Securitized Products Special Topics

Recovery Bonds: Diversifying Exposure Moves Beyond Disasters

Aspects to Track as Utility Fee Issuance Picks Up

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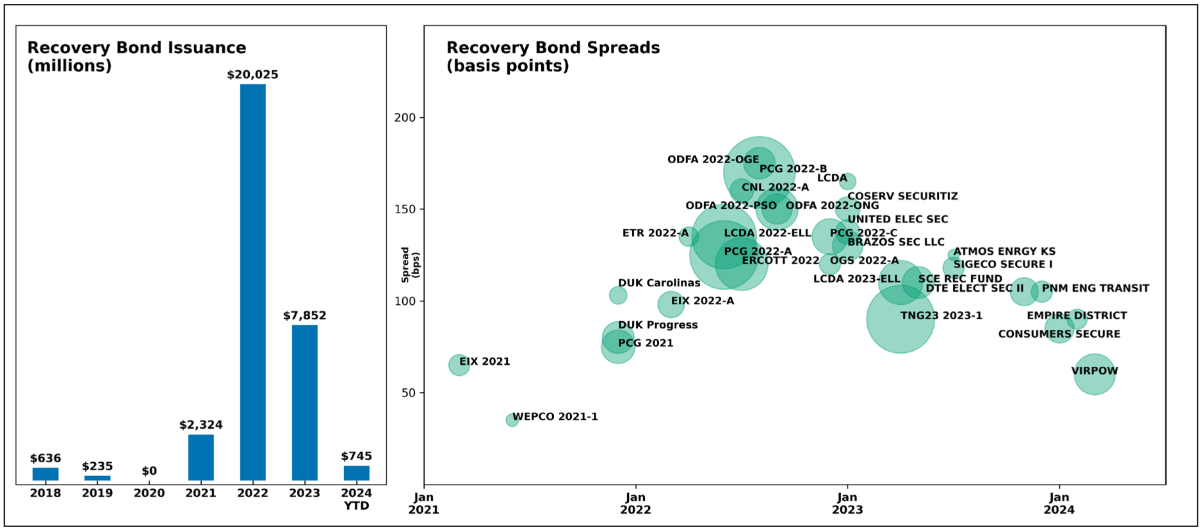
Recent recovery bond deals underscore the growth potential of the sector (aka utility fee, rate payer, and other labels), and its decreasing association with natural disasters that have traditionally driven issuance. Utility firm issuers are now tapping securitized markets with fee collateral tied to energy transition costs or deferred fuel cost, rather than recovery of expenses related to winter storms or wildfires. New issuers and geographies, such as Missouri and Virginia, have joined the market. The public-service commissions of several other states, including Colorado, Kentucky, and New Mexico, reportedly have been moving to approve utility fee securitizations. Duke Energy, which sponsored a utility fee deal back in 2021, is close to securitizing fees on South Carolina customers, according to SEC filings. All told, securitized investors are poised to see more diverse recovery bond offerings, and potentially greater liquidity in the sector.

The first two recovery bonds deals of the year provide market benchmarks, and illustrate evolving aspects in the sector (Figure 1)**.** The $1.28 billion Virginia Power Fuel Securitization (VPFS 2024) priced its $842 million A-2 class (5.4-year WAL) at 75bp over Treasuries. The deal is backed by deferred fuel cost (DFC) fees that Virginia Power is authorized to impose on its customers. In turn, the $305 million Empire District Electric Company deal (Liberty 2024-A) priced in mid-January its $180.5 million A-1 class (4.84-year WAL) at 90bp over Treasuries. The deal also included a longer, $125 million A-2 class (11-year WAL). The deal is backed by utility fees that Empire will impose on its customers in Missouri.

Figure 1. Recovery Bonds Issuance, 2018-2024 YTD



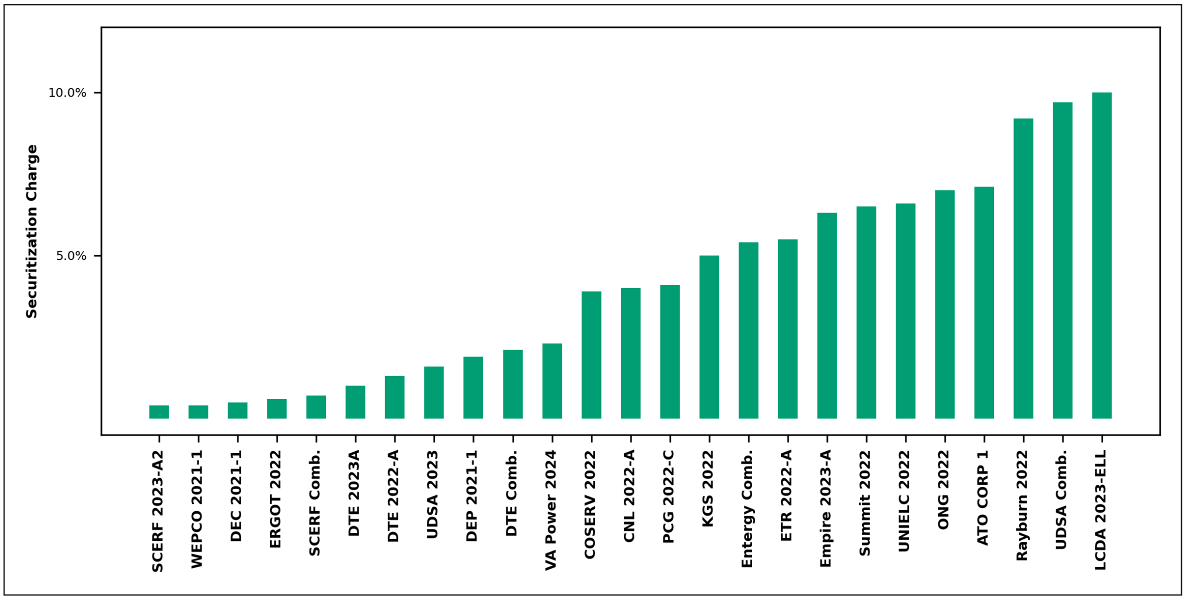
Source: Bloomberg and Academy Securities

Multi-Fee Charges and More Commercial Customers

We expect utility fee deals to continue offering robust legal framework, minimal credit concerns, and collateral performance that is uncorrelated to other securitized segments.[1] Recovery bonds unique ability to adjust fees based on past or projected future shortfalls (true-up mechanism) is a robust credit enhancement feature. Deals can include uncapped true-up provision, aimed at ensuring timely bond payments until full payoff. But the recent crop of deals, including late 2023 issuance, does highlight a few aspects we suggest investors track:

- **Percentage of securitization charge of customer's bill.** While there is limited concern over customers' motivation to make timely payments on their utility bills, onerous fees can drive performance issues, and potentially lead to political backlash. Securitization charges hover around 5% on average, according to rating agencies. But we find much variation across deals (Figure 2). Charges range from a very low 0.4% on SCERF 2023-A deal, to as high as 10.0% on Louisiana Utilities Restoration Corporation Project/ELL. The two deals in 2024 YTD feature 2.3% charge on VPFS 2024 and 6.3% on Liberty 2024-A. Notably, the Liberty deal charges look to recover costs associated with two separate sources: Winter Storm Uri in 2021, and Liberty's retirement of the Asbury Power Plant. The accumulation of fees can lead to an overall securitization charge that significantly stretches customer economics, especially in weaker economic regions.

Figure 2. Securitization Charges (% of an Average Residential Customer's Bill)



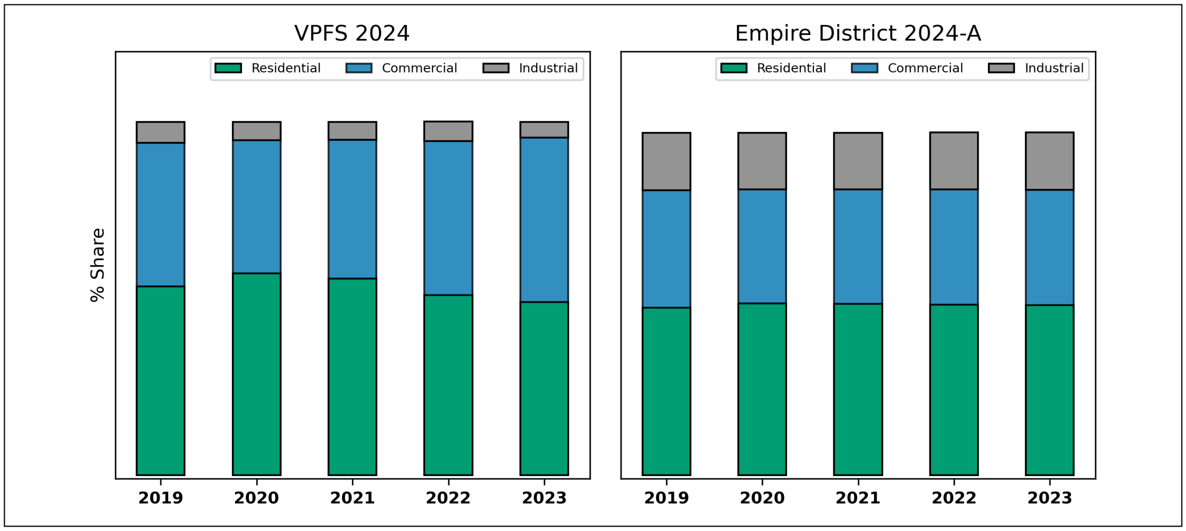
Source: Deal Documents, Ratings Agencies, and Academy Securities

1 "Recovery Bonds: No Need to Closely Watch the Fed or the Economy Here," Securitized Products Special Topics, Academy Securities, November 30, 2022

- **Natural disasters impact.** Utility firms' increasing use of securitized markets to recover all sorts of expenses (including potentially infrastructure improvements) does not necessarily reduce natural disasters impact on the recovery bonds sector. In fact, as firms impose a variety of new fees on their customers, future natural events, and their attendant costs, can present firms with a political or economic challenge to introduce additional fees to recover disaster costs. The multi-fee charge in the Liberty deal may illustrate how the issuer may be getting closer to maximizing the viable charges on its customers. A repeat of Winter Storm Uri consequences could weaken the issuer's finances without the ability to re-tap the securitization market.

- **Commercial customer exposure**. Elevated exposure to commercial and industrial customers can introduce performance volatility on utility fee collateral. The electric consumption of such commercial customers is more closely tied to economic cycles and regional economies compared to residential customers. We conjecture commercial consumption can vary either because (1) customers can adjust their usage in response to economic conditions, or (2) business-driven relocations of commercial customers away from the utility service area. Utility fee deals can feature higher commercial exposure as (1) new issuers with higher commercial customer component enter the market, or (2) as existing issuers see rising commercial component across their customer base. For example, first-time issuer Liberty has a relatively high 58% of non-residential customers (Figure 3). In turn, Virginia's power is seeing significant growth in commercial customer electricity usage, especially across data center users. Northern Virginia is the dominant data center cluster, boasting >50% of the data center development in the U.S, as we discussed in a report on the data center sector.[2]

Figure 3. Utility Fee Issuers Sales Revenue by Customer Class



Source: Deal Documents, Ratings Agencies, and Academy Securities

2 "Data Centers: Takeaways from 2023-Vintage Deals," Securitized Products Special Topics, Academy Securities, August 24, 2023

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