31 March, 2007

Environmental ABS beckons

The US structured finance markets can expect growth in a new type of securitisation – environmental control bonds. Several states have already passed legislation and securitisation deals could follow. Meanwhile, in Europe a carbon emissions trading market is rapidly developing, with the prospect of emissions credits soon being repackaged into CDOs. **John D'Antona** and **William Thornhill** report.

This year, **Potomac Edison** and **Monongahela Power** will be the first US power companies to issue asset-backed securities in the form of environmental control bonds (ECBs). Each deal will be the first for the two West Virginia-based firms. The former's offering will total US$100m, while the latter's is sized at US$345m. The Triple A rated offerings will be structured as senior/subordinated notes with tranche average lives ranging from one to 20 years. The collateral pool represents the right of the issuer to collect environmental control charges (ECCs) in tariffs from residential and business customers.

Barclays Capital, *First Albany*, *Loop Capital*, *Bear Stearns* and *Scotia Capital* will serve as underwriters, and Saber Partners will serve as financial adviser, for both deals. Marketing roadshows are under way.

"These deals differ from previous offerings as they mark the first time the proceeds will be used to finance an environmental project," said Jennifer San Cartier, director at Fitch. "Normally these deals are used for other purposes, such as raising capital to recover costs."

Joseph Fischera, a partner at Saber Partners, explained that investors are uniquely protected in these types of deals as the right to collect tariffs is supported by irrevocable state regulatory guarantees. This allows for the right to collect, and if necessary to raise charges, as much as needed to guarantee timely repayment of the bonds.

Furthermore, investors are protected by a pledge in the legislation from events that might harm the environmental control property (issuer) and which therefore could hinder the payment of the bonds.

Proceeds from the sale will be used in part to finance environmental control equipment, such as the construction and financing of a flue gas desulphurisation plant for the greater West Virginia, Maryland and Virginia metropolitan area.

Florida, Wisconsin and Utah have all passed legislation to allow their respective state-sanctioned power companies to collect such tariffs. Florida has stated its intention to use the proceeds to recover costs associated with hurricane damage, while Wisconsin and Utah, like West Virginia, are looking to fund capital construction projects.

Credit enhancement for the two deals comes from the "true-up mechanism". The periodic true-up mechanism requires that the ECCs be reviewed and adjusted at least semi-annually to correct for any over or under-collection of ECCs, to maintain the required balances in the capital sub-accounts, and to guarantee timely payment of debt service and other charges in connection with the ECBs.

Additionally, non-routine true-ups are provided in case of an event that requires adjustment to the true-up mechanism. For example, the loss of a major industrial customer accounting for a substantial portion of the electric load might require a non-routine true-up. An excess funds sub-account will also be established for the term of the transaction.

The most recent utility-issued ABS bond offering was from **AEP Texas** last October. That was a US$1.7bn rate reduction bond through *Credit Suisse*, *JPMorgan* and *RBS Greenwich* that priced in spite of some lacklustre sales. The US$437m 10-year piece priced at swaps plus 6bp, 1bp wider than talk, and the US$500m 13-year certificates came at swaps plus 14.1bp, 2bp to 3bp wider than guidance. Investors balked at paying the early price talk offered for these esoteric and long-duration securities.

"I can tell you it hit trouble at every turn, with price talk having to be widened," said a co-manager at the time. "Every step of the way . . . the bonds had to widen as investors just wouldn't step up, as the weighted average lives for the bonds were simply too long for the spread levels attached."

Securitised exits

In Europe, meanwhile, a number of initiatives have got off the ground that suggest carbon credits could eventually be monetised via a securitisation exit.

Mayer Brown Rowe & Maw partner Edmund Parker, a derivatives and structured finance specialist (and the author of a chapter on emissions trading in "Practical Derivatives: A Transactional Approach") noted that there are at least 10 European climate exchanges, including the UK's European Climate Exchange (ECX), Powernext in France and Nordpool in Germany. These exchanges trade emissions allowance contracts.

"When you combine with that the documentation standardisation projects of the three major trading associations (ISDA, IETA and EFET), the conditions are right for these derivatives to be embedded into bonds to create emissions allowance-linked securities and CDO-style structures," Parker said.

Last year, HVB priced the €300m **Breeze II** deal, which was based on collateralised revenues generated from European wind-turbines. Had the project been located in a developing country, the firm or country running the project could have taken advantage of the Kyoto Protocol's Clean Development Mechanism and earned tradable emission credits to sell under the EU's emissions trading scheme, thereby generating an additional return.

The EU has set up an Emissions Trading Scheme (ETS) under which around 12,000 EU industrial installations, responsible for half the EU's carbon dioxide output, are allocated allowances. The scheme aims to reward financially companies that reduce emissions and penalise those that do not. The EU's ETS is run in five-year stages, with the next due to begin in January 2008. With the EU committed to cutting emissions by 20% by 2020, scarcity will be built into the market, suggesting credits will become an appreciating asset. And pricing transparency is reasonably developed, with a number of brokers, including Co2e, Evomarkets and Natsource, providing price information and counterparty matching services.