RATE REDUCTION BONDS

A Q&A With Galliard Analysts

December 2022

There has been a lot of recent new bond issuance of utility related securitizations and Galliard has been an active participant in this market. Often called rate reduction or stranded cost utility bonds, the asset class provides a unique opportunity for Galliard's corporate, municipal and structured teams to collaborate. Below is a Q&A with three Galliard analysts, René Hoogmoed, Matt Robertson and Will Moeller, to learn more about their view on rate reduction bonds.

RENÉ HOOGMOED, CFA
Senior Principal
Corporate Credit Analyst - Utilities

MATT ROBERTSON, CFA
Senior Principal
Structured Analyst

WILL MOELLER, CFA
Director
Municipal and Corporate Analyst

Q: GALLIARD HAS BEEN BUYING UTILITY RELATED SECURITIZATIONS LATELY. CAN YOU EXPLAIN THIS ASSET CLASS?

RENÉ: Certainly. Although there has been a flurry of issuance lately, the structure has been around since the mid-1990s and was initially used to recover stranded costs from utility deregulation. Without getting too deep, utilities rely on these types of bonds to recover costs that would otherwise be too large to run through the regular rate-setting process. The alternative would have been a temporary, large increase of ratepayers' utility bills, which is obviously not a desirable option. As a result, these vehicles were often described as rate reduction bonds.

Since then, securitizations in the utility space have been used for a wide variety of purposes, including extensive damages from weather events, such as storms and wildfires. The recent pick-up in issuance can mostly be attributed to one major weather event, winter storm Uri. In February 2021, the storm caused widespread damages in the South Central United States and triggered a dramatic increase in natural gas and power prices that would have been too big a burden for ratepayers' monthly utility bills.

For Galliard, these bonds have provided an interesting opportunity to collaborate between our different sector teams. As the corporate utility analyst at Galliard, I have seen the credit profiles of some of my credits deteriorate, as these companies still had to borrow money and pay their suppliers – even though there was a lot of uncertainty about how they would ultimately get paid back for fronting that money. Now, as the utilities receive the securitization proceeds, we should expect the credit profiles of these companies to stabilize.

Q: MATT, CAN YOU EXPLAIN HOW THESE BONDS ARE STRUCTURED?

MATT: Stranded cost utility bonds benefit from features that we look for in high quality securitizations. First and foremost, they are collateralized by specific, bankruptcy remote assets (cash flows), where no higher claim exists. In this case, the assets are ratepayer charges that have been authorized by applicable state law and also approved by state regulators. The charges show up as a specific line item on ratepayer monthly billing and they are non-bypassable and irrevocable. Second, there are credit enhancement features in place that aim to ensure cash flows will be sufficient to meet bond obligations. Specifically, the monthly charges are subject to ongoing adjustments for fluctuating energy use and/or changing population. In our experience, these features lead to stable bond cash flows and stable credit ratings.

Q: WILL, HOW DID MUNICIPALITIES GET INVOLVED IN RATE REDUCTION BONDS?

WILL: While not unprecedented, municipalities have not historically been part of this market. Getting involved in the wake of Uri made sense for a couple reasons. First, state governments could work with utilities and regulators to enact laws allowing this type of financing. Second, some state agencies already had established bond issuers – like the Oklahoma Development Finance Authority – known to the

municipal bond market. Furthermore, the municipal bond market has buyers accustomed to buying longer maturities, differing from typically shorter-maturity asset-backed securities market, which broadens the buyer base for these bonds. Name aside, these bonds are different than most municipal bonds. The municipal issuer is not on the hook for the debt – it's just the conduit issuer passing payments through from ratepayers to bondholders.

Q: SO WILL, ARE THESE BONDS ANALYZED THE SAME WAY AS MUNICIPAL BONDS?

WILL: No, traditional credit analysis on municipal bonds, like analyzing debt service coverage or additional bonds test covenants, doesn't really apply here. However, it is worth considering the political risk involved in these transactions.

Q: HOW DO YOU THINK ABOUT THE RISKS?

MATT: At the end of the day, the biggest risk for stranded cost bonds is political risk. Utility ratepayers could grow weary of additional utility charges from future events, like natural disasters, and apply pressure to the political process underlying these charges. Offsetting this risk, issuers offer a non-impairment pledge that protects bondholders from adverse government intervention going forward. The other risks are mass population shifts or technological changes that could leave existing charges in the hands of fewer ratepayers pose additional risks; however, mass exodus out of a service area is contrary to observed population growth and energy demand. Furthermore, the aforementioned "non-bypassable and irrevocable" clauses also protect existing charges.

Q: COMPARED TO A UTILITY'S CORPORATE BONDS, HOW DO YOU VIEW THE RISK PROFILE OF THESE BONDS?

RENÉ: One of the characteristics I really like about these bonds is the fact they are tied to a known event, tied to damages that have been analyzed, quantified and blessed by the regulators. This provides a lot of cash flow certainty. In contrast, when I underwrite that same utility I have to incorporate the risk of the next weather event that could come their way.

Q: ANY FINAL THOUGHTS?

WILL: The utility space has certainly been disproportionately impacted by major weather events lately. From a utility's perspective, these bonds will play an important role going forward serving as the long-term financing solution to one-time costs. From an investor's perspective, the bonds offer diversification benefits versus traditional corporate, municipal, or structured bonds. At Galliard, our multi-sector team will continue to evaluate the asset class as it evolves to determine relative value and suitability for client portfolios.

A LITTLE BIT ABOUT OUR AUTHORS:

RENÉ: As a senior credit analyst, René focuses on corporate bond credit research covering the energy, basic materials, and utility industries. He trades high yield bonds and manages Galliard's Core Plus portfolios. René is a member of the Credit Sector Team at Galliard. He holds a Bachelor of Arts in International Marketing from HEAO University (Arnhem, The Netherlands) and a Masters in Business Administration from Carlson School of Management at the University of Minnesota.

MATT: Matt oversees investment research, valuation, and monitoring of structured financial products. In this role, he covers traditional asset securitizations such as commercial mortgage-backed securities (CMBS), and consumer and industrial receivables/asset-backed securities (ABS). In addition, he covers structured government securities, such as SBA loans, Ginnie Mae Reverse Mortgages, EXIM Bank guaranteed bonds, and OPIC guaranteed bonds. Matt is also involved with the research and monitoring of Galliard's covered bond investments.

WILL: As a credit analyst, Will covers industrials and municipals. He is a member of the credit sector team at Galliard. Will holds a Bachelor of Arts in Economics from Macalester College and a Masters in Business Administration from California Polytechnic State University.

FOR MORE INFORMATION CONTACT: galliardclientservice@galliard.com OR VISIT: www.galliard.com

The information contained herein reflects the views of Galliard Capital Management, LLC and sources believed to be reliable by Galliard as of the date of publication. No representation or warranty is made concerning the accuracy of any data and there is no guarantee that any projection, opinion, or forecast herein will be realized. The views expressed may change at any time subsequent to the date of publication. This publication is for information purposes only; it is not investment advice nor a recommendation for a particular security strategy or investment product.

FOR INSTITUTIONAL INVESTOR USE ONLY

© 2022 Galliard Capital Management, LLC