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As Climate Damage Rises, Utilities Turn to ‘Recovery Bonds’

As climate change makes extreme weather events more common, US utilities and energy companies are turning to a once rare vehicle to raise funds for coping with the infrastructure damage they cause: recovery bonds. By late November, utilities were on track to sell nearly $20 billion of recovery bonds in 2022, a record, and up from $2.3 billion in 2021. What’s the attraction? Companies issuing recovery bonds aren’t on the hook to pay them back out of their own coffers. Expect the demand for recovery bonds to heat up even more as the Earth does.

1. What is a recovery bond?
It’s a type of bond that is sold by an energy or utility company to “recover” the costs of a one-time big expense, most commonly storm damage or the retirement of a coal plant or to pay for other plant equipment costs. Here’s how recovery bonds are different from typical debt offerings: Utilities can seek regulatory approval to set up a special finance subsidiary to sell the recovery bonds and are then authorized to add a small ongoing charge to customers’ monthly electricity bills. Those charges, which can continue for dozens of years in some cases, get transferred to the finance subsidiary and the finance subsidiary then distributes that money to bondholders in the form of regular coupon payments plus principal. If some customers don’t pay their charge, then the shortfall is made up by increasing the charge on all other customers. The state pledges never to interfere with this collection mechanism.

2. Can you give me an example?
You probably remember headlines from the winter storm, called Uri, that paralyzed Texas in February 2021. That same storm inflicted billions in economic costs on energy utility companies in Oklahoma, Louisiana and Kansas. Utilities in all four states chose to issue recovery bonds rather than add a massive one-time surcharge to customers’ bills. In Oklahoma, after receiving permission from the state legislature, four utilities sold about $2.8 billion in recovery bonds to investors, including BlackRock, Citadel and a collection of insurance companies.

3. Why are so many of them being sold recently?
Fire and ice. A big chunk of the recent increase comes from bonds sold to deal with the damage from massive wild fires in California from 2017-19 as well as Uri. In Texas, a planned $3.4 billion in taxable municipal debt issued by a state agency to help utilities there will be the state’s largest long-term muni offering ever. The fires and ice storms have been linked to climate change, which is making extreme weather more likely worldwide, leading to greater damage to energy grids in the wake of hurricanes or blizzards. Climate change is also leading to more pressure to retire coal plants early. Utilities in some states, including Indiana, aim to sell recovery bonds to help cover the costs of shutting down their coal plants early.

4. What’s the advantage of a recovery bond?
From the point of view of investors, recovery bonds are unusually secure: They’re backed by state laws guaranteeing that payments will continue even if the utilities go bankrupt. Recovery bonds have also offered higher yields than on comparable corporate bonds. Securities offered in August by the Oklahoma Development Finance Authority included debt with a weighted average life of about 22 years that yielded about 4.7%, or 135 basis points above Treasuries, data compiled by Bloomberg

show. That spread was fatter than on other debt with top credit ratings. For example, a comparable Microsoft Corp. bond maturing in 2045 traded in late August at around 76 basis points above Treasuries, according to Trace pricing data.

5. How can the bonds both be safe and offer such high returns?
In Oklahoma and other states where utilities have sold recovery bonds, some critics have claimed that the bonds are being sold at higher-than-necessary interest rates. They argue that's because the utilities aren't paying the interest — their customers are — meaning the utilities have little incentive to push for a better deal. If true, households and business customers are getting the short end of the stick, facing an unnecessarily large extra charge on their monthly electricity bills for decades — even if that's still better than the alternative of a huge one-time utility bill hike.

The Reference Shelf

- A Bloomberg article on the rise in recovery bonds.
- An article on PG&E's fire-related recovery bond.
- A paper by the Natural Resources Research Institute on non-traditional approaches to borrowing for utilities' capital expenditures.

Bloomberg Green

By Scott Carpenter

November 29, 2022