

RATING METHODOLOGY

Moody's Global Approach to Rating Securities Backed by Utility Cost Recovery Charges

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1. Scope

This methodology describes our global approach to rating securities backed by utility cost recovery charges ("UCRC" bonds) that are established by special legislation and financing orders issued by utility regulatory bodies. The charges backing UCRC bonds rated by us have been established by state legislation and state utility regulatory bodies in the United States. For UCRC bonds backed by charges authorized by other jurisdictions, we will analyze the specifics of the securitization's legal framework and regulations – and their implications for the quality of the protections afforded to investors – within the general methodology described in this report.

Examples of cost recovery charges include those imposed to cover certain costs of utility companies that had been incurred in a regulated environment but could no longer be recovered because of a change to a more competitive regulatory regime (i.e., charges sometimes referred to as "stranded utility charges") and those imposed to pay for environmental cleanups, clean energy or for the replenishment of reserves established for repair of facilities damaged by natural calamities, such as hurricanes or tornados.

2. Executive Summary

A utility cost recovery charge bond is a bond typically issued by a special purpose entity of a utility, or by a special borrowing conduit, to recover specified costs as authorized by special legislation and a specific financing order issued by a public service utility regulatory body. The bonds are backed by a property right created by the legislation, which provides the right to impose and collect special charges on customers' monthly electric bills.

This credit rating methodology was republished on June 22, 2015 containing an updated monitoring section and minor other editorial updates in the body of the text and in certain footnotes. The content of this Credit Rating Methodology has not been changed.

The credit quality of the bonds depends on the legal strength of the property right, which in turn depends on the specifics of the related legislation and financing order, and on the size and economic strength and stability of the ratepayer base against which the costs will be imposed. Therefore, our credit analysis of cost recovery charge securitizations focuses on both legal and economic factors that can influence whether investors in UCRC bonds will be paid as promised.

On the legal side, we assess the extent to which the legislation that authorizes the cost recovery charges¹ provides clear procedures for insulating the transaction from claims by other parties and is likely to be able to withstand challenges to rescind or alter the legislation prior to the legal final maturity of the securities. Consequently, our analysis focuses on the extent to which the legislation clearly defines (1) a property that entitles the owner of such property – the utility, or, in some cases, a public trust or corporation – the right to charge the fee throughout the life of the security in an amount sufficient to make full and timely repayment of principal and interest on the security, (2) the process the owner of the property must follow to charge the fee, (3) the irrevocable right of the owner of the property to transfer the fee to a special purpose financing vehicle for securitization purposes, (4) the type of financing vehicle authorized to issue securities backed by the fees, and (5) the process to be followed such that the transfer would be viewed as a “true sale” of the rights to the cash flows rather than a pledge of collateral for a financing for transactions that involve the transfer of the property from the utility to the issuer. A true sale would insulate the securitization from a bankruptcy of the utility, protecting securitization investors from potential claims on the cash flows by the utility's creditors. In addition, we assess whether the legislation has a government pledge not to impair the utility's right to collect the charges and the consequences if the government nevertheless does attempt to impair the right.

We also examine the likelihood that other potential claimants, such as other creditors of the financing vehicle if it were to become bankrupt or investors in other securities that have been issued by the utility, might make a successful claim on the cash flows of the securitization. Furthermore, we consider the breadth of the market to whom the charge will be applied and the extent to which the charge might be “bypassable,” that is, the extent to which current or future customers might be categorized as outside the scope of the applicability of the charge.

Our assessment of the overall legal strength of the property right involves qualitative and judgmental factors. Transactions that are strong with respect to each of such characteristics may achieve the highest rating while the impact of weakening any of the attributes would be evaluated on a case-by-case basis.

On the economic side, our analysis focuses on the likelihood that the charges established by the legislation and accompanying regulations will be sufficient to repay the securitization bonds and on whether the charges might become onerous enough to cause pressure to rescind or alter the charges through future legislative or legal actions. As part of that assessment, we evaluate (1) possible changes in the size and composition of the customer base against whom the fee is to be charged, incorporating an evaluation of the breadth and diversity of the customer base, (2) the likely per capita energy usage (in those cases in which the fee charged is based on the usage amount), and (3) the fee rate, including any mechanism built in by the legislation that enables the fee to be reset over time to offset shortfalls that might develop over the life of the securitization (i.e., the transaction's “true up” mechanism). Generally the true-up mechanism is in effect the most important credit protection for UCRC transactions, limiting the risk that the cost recovery charges will be insufficient to pay off the bonds, thereby limiting the need for traditional sources of credit enhancement such as subordination and reserve funds.²

In analyzing a transaction's true-up mechanism, we examine how high rates would need to be set under “stressful” future scenarios to fully pay off the bonds, to assess the risk that onerous future rates might cause pressure to overturn or change the legislation and/or regulations establishing the charges. The variables that we typically “stress” test for UCRC bonds are the base against which the charge is to be

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¹ Throughout this report we use the terms “cost recovery charges” and “cost recovery fees” interchangeably.

² The true-up mechanism also limits the need to analyze the underwriting of the customer base, since the mechanism adjusts for all shortfalls, including those caused by customer defaults.

applied (usually energy usage) and the servicing fee. To obtain a high rating, we would expect that even in a stressful environment, such as one in which energy usage declined dramatically, the charge per customer necessary to pay off the bonds would be reasonably low both in absolute terms and as a percentage of the customer's energy bill. The specific stresses that we place on the variables are issuer-specific and are determined on a case-by-case basis.

In addition, we analyze the implications of other structural features of the securitization that could affect the risk of investor loss. For example, we examine the risk implications of how the cash flows are allocated among the various classes of investors and the other participants in the transaction, and the extent to which any other sources of funds are likely to be sufficient to offset any remaining shortfalls to investors, whether the shortfalls are temporary ("liquidity") or permanent ("credit enhancement").

3. Analyzing the Risk Factors

Because of the unique characteristics of this highly regulated asset class, our credit analysis of UCRC securitizations focuses primarily on the legislation and the true-up mechanism. The degree of certainty that the fees generated through the legislation will be sufficient to pay off the securitizations in full is a complementary aspect of the analysis.

Depending on the risks and mitigants in the relevant jurisdiction, transaction ratings will typically be positioned between the government rating and the country ceiling. Risks that could lead us to determine transaction ratings to be lower than the country ceiling include, for example, continued high levels of debt burden in a utility system. Such high levels of debt, if deemed unsustainable in the long term, may lead to political pressure to adjust the regulatory framework around the system deficit, with some potential negative impact on the related securitization transactions.

In the following sections, we describe the factors that typically lead to a high degree of certainty and thus high ratings on the bonds.

3.1 Protection against Future Impairment of the Right to Collect the Charges

Utility cost recovery charges are established by special legislation that authorizes the creation of a property right to collect future surcharges on customers' monthly electricity bills as the means to pay back the UCRC bonds. Consequently, we analyze the extent to which investors are protected against the enactment of future legislative changes that would weaken that right. For example, investor risk would be mitigated in a situation in which (1) the legislation contained a pledge by the jurisdiction not to impair the right to collect the special charges until the maturity of the bonds and (2) violation of that pledge would be a violation of law ³.

3.2 Irrevocability of the Financing Order

The legislation is typically accompanied by a financing order issued by the public service commission that authorizes the utilities to impose and collect the surcharges on the customer's monthly electric bill during the term of the bonds. Our analysis assesses whether the financing order is irrevocable, which would protect investors against future adverse changes that may reduce the charges backing the bonds.

3.3 Sufficiency of the Charges and the True-Up Mechanism

The charges are usually assessed as an amount linked to a customer's energy usage. Our analysis considers whether the financing order places any limits on charges – e.g., caps on the levels of charges or limits on the length of time that the charges can be imposed – that might cause the collections to be insufficient to provide for timely payment of the principal and interest on the UCRC bonds. In addition, we analyze whether the period over which the charges are allowed to be levied provides sufficient cushion to pay off the bonds by maturity in the event that collections come in more slowly than originally projected.

³ Violation of the non-impairment pledge would be a violation of the Contract Clause and the Takings Clause under the Federal and State constitutions.

As part of that analysis, we evaluate the power of any true-up mechanism that is provided for in the legislation and detailed in the financing order to correct for shortfalls that may develop over the life of the securities. A true-up mechanism typically adjusts future fee rates on a scheduled periodic basis (e.g., semiannually or annually) to correct for any under- (or over-) collections in a preceding period and to ensure the full and timely payment of future scheduled debt service, based on updated usage forecasts. The greater the frequency with which the true-up adjustments are made, the less likely that investors will suffer a shortfall at the final maturity date.⁴

That is particularly important as the security approaches the final maturity date; frequent rate adjustments based on then-current projections mitigate the risk that actual collections will deviate substantially from those projections, limiting the possibility of shortfalls at the final maturity date. Consequently, our analysis assesses the conditions under which more frequent true-ups are allowed, especially near the final maturity.⁵

3.4 Non-Bypassability of the Charges

We evaluate whether the charges are “non-bypassable,” that is, whether the charges must be collected from all existing and future customers of the utility or its successors or assignees within the utility’s service territory, and whether the financing order provides that a severance fee be charged to customers who switch to other service providers within the territory during the life of the bonds. We evaluate any exceptions to the non-bypassability rule, and consider the materiality of those exemptions to the cash collections. Charges that cannot be bypassed (i.e., those that cannot be avoided by the customers in the utility’s service area) ensure a continuing payer base for the charges, leading to less risk for investors. As described in the Structural Features section (Section 3.8), the power of the true-up mechanism to protect investors is dependent on the non-bypassability of the charges. As a result, non-bypassability (with limited, immaterial exemptions) has been a key factor behind the high ratings that are typically assigned to these transactions, without the need for considerable protection from traditional types of credit protection, such as reserve accounts or subordination.

3.5 Bankruptcy of the Utility

For structures in which the initial owner of the property is a utility, a bankruptcy of the utility could expose securitization investors to the risk that other creditors of the utility might make a claim on the cost recovery charges or that payments to securitization investors might be delayed as a result of an imposition of an automatic stay on payments from the utility company.^{6,7} However, that risk would be limited if it were clear that a bankruptcy court would view the transfer of the rights to the charges as a “true sale” of those rights, rather than as a financing of the company. As a result, we analyze whether the legislation clearly establishes the utility’s right to receive and transfer the rights to the charges and provides unambiguous procedures for transferring those rights to the financing vehicle as a true sale, and whether those procedures are followed in the financing order.

In cases where the utility is the servicer of the transaction, we analyze whether a bankruptcy of the utility could lead to a disruption in servicing, e.g., billing and collecting. However, given the essential service provided by the utility, we expect that government authorities would intervene to prevent any disruption in servicing that might result from a bankruptcy. As a result, where the servicer is a regulated utility, we view operational risk as low. Consequently, we typically would consider a transaction to be consistent with a Aaa rating even if the servicer were not investment grade, as long as the transaction were structured with some mitigants for operational risk, such as the inclusion of a backup servicer and/or provision for additional liquidity.⁸

⁴ Generally, the charges collected rank senior to other charges of a utility system and represent only a small amount of the total revenues of such system.

⁵ Transactions typically allow for more frequent true-ups during the “tail period” between the transaction’s stated “expected” maturity (determined by the sponsor) and the “legal” final maturity. The legal final maturity is the important date from our rating perspective, the date by which all principal must be repaid.

⁶ In some transactions, the property is created by law for the benefit of a public trust or corporation that also is created by the same law. In such cases, the true sale risk would be non-existent as there is no sale or transfer of the property.

⁷ For a discussion of how Moody’s analyzes legal risks in structured finance transactions, see Moody’s Related Research section at the end of this report.

⁸ The rating standard for a backup servicer likely would be lower than investment grade, but would depend on the specific facts and circumstances of the transaction and servicer.

In addition, we analyze whether the bankruptcy of the utility could cause a disruption in the remittance of payments by the utility to bondholders. Such a disruption could occur if the remittances of the charges were “commingled” with the other funds of the utility and the bankruptcy court ordered a halt to payments until proper ownership of the funds could be sorted out. Our analysis includes an assessment of the ways in which the utility separates the cost recovery charges received from its other funds and the frequency with which it transfers the funds to the trust.

3.6 Bankruptcy of the Financing Vehicle

Another potential risk to investors in UCRC securitizations is a bankruptcy of the financing vehicle. That could expose investors to the risk that other creditors of the vehicle might make a claim on the cost recovery charges or that payments to investors might be delayed by the imposition of an automatic stay. Consequently, we analyze (1) the likelihood that a third-party creditor would be able to successfully petition the owner of the assets (i.e., the financing vehicle) into an involuntary bankruptcy proceeding or (2) the likelihood that the owner of the assets would voluntarily seek the protection of the bankruptcy courts.

To analyze the likelihood of an involuntary bankruptcy, we assess the characteristics that would mitigate that risk, such as if the financing vehicle had (1) no assets other than the right to the cost recovery charges, (2) no indebtedness other than the securitization debt, (3) limited activities that could give rise to contractual or other liabilities, and (4) agreements with the sponsor and other contracting parties not to petition for the dissolution, liquidation or bankruptcy of the securitization vehicle. Similarly, factors that would mitigate the risk of a voluntary bankruptcy would include (1) charter documents of the owner of the assets that require directors who are independent of the utility and (2) a unanimous vote of directors as a condition to filing a voluntary bankruptcy.

3.7 Economic Factors

Even if the financing order is irrevocable, the charges or the law that authorizes them could be subject to challenge in the courts or to future political pressure to rescind or change them through legislation. That is more likely the higher the charges, i.e., the more the economic incentive for a challenge or in circumstances where the financial imbalances in a utility system increase. Consequently, our economic analysis focuses on the size of the cost recovery charge, both in absolute terms and as a percentage of the customer's energy bill. Typically the percentage of a residential customer's monthly bill devoted to the cost recovery charge is less than 10%.

We typically also look at stressful collection scenarios. For example, in one scenario, we assume (1) that energy usage falls short of the utility's projections⁹ by a progressively increasing amount each year (typically 5% per year), (2) that forecasted collections in peak usage months do not materialize (for example, 100% of the collections in the peak month and 50% of the collections in the second highest-usage month), and (3) that the servicing fee is considerably higher than the current, “normal,” servicing fee, representing the fee that would be required if the original servicer needed to be replaced in a stressful environment. In another scenario, we typically assume that energy usage is lower than projected by a set amount throughout the life of the securitization (typically 25%). For highly rated transactions, we would expect that the cost recovery charge would remain relatively low even in those highly stressful scenarios.

While the specific stresses that we place on the variables have been quite similar to date, this reflects the fact that all rated transactions to date have involved requests for the highest ratings and been supported by highly diverse, broad-based service areas. However, in general, stresses are issuer-specific and are determined on a case-by-case basis. One of the factors that we use to determine the appropriate stress level for a transaction is the variability of the base against which the charge is applied, for example, the population in the service area or the energy usage in the service area. Customer bases that are less broad-based and diversified tend to be more variable; as a result, we would apply more severe stresses in those situations.

⁹ We typically assess the reasonableness of the utility's projections by analyzing (1) the historical energy usage in the utility's service region and the variances between past projections and actual outcomes, and (2) the likely growth in electricity usage in the service area of the utility, taking into account the projected economic growth in the region and the possible competitive impact of technological advances, such as those in the development of solar energy.

In particular, we evaluate the economic diversity of the utility's service region to assess the potential variability in its economic health, which tends to drive changes in population and energy usage. An area that relies on multiple industries for economic growth will likely have a more stable business climate than an area that is dependent on the fortunes of one industry. In the latter case, the area's prospects will falter if that particular industry runs into hard times.

We also consider the mix in the customer base among residential, commercial, and industrial users. A utility with a large residential base relative to commercial and industrial users will tend to have less volatility in energy consumption, since energy consumption by commercial and industrial operations is more closely tied to the business cycle. Furthermore, residential customers are less likely to quickly embrace new energy production technologies and are less likely to cut back energy consumption dramatically if the price of energy were to rise. The higher variability of a commercial and industrial base can be exacerbated further if the service area's customer usage is concentrated in a few large commercial or industrial operations, which could make the overall energy consumption vulnerable if those entities were to decline or leave the area.

3.8 Structural Features

The key structural feature of UCRC transactions is the true-up mechanism. Our rating is highly dependent on the extent to which the mechanism adjusts the charges to correct for past shortfalls or forecasted future shortfalls. The effectiveness of those rate changes in raising funds depends, in turn, on how easily customers can escape the charges and how sensitive electricity usage is to increases in the utility charges. Therefore, our analysis of the true-up mechanism goes together with our analysis of how bypassable the cost recovery charges are and how easily customers can cut back on electricity usage (through alternative sources of energy or conservation). To be consistent with a particular rating, a strong true-up mechanism combined with non-bypassable charges mitigates the need for credit enhancement in the form of alternative sources of funds.

In addition, our analysis of the credit risk of a UCRC transaction incorporates our assessment of the implications of the transaction's cash flow allocation structure (sometimes referred to as the cash flow "waterfall"). In particular, we focus on the seniority of principal and interest payments to the bond's investors *vis-à-vis* payments to other participants. In addition, we analyze the extent to which the transaction has an alternative source of liquidity to pay principal and interest in the event that there is a temporary interruption in the flow of the cost recovery charges. For example, in many transactions there is a capital or reserve account with funds sufficient to pay interest for at least 1-2 months, if needed. Furthermore, we assess the extent to which the credit enhancement that is available in the transaction is likely to be sufficient to offset any shortfalls that might develop in the period between the final true-up adjustment and the maturity of the bonds.

4. Monitoring

In monitoring UCRC transactions, we apply the key components of this methodology. More specifically, we analyze, whether bond balances are in line with the scheduled principal amortization, which indicates the extent to which payments have been in line with our original expectations.

We review the periodic information received and look at whether there has been a draw on the reserve accounts. This data point provides further clues as to the steadiness of the cash flows and accuracy of true-up adjustments.

In addition, we analyze the factors that determine the future strength of the transaction. For example, we monitor any legal or political developments that could indicate an increased risk of changes in the legislation that could impair future cash flows to the transactions. Such risk may materialise, for example, in case of continued high financial imbalances in the system that may lead the system deficit to be viewed as unsustainable over the long-term.

Depending on the jurisdiction, we also follow the rating of the utility as a proxy to assess any changes to the economic health of the service region and the potential for changes in the size and composition of the ratepayer base. Furthermore, we monitor the rating of the utility collecting the charges (as an indicator of its financial condition) to track the risk, typically quite small, that a bankruptcy could lead to disruption in billing and collections and in the remittance of payments to the bondholders.

In other instances, we may be more concerned with the behavior of the regulator of the utility system and less with individual utility companies. This could lead to a lower rating in the space between the local currency ceiling and the sovereign rating or the utility rating.

Thus changes on our expectations and other analytical components could have an impact on the rating of the securities and may result in a reassessment of the rating.

Moody's Related Research

The credit ratings assigned in this sector are primarily determined by this credit rating methodology. Certain broad methodological considerations (described in one or more secondary or cross-sector credit rating methodologies) may also be relevant to the determination of credit ratings of issuers and instruments in this sector. Potentially related secondary and cross-sector credit rating methodologies can be found [here](#).

For data summarizing the historical robustness and predictive power of credit ratings assigned using this credit rating methodology, see [link](#).

Please refer to Moody's Rating Symbols and Definitions, which is available [here](#), for further information.

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Report Number: SF404788

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