These objectives could include achieving on or off balance sheet accounting and financial disclosure treatment of the financing and the timing and manner of recognition of any associated tax liability. Credit quality may be improved through various methods of credit enhancement, including over-collateralization, maintenance of reserve funds, payment guarantees from the originator, guarantees of third parties such as a letter of credit or insurance, or some other method. The credit quality of corporate securities, on the other hand, is determined largely by the financial (capital structure) and business risks (market disruption, competition, etc.) associated with the corporation in which funds are invested.

Second, corporate debt securities typically have an established maturity term upon the date of which all principal is repaid, whereas ABS securities return cash flow to the investor when received and therefore prepayments or delinquencies upon the underlying financial assets may advance or delay scheduled principal repayment. ABS securities typically have interest rates which slightly exceed those of identically rated corpo-

37. Credit card backed securities have, in recent years, made up approximately 30% of the market (when mortgage backed securities are excluded from consideration), with an additional approximately 20% each made up of auto and home equity loans. New and innovative security types, such as rate reduction bonds, increased to approximately 20% of the market in the fourth quarter of 1996. Over one-half of ABS securities issued in 1996 offered a floating interest rate. See *Fourth-Quarter ABS Public Ratings Volume Hits \$3.1 Billion*, STANDARD & POOR'S CREDIT WEEK, February 5, 1997; Hiller, *supra* note 36, at 8-11; ASSET SECURITIZATION, *supra* note 36; ASSET-BACKED SECURITIES, *supra* note 1.

38. Hiller, *supra* note 36, at 6-7, 11-12; ASSET SECURITIZATION, *supra* note 36; ASSET-BACKED SECURITIES, *supra* note 1.

rate securities because of risks associated with this payment date uncertainty. The form of an ABS security may differ (certificate, note, etc.) and may be classified into one of three categories: pass-through certificates, pay-through certificates, or collateralized debt.<sup>39</sup> Pass-through certificates, as their name implies, flow through cash flows received from the underlying financial assets without changing the timing of such payments, and involve the sale of the assets to a grantor trust in which investors purchase an equity interest. Pay-through certificates typically involve sale of the underlying asset to a special purpose entity (i.e. a partnership or corporation) which issues debt securities sold to the public, altering the underlying asset cash flows, and providing payments to investors which differ in amount and timing from cash received from payors on the underlying assets. Collateralized debt is essentially similar to traditional asset-based borrowing. The owner of the assets borrows money and pledges the underlying assets to secure repayment.

Stranded costs which are to be recovered through "Rate Reduction Bonds" (RRB) are themselves different from the typical financial assets which have been securitized in past years in two respects. First, these latter assets are typically "receivables," already an enforceable contract right at the time of their securitization, and require only collection by the servicing organization. Stranded costs, on the other hand, are to be collected only in connection with the provision of future electric service by the servicer or another organization. Thus, the service and financial capability of that servicer will significantly affect the bonds' ratings and interest costs. Second, a credit enhancement mechanism unique to the special circumstances of public utility regulation is employed to achieve high credit ratings and low interest costs for these bonds. This mechanism, as will be explained further below, is the periodic "true-up" procedure.<sup>40</sup>

#### *B. Use of Asset-Backed Securities to Finance Electric Service Assets*

Securitization procedures similar to those described in this article have been employed in the United States to finance conservation and electric service receivables. Securitization also has been employed in Europe as a method for reducing costs incurred in connection with the recovery of construction costs associated with terminated nuclear programs.

In 1995, Puget Sound Power & Light Company issued \$202 million of pass-through certificates with an annual interest rate of 6.45%. These debt securities were secured by Puget's right to collect compensation from its customers for conservation expenditures previously approved by the Washington Utilities & Transportation Commission. That right, as in the case of stranded costs, was guaranteed by statute upon Commission issuance of an

39. Hiller, *supra* note '36, at 6-7, 11-12; ASSET SECURITIZATION, *supra* note 36; ASSET-BACKED SECURITIES, *supra* note 1.

40. Christopher J. Donnelly et al., *DCR's Perspective on the Securitization of Electric Utility Stranded Costs*, DUFF & PHELPS CREDIT RATING CO., Feb. 1997, at 4-5 [hereinafter DUFF & PHELPS]; Jeanne K. Cotroneo, *New Bond Type Helps U.S. Utilities' Market Transition*, STANDARD & POOR'S CREDIT WEEK, May 14, 1997, at 12 [hereinafter STANDARD & POOR'S].

irrevocable order approving the securitization. The certificates, with an expected maturity of nine years, were rated AA or AAA by each of the major rating services, though Puget's mortgage debt was rated only BBB at the time.<sup>41</sup>

In 1996, Centerior Energy Company, whose mortgage debt is rated Ba2, issued \$150 million of ABS certificates with an annual interest rate of 7.2% secured by all of its receivables from electric retail sales and related services. These certificates were rated AAA, though only traditional receivables and not a statutory contract right were employed as collateral. Also in 1996, Orchard Securities Ltd. issued \$355 million of twelve year floating rate notes, backed by Finmeccanica SpA's claims for recovery of costs related to the termination of construction of nuclear power plants by Italy. In 1991, Italy had adopted a law providing for recovery of such costs and implemented a special surcharge on all electricity consumption to pay for such costs. The Spanish Nuclear Moratorium Fund also issued \$1.73 billion of bonds of varying maturities (the longest being 25 years backed by a direct government guarantee) collateralized by the compensation rights of four Spanish utilities to recover costs associated with terminated nuclear construction programs under a 1994 law and royal decree. A dedicated surcharge of 3.54% was implemented on all Spanish electric bills. These bonds were also rated AAA.<sup>42</sup>

### C. State Legislation Authorizing Issuance of Asset-Backed Securities to Finance Stranded Costs

Four states (California, Pennsylvania, Montana and Rhode Island) have enacted legislation which permits securitization of electric utility stranded costs.<sup>43</sup> At least ten additional states are considering or have been requested to consider adopting such legislation during 1997.<sup>44</sup> Typically, though not always, permission to employ securitization is proposed as a part of broad legislation which comprehensively restructures the electric industry and state utility regulatory processes to permit a competitive electric market place.

41. STANDARD & POOR's, *supra* note 40, at 10; Dean M. Colucci et al., *How Utilities Can Benefit from Stranded Assets*, ELEC. WORLD, March 1997, at 43.

42. STANDARD & POOR's, *supra* note 40, at 10; Colucci, *supra* note 41, at 43. Utilities have in recent years also employed portions of the securitization process discussed in this article, including the formation of trusts or special purpose entities to purchase subordinated, long-term utility debt with funds obtained by issuing securities to the public. Such securities, because of their subordinated character and lengthy maturity dates, have typically been rated at or below the rating assigned to utility mortgage bonds. See *Fitch Rates PECO Energy Cap 50 Million Trust Receipts "BBB+," Fitch Rates CMS Energy \$150 Million Convertible Trust Preferred "BB-,"* PR Newswire, Financial News, June 5, 1997, available in LEXIS, Energy Library, Allnws.

43. See CAL. PUB. UTIL. CODE §§ 330(w), 365, 841(a), 841(e) (West Supp. 1997); 66 PA. CONS. STAT. ANN. §§ 2808, 2812 (West 1997); S.B. 390, 55th Leg., Reg. Sess. §§ 3, 12, & 31 (Mont. 1997) (enacted); H.B. 7003, Gen. Ass., Reg. Sess. §§ 39-1-43 to -60 (R.I. 1997) (enacted).

44. Additional states in which the adoption of legislation authorizing securitization is or has been considered in 1997 include: Connecticut, Illinois, Massachusetts, Michigan, Nevada, New Hampshire, New Jersey, New York, Texas and Vermont.

Prior to authorizing the issuance of "transition" or "rate reduction bonds", the legislation first defines "stranded" or "transition" costs permitted to be recovered through the securitization process. The Pennsylvania definition is typical of that adopted in such statutes:

**Transition or Stranded Costs:** An electric utility's known and measurable net electric generation related costs, determined on a net present value basis over the life of the asset or liability as part of its restructuring plan, which traditionally would be recoverable under a regulated environment but which may not be recoverable in a competitive electric generation market and which the Commission determines will remain following mitigation by the electric utility.<sup>45</sup>

The key phrases in the above definition are that such costs are such as would "traditionally . . . be recoverable under a regulated environment but which may not be recoverable in a competitive electric generation market," are recoverable only net of above market asset values and only after aggressive efforts at mitigation or avoidance of these costs. As stated in the note below, reliance upon net present value whole life measurement is not uniformly adopted in other jurisdictions. Each statute identifies various categories of primarily generation or supply costs to be included as transition or stranded costs, including generating plant capital and decommissioning costs, IPP and other purchased power costs, regulatory assets (i.e. costs deferred from prior periods) and employee severance and retraining costs.

These costs are to be recovered through either a "competitive transition charge" (CTC), defined as a "nonbypassable charge applied to the bill of every customer accessing the transmission or distribution network" and which charge is designed specifically to recover such costs, or through "transition bonds" defined as "any bond, debenture, note, interim certificate, collateral, trust certificate, or other evidence of indebtedness or ownership that is secured by or payable from fixed transition amounts or transition property."<sup>46</sup> Proceeds from such bonds are required to be used to reduce capitalization, to finance transition costs or acquire transition property. Transition bonds may be issued only after the state public utility commission issues a "qualified rate" or "financing" order (hereafter referred to as "financing order") approving the stranded costs to be securi-

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45. 66 PA. CONS. STAT. ANN. § 2803 (West Supp. 1997). See also CAL. PUB. UTIL. CODE § 840 (West Supp. 1997); S.B. 390, 55th Leg., Reg. Sess. § 3, Item 22 (Mont. 1997) (enacted). As described in Section A above, what constitutes transition or stranded costs may vary in individual states, most particularly with the elimination of nuclear decommissioning and employee severance or retraining costs. Also, methods other than whole-life net present value analysis, including pricing information from market sales of divested generation plants, may be employed to value these costs. See discussion *supra* pp. 376-77.

46. See, e.g., 66 PA. CONS. STAT. ANN. §§ 2803, 2804, 2812 (West Supp. 1997); S.B. 390, 55th Leg., Reg. Sess. § 3, Item 19, § 31 (Mont. 1997); R.I. GEN. LAWS §§ 39-1-45, -46 (1997). Pennsylvania defines a separate nonbypassable charge, the "Intangible Transition Charge," to be employed in recovering costs associated with transition bonds, and requires that other rate components be reduced to eliminate costs which are securitized and recovered through this charge.

tized and the charge to be employed in amortizing and recovering the costs associated with the bonds.<sup>47</sup>

Once issued, the financing order creates a property right identified in some statutes as "transition property." This property right is employed as the asset or collateral which supports the credit evaluation of the transition bonds. Transition property is defined in the Montana statute as follows:

"Transition property" means the property right created by a financing order including without limitation the right, title, and interest of a utility, assignee or other issuer of transition bonds to all revenue, collections claims, payments, money, or proceeds of or arising from or constituting fixed transition amounts that are the subject of a financing order including those nonbypassable rates and other charges and fixed transition amounts that are authorized by the commission in the financing order to recover transition costs and the costs of recovering, reimbursing, financing or refinancing the transition costs and acquiring transition property including the costs of issuing, servicing and retiring transition bonds.<sup>48</sup>

Legislative establishment of this defined property right is beneficial since there is no existing "receivable" or contract right such as exists in home mortgage, credit card, or auto debt, which may serve as the "asset" for credit evaluation purposes. Rather, a utility's entitlement to recovery of its existing plant investment derives from the "regulatory compact," from specific PUC orders or by implication from the legislatively mandated regulatory scheme. By defining and conferring the property right by statute rather than in a regulatory decision, its establishment is rendered more permanent and assured, thereby contributing to credit enhancement.<sup>49</sup>

The statutes next contain a series of provisions whose purpose is to assist in procuring a high credit rating for the bonds. First, the transfer of the "transition property" from the utility to a trust or special purpose entity which will issue the transition bonds is stated to be a "true sale" under state law. As will be described further below, the transfer must qualify as a sale under state law in order to remove the property from the utility's bankruptcy estate and the reach of its creditors. Removal from the bankruptcy estate is necessary so that the credit evaluation of the securities can focus only upon the quality of the collateralized assets and additional credit enhancement, rather than the credit quality of the utility. In other words, it is this feature of the ABS transaction which permits the ABS securities to be assigned a credit rating above that of the utility.

47. Under the Pennsylvania statute, "Qualified Rate Orders" (QRO) may be issued to "facilitate the recovery or financing of qualified transition expenses of an electric utility or assignee." 66 PA. CONS. STAT. ANN. § 2812 (West Supp. 1997). The Pennsylvania statute and certain bills being considered for adoption also require the Commission to determine whether the QRO or financing order will be "irrevocable." As described below in the text, the irrevocability of the QRO or financing order is an essential element of the regulatory process needed to support the hoped for high rating and low cost of the transition bonds. Thus, while it may be possible to issue bonds absent a determination of irrevocability, such bonds would be substantially different in character and market than the ABS bonding concept evaluated in this article.

48. S.B. 390, 55th Leg., Reg. Sess. § 3, Item 24 (Mont. 1997).

49. See STANDARD & POOR'S, *supra* note 40, at 11; DUFF & PHELPS, *supra* note 40, at 2.

Second, the financing order is typically deemed to create a security interest in transition property upon behalf of the trust or special purpose entity. The interest must be perfected within a certain number of days (typically ten) by the filing of a financing statement in accordance with general state law applicable to secured lending, or by a special filing procedure with the PUC as defined in the statute. The statute further expressly provides that the PUC shall have jurisdiction over all disputes which arise respecting the transition property and the charges imposed upon customers to obtain its recovery, and that commingling of transition charge recoveries with other moneys of the utility or replacement servicer shall not interfere with the first priority given the trust or SPC's security interest. That security interest is also expressly stated to take precedence over that of any judgment creditor, and the trust or SPC may obtain a Commission Order directing the utility or replacement servicer to sequester all funds collected pending payment to the SPC or trust.

Third, financing orders are irrevocable where designated as such by the PUC, and transition bond terms and underlying property rights may not be altered or impaired by the state legislature via subsequent legislation. The bonds, however, are not obligations of and are not guaranteed by the state, and a legend is added to the face of the bonds stating this fact.

Fourth, the electric utility, trust, or SPC is authorized to further sell or assign the "transition property," which is an important ownership right required to be accorded if the property's transfer is to qualify as a "sale" under state law. The utility is also authorized to contract with any assignee to operate its electric system which, as noted above, is a prerequisite for the recovery of transition charges needed to repay the bonds.

Fifth, the obligations of the utility are made applicable to any replacement electric system operator or competitive electric supplier serving former customers of the utility, thereby separating the obligation of repayment of the transition bonds from the business and financial fortunes of the utility. Rather, the obligation of bond repayment attaches to the function of providing electric supply, transmission and distribution service within the state.<sup>50</sup>

Despite commission adoption of an order authorizing issuance of transition bonds, the final decision whether such bonds are issued is preserved to the utility, but the authority to issue the bonds lapses after a time unless renewed, and the utility is required to file its written consent to the terms and conditions of the financing order prior to bond issuance. California provides for issuance of the bonds by a state agency or special purpose

50. See 66 PA. CONS. STAT. ANN. § 2812 (West Supp. 1997); S.B. 390, 55th Leg., Reg. Sess. § 31 (Mont. 1997); CAL. PUB. UTIL. CODE § 840-43 (West Supp. 1997). In its report, "Stranded Utility Costs: Legislation Jolts the ABS Market," Moody's, in explaining its expectation that RRBs will achieve AA or AAA ratings, emphasizes the importance of this structure as a factor in its credit rating as follows: "The stream of fees that will support these securitized transactions isn't linked to the existence of any specific utility, but to customer usage, and must by law be paid." See Lori A. Burkhart, *Moody's Predicts Securitizations Will Win High Ratings*, PUB. UTIL. FORT., May 1, 1997, at 8. Each statute's "true sale" characterization of the state law effect of the transaction is expressly made inapplicable to the characterization of the transaction for federal and state income tax purposes.

entity established by a state agency, thus permitting avoidance of various state income and other taxes (but not federal income taxes). Finally, the statute expressly provides for Commission adoption of an annual true-up mechanism, described below, to assure that sales variations do not prevent full recovery of moneys needed to pay interest and retire the principal of the bonds.<sup>51</sup>

#### *D. Structuring an Asset-Backed Security to Finance Stranded Costs*

The structure of an asset-backed security depends upon the objectives for which it is being issued. The objectives in issuing rate reduction bonds are to reduce costs associated with financing and recovering stranded or other transition costs, to remove the debt associated with such costs from the balance sheet of the electric utility, and to avoid realizing an immediate taxable gain upon the transfer of the transition property. This section will summarize the structure being proposed for Rate Reduction Bond (RRB) transactions to regulatory commissions in California and Pennsylvania to achieve these objectives.

##### 1. The Structure Proposed for Rate Reduction Bonds

The structure outlined by Pennsylvania and California utilities in application proceedings for issuance of RRBs was of necessity stated only in general terms and subject to modification. Both the structure of ABS securities and their supporting legal documentation must be reviewed and accepted by a number of important constituencies. In California, this begins with the California Infrastructure and Economic Development Bank which will be the issuer or which will designate the special purpose entity which will issue the bonds. Additional reviews are required by credit rating agencies which establish the credit rating which substantially influences the interest cost and thus the savings obtained from the bonds. The Securities & Exchange Commission and the Internal Revenue Service must accept the utilities' proposed characterization of the transaction for financial and tax reporting purposes. If any of the above entities objects to the proposed structure as developed by the utilities and presented to the CPUC or PAPUC for review, that structure may need to be changed. A number of alternative forms are available which may be employed in an effort to achieve the utilities' structuring objectives should their chosen forms not produce the desired result.

The utilities propose to form one or more wholly-owned Special Purpose Entities (SPE). The capitalization of the SPE will be composed entirely of debt, with the exception that the utilities will contribute approximately 0.5% of the total as equity. Title to the transition property will be transferred to the SPE through an appropriately documented sale. As discussed above, a "true sale" of the property is essential for it to be removed from the utilities' bankruptcy estate. This is important to assure that the

51. See 66 PA. CONS. STAT. ANN. § 2812 (West Supp. 1997); S.B. 390, 55th Leg., Reg. Sess. § 31 (Mont. 1997); CAL. PUB. UTIL. CODE § 840-43 (West Supp. 1997); R.I. GEN. LAWS §§ 39-1-46 (1997).

transition property and the revenue stream which it represents are dedicated only to repayment of the transition bonds, and cannot be reached by other creditors of the utilities. Although the transaction is characterized in the statute as a "true sale," it remains necessary that the legal documentation of the transaction support that characterization. In addition, it is necessary that the SPE itself be "bankruptcy remote" and that there be certain assurances that it will operate with a degree of independence from the utility in order that it not be "substantively consolidated" with the utility for bankruptcy purposes. To achieve these objectives, explicit restrictions are placed in the SPE's organizational documents upon its ability to declare bankruptcy. Moreover, its activities are typically restricted to the RRB transaction to prevent any other activity from interfering with RRB cashflows to bondholders. To obtain the desired degree of independence from the utility, the SPE's organizational documents will require several independent directors or an independent trustee. Also, to demonstrate independence, the utility must charge a market-based fee for servicing the bonds, including billing and collection activities, and partial bill payments must be allocated in some neutral manner between current service and transition charges. Other transaction terms must also be "even-handed," demonstrating the SPE's independence of its creator and establishing its "bankruptcy remoteness." The utility will be required to obtain a legal opinion for presentation to the credit rating agencies. The opinion must confirm that the transaction qualifies as a "true sale" and will be effective in removing the transition property from the utility's bankruptcy estate.<sup>52</sup>

Following its formation, the SPE will issue its own debt securities collateralized by the transition property to the issuer of the RRBs. The issuer, either the California Infrastructure Bank or its designee, will then issue RRBs in the form of notes or certificates to investors. These notes or certificates will have expected terms of between three months and ten years and legal final maturities of between one and thirteen years, with the latter maturities designed to provide a margin should cash flow be less than anticipated. The debt of the SPE will secure the RRBs, which may be structured as pass-through certificates. Proceeds from the issuance of the RRBs will be transferred from the issuer to the SPE, and from the SPE to the utilities in return for the transition property. Principal of the RRBs will be amortized in equal annual amounts rather than on a mortgage basis (i.e. in California) in order that residential and small commercial customer rates may be reduced each year after the end of the rate freeze as the principal is amortized.<sup>53</sup>

Payment of interest and principal on the bonds will be obtained from a separately stated, usage-based charge applied to residential and small commercial customer bills and termed the Fixed Transition Amount (FTA)

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52. *PG&E Application*, *supra* note 32, at 2-2, 3-3 to 3-4; *SCE Application*, *supra* note 32, at IV-1 to IV-9. The above description is taken from the California Applications. However, the essentials of the structure proposed in Pennsylvania are similar. See Pa. P.U.C. Docket No. R-00973877 (Jan. 1997), *Testimony of J. Barry Mitchell, Vice President of Finance & Treasurer*.

53. *PG&E Application*, *supra* note 32, Sections 2, 3; *SCE Application*, *supra* note 32, Section IV.

(Intangible Transition Charge in Pennsylvania). As previously noted, this charge will be revised at least annually pursuant to a true-up mechanism that assures that sales variations from projected levels cause neither over- nor under-collection of the required principal and interest. A small "over-collateralization" fund is provided to protect against customer non-payments following termination of the FTA true-up mechanism. Customers will be entitled to make payments directly to the SPE, which will have the right to sue customers directly for nonpayment of the billed charges. The interest rate on the bonds may be set as a "floating rate" if this is believed to provide the lowest cost or achieve greater market acceptance, but the utilities state that ratepayers will not be subject to any floating rate risk. A servicing fee of 1.5 to 2% will be charged for meter reading, billing and collecting services when performed by the utilities and for the preparation of a monthly service report. But, these proceeds, along with the "float" from interest earnings during periods when funds are held by the utility or SPE while awaiting payment to the RRB issuer, will be credited back to ratepayers. The utility and SPE will make monthly payments to the Issuer, who, in turn, will make quarterly payments to investors. Fees related to the issuance of the RRBs are expected to be less than 1% of bond proceeds, a level which the utilities characterize as reasonable when compared to other similar financings.<sup>54</sup>

Extensive cost and revenue tracking accounts are established by the California utilities to assure that benefits of the RRB bonds flow to residential and small commercial customers as required by the statute. These accounts assure that recovery of the transition costs assigned to these customers through the transition bonds does not improve the "opportunity" granted utilities to achieve recovery of their stranded costs. Amortization of principal and interest associated with the bonds is to be recovered through a non-bypassable charge. The utilities propose that this charge be usage-based, and that it be assessed against all customers who benefit from the full 10% rate reduction, even though the customer selects an alternative energy supplier, self-generates, moves production from the service territory, qualifies for a different rate schedule, or is municipalized. In these latter cases, the charge is to be assessed based upon the customer's historic usage while served by the utility.<sup>55</sup>

As noted, the utility's proposed structure is subject to revision if needed to satisfy the concerns of various reviewing agencies. These reviews will occur, for the most part, after the Commission has issued its order approving RRB issuance. The utilities commit to filing an "Advice Letter" with the Commission to advise it of any changes made in the terms of the transaction and to permit it to disapprove such changes during a five day window prior to bond issuance.

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54. *PG&E Application*, *supra* note 32, Sections 2, 3; *SCE Application*, *supra* note 32, Section IV.

55. *PG&E Application*, *supra* note 32, at 6-4 to 6-5; *SCE Application*, *supra* note 32, at III-6 to III-

## 2. Achieving a High Credit Rating and Reduced Interest Cost

Reduction of financing costs is achieved by obtaining a high credit rating for the transition bonds. This requires satisfying the rating agencies that the required level of assurance exists of payment of bond interest and principal. In its publication, "DCR's Perspective on the Securitization of Electric Utility Stranded Costs," Duff & Phelps Credit Rating Company has defined five areas of analysis as to which satisfactory showings must be made to achieve a AAA or AA credit rating:

1. The originator/servicer and its business should be well understood.
2. The credit risks of the transferred assets should be understood and addressed.
3. The legal structure should give investors rights to the collateral and protect them from possible legal challenges and from the originator's risks as an operating entity.
4. The transaction documents should address other material transaction-specific issues such as cash flow allocation, servicing and auditing non-performing collateral, and failure to perform by parties.
5. Detailed monitoring procedures should be in place.<sup>56</sup>

In a stranded or transition cost securitization, possessing confidence in the originator/servicer and the procedures by which an acceptable replacement will be obtained is vital. This is because the entity does more than merely collect the outstanding receivable being securitized as is typical of financial ABS securities. Rather, no payment obligation arises until electric service is provided and bills are rendered. Thus, the rating agency must be confident that either the existing utility or some other entity will provide the necessary service and then assess and collect the charges needed to pay interest and amortize principal of the transition bonds.<sup>57</sup> In addition, the rating agency must have confidence in the ability and willingness of the service territory and its government to support the charges needed to amortize the bonds.

Achieving the required confidence necessitates two analyses: 1) evaluation of the "geographic area served, its economic history and its probable direction for the future," "its political climate," the "customer base, its mix between commercial, residential wholesale and industrial customers, customer and industry concentrations and the demographic outlook" and the capability of the utility to perform its obligations as servicer, and 2) the structure adopted in the legislation under which competitive electricity suppliers will be permitted to serve and bill directly retail customers and under which the utility may well be replaced as servicer of the transition bonds or electric system operator. Specific concerns evaluated include the ability of the utility or alternative servicer to terminate service to customers who fail to pay that portion of their bill, proposed to be separately stated in these securitization proposals, intended for use in defraying interest and principal amortization of transition bonds; how partial payments will be allocated between current service charges and transition bond costs; and commin-

56. DUFF & PHELPS, *supra* note 40, at 2.

57. STANDARD & POOR'S, *supra* note 40, at 12; DUFF & PHELPS, *supra* note 40, at 4.

gling risk which is viewed as increasing as the financial strength of the entity which services the bonds declines. This latter concern is significant in many states which are actively exploring permitting customers to designate their non-utility supply provider as their billing entity for all charges (including charges of the transmission and distribution utility). Rating agencies strongly advocate maintaining the service termination authority, at least equally sharing partial payments between current service and transition bond charges, and reducing commingling risks by requiring less financially capable entities who typically also have little retail billing and collection experience to sequester collected funds or make payments to the SPE on a substantially more frequent basis than is required of the utility (every week or several days versus every thirty days).<sup>58</sup>

The asset which will back the transition bonds is the property right created under the statute and the Commission's financing order providing for recovery of stranded or transition costs. Evaluating the credit risks associated with this asset involves evaluating the structure established by the legislation and the legal documents transferring that right. It is particularly important that the "legislation provides a comprehensive framework for the securitization of these assets, [and] that the legislation will remain in effect for the life of the transaction." It is also important that the transaction documents support the requirement that transfer of the right is a "true sale" for bankruptcy law purposes. The various statute and contract provisions discussed above have been commented upon favorably by the credit rating agencies as providing an appropriate legal and contract structure to provide the necessary assurance of asset credit quality to obtain the desired high credit rating.<sup>59</sup>

Significant concerns in this area include that the proposed maturity for the bonds not be unduly extended, as technological changes in the industry or political changes could threaten full recovery of the transition bond moneys. Also, the rating agency will review carefully the utility's history of accuracy in projecting sales and the terms of the true-up mechanism. Both the Pennsylvania and California statutes and securitization proposals provide for an annual true-up which the Commission must review and approve within ninety days of its filing. The California proposal, in addition, provides for a quarterly true-up filing if collected revenues vary from projections by more than a specified level. In addition to the true-up, as a credit

58. DUFF & PHELPS, *supra* note 40, at 4-5; *PG&E Application*, *supra* note 32, at 3-8 to 3-10; *SCE Application*, *supra* note 32, at IV-5 to IV-8. Duff & Phelps issued a special report addressing the effect that aggregators could have on transition bond security ratings. *Stranded-Cost Securitization - Potential Aggravation with Aggregators*, DUFF & PHELPS CREDIT RATING CORP., Apr. 1997. Although noting that at present restructuring statutes and regulations imposed few if any qualifications for attainment of aggregator status, Duff & Phelps concluded that a number of options exist to preserve security ratings despite the presence of aggregators as servicers, including those stated in the text.

59. DUFF & PHELPS, *supra* note 40, at 5-7; STANDARD & POOR'S, *supra* note 40, at 10-12; see discussion, *supra* note 50. As respects the approximate ten year maturity proposed for the California and Pennsylvania bonds, Duff & Phelps states that it views this time frame as "reasonable" in that it is unlikely conditions in the industry would change to the point where technological or political changes would impair cash flows needed to support the bonds.

enhancement to assure a top rating, both the California and Pennsylvania proposals provided for a small over-collateralization (in the amount of approximately \$25 million) to assure that no under-recovery in the final bond payment would occur at a time after the true-up mechanism had ceased to operate.<sup>60</sup> Additional credit enhancement may be employed if needed to obtain the desired credit rating.

In their reports, each of the credit rating agencies has commented favorably on the transaction structure developed under the Pennsylvania and California statutes. Moreover, the AAA and AA ratings which prior similar securitizations obtained, despite the BBB or lower mortgage credit rating of their sponsoring utilities, clearly suggest that the goal of a high credit rating and thus of low interest cost will be achieved.<sup>61</sup>

### 3. Treatment of Rate Reduction Bonds for Accounting Purposes

An objective of many securitizations, including the issuance of rate reduction bonds, is to remove both the assets and the dedicated capital (the asset backed securities) from the sponsoring firm's balance sheet. Such treatment is viewed as permitting a clearer presentation of the company's financial strength since the ABS securities, and in this case the rate reduction bonds, are issued "without recourse" to the earnings or general assets of the company. In other words, because the statute authorizing the securitization effectively provides that the rate reduction bond holders may look only to revenues collected under the competition transition charge (CTC) and its true-up mechanism as the source of interest and principal payments upon the bonds, and not to other assets and revenues of the company, and because the company has sold as "transition property" the right to receive and benefit from the CTC, neither the asset (the transition costs supported by the CTC) nor the transition bonds financing that asset should remain upon the company's balance sheet. Indeed, reflection of the transaction upon the sponsor's balance sheet produces a strange financial picture requiring significant explanation in balance sheet footnotes. Because the transition bonds are classed entirely as debt, though they replace capital, forty to forty-five percent of which is equity, the securitization transaction produces an apparent capital structure for the company which is unreasonably laden with debt, and therefore financial risk.

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60. STANDARD & POOR's, *supra* note 40, at 12-13; DUFF & PHELPS, *supra* note 40, at 4-7; DANIEL SCOTTO & ROBERT RUBIN, CORPORATE BOND RESEARCH—UTILITY SECURITIZATION (1997); *PG&E Application*, *supra* note 32, at 3-7; *SCE Application*, *supra* note 32, at IV-9.

61. In its report, *Stranded Utility Costs: Legislation Jolts the ABS Market*, Moody's Investors Service predicted that a properly structured transition cost securitization will be successful in achieving a credit rating of AAA or AA even though that rating is significantly above that of the sponsoring utility. See Lori A. Burkhart, *Moody's Predicts Securitizations Will Win High Ratings*, PUB. UTIL. FORT., May 1, 1997, at 8. See discussion, *supra* note 50. Moreover, Moody's acted recently to increase the ratings upon Pacific Gas & Electric's and Southern California Edison's mortgage debt in recognition of California's progress and fiscal responsibility in pursuing electric restructuring, including its intended use of securitization. See *Moody's Likes California Utility Environment and Securitization*, 8 Elec. Daily (1997).

In November 1996, three major California utilities sought approval from the Chief Accountant of the Securities and Exchange Commission to employ "off balance sheet" accounting in connection with the issuance and amortization of the rate reduction bonds. The utilities argued that the "transition property" constituted a "financial asset" which had been sold and thus, under the terms of the Financial Accounting Standards Board's (FASB) Standard No. 125, was properly accounted for "off balance sheet". After consulting with FASB Staff, the Chief Accountant disagreed with the utilities' analysis, concluding that the "transition property" did not qualify as a "financial asset" because it did not constitute a "contract right" having been created by statute and regulatory decision. Accordingly, both the transition costs and the transition bonds must be recorded on utility balance sheets along with appropriate footnote explanations of the non-recourse nature of the financing and of the asset sale.<sup>62</sup>

This adverse ruling does not seriously interfere with the proposed RRB issuance, as the rating agencies and investment advisory professionals are fully aware of the fundamentals of the transaction. Thus, neither RRB credit ratings nor market acceptance of the bonds are expected to be adversely affected.

#### 4. The Treatment of Rate Reduction Bonds for Income Tax Purposes

A more serious concern for utilities desiring to employ Rate Reduction Bonds to reduce transition costs is the treatment that the Internal Revenue Service (IRS) will accord the RRB transaction. Under the Internal Revenue Code, the sale of business property may cause the immediate recognition of taxable gain where the proceeds of that sale exceed the taxpayer's tax basis in the property. Assuming the use of accelerated depreciation, and to the extent that transition property consists of deferred

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62. See *SEC Says FASB-125 Requires California Stranded Assets to be Kept on Books*, ELEC. UTIL. WK., March 10, 1997, at 7; *PG&E Application*, *supra* note 32, at 3-12; *SCE Application*, *supra* note 32, at IV-16. A second important accounting issue, however, appears to be in the process of being decided in favor of the utilities. In the fall of 1996, the SEC Chief Accountant also began an examination of the proper application of FASB Standard No. 71 to the generation related assets of utilities engaged in a transition to a competitive marketplace. Under FASB Standard No. 71, utilities are permitted to record and maintain on their books assets whose recovery in regulated prices has been deferred, though an unregulated company would be required to write off such assets. Such treatment is permitted, however, only where the utility's prices are being set on the basis of cost of service ratemaking and the regulator has indicated that recovery will be permitted. The issue being examined, first by the SEC Chief Accountant and more recently by the FASB Emerging Issues Task Force, was whether the transition period (the period from January 1, 1998 to March 31, 2002) during which the major California utilities rates are frozen at their June 1996 level (and therefore not set upon the basis of a specific cost of service analysis) and during which the opportunity to recover transition costs through "headroom" is provided, still qualifies for SFAS-71 deferral treatment. Trade press reports indicate that the Task Force has tentatively concluded, without a dissenting vote, that as the regulator is providing opportunity to recover the assets and their recovery appears "probable", that the assets need not be written off. See *FASB EITF Agrees on Continued SFAS-71 Accounting During "Transition Period"*, ELEC. UTIL. WEEK, May 26, 1997, at 2; *SEC Questions Application of FASB-71 During California "Transition Period"*, ELEC. UTIL. WEEK, March 10, 1997, at 8.

costs whose tax benefits have already been flowed through to ratepayers, the taxable gain upon a "sale" of transition property recognized for tax purposes could be substantial. Absent "sale" treatment, the tax still must be paid, but only as service is provided to customers and FTA revenues are received. This timing difference, however, is critical to the perceived benefit of the RRB transaction. Indeed, the California utilities have computed that treatment of the RRB transaction as a "sale" for tax purposes and immediate assessment of the resulting tax reverses the otherwise substantial present value benefits of the bonds' issuance producing a small present value cost to ratepayers of pursuing securitization.

In February 1997, the California utilities filed a request for a private letter ruling with the IRS. That request asks the IRS to rule that: 1) the securities issued by the SPE are considered debt for federal income tax purposes, and 2) income and associated tax will accrue on the transition property only when the related electric services are provided to customers and FTA revenues are received. The utilities argue that: 1) their transfer of the transition property to the SPE has no federal income tax consequences (not a "tax sale") because the utility and the wholly-owned SPE are viewed as a single entity for tax purposes; 2) that the SPE has merely issued secured debt securities to the issuer, and thus there is only a financing and not a sale for federal tax purposes from that transaction; and 3) that income can accrue on the transition property only after electric services have been rendered, because it is only after the rendering of service that the utility is entitled to receive revenue from customers necessary to amortize and pay interest upon the RRBs.<sup>63</sup>

This issue has also been addressed in a report issued by the Massachusetts Division of Energy Resources.<sup>64</sup> That report notes that savings from securitization for certain Massachusetts utilities could be limited by the low cost of their existing debt, by bond and other financing restrictions which requires maintenance of their current equity ratio and thus limits the amount of higher cost equity which can be replaced by lower cost asset-backed debt and by the magnitude of the tax liability associated with the often highly depreciated (i.e. for tax purposes) underlying physical assets. To minimize the risk that an asset sale would be found for tax purposes, the Report recommends that Massachusetts' proposed electric restructuring legislation permit securitization of primarily above-market costs associated with purchase power contracts. It reasons that these costs are expenses and not plant assets, unlike above-market generation plant investment costs, which expenses are not amenable to a sale. The only above market generation asset costs which the Report recommends be securitized are those of assets which the utility has agreed to divest.

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63. *PG&E Application*, *supra* note 32, at 3-10, 3-11; *SCE Application*, *supra* note 32, at IV-16 to IV-18; *Testimony of John J. Gillen*, Docket R-00973877, at 7 (Pa. P.U.C. 1997).

64. See MASSACHUSETTS DIVISION OF ENERGY RESOURCES, AN ANALYSIS OF SECURITIZATION IN THE CONTEXT OF LEGISLATION PROPOSED BY THE JOINT COMMITTEE ON ELECTRIC UTILITY RESTRUCTURING (April 16, 1997). All of the factors discussed in the text, it should be noted, are also present as to the California utilities.

On September 9, 1997, the IRS issued the requested private letter rulings. As the utilities expected, the IRS affirmed that the RRB transaction did not constitute a sale imposing immediate tax liabilities. Rather, it accepted the utilities position that the transaction constituted a financing and that no taxes are owed until after related electric service has been rendered and fees collected from the customer. Thus, this substantial uncertainty has now been fully removed from the securitization process.

*E. Additional Issues Which Have Arisen in Regulatory Proceedings to Implement Securitization*

On May 27, 1997, the PAPUC issued an Order authorizing PECO Energy Company to issue \$1.1 billion of "transition" bonds rather than the \$3.6 billion the Company had requested.<sup>65</sup> Based upon a comparison of revenue requirements over the future test year period both with and without issuance of the proposed bonds, PECO Energy calculated that the requested \$3.6 billion bond issuance would permit it to reduce annual revenues by \$111 million or 3.4%.<sup>66</sup>

65. PAPUC Order, *supra* note 3. In a recent settlement of PECO's separate electric restructuring docket, Docket No. R-00973953, it has been proposed that this authority be increased to permit the issuance of \$4 billion of such bonds. The utility indicates that it expects this refinancing to produce a rate reduction of 3%, and guarantees as part of the settlement a total rate reduction of 10% to become effective September 1, 1998, through December 31, 2001, and with lesser rate reductions thereafter. The utility also agreed to extend the rate cap provisions of the Pennsylvania Competition Act for approximately three years and to write-off a total of \$2 billion of its claimed stranded costs. See *Joint Petition for Partial Settlement of PECO Energy Company's Proposed Restructuring Plan and Application for A Qualified Rate Order*, Docket No. R-0097395, at 7-11 (Pa. P.U.C., August 26, 1997). Under the terms of the settlement, court challenges filed to the Pennsylvania restructuring statute and to the May 27<sup>th</sup> Securitization Order must be withdrawn, which would then permit issuance of the authorized RRBs. However, this settlement is contested by potential competitors of PECO who contend that the credit permitted to those who purchase their generation from alternative suppliers has been set too low and thereby effectively precludes all supply competition in the PECO service territory for years into the future. Enron Energy Service Power, Inc., one such competitor, has filed a petition requesting approval of an Alternative Electric Competition and Customer Choice Plan, which proposes securitization of PECO's full \$5.4 billion recoverable stranded costs under the settlement, including rate reductions twice the size of those proposed by PECO in its plan and a significantly larger credit for customers who choose to purchase their supply from suppliers other than PECO (i.e. 3.4 cents versus 2.8 cents). Enron further proposes, as part of its alternative plan, that it be designated in place of PECO as the supplier of "default service" in PECO's service territory, that it pay PECO the latter's recoverable stranded costs and that it therefore be entitled to recovery of all CTC revenue which will be capped at a total of \$5.4 billion. The PUC has consolidated this plan with that proposed in the settlement for evidentiary hearings and determination by early next year. See, e.g., *Petition of Enron Energy Services Power Inc. For Approval of an Electric Competition and Customer Choice Plan, etc.*, Docket No. P-00971265 (Pa. P.U.C., October 7, 1997); *Enron, Other Marketers Challenge PECO Over Settlement to Bring Competition*, THE ENERGY REPORT, September 22, 1997.

66. In its original testimony, PECO Energy presented two ratepayer benefit calculations from alternative securitization programs. First, it noted that if it were permitted to securitize its entire claimed stranded cost which at that time it calculated to be \$7.1 billion, an annual revenue reduction of approximately \$120.9 million or 3.7% could be obtained, whereas securitization of its requested \$3.6 billion of stranded costs would produce an annual revenue reduction of \$95.5 million or 2.9%. See *Testimony of Alan B. Cohn*, Docket No. R-00973877, at 39-41 (Pa. P.U.C. 1997).

The California utilities have requested in applications filed with the California PUC on May 6, 1997, that they be authorized to issue a total of \$7.4 billion of such bonds. The California utilities have sized the bond issuance request to produce a 10% rate reduction for residential and small commercial customers over an approximate four year period (January 1, 1998, to March 31, 2002), during which generation plant-related transition costs are to be recovered. The reduction is produced by spreading out the recovery of a portion of the generation plant related transition costs to be recovered from small residential and commercial customers during the approximate four year period to the ten year period for principal amortization of the RRBs and because the interest cost of the bonds is less than the cost of the mortgage debt and equity capital which will be retired employing the bond proceeds.<sup>67</sup>

These initial securitization proceedings have involved several interesting issues. First, in both California and Pennsylvania, securitization produces different cost savings depending upon the costs which are securitized. In Pennsylvania, the benefits of securitization to ratepayers were significantly reduced to the extent that costs requested to be securitized were not already being recovered in rate levels. The Pennsylvania PUC, in its authorization for securitization of \$1.1 billion of stranded costs, specified that the costs securitized be predominantly from that group already reflected in the Company's rates.<sup>68</sup> In California, intervenors challenged the utilities' request that proceeds from the bonds be used to retire capital in proportion to its existing capital ratios, seeking instead retirement of a greater percentage of high cost equity to maximize ratepayer benefits. Even more significant, intervenors have challenged the utilities' proposal that securitization be limited to a ten year period, proposing twenty-five and thirty year bond terms. Such a securitization would likely not qualify for the highest credit ratings and thus would experience higher interest costs. Moreover, the securitization charge would interfere with competitive market decisions for a much longer period and would therefore seem undesirable.<sup>69</sup> Finally, the comparative effect of securitization in the two cases is instructive. In California, a 10% rate reduction is achieved because

67. *In Re Application of Pacific Gas & Electric Co., Southern California Edison Co. & San Diego Gas & Electric Co.*, Docket Nos. A.97-05-006, A.97-05-018 & A.97-05-022 (filed May 6, 1997). California permits only \$10 billion of RRBs to be outstanding at any one time. See CAL. GOVT. CODE § 63071 (West 1997 & Supp.1997). California also reduces the equity allowance on certain transition costs (primarily nuclear generation plant investment and associated costs) whose accelerated recovery it is permitting to an amount which is 10% less than the utility's current debt cost grossed up for the payment of income taxes. See *Re Proposed Policies Governing Restructuring California's Electric Service Industry and Reforming Regulation*, 166 Pub. Util. Rep. 4th 1 (Cal. P.U.C. 1995). See also R.I. GEN. LAWS § 39-1-27.3 (Supp. 1997) (return on stranded generating assets to be limited to 1% plus BBB bond rate); *Re Central Power & Light Co.*, Docket No. 14965, 139-40 (March 31, 1997) (return on generation plant assets whose depreciation allowance has been adjusted to accelerate the amortization from 32 to 20 years to accelerate investment recovery is reduced to equal embedded cost of debt).

68. PAPUC Order, *supra* note 3, at 44-45.

69. See *Opening Brief of the Office of Ratepayer Advocates*, Application Dockets A.97-05-006, A.97-05-018 & A.97-05-022 (June 16, 1997); *Opening Brief of the Utility Reform Network*, Application Dockets A.97-05-006, A.97-05-018 & A.97-05-022 (June 16, 1997).

securitization is being used to "stretch out" cost recovery, thus reducing required rates, whereas in Pennsylvania the rate reduction is reduced because a seven year securitization is proposed for stranded costs, including significant nuclear generation plant costs with lives extending out to approximately 2015.

Four additional issues significant to securitization and stranded cost recovery are addressed in the two proceedings. First, California intervenors have challenged the utilities' proposal that service termination be preserved as a remedy to enforce payment of the FTA charges though such charges are not incurred to provide current service and are used to support assets sold to a third party (i.e., the SPE). Also, California intervenors have challenged the true-up mechanism, arguing that it "guarantees" cost recovery whereas the statute only permits an "opportunity" for such recovery. However, as noted above, maintenance of each is considered essential by the rating agencies and will thus likely be important to obtaining a suitably high credit rating. However, as transition costs are presently collected in utility rates enforceable by the termination power, and as the utilities demonstrate in their evidence that securitization does not improve their opportunity during the recovery period to collect transition costs, these challenges should fail.

Second, PECO Energy proposed paying a premium to attract equity shareholders in the open market to permit retirement of their shares as a part of the securitization program. The cost of the needed premium was estimated by the company to be approximately \$100 million. Consumer intervenors opposed the company's proposal, arguing that it reduced ratepayer savings. They proposed instead that the company employ a special dividend procedure which would forcibly retire a certain portion of each shareholder's equity and would moreover impose ordinary income tax treatment of the payment upon the shareholders. Despite the fact that the statute expressly authorized the incurrence and recovery of such premiums, the Pennsylvania PUC deferred decision on this matter.<sup>70</sup>

There is merit to the company's proposal. The one group which receives no benefit from electric restructuring, absent the premium payment, is existing shareholders whose shares are retired to permit the company to reduce its capitalization. Ratepayers are benefited by the rate reductions achieved through securitization and expected from the competitive generation market. Shareholders who continue with the company should benefit from increased share price due to the removal of uncertainty respecting the recovery of stranded costs and from the reduction in shares available in the capital markets. Perhaps the special dividend procedure can be supported where it retires but a pro rata portion of each shareholders' holding, thus permitting each shareholder to benefit along with his loss, but this balance and alternatives which avoid ordinary income tax treatment should be carefully evaluated before a final decision is reached.

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70. PAPUC Order, *supra* note 3, at 59-62.

Third, in both the Pennsylvania and California proceedings, issues have arisen over when costs must be recognized and recovered. This is an important issue since the essence of the opportunity permitted utilities for recovery of stranded costs is through "headroom" under statutory imposed rate caps. Where the utility is permitted to defer recognition and recovery of normal operating or other costs to periods beyond the rate cap period, thus "freeing up" headroom for use in recovery of stranded costs, an "opportunity" may quickly transform into something more. Both the Pennsylvania PUC and the California PUC indicated strong reluctance to permit such deferrals, but noted that each request must be examined upon its own merits.<sup>71</sup>

Finally, several potential competitors of PECO Energy participated in the PAPUC investigation of its securitization request and objected to various aspects of the proposal. The competitors argued that PECO not be permitted to use float from ratepayer payments intended ultimately for use in repaying transition bonds in its competitive generation operations and that its use of bond proceeds be strictly limited to paying the costs of the securitization and the reduction of its capitalization. The PAPUC approved a settlement providing the desired assurance as to use of bond proceeds, and directed that float on ratepayer payments intended for transition bond servicing not be employed in PECO's competitive generation operations.<sup>72</sup>

On September 3, 1997, the California PUC adopted an Interim Order adjudicating issues raised as discussed above respecting each utility's application, and further adopting a Financing Order approving RRB issuance in the amounts requested for each utility. Each of the challenges to the utility proposals as described above was rejected, and the transaction as proposed by the utilities and as described in Section III.D.1, was approved. In light of the very substantial net present value savings produced by the proposed transaction of \$970 million, the California PUC found that the statutory requirement for ratepayer benefit in issuing the bonds was met. However, the utilities argument that their obligation under the California 1996 Restructuring Law to provide the 10% rate reduction to residential and small commercial customers was contingent upon successful issuance and financing of the reduction by RRB's was rejected. Thus, even though the bonds are not issued, the utilities are obligated to provide the statutorily mandated 10% rate reduction. The utilities intend to begin issuance of the bonds in October 1997.<sup>73</sup>

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71. PAPUC Order, *supra* note 3, at 22-24; *In re Restructuring of Electric Services Industry, Interim Opinion*, Application 96-08-001 et seq., Decision 97-06-060, at 9-10, 32-38, 47-53 (Cal. P.U.C., June 11, 1997).

72. PAPUC Order, *supra* note 3, at 5, 65-68.

73. *Re Application of Pacific Gas & Electric Company for Authority to Reduce Rates Effective January 1, 1998, etc.*, Application Dockets 97-05-006, 97-05-018 & 97-05-022, Decision 97-09-054 (Cal. P.U.C., September 3, 1997).

IV. SECURITIZATION SHOULD BE EMPLOYED WHEREVER IT CAN  
PRODUCE MEANINGFUL RATE REDUCTIONS FOR RATEPAYERS  
WITHOUT UNREASONABLY RESTRICTING FUTURE  
COMMISSION REGULATION

As stated in Section I, securitization has been criticized as unfair to ratepayers and as creating significant competitive advantages for existing utilities that will prevent the development in the near term of a truly competitive electric supply market. These disadvantages arise, it is asserted, because 1) stranded costs cannot be accurately measured, utilities have an incentive to misstate and over-recover these costs, and these errors will injure both ratepayers and alternative suppliers, 2) securitization unnecessarily and improperly delays customer receipt of the benefits of the competitive market place and may in fact increase ratepayer costs, and 3) the capital infusion from securitization will permit existing utilities an undue competitive advantage.

A. *Securitization Can Produce Meaningful Savings for Ratepayers  
Without Unreasonably Restricting Future Commission  
Regulation*

As data from both the Pennsylvania and California proceedings show, the benefits of securitization depend in part upon the nature of the stranded costs to be recovered, the period over which they are to be recovered and the "headroom" present for stranded cost recovery under existing rates.<sup>74</sup> Securitization, to achieve a high credit rating and thereby reduce cost, is presently restricted to the employment of securities with approximately ten- and perhaps fifteen-year maturities. Employment of longer periods increases investment risk and moreover, while creating greater immediate rate reductions, further delays the date upon which an electric supply market unconstrained by the need to recover such costs will operate. Where the stranded costs reflected in a utility's rates are to be recovered by regulation over a period which significantly exceeds the maximum term over which highly rated RRBs may be issued, and where "headroom" in a utility's rates is small relative to the magnitude of stranded costs to be recovered, savings from issuance of the bonds will be limited. Nevertheless, to the extent that achieving such savings imposes no cost upon regulators or ratepayers, no reason exists to forego even a modest cost savings. As is demonstrated from data in both proceedings, careful selection of those costs which offer the greatest savings (costs presently supporting base rates and with near term recovery periods) can still produce a meaningful rate reduction.

A significant cost associated with securitization, at least in the eyes of its opponents, is that it reduces the flexibility of regulators in addressing future unknown events and cost levels to best further the public good (i.e. the "prejudgment problem"). While securitization financing orders and the stranded cost recovery they permit are irrevocable, the same is substan-

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74. See discussion *supra* pp. 392-93.

tially true for any PUC order which adjudicates and permits stranded cost recovery. Whether securitization is employed or not, a PUC order mandating electric restructuring on a specified schedule, and which states an allowance for stranded cost recovery from ratepayers, establishes rights in the utility which the regulator cannot ignore in future decision-making.<sup>75</sup> Moreover, as described above, very substantial stranded cost recovery is required if the financial integrity of existing utilities is to be maintained. These two factors clearly support substantial use of the securitization process. As substantial stranded cost recovery must be permitted to maintain utility financial integrity and as the commission will bind itself to provide this recovery, no reason exists not to obtain for ratepayers the meaningful rate reductions which securitization's employment can provide. Moreover, as described below, decisional flexibility can, when needed, be maintained through securitizing only a portion of a utility's stranded costs and by true-up or other procedures.

#### *B. Arguments in Opposition to Securitization*

##### 1. Inaccuracy in Stranded Cost Measurement Does Not Prevent Securitization from Operating Fairly as to Ratepayers and Alternative Energy Suppliers

Opponents of securitization assert that measuring stranded costs is imprecise and that the utility has an incentive to inflate its stranded cost claim. If stranded costs are overstated, the utility collects its generation related costs twice from its ratepayers — once through the securitization process and once when it subsequently sells generation from the plant to its ratepayers at a price above that which it had estimated. Moreover, the argument goes, the overstatement provides the utility with an advantage over its competitive suppliers in that the unrecovered cost of its generation plant is reduced below that of its competitors who cannot benefit from such an inaccuracy. Thus, it is argued, the utility is accorded a competitive advantage, and it may presumably outbid its competitors in making electric sales.

The particular element of stranded cost measurement whose estimation produces the opportunity for error is the estimated future market value of stranded generation assets. As described above, stranded costs are defined as the extent to which utility generation related book costs recoverable under regulation exceed the assets' market value in a competitive market. Since a competitive market does not yet exist, the market value of these plants must be estimated. Opponents point out that this estimation process, which involves a projection of future fuel prices for up to twenty years, generating unit heat rates, operating availability and other cost related factors, is the same estimation process which was used in the 1970s

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75. These rights arise under both constitutional and statutory guarantees, and may be protected by appeals to state courts or direct challenge to state actions in federal district courts. See discussion and citations, *supra* notes 17, 19 and 27.

to demonstrate that nuclear plant construction and PURPA contracts, which now contribute the majority of stranded costs, were economically beneficial and should be effected.

This argument is not without merit. However, estimates are required whenever decisions must be made respecting long lived assets, and those decisions may prove to be wrong. More importantly, there are a number of options available and being adopted by Legislators and PUCs which avoid or mitigate this concern. First, as described in Section A3 above, several PUC's have encouraged divestiture of all or a portion of utility generation assets, in part for the purpose of obtaining "market" data as to the value of these assets. The data obtained will be the actual prices at which non-utility generators are willing to purchase a generating plant based on their estimate of the future market price of electricity. The PUCs of these states are carefully reviewing the auction procedures, and they may be required by statute to affirmatively find that the procedures will produce a reasonable estimation of plant market value.<sup>76</sup> Although these market estimates themselves rely upon the market participant's price estimates, the same as evidentiary market estimates do, this provides a valuable benchmark outside the control of the utility and under circumstances where its proponent is risking significant capital upon the basis of the estimate's accuracy. It is thus clearly an estimate with credibility.<sup>77</sup>

Next, several states are delaying final market valuation of generation related assets until after the competitive supply market has begun to operate.<sup>78</sup> Through such delay, it should be possible to obtain more accurate

76. See *Re Application of Southern California Edison Co. for Authority to Sell Gas-Fired Electrical Generation Facilities*, Application 96-11-046, Interim Order, Decision No. 97-09-049 (Ca. P.U.C., September 3, 1997); *Re Application of Pacific Gas & Electric Company for Authorization to Sell Certain Generating Plants and Related Assets*, Application 96-11-020, Interim Order, Decision No. 97-09-046 (Ca. P.U.C., September 3, 1997); R.I. GEN. LAWS § 39-1-27.3 (1997). Certain of these statutes and PUC Orders specify that market data is to be given precedence over administrative determinations, though the market data comes from other states or unit sales of other utilities. Divestiture, however, may raise due process confiscation issues if ordered directly by the PUC, may risk disruption of service reliability and should be considered only after other less drastic alternatives as described above have been tried. See materials cited *supra* at notes 17, 19 and 26.

77. One such sale has already taken place, at approximately 45% above book value. Although this sale may not be representative of pricing available in other regions of the country or with less desirable generation assets (i.e. this sale involved hydro- and gas-fired capacity in New England) it does strongly suggest that this double recovery concern may be overstated. One factor believed to have contributed to the favorable pricing received in this sale is the advantage that a would-be energy market competitor receives from "instant market entry," obtained from purchase of an existing generating unit as compared to the several year delay likely to be experienced in construction of a new unit. See, e.g., *PG&E buys 18 Northeast Power Plants Totaling 5,000 MW for \$1.59 Billion*, 25 ENERGY REPORT, No. 31, August 11, 1997. The utility making the sale, New England Electric System, has indicated that this premium will permit it to boost the rate cuts it provides ratepayers from 10% to 15% as the result of electric restructuring. Many bidders sought the capacity, including such major market participants as Duke Energy, Southern Company and others.

78. R.I. GEN. LAWS § 39-1-27.3 (Supp. 1996) (market valuation delayed until 40% of New England sales have retail access); H.B. 6774, 1997 Reg. Sess. § 9 (Conn. 1997) (securitization permitted initially of only 70% of stranded costs with known value, a subsequent proceeding to be completed by January 1, 2005, to finalize valuation after which adjustments are made in non-securitized stranded cost recovery); S.B. 1714, 181st Gen. Ct., Reg. Sess. § 135(c) (Mass. 1997) (utility must reimburse

data for use in stranded cost valuation. Further, several states have proposed that adjustments be made where it is determined that mistakes in estimation were made. One such adjustment procedure is to require that the benefits of any additional profits or revenues achieved by a utility as the result of a mis-estimation be turned over to or shared with ratepayers, thus correcting any ratepayer overpayment and substantially reducing any competitive injury since the utility does not profit from the mis-estimation.<sup>79</sup> Finally, with respect to competitive advantage, virtually all restructuring statutes authorize the commission to investigate and in certain cases to penalize or prevent exercises of market power. Where a competitor believes it is being adversely affected by utility market power attributable to a mis-estimation error, it could file a complaint and obtain protection from the Commission or from antitrust authorities.<sup>80</sup>

Rhode Island combines in its electric restructuring statute two of the above approaches. The statute directs that utilities must sell or otherwise dispose of at least 15% of their generation assets (or a greater portion if required by another state) and are to file a divestiture implementation methodology with the PUC by July 1, 1997. Divestiture, however, is not to

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Massachusetts Electricity Deregulation Public Trust for any over-recovery of stranded costs as determined from biennial reviews by the PUC). The Connecticut bill and Rhode Island statute further provide that (as quoted in the Connecticut bill):

The department shall not set the amount of generation assets recovered as stranded costs so high as to result in a cost structure that would give the company an unfair competitive advantage, nor so low that the company cannot maintain its financial integrity, recover its capital costs and attract needed capital . . . .

CONN. GEN. STAT. § 9(d)(4).

79. For example, New York Senate Bill No. 3486 provides that:

As a condition to such a determination of irrevocability [i.e. of the qualified rate order, its determination of transition property and permission to recover that property], the Commission may, among other things, determine that other portions of the qualified intangibles expenditures shall be recoverable only through rates that are subject to further discretionary adjustment by the Commission, or shall not be recoverable at all, and/or that other rates and charges presently authorized under this Article, or amounts presently included in the electric corporation's rates or rate base, shall be reduced or otherwise modified on such basis as is otherwise specified in the Order, and shall not otherwise be recoverable from the electric corporation's ratepayers.

S.B. 3486, 220th Leg., Reg. Sess. § 3(B)(2) (N.Y. 1997). The New York Senate Bill further only permits the N.Y.P.S.C. to adopt a qualified rate order where it determines that granting the order "would result in significant rate savings to the customers of the electric corporation." *Id.* § 3(B)(1). The California Public Utilities Commission, in connection with its permission to PG&E and SCE for accelerated recovery of capital investment in the Palo Verde and Diablo Canyon Nuclear Generation Stations, has required that profits above future cost levels be shared equally between ratepayers and shareholders. *See Re Pacific Gas & Electric Co.*, 178 Pub. Util. Rep. 4th 1, 41-42 (Cal. P.U.C., May 21, 1997); *Application of Southern California Edison Company for Authority to Make the Following Changes to its Present Ratemaking for its Share of Palo Verde NGS*, Application 96-02-056 at 2 (Cal. P.U.C. 1996). Similarly, in proposing that the California utilities' \$7.4 billion securitization applications be approved, the Interim Opinion points out that the amount being securitized is as little as 25% of the three utilities' total claimed stranded costs. *See Re Application of Pacific Gas & Electric Company/Southern California Edison Co./San Diego Gas & Electric Co.*, Application Dockets 97-05-006, 97-05-018, 97-05-022, Financing Orders-Decisions 97-09-055, 97-09-056, 97-09-057, at p. 5 (Ca. P.U.C., September 3, 1997).

80. 66 PA. CONS. STAT. ANN. § 2811 (West 1997); S.B. 390, 55<sup>th</sup> Leg., Reg. Sess. § 3205 (Mont. 1997); R.I. GEN. LAWS §§ 39-1-43 to -60 (1997).

occur until "40% of New England retail sales have retail access available." Upon completion of divestiture and the resulting market valuation, the utility's stranded cost recovery amount and charge is to be adjusted. The New Jersey Board of Public Utilities, after characterizing securitization as a "relatively risk-free mitigation tool for utilities," has also addressed mitigation of competitive and ratepayer equity concerns:

[S]ecuritization holds the promise of helping to further reduce the impact on ratepayers of stranded cost charges, and to provide some immediate rate relief. . . . [However], because of the nature of securitization, whereby proceeds may be utilized in rather large up-front lump sums, to buy-down contracts or retire debt and equity on the basis of market price projections, we believe it is advisable to put a limit on the amount of securitized debt which can be issued by each utility. We further emphasize that proceeds from the sale of securitized bonds must be utilized by the utility solely to reduce generation-related stranded cost, and not to subsidize any other activity of the utility.<sup>81</sup>

The Michigan Public Service Commission, in its recent Report on electric industry restructuring, expressed both the problem and an additional possible solution, as follows:

Stranded cost recovery is an important element of electric restructuring and is needed to protect the interests not only of the utility, but also of those who wish to remain traditional sales customers of the serving utility. Electric utilities in Michigan have made significant investments in order to meet their obligations to serve customers residing in the franchised service territories. . . . In the process of implementing customer choice, the Commission is committed to ensuring that customers who choose to remain sales customers to the existing utility are not harmed by the change. A reasonable stranded cost mechanism is essential to achieving that goal. . . . It would not be equitable to increase rates for remaining customers to pay for costs associated with customers who choose direct access. Nor would it be appropriate to disallow the recovery of costs that were prudently incurred by the utility. . . . The uncertainty regarding both the estimated future market price of power and the potential impact of utility mitigation measures makes it imperative that a true-up mechanism be established. . . . The Commission concludes that an annual true-up mechanism is necessary to assure that electric restructuring is carried out in a manner that protects the public interest. . . . The Commission envisions that such a mechanism would provide for annual adjustments up or down to stranded costs to reflect changes in the actual market price of power from a base point and other relevant factors.<sup>82</sup>

81. N.J. Res. Order, *supra* note 16, at 117-18. On September 9, 1997, in *Re Energy Master Plan Phase II*, Docket No. EX94120585Y et al. (N.J.B.P.U., September 9, 1997), the Board expanded upon the role which it perceives for securitization in utility stranded cost recovery. The Board states that: "securitization should not be the primary means for a utility to address [i.e. mitigate] stranded cost recovery, or achieve rate reductions, rather it should only be considered as a supplemental part of an overall strategy on the part of a utility to mitigate stranded costs and achieve the targeted level of rate reductions. . ." Consistent with this view, the Board proposed that, absent special circumstances, only 50% of a utility's recoverable, non-mitigatable stranded costs should be securitized. The Board further indicated that the level of securitization permitted could be increased by greater price reductions for ratepayers and by the extent of its comfort with the utility's stranded cost valuation evidence. (Slip Op., pp. 11-13).

82. Mich. Res. Order, *supra* note 20, at 9-12. As respects securitization, the Commission noted that its employment would require legislation and determined not to prejudge that legislative issue. However, it concluded that: "if securitization reduces customer rates on a net present value basis over

As with the "prejudgement" concern, mis-estimation is a problem with electric industry restructuring whether securitization is employed or not. The same stranded cost estimation process is employed regardless of whether costs are recovered through a PUC-established CTC or through transition bonds. Mechanisms exist for assuring no injustice to either ratepayers or competitors under both securitization and alternative stranded cost recovery mechanisms. While the securitized transition costs themselves may not be able to be adjusted without adversely affecting the bonds' credit rating, recovery of other costs could be denied or reduced based upon a true-up procedure or, as described above, the benefits of plant operation could be shared or assigned to ratepayers to correct mis-estimation errors.

2. Stranded Cost Recovery Does Not Improperly Delay Receipt of the Benefits of a Competitive Electric Supply Market and Does Not Provide Competitive Advantages to Utilities from Uneconomic Generation Asset Cost Recovery

Stranded cost recovery with or without employment of securitization delays full receipt of the operation and benefits for ratepayers of a fully competitive market place. However, as described above, under the "headroom" approach adopted to permit recovery of these costs, this delay is inevitable and is the burden borne by ratepayers in the balancing of interests adopted by the regulator to move to a competitive market expeditiously and with fairness to the company and its need for stranded cost recovery. The important point is that it is not securitization which delays achieving the full market benefits of competition, but rather the need for a mechanism that permits recovery of stranded costs within a reasonably limited period such that market benefits will arrive as expeditiously as possible. All stranded cost recovery mechanisms delay the full functioning of the competitive market. Securitization, where it is less costly than alternative mechanisms, causes less delay. The result, both in terms of the magnitude of stranded cost recovery and the delay before market or other cost reductions are flowed through to ratepayers, is a balancing judgment by the Legislature or regulator reflecting the interests of ratepayers and shareholders. As the New Jersey Commission explained:

[T]he fundamental reason for restructuring the electric power industry in the state is to reduce the cost of electricity to New Jersey customers. However, as described previously, the stranded cost problem in New Jersey is sizable. If all stranded costs are subject to guaranteed recovery from ratepayers, there could be a significant period of time before these uneconomic costs are written down, and actual electricity bill reductions are realized by customers, despite the availability of low cost energy in the market. . . . [W]e believe that the introduction of a near term rate reduction on the order of 5-10%, concur-

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the life of the assets, securitization would be a viable approach." *Id.* at 13. In its press release announcing its Electric Restructuring Order, the PSC stated that securitization could reduce Michigan electric rates by as much as 9% based upon a 15 year term for RRBs.

rent with the unbundling of rates and the introduction of retail customer choice and in conjunction with securitization, is an appropriate goal.<sup>83</sup>

Finally, while it is true that securitization maintains utility financial integrity of utilities by permitting retirement of capital invested in uneconomic generation assets, and thereby improves the ability to compete in the new marketplace, this capital is not available for use in the utilities' competitive generation business. Rather, under the financing order and statute, it must be employed to retire existing debt and equity capital.<sup>84</sup> Further, even the float on this capital and on the funds to be used to pay transition bonds may not, under the Pennsylvania PUC Order or the California utilities proposal, be used in the utilities generation business, but instead must be returned to ratepayers.<sup>85</sup> Other than for the fact that its financial integrity is preserved to permit it to compete in the new marketplace, the utility receives no special benefit to permit it to compete in that new marketplace. Absent stranded cost recovery through securitization or an alternative mechanism, the utility's financial integrity would be destroyed and its ability to compete in the new marketplace severely impaired.<sup>86</sup>

Also, as respects maintenance of the utility's financial condition from the recovery of stranded costs, whether through securitization or an alternative mechanism, it should be noted that utilities are not the only generation competitors with uneconomic assets. Both PURPA and non-PURPA generation owners are sellers under uneconomic contracts. These sellers, who can be expected to compete with utilities in the future market for electric power sales, expect to recover all or substantially all of their contract entitlements under PUC electric market restructuring plans. Indeed, as described above, several commissions have indicated that PURPA costs are to receive favored recovery treatment. Clearly, there is no competitive inequity in utility stranded cost recovery where similar recovery is permitted a major class of competitors.

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83. N.J. Res. Order, *supra* note 16, at 118-20.

84. In its Report on Senate Bill 55 (*see* discussion of Report, *supra* note 4), the Illinois Commerce Commission pointed out that the Bill's language, although it required that proceeds of the securitization financing be used to recover previously incurred costs or to refinance existing capital, was not restrictive enough to prevent use of the capital at the holding company level (i.e. the existing securities retired being the debt and equity of the wholly owned subsidiary) in an anti-competitive manner. This drafting inadequacy, it noted, could be corrected by mandating that the proceeds be used ultimately to retire securities of the parent held by the public. The Report further argues that securitization will increase a utility's cost of capital by creating a favored security class with first claim to revenues produced by electric service operations. As described above (*see* discussion *supra* Section III.D.2.), the financial rating agencies unanimously reject this assertion and, to the contrary, expect securitization to improve shareholder value and thus reduce capital attraction costs. Securitization, by resolving uncertainties respecting stranded cost recovery, by replacing higher cost with lower cost capital and thereby reducing rates and improving competitiveness, will reduce risk and thus capital attraction costs.

85. *See* discussion *supra* p. 382-83.

86. *See* discussion *supra* pp. 395-96.

## V. CONCLUSION

This Article has examined a series of proposals now before state legislators and PUCs for the use of a financing "tool" called securitization. Securitization is a tool which has been used beneficially for more than a decade by the financial services industry, and is moreover a tool whose use has been expanding within and beyond that industry. As this article points out, under favorable conditions, securitization of electric utility stranded or transition costs can produce rate decreases of at least 10% which benefit ratepayers while preserving electric utility financial integrity for the benefit of shareholders. Several market participants have objected to securitization, arguing that uncertainties in stranded cost measurement, the delay which it causes in achieving operation of a fully competitive market, and other factors in its application may result in unfairness to ratepayers and/or improper advantage over competitors. It has been shown that, to the extent these objections have merit, they are not specific to securitization, but rather are objections to the uncertainties of the electric restructuring process and to stranded cost recovery. More importantly, carefully drafted legislation and a properly framed financing order avoids these objections. The decision to employ securitization is separate from the decision to restructure the electric industry, deciding what form that structure should take and the measure of stranded cost recovery permitted. However, unlike other procedures which provide for stranded cost recovery, securitization has the unique advantage that it reduces the level of stranded costs by approximately 10% (under favorable conditions) while it permits their recovery. Moreover, it preserves transmission and distribution utility financial integrity, thereby reducing corporate risk and associated equity return requirements, producing further savings for ratepayers in the future operation of those systems.

Securitization should be employed wherever it can provide meaningful savings for ratepayers. Such savings are likely to exist wherever stranded cost recovery is being advanced for recovery over a limited period for the purpose of producing an expeditious transition from the regulated to the competitive marketplace. Securitization should thus be a useful tool for most PUCs in the balancing judgments between ratepayer and shareholder interests needed to effect a fair transition from a regulated to a competitive electricity marketplace.