

MOODY'S

INVESTORS SERVICE

RATING METHODOLOGY

Utility Cost Recovery Charge Securitizations Methodology

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This rating methodology replaces *Utility Cost Recovery Charge Securitizations Methodology* published in February 2021. We made several limited clarifications in the "Rating Approach" section when describing utility cost recovery charges. We added a section on environmental, social and governance considerations and made limited editorial updates throughout the methodology to improve readability.

Scope

This rating methodology applies to securities backed by utility cost recovery charges.

In this methodology, we explain our global approach to assessing credit risks for utility cost recovery charge (UCRC) securitizations, including quantitative and qualitative factors that are likely to affect rating outcomes in this sector.

We discuss the asset and structural analysis, as well as other considerations. We also describe our monitoring approach.

Rating Approach

In this section, we describe the key characteristics of the assets backing UCRC securitizations and the typical UCRC structure and summarize our approach to assessing credit risks for securities backed by UCRCs, including quantitative and qualitative factors that are likely to affect rating outcomes in this sector.

UCRCs are established by special legislation and financing orders typically issued by utility regulatory bodies. The charges backing the UCRC securities that we rate in the US have been established by state legislation and in most cases by state utility regulatory bodies. For UCRC securities 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 UCRCs 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, carbon transition, wildfire risk mitigation expenses, wildfire litigation costs, or for the replenishment of reserves established for repair of facilities damaged by natural calamities, such as hurricanes or tornadoes.

A UCRC security is 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 in most cases by a public service utility regulatory body. The securities are backed by a property right created by the legislation which provides the right to impose and collect special charges on customers' monthly utility bills.

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

On the legal side, we assess the extent to which the legislation that authorizes the UCRC¹ provides clear procedures for insulating the transaction from claims by other parties and is likely 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, corporation, cooperative or other type of entity – 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 property owner must follow to charge the fee.
- 3) The irrevocable right of the property owner to transfer the fee to a special purpose financing vehicle for securitization purposes. In some structures, the property right is created at the UCRC securitization issuer or its affiliate, hence there is no sale.
- 4) The type of financing vehicle authorized to issue securities backed by the fees.

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the issuer/deal page on ratings.moodys.com for the most updated credit rating action information and rating history.

¹ We use the terms cost recovery "charges" and cost recovery "fees" interchangeably.

- 5) The process to be followed such that the transfer is 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 insulates 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 became bankrupt or investors in other securities issued by the utility, might make a successful claim on the securitization's cash flows. Furthermore, we consider the breadth of the market where 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 charge's applicability.

Our assessment of the overall legal strength of the property right involves qualitative and judgmental factors. Transactions that we consider strong based on certain attributes may achieve the highest rating. We evaluate the impact of any of the attributes weakening on a case-by-case basis.

Our analysis examines the likelihood that the charges established by the legislation and accompanying regulations will be sufficient to repay the securities, and 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 may evaluate:

- » 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.
- » The likely per capita energy usage (in those cases in which the fee charged is based on the usage amount).
- » 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).

Asset-level Analysis

In this section, we explain how we analyze the underlying assets that back UCRC securitizations and how we estimate potential losses on those assets.

Protection Against Future Impairment of the Right to Collect the Charges

UCRCs are established by special legislation that authorizes the creation of a property right to collect future surcharges on customers' monthly utility bills as the means to pay back the UCRC securities. 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 securities and (2) violation of that pledge would be a violation of law.²

² Violation of the non-impairment pledge would be a violation of the Contract Clause and the Takings Clause under the Federal and State constitutions in the US.

Irrevocability of the Financing Order

The legislation is typically accompanied by a financing order issued by the public service commission³ that authorizes the utilities to impose and collect the surcharges on the customer's monthly utility bill during the term of the securities. Our analysis assesses whether the financing order is irrevocable, which would protect investors against future adverse changes that may reduce the charges backing the securities.

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 UCRC, both in absolute terms and as a percentage of the customer's utility bill. Typically, the percentage of a residential customer's monthly bill devoted to the UCRC is around or less than 10%.

In certain jurisdictions, we may also review stressful collection scenarios provided by the sponsor or its agent, in which some factors have been stressed, such as energy usage and/or servicing fees.

Depending on the availability of information, we may assess the reasonableness of the utility's projections by analyzing (1) the historical usage in the utility's service region and the variances between past projections and actual outcomes, and (2) the likely growth in usage in the utility's service area, 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 general, any stresses would be issuer-specific and considered on a case-by-case basis. One relevant factor we may use to examine the appropriate stress level for a transaction is the variability of the customer base against which the charge is applied; for example, the population in the service area or the usage in the service area. Customer bases that are less broad-based and diversified tend to be more variable.

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 usage. An area that relies on multiple industries for economic growth likely has a more stable business climate than an area dependent on the fortunes of one industry. In the latter case, the area's prospects may falter if that particular industry runs into difficulties.

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 tends to have less volatility in consumption, since consumption by commercial and industrial operations is more closely tied to the business cycle. Furthermore, residential customers are less likely to quickly embrace new technologies and are less likely to cut back consumption dramatically if the price rises. 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. Overall consumption could be vulnerable if those entities decline or leave the area.

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

³ In the US, in some cases, the body approving the financing order is not a public service commission

switch to other service providers within the territory during the life of the securities. 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 Analysis" section, the power of the true-up mechanism to protect investors is dependent on the non-bypassability of the charges. Therefore, non-bypassability (with limited, immaterial exemptions) is a key factor in our analysis and combined with the true-up mechanism could provide considerable credit protection in the absence of traditional types of credit protection, such as reserve accounts or subordination.

Structural Analysis

In this section, we explain how we analyze the structural features of a UCRC securitization, including how we assess available cash flows for securities, taking into account asset cash flows and available credit support.

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. A complementary aspect of the analysis is our degree of certainty that the fees generated through the legislation will be sufficient to pay off the securitizations in full.

Depending on the risks and mitigants in the relevant jurisdiction, transaction ratings typically are positioned between the government rating and the country ceiling. Risks that could lead us to assign transaction ratings lower than the country ceiling include, for example, continued high debt burden levels in a utility system. Such high debt levels, 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.

True-up Mechanism

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 usage is to rate increases. Therefore, our analysis of the true-up mechanism goes together with our analysis of the UCRC's bypassability and how easily customers can cut back on 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.

Generally, the true-up mechanism is, in effect, the most important credit protection for UCRC transactions, limiting the risk that the UCRCs will be insufficient to pay off the securities and thereby limiting the need for traditional sources of credit enhancement such as subordination and reserve funds. The true-up mechanism also limits the need to analyze the creditworthiness of the customer base since the mechanism adjusts for all shortfalls, including those caused by customer defaults.

Sufficiency of the Charges

The charges are usually assessed as an amount linked to a customer's 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 period the charges can be imposed – that might cause the collections to be insufficient for timely payment of the principal and interest on the UCRC securities. In addition, we analyze whether the period during which the

charges are allowed to be levied provides sufficient cushion to pay off the securities by maturity in the event that collections come in more slowly than originally projected.

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 of the true-up adjustments, the less likely that investors will suffer a shortfall at the final maturity date. Generally, the charges collected rank senior to other charges of a utility system and represent only a small amount of the total revenue of such a system.

This 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.

Cash Flow Allocation and Credit Enhancement

Our credit risk analysis 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 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 if there is a temporary interruption in the flow of the UCRCs. For example, many transactions have a capital or reserve account with funds sufficient to pay interest for at least one to two months if needed. Furthermore, we assess the extent to which the credit enhancement available in the transaction is sufficient to offset any shortfalls that might develop in the period between the final true-up adjustment and the securities' maturity.

Other Considerations

Along with our asset and structural analysis, we consider other quantitative and qualitative factors in our credit analysis, such as legal risks, transaction counterparties, and environmental, social and governance (ESG) considerations.

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 the utility's other creditors might make a claim on the UCRCs or that payments to securitization investors might be delayed by an automatic stay imposed on payments from the utility company.^{4, 5} 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 collection. However, given the essential service the

⁴ 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.

⁵ For more information on how we analyze legal risks in structured finance transactions, a link to a list of our sector and cross-sector methodologies can be found in the "Moody's Related Publications" section.

utility provides, we expect that government authorities would intervene to prevent any servicing disruption 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 is not investment grade, as long as the transaction is structured with some mitigants for operational risk, such as the provision for additional liquidity.

In addition, we analyze whether the utility's bankruptcy utility could cause a disruption in payment remittances by the utility to investors. Such a disruption could occur if the remittances of the charges were "commingled" with the utility's other funds, 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 how the utility separates the received UCRCs from its other funds and how frequently it transfers the funds to the trust.

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 UCRCs 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 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 UCRCs, (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.

Environmental, Social and Governance

Environmental, social and governance (ESG) considerations may affect the ratings of securities backed by UCRCs. We evaluate the risk following our cross-sector methodology that describes our general principles for assessing these ESG issues⁶ and may incorporate it in our analysis.

Monitoring

In this section, we describe our approach when monitoring transactions. We generally apply the same key components as we apply when assigning ratings, except for those elements of the methodology that could be less relevant over time.

In monitoring UCRC transactions, we analyze whether the securities' balances are in line with the scheduled principal amortization, which indicates the extent to which payments are in line with our original expectations.

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

⁶ A link to a list of our sector and cross-sector methodologies can be found in the "Moody's Related Publications" section.

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 legislative changes that could impair the transaction's future cash flows. Such risk may materialize, for example, in the case of continued high financial imbalances in the system that may support a view that the system deficit is unsustainable over the long term.

Depending on the jurisdiction, we also follow the utility's rating as a proxy to assess any changes to the service region's economic health and the potential for changes in the size and composition of the customer 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 investors.

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

Thus, changes in 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.⁷

⁷ For example, in methodologies where models are used, modeling is not relevant when it is determined that (1) a transaction is still revolving and performance has not changed from expectations, or (2) all tranches are at the highest achievable ratings and performance is at or better than expected performance, or (3) key model inputs are viewed as not having materially changed to the extent it would change outputs since the previous time a model was run, or (4) no new relevant information is available such that a model cannot be run in order to inform the rating, or (5) our analysis is limited to asset coverage ratios for transactions with undercollateralized tranches, or (6) a transaction has few remaining performing assets.

Moody's Related Publications

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For data summarizing the historical robustness and predictive power of credit ratings, please click [here](#).

For further information, please refer to *Rating Symbols and Definitions*, which is available [here](#).

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