Securitized Products Special Topics

Recovery Bonds: No Need to Closely Watch the Fed or the Economy Here

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Unique Dynamics to Drive Stranded ABS Collateral Performance

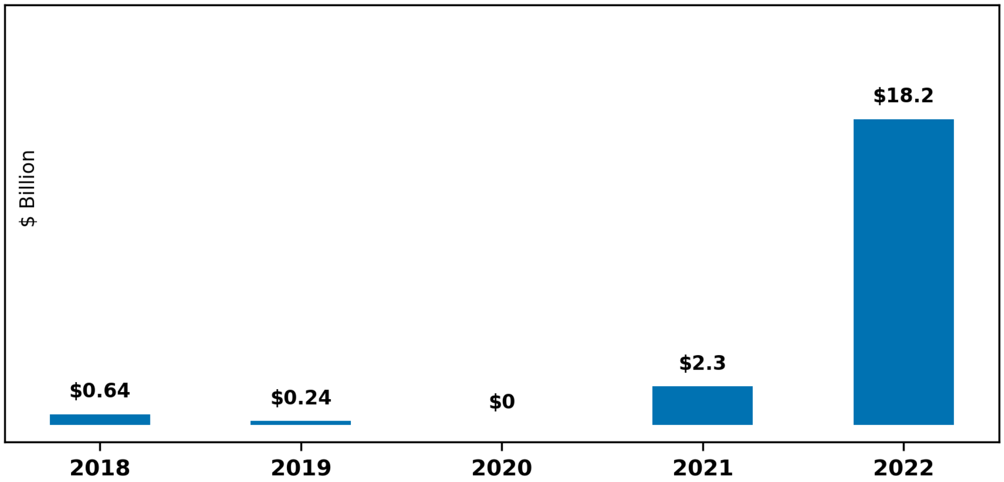
Utility cost recovery bonds or stranded asset ABS should continue to occupy a unique spot across securitized products, with collateral performance poised to be much less dependent on the interest rate or the economic environment. Rate-driven lending pullback or recession-driven rising delinquencies should not be key drivers of recovery bonds dynamics. Rather, we expect greater adoption of securitized financing to recover utility companies' costs to determine issuance levels down the road. In turn, legislative and legal risks, as well as the structure of the recovery charges utility customers face, play a bigger role in impacting the collateral performance outlook in the segment.

All told, investors may find stranded ABS performance uncorrelated to other securitized segments. Still, the sector typically offers very long-duration bonds, that may be less suitable for investors looking for shorter-duration, highly liquid exposures.

Issuance Rises Amid Range-bound Spreads

Recovery bonds issuance (aka rate-payer securitization) shot up to $18.2 billion in 2022 YTD, compared to $2.3 billion in 2021 (Figure 1).

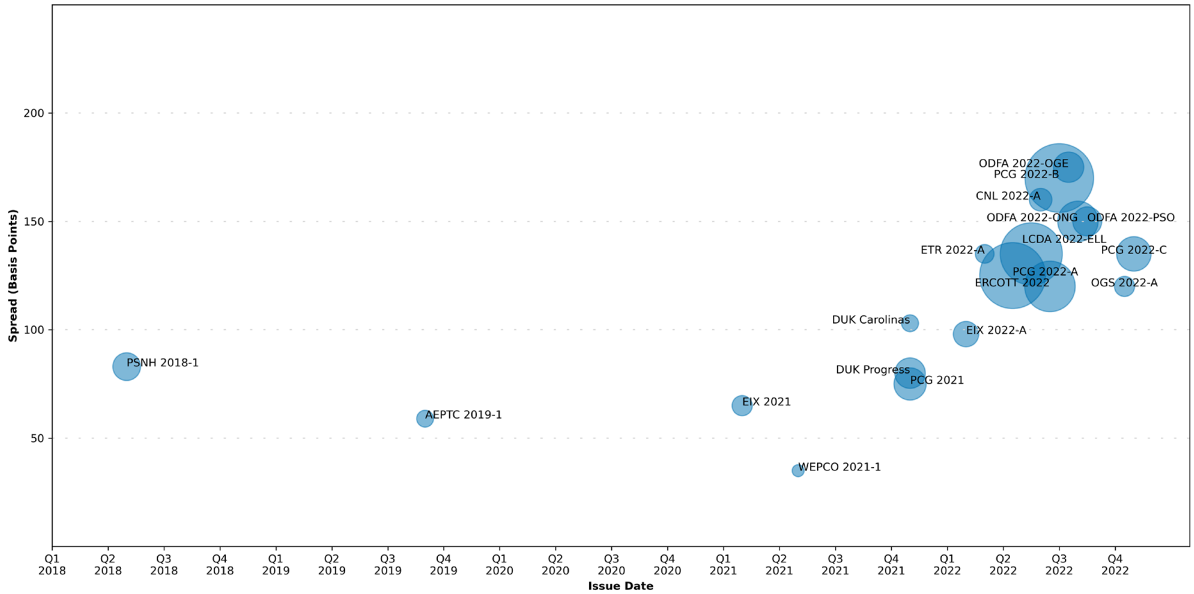
Figure 1. Recovery Bonds Issuance, 2018-2022



Source: Bloomberg and Academy Securities

Issuance spreads widened over the year but remained range-bound (Figure 2). The recently issued PG&E Recovery Funding deal priced its 20.5-year WAL A3 bond at 140bp over Treasury benchmark. This compares to a 92bp spread on a similar WAL bond of the EIX deal issued back in February 2022.

Figure 2. Recovery Bonds Spread Levels



Source: Bloomberg and Academy Securities

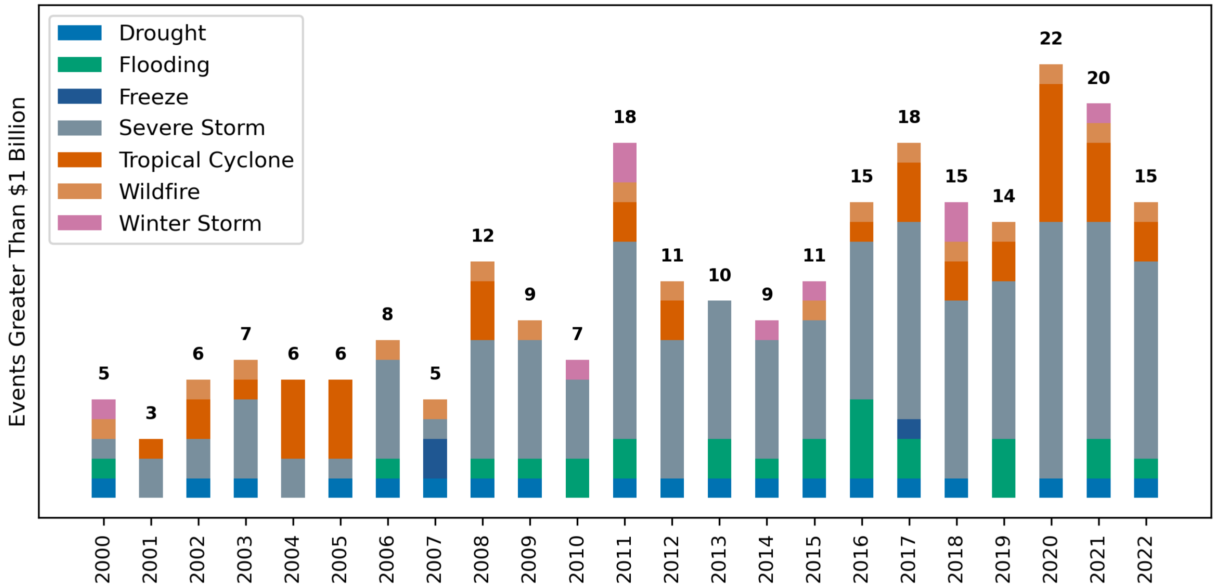
Increasing Natural Disaster Frequency to Stimulate Issuance

Recouping natural disaster-driven losses stood behind several of the recovery bond deals this year. For example, the PG&E Wildfire Recovery Funding deals are tied to loss recovery following the wildfires in California in 2017. Losses following Winter Storm Uri in 2021 drove deals such as ODFA 2022-ONG and ERCOTT 2022.

Rising incidence of natural disasters and the attendant costs may increasingly motivate the legislative framework that facilitates recovery bond deals. During the first nine months of 2022 there have been fifteen separate billion-dollar weather and climate disaster events, according to the National Centers for Environmental Information (NCEI). These include ten severe storm events (tornado outbreaks, hailstorms and a derecho), two tropical cyclones (Ian and Fiona), the Kentucky/Missouri flooding, the Western/Southern Plains drought/heatwave and Western wildfires (Figure 3). A recent Academy ESG report discussed the broader implications of the increasing costs and frequency of billion-dollar Extreme Weather Related & Climate Events (EWRCE).[1]

1 "The Water-Energy Nexus Challenge, No Longer Just Venezuela", Academy ESG Monthly, October 2022

Figure 3. Billion-Dollar Disaster Events in the US, 2000-2022



Source: NOAA National Centers for Environmental Information (NCEI) and Academy Securities

Aspects to Track on Recovery Bond Deals

We suggest investors track the following aspects on recovery bond deals:

- **Fixed versus usage-based recovery charges**. The special charges that the utility companies impose on customers' monthly bills and back the securitization deals can be fixed or variable, based on the customer's energy usage amount. As such, recovery bonds collateral can be sensitive to the number of customers, their usage levels, or both. Deals backed by fixed charges, such as ODFA 2022-ONG, could see adverse collateral impact if the number of customers dwindles over time, perhaps because of migration trends. Deals with usage-driven charges, such as ODFA 2022-PSO, could be negatively impacted if customers reduce their power consumption, perhaps because they switch to alternative forms of energy.

- **Recovery charge percentage of bills**. Excessive recovery fees as a percentage of the monthly bills can jeopardize customers' ability to pay, or it generate political pressure to reverse the imposition of the fees. To be sure, customers are much less likely to default on their energy bills compared to other obligations, given the necessity of the service. But amid rising energy fees (notably, New York City's gas prices are >60% higher compared to a year ago, as reported this week), we would generally look for lower percentage fees on recovery deals' collateral. Recent recovery deals varied in their fee percentage. For example, in ODFA 2022-ONG, the charges represent about 7.0% of the total natural gas bill by an average residential customer, according to rating agencies. In turn, in PG&E Wildfire Recovery Funding 2022-A the fixed charges are about 1.7% of the total electricity bill of an average residential customer. In ERCOTT 2022 the charges are about 0.4% of an average electricity bill.

- **Accumulation of recovery charges.** Successive natural disasters, and the need to recover accumulating losses, may lead utility companies to impose different fees on customers' bills. This may also call into question the ratepayers' ability to pay. For example, the PG&E 2022-A deal, which had a relatively low charge percentage compared to similar deals, was backed by a new recovery charge tacked on top of and earlier charge tied to a 2021-vintage deal. Still, the combined charges still resulted in a relatively low 2.1% of the total electricity bill of an average customer, according to presale reports.

- **Commercial vs. residential customer breakdown.** A higher exposure to residential customers should be supportive of collateral performance. Commercial and industrial customers are more likely to switch energy sources, according to presales. For example, in ODFA 2022-ONG 80% of the charges will be collected from residential customers.

- **Check the strength of charges special legislation and financing orders.** The strength of the collateral in recovery bond deals critically depends on the legislative and regulatory framework that established the right to impose charges on customers' bills. This is the aspect that clearly detaches recovery bonds' collateral from standard economic drivers that impact collateral performance in other securitized segments. But it also poses a challenge to investors that may not be well-versed in the nuances of state legislation and state utility regulatory bodies. Key aspects to analyze are the irrevocability of the financing order and the inclusion of pledges in the legislation not to impair the right to impose the recovery charges until the bonds' maturity. Separately, investors should also assess the utility and the issuer bankruptcy risks, which are more familiar legal risks of securitizations. PG&E near collapse in 2018 and the subsequent bankruptcy filing of the utility company spotlights such bankruptcy considerations on recovery bonds. PG&E exited bankruptcy in 2020.

- **Analyze charges "non-bypassability."** Charges that cannot be bypassed, or avoided by certain type of customers, should be more supportive of deals' collateral stability. For example, in the recent PG&E deal customers participating in the so-called CARE and FERA programs in PG&E's service area are exempt from the recovery charges. Such exempted customers accounted for only 12% of PG&E's total deliveries in 2021, according to deal documents.

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