

Basics of Stranded Costs and Securitization

Across the United States, states are switching from a traditional cost-of-service utility business model, where payments to investor-owned utilities are based on a simple mark-up of the utilities' costs, to a market-based model, where generating companies compete to provide electricity to end-users based on price and quality of service. The transition from a cost-of-service model to a market-based model is known as "restructuring." Restructured states all face decisions on how to manage the transition to the new business model.

The market-based model is generally considered to reduce consumer costs (and increase customer choices), which means that incumbent utilities see lower and less-certain revenues and lower profits under the new model. In turn, the value of the incumbent utilities' assets declines and many of their long-term contracts, which were signed based on a more certain regulated environment, may no longer be economically viable. The difference between the value of assets and contracts before restructuring and after restructuring is the largest component of what is known in the industry as "stranded costs."

The question faced by the states, therefore, is who should bear the burden of the losses that result from the transition from one legislated business model to the other, and how should the transition be designed to ensure economic efficiency and fairness to all stakeholders that will be affected by the change. Since electric market restructuring began in earnest in the late 1990s, most legislators, utilities, regulators, and economists have generally agreed that it is important to honor the regulatory compact made in the past between the utilities and the stakeholders they serve. This, along with many other considerations, has led legislatures to assign to consumers the responsibility to cover the stranded costs, but also to allocate to the consumers the benefits of lower rates arising out of restructuring. Fortunately, consumer gains are expected to outweigh consumer losses. If this were not the case, the restructuring would not make political sense. Some states have even gone so far as to mandate that post-restructuring rates be set well below the rates that existed prior to restructuring, during a reasonable "adjustment" time period. Consumers, therefore, end up with net positive benefits even after covering the costs of restructuring.

One common tool employed by states and financial markets to pay back affected utilities for their stranded costs is "securitization." Fundamentally, securitization is a financing mechanism through which an independent enterprise is established to 1) issue bonds; 2) sell the bonds to investors; 3) use the proceeds from the bond sales to buy out the utilities' stranded assets (which removes the stranded assets from the utilities' rate bases); and 4) place charges on consumers' electric bills for a limited amount of time to re-pay the bond investors. Such securitization mechanisms require legislative action at the state level to establish the securitization enterprise and provide the legal authority for it to collect and make payments to the parties involved.

Many states euphemistically refer to the bonds issued through securitization as "rate reduction" bonds. This label presumes that some economic benefit is gained through the issue and pay-down of the bonds. That economic benefit stems largely from one important concept: Interest rates paid to bond investors are substantially lower than the cost of capital provided to incumbent utilities prior to restructuring. The interest rates are lower because the payments are mandated by law, thereby reducing the risk that the bonds will not be repaid. This often allows these securitization bonds to be rated as high as AAA by the bond rating agencies. As a result, the bonds can be sold to investors with much lower interest rates. The difference is substantial—cost of capital rates for investor-owned utilities can range from 7% to 10%, while rates for municipal or AAA-rated bonds can range from 3% to 5%. Essentially, the consumers no longer pay the utility for the stranded assets, but instead pay the bond investors (at lower rates that arise from the securitization's lower interest payments).

While this overview of securitization presumes its use for restructuring, there are many examples over recent years where the mechanism has been used to pay down utility assets that are no longer deemed "used and useful" by state regulators. Examples include nuclear power plants built on geologically unstable ground; coal plants where the cost of mandated emissions controls are higher than the value of the plant; or coal plants whose operating costs now exceed the value of the electricity they produce. We may expect to see more use of securitization as electricity business models evolve over the next several years to accommodate developments in technology, environmental concerns, and economic conditions.

Sources:

Congressional Budget Office. "Electric Utilities: Deregulation and Stranded Costs." October 1998. <https://www.cbo.gov/sites/default/files/105th-congress-1997-1998/reports/stranded.pdf>

Mauro, Chris F., CFA, RBC Capital Markets. "Municipal Securitization—A New Financing Trend in the Municipal Market?" November 2014. <https://www.rbccm.com/municipalfinance/file-826934.pdf>

Ramsey, Kim E., Akin Gump Strauss Hauer & Feld LLP. "Electric Utility Securitizations." January 2014. <https://www.akingump.com/en/experience/industries/energy/speaking-energy/electric-utility-securitizations.html>

Virginia State Corporation Commission staff report. "Chapter 4: Stranded Costs." September 2007. <https://www.scc.virginia.gov/comm/reports/streprt4.pdf>

Author: Richard Tazelaar (9/2017)
Contact: EnergyFreedomCO@gmail.com
Posted: <http://EnergyFreedomCO.org>