

Rate Reduction Bonds —

A Diversifying Asset Class

Kristan Blake, Research Analyst

An asset-backed security (ABS) is a bond collateralized by a distinct pool of assets. The most common collateral types found in asset-backed securities are credit card receivables, auto and equipment loans or leases, home equity loans, student loans and installment sales contracts for manufactured housing units. Each bond has a specific collateral pool assigned to it at origination. The performance of the underlying collateral will largely determine the performance of the bond.

The ABS market allows for non-AAA rated issuers to access the capital markets at AAA funding rates. This is accomplished by isolating the ABS from the corporate credit risk of the issuer. Securitized assets are usually accounted for off the balance sheet of the issuer. Investors benefit from the high quality of the ABS market, 85% of which is AAA at origination. High credit quality and increasing issuance have resulted in an extremely liquid and stable market.

What is a Rate Reduction Bond?

A rate reduction bond (RRB) is the securitization of a cashflow stream generated by a fee charged to utility consumers. Deregulation of the electric utilities was introduced to foster a competitive environment and to reduce the rates charged to customers. However, when states deregulated utilities, the resulting decrease in revenue caused many utility company assets to become uneconomic to operate. These uneconomic assets are referred to as "stranded assets." RRBs were developed to enable utilities to bridge the gap between the book value of stranded assets in the previously regulated environment and their current market value in a deregulated one. The use of RRBs allows for an extended recovery period of those costs at a AAA funding rate.

Structure

Utility companies were *granted the right to charge consumers a fee* (often referred to as a transition property) to recover the costs associated with their stranded assets. In order to securitize this payment stream, the utility company must transfer the rights for the fee collection to a newly created Special Purpose Vehicle (SPV). The SPV then issues certificates (which are purchased by bondholders) and the proceeds are passed back to the utility company.

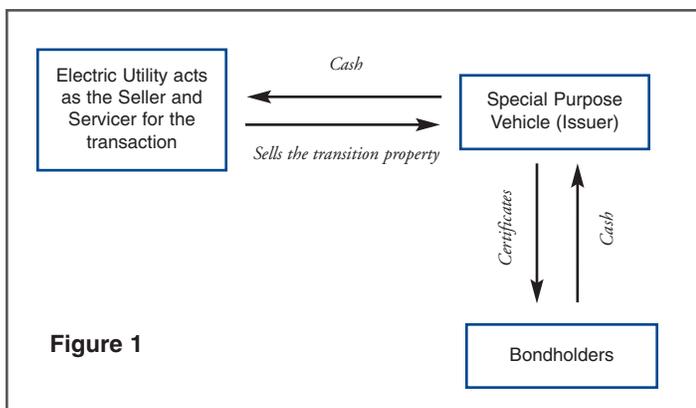


Figure 1

What is the role of an SPV?

An SPV is a bankruptcy-remote entity established for the sole purpose of issuing debt securities. The bankruptcy remote component of the SPV is crucial to the securitization and isolates the bondholders from event risk associated with the originator and servicer. On 4/6/01, Pacific Gas and Electric, a California-based provider, declared bankruptcy following the energy crisis in that state. On 4/9/01, the rating agencies affirmed the AAA rating of all \$2.9 billion outstanding PG&E rate reduction bonds. The ratings were affirmed because the assets (the right to collect the transition charge) were sold to PG&E Funding (a bankruptcy remote SPV) and were no longer part of the PG&E bankruptcy estate. All required payments due to bondholders have been made to date.

An Example of a Typical RRB Structure

In August of 2003, Oncor Electric Delivery Company (a wholly owned subsidiary of TXU US Holding Co) came to market with their first rate reduction bond. Oncor Electric Delivery Transition Bond Company is the SPV created by Oncor Electric Delivery Company to issue the bonds. The typical total deal size range for a RRB is anywhere from \$35 million to \$3 billion. Oncor 2003-1 is an average-sized deal at \$500 million. Oncor 2003-1 has a similar structure to most RRBs. It is a fully amortizing, sequential pay bond (see Figure 2). The amortization schedule pays principal first to A1 until A1 is paid in full, then to A2 until A2 is paid in full, and follows in this manner until A4 is paid in full. A1-A4 are all rated AAA by the three major rating agencies (S&P, Moody's, and Fitch), based on the underlying collateral quality and structure of the deal.

Figure 2

Servicer/Seller:	Oncor Electric Delivery Company
Issuer:	Oncor Electric Delivery Transition Bond Company LLC (The Special Purpose Vehicle)
Deal Size:	\$500,000,000
Bloomberg Ticker:	ONCOR 2003-1

Bond Structure:

Class	Rating	
	(S&P/Moody's/Fitch)	Average Life
A1	AAA/Aaa/AAA	2.00
A2	AAA/Aaa/AAA	5.00
A3	AAA/Aaa/AAA	8.00
A4	AAA/Aaa/AAA	10.83

Kristan Blake is the primary ABS Research Analyst for Conning Asset Management. She joined the firm in 2001 and is responsible for ABS analysis and surveillance. Ms. Blake is a graduate of Springfield College with a BS in Business Management.

Credit Enhancement

Credit enhancement available to rate reduction bonds includes a prefunded reserve account (typical in basic ABS structures). A reserve account is a predetermined dollar amount that is held by the SPV as further protection for bondholders in the event of any shortfall between fees collected from rate payers and payments owed to bondholders. RRBs also benefit from a "true-up mechanism" which allows for consumer charges to be adjusted up or down in order to amend any shortfalls or surpluses experienced by the trust. The true-up mechanism makes the repayment schedule more predictable than any other ABS asset class. In fact, every transaction since 1995 has adhered exactly to its stated payment schedule with the exception of one transaction for which an early redemption provision was exercised.

Credit Quality

The cash for the repayment of a RRB comes from the fee charged to all utility users in a specific area (this charge often appears at the bottom of a regular electric bill). The charge assessed to customers is based on the amount of power transmitted through the grid irrespective of power supplier. Changing the power supplier (going to a competing supplier) does not void the charge. The only way to avoid the charge is to disconnect from the grid entirely. Because most electric power consumers rely exclusively on the grid for their power delivery, the number of customers and usage patterns is very predictable. The rate-paying group is therefore extremely diverse, and includes both private residences and companies, which significantly reduces credit risk.

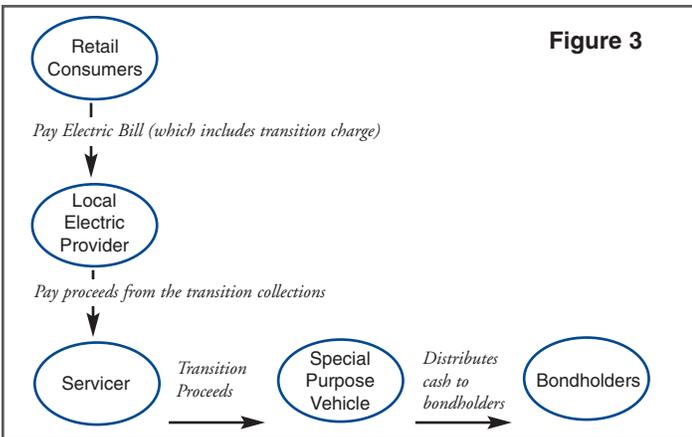


Figure 3

Legal Issues

All outstanding RRBs have State pledges to protect bondholders from any alteration to the authorizing legislation that would hurt bondholders. A typical State pledge contains language that articulates that the State will not take any action or permit any action that would impair, reduce, or alter the value of the transition property until the bonds are repaid in full.

In 1998, a California ballot initiative called Proposition 9 sought to reverse key provisions of AB 1890, the legislation that allowed for the collection of the transition property in California. While the proposition was ultimately defeated, even before its defeat, both S&P and Moody's affirmed the AAA ratings on \$6 billion of RRB issuance from California utilities.

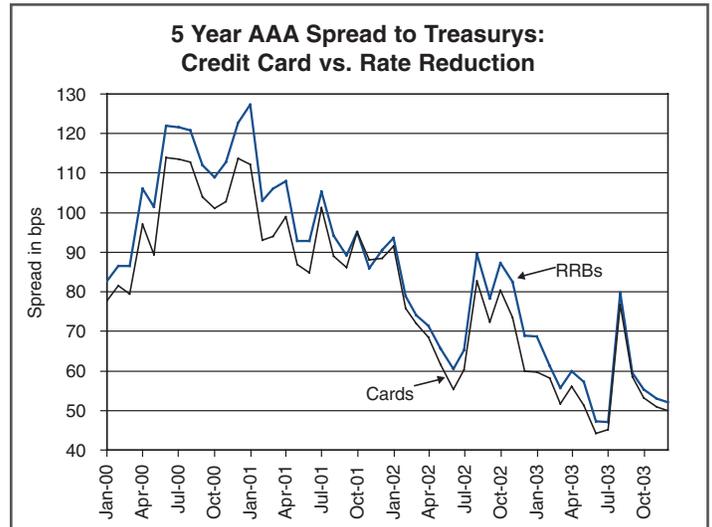
S&P stated that the bonds were protected by 1) the State pledge not to take or permit action that would impair the bonds and 2) protection from the federal and state constitutional provisions protecting against the impairment of contracts.

How much more Supply can we expect?

Since RRBs were introduced to the ABS market in 1995, there have been more than \$31 billion of issuance. Estimates for further rate reduction issuance range between \$5-8 billion, with issuance concentrated in Texas, New Jersey and Michigan. Since all of these states have already issued RRBs, the process will not require new legislative action and should be straightforward. Most of the remaining supply is expected to occur in late 2004 and early 2005.

Trading verses other AAA ABS

RRBs currently trade at spreads comparable to AAA-rated credit cards, which are the benchmark for the ABS market. It can be argued that RRBs are in fact of higher credit quality than credit cards because the borrower base is more widely diversified and the transition charge cannot be avoided by the ratepayer. Historical RRB spreads have widened and compressed on headline news, but have generally tracked credit card spreads. Previous RRB spread gaps to credit cards have presented buying opportunities. While recent spread differentials offer only an incremental yield pick-up, RRBs still offer value as a diversifying asset class. ♦



Source: JP Morgan

Asset Management Viewpoint is published by Conning Asset Management Company. It is intended to inform readers about developments of interest but should not be considered investment advice. Data in this report were compiled from sources we consider reliable but are not guaranteed by us. This report does not purport to be complete. Opinions are subject to change without notice.

CONNING ASSET MANAGEMENT COMPANY

CityPlace II, 185 Asylum Street, Hartford, CT 06103-4105
860-527-1131, www.conning.com

Copyright 2003

Conning Asset Management Company

