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Recent Financing Trend: Reopening Previous Issues of Debt Securities

We have recently noticed an increase in the popularity of debt "reopeners," including reopener issuances in March 2012 by Mississippi Power Company, in May 2012 by both Georgia Power Company and Westar Energy, Inc. and in June 2012 by Southwestern Public Service Company. This financing technique is known by several different names, including "reopener," "reopening," "add-on," "tack-on" or "tap." Regardless of the name, the procedure is the same. Namely, after the original issuance date of a series of debt securities, the issuer chooses to offer additional securities of such existing series rather than offer a new series with different terms. These reopened securities must have the same terms (maturity, coupon, interest payment dates, CUSIP number, exchange listing, redemption provisions, etc.) as the originally issued securities. The selling price and issue date will likely be the only difference; with the interest rate already fixed, a discount or premium in the selling price is needed to produce a yield reflecting the current market. Additionally, if the issuance of the additional securities occurs after the first interest payment date on the outstanding securities, the initial interest payment date would differ. Additional securities issued pursuant to a reopener should trade fungibly with the originally issued securities.

Why Reopen?

There are several reasons why issuers often want to reopen a series of debt securities, as opposed to issuing a new series. Unlike equity issuances, debt offerings do not typically include an option permitting underwriters to purchase additional securities within a specified period of time (a "green shoe"). A reopening, however, can satisfy additional investor interest in an issuer's debt offering. Unexpected investor demand may be a motivation for an immediate reopening of a recently issued series of securities, but reopenings are not limited to the typical 30-day green shoe option exercise period.

For an issuer requiring new funds, but less than $250 million principal amount, liquidity is another driving force behind the popularity of reopeners. Debt securities that are "index eligible" have more market information

readily available to investors and are more easily traded. In order to be "index eligible" (i.e., eligible to be included in the Barclays Capital US Aggregate Bond Index) a debt issue must aggregate at least $250 million principal amount. A series of securities that is "index eligible" will likely receive more favorable pricing terms than a non-"index eligible" series of securities. So, if an issuer seeks to issue less than $250 million principal amount or if an original issuance was less than $250 million principal amount, a reopener may result in a combined series greater than $250 million and therefore cause the series to be "index eligible."

Requirements & Mechanics

An issuer interested in the reopening technique needs to ensure that the indenture (or other operative document pursuant to which the debt was issued) permits the issuance of reopened debt without the consent of the holders of the original series. The offering document for the original issuance should also disclose the issuer's ability to increase the principal amount and issue additional securities of such series.

A reopener that is registered under the Securities Act of 1933 is basically a routine takedown from the shelf registration statement.[1] The reopener prospectus should be near-identical to that from the original issuance, but any reopening needs up-to-date disclosure (risk factors, issuer developments, financial data, etc.). The reopener prospectus should also include a description of the reopening on the cover page, set out the details of the previously sold securities and note the formation of a fully fungible single series.

Investors who purchase reopened debt are required to pay, as part of the purchase price, accrued interest. The amount of the accrued interest depends on the date of the reopening issuance. In the case where the reopened debt will be issued prior to the first interest payment date following the original issuance, the purchasers will need to pay accrued interest for the period beginning on the date of the issuance of the original securities to, but not including, the date of issuance of the reopened debt. Alternatively, if the reopened debt is issued after an interest payment date on the original issuance of debt, purchasers of the reopened debt will need to pay accrued interest for the period beginning from the most recent interest payment date to, but not including, the date of issuance of the reopener.

The closing documentation for a reopened series will be substantially similar to that of the original issuance. Although the substance of the documents will appear very similar, a complete set of standard agreements, including underwriting agreement, opinions, comfort letters, certificates and receipts, will be necessary. However, the document that, pursuant to the indenture, originally established the series may not be required at the closing of the reopening.

[1] Reopenings of Rule 144A transactions can present a tricky issue. If an issuer reopens an original series of securities that were offered under Rule 144A under the Securities Act, the "restricted period" for the original securities will be restarted, as it will be impossible to distinguish between the originally issued and newly issued securities.

Tax Considerations

For the reopened securities to be fungible with the original issuance, they must have the same tax characteristics. If both the original issuance and the reopened securities are issued with no more than a *de minimis* amount of original issue discount,[2] as long as the securities otherwise have identical terms, they should have the same tax characteristics, even if they technically are not part of the same "issue" for tax purposes.[3]

The tax considerations for a reopening can be more complicated if either the original issuance was issued with original issue discount or the reopened securities will be sold with more than a *de minimis* amount of discount. In that circumstance, to be fungible from a tax perspective, a reopening of debt securities must either close within 13 days of the original issuance as part of a common plan or single transaction, or the additional debt must be part of a "qualified reopening," as determined by one of two tests. Debt securities issued in a qualified reopening are treated for tax purposes as if they were issued in the original issuance. As a result, the reopened securities issued in a qualified reopening have the same tax characteristics, including amount of original issue discount, as the original issuance, and any additional discount in the reopening is treated as market discount.

The Treasury regulations restrict qualified reopenings to two circumstances. First, if the reopening date is not more than six months after the issue date of the original debt securities, then the reopening will be a qualified reopening if (a) the original debt securities are publicly traded[4] and (b) on the pricing date of the reopening (or, if earlier, the announcement date), the yield on the original debt securities is not more than 110 percent of the yield on the issue date of the original debt securities.

Second, if the original debt securities are publicly traded and are not tax-exempt obligations or contingent payment debt obligations, then the reopening will be a qualified reopening if the new debt securities are issued with no more than a *de minimis* amount of original issue discount (determined without applying the qualified reopening rules).

Given this additional level of tax analysis regarding reopeners, many issuers choose to include a tax section in the prospectus supplement disclosing these considerations.

[2] For a noncontingent fixed rate debt security, the amount of original issue discount generally will be the difference between the amount payable at maturity and the issue price of the debt security. Original issue discount is de minimis if it is less than 0.25 percent of the amount payable at maturity multiplied by the number of complete years to maturity from the issue date.

[3] If such reopenings meet the requirements for a qualified reopening described below, then the reopened securities will be treated as the same "issue" for tax purposes.

[4] Whether a debt security is publicly traded is determined under Treasury regulations Section 1.1273-2(f). In general, debt securities that are listed on a specified exchange, that are traded on a contract market designated by the CFTC or an interbank market, for which a system of general circulation disseminates price quotations or recent trading prices, or for which price quotations are readily available from dealers, brokers or traders (subject to certain exceptions), generally are treated as publicly traded. Proposed Treasury regulations would expand the definition of publicly traded to include any debt security for which the price for an executed purchase or sale is reasonably available or for which firm or indicative quotes are available.

Cost Recovery Through Rate Reduction Bonds; A Short Survey

Utility rate reduction bonds help utilities recover certain categories of costs in a fashion that minimizes the rate impact for their customers and resulting stress on the utility's ongoing rate structure. The categories of costs recoverable through this type of financing, and the number of states sponsoring such issuances, have continued to grow in recent years. We thought it would be useful to identify the states that sponsor this type of financing and to survey the types of costs recoverable from proceeds of a rate reduction bond issuance. Although still utilized in less than a majority of the states, rate reduction bonds have represented a significant source of funding for the utility industry in recent years, with more than $45 billion of issuances since the structure was introduced in the late 1990s.

Rate reduction bonds minimize costs by qualifying for triple A ratings and accordingly are issued with yields considerably lower than those based on the sponsoring utility's long-term debt rating. In order to be eligible for this level of credit quality, rate reduction bonds must possess certain common structural characteristics.

- First, the bonds must be authorized by specific state enabling legislation entitling the utility to impose and collect usage-based customer charges that are dedicated to payment of the bonds.
- The charges must be non-bypassable; that is, they cannot be eliminated by switching to alternative providers of service.
- The legislation requires the utility to seek and receive an irrevocable financing order from the state utility regulator. The financing order creates a present intangible property right to impose and collect the non-bypassable charge in amounts necessary to service the bonds.
- The legislation and financing order provide for a periodic true-up rate mechanism, by which at least annually, and more frequently in many cases, the special charges are reviewed and adjusted to correct for any undercollection, to assure timely payment of the principal and interest on the bonds.
- The legislation also provides for a covenant by the state that until the bonds have been paid, the state will not impair the value of the securitization collateral or, but for the true-up process, reduce, alter or impair the special charges to the utility's customers.

In a rate reduction bond transaction, the sponsoring utility typically sells its rights to the special customer charges and related statutory rights and entitlements to its bankruptcy remote subsidiary. This is done pursuant to provisions of the legislation that provide that the sale of this intangible property will be perfected under state law as an absolute transfer. The subsidiary issues the bonds and pledges its entitlements and rights as collateral to the trustee under the bond indenture.

The Internal Revenue Service has issued specific guidance for rate reduction bond structures under which the sponsoring utility is not required to recognize income when it receives the proceeds of the bonds in return for the transfer to the issuer of the intangible rights under the financing order. Instead, the non-bypassable charges are recognized as income to the utility under its usual method of accounting. In addition, the bonds are treated as obligations of the utility.

Enabling legislation for rate reduction bonds has generally been adopted for limited categories of identified costs and not typically for general utility financing. For such legislation to be supported and passed and bonds to be issued thereunder, there typically must be special circumstances that incent both the local utility and legislators and regulators to find that more customary means of utility financing should be supplemented. Both the utility and the regulator lose elements of their normal compact in connection with rate reduction bonds. For the state and regulator, the flexibility to adjust this component of the utility's rates, as interest rates and financing costs vary, is lost. To obtain the lowest rates, rate reduction bonds are non-redeemable and the charges to customers must meet debt service for the life of the bonds. The utility, on the other hand, forgoes its equity return on the component of its rate base financed with rate reduction bonds. The customers' charges are essentially a straight pass-through of debt service. Equity investment in the special purpose issuer has traditionally been 0.05% of the principal amount of the bonds and treated as credit enhancement, without a return other than from investment of such funds when not needed for bond service. As a result, assets financed with rate reduction bonds do not generally bear a meaningful equity return.

As of the date of this article, approximately 20 states have adopted statutes permitting the issuance of rate reduction bonds. Certain of these statutes have been for single offerings or are subject to sunset provisions and certain statutes remain as a generic option for the particular company. The classes of recoverable costs have included the following:

Transition to Competitive Market Costs

These are costs incurred by the utility that would have been recoverable under a regulated monopoly market structure but are not recoverable through market prices in a competitive market. Depending on the state, these costs may include, among other things, generating assets sold below cost, mitigation costs in the transition to competition, and

uneconomic purchased power or fuel costs. Transition bonds are the most common form of rate reduction bonds and are or have been available to utilities in California, Connecticut, Illinois, New Hampshire, Massachusetts, Michigan, Montana, New Jersey, Pennsylvania and Texas.

Storm Recovery Costs

These are costs incurred in connection with the restoration of service and infrastructure after large-scale storm events. In Arkansas, Florida, Louisiana and Texas the securitization proceeds may recover such costs and also fund reserves for future storms.

Environmental Costs

These are costs incurred while constructing, installing or placing in operation equipment intended to control and lessen utility environmental impacts, costs intended to increase the efficiency of energy production or costs associated with retiring existing facilities to reduce, control or eliminate environmental pollution in accordance with federal or state law. Securitization is permitted to cover environmental costs in West Virginia and Wisconsin.

Investment Recovery Costs

In Louisiana recovery through securitization is permitted for costs of cancelling an electric-generating or transmission facility, capital investments in excess of $350 million or costs associated with purchasing or acquiring long-term supplies of fuel of any type or facilities of any type for the production, delivery or storage of such supplies.

Conservation Investment Costs

These are costs associated with energy conservation programs, including loans made to customers for this purpose and conservation measures installed at the expense of the utility. Conservation investment costs have been recoverable through securitization in Oregon and Washington.

Rate Stabilization or Phase-in Costs

These include costs incurred to acquire energy or fuel or other costs in excess of amounts that the utility had been allowed to charge customers currently and costs deferred as a phased implementation of increases in rates. Recently enacted statutes in the states of Ohio and West Virginia permit recovery for costs of this type. Maryland also permits recovery for costs associated with rate stabilization.

Regulatory Assets

The Michigan statute has a generic authorization for use of securitization to finance a utility's regulatory assets generally in addition to more specific references to costs stranded in a competitive market.

Other

Many state rate reduction bond statutes authorize financing the costs of acquiring equity or debt with the proceeds of a bond issuance. Many also include in the calculation of the costs to be recovered, carrying costs incurred during the period from when the costs were initially incurred until recovery through the issuance of the rate recovery bonds. In addition, certain unique situations have also been addressed. For example, California adopted a specific provision allowing Pacific Gas and Electric Company to recover costs as authorized by the public utilities commission relating to its Chapter 11 reorganization in 2003. Finally, the Idaho statute appears to include virtually anything the utility could finance through ordinary means of financing.

Rate reduction bond statutes have continued to be enacted in recent years. In the last year statutes have been enacted in Ohio and West Virginia authorizing rate reduction bonds to be issued for phase-in costs in Ohio as well as "expanded net energy costs" in West Virginia. Also rate reduction bond statutes have continued to be drafted, if not yet implemented, for a number of other potential uses. Lawyers at Hunton & Williams have participated in drafting proposed legislation to enable cost overruns on nuclear power plant construction to be financed with rate reduction bonds. Finally, it bears noting that issuances have continued under rate reduction bond statutes, including, within the last 12 months, the financing of costs associated with a cancelled generating facility ($207 million issued in September 2011 by an Entergy Louisiana, LLC, subsidiary under a Louisiana statute), and transition to competition costs ($1.695 billion issued in January 2012 by a CenterPoint Energy Houston Electric, LLC, subsidiary and $800 million issued in March 2012 by an AEP Texas Central Company subsidiary, each under a Texas statute). Lawyers at Hunton & Williams represented underwriters on nine of the last fourteen rate reduction bond issuances, including these three.

The Rating Agency Condition: A Cautionary Note

Issuers of asset-backed securities often find themselves with a need or desire to amend, supplement or obtain a waiver of the contractual terms of the outstanding securities. Indentures and contracts under which the securities are issued typically do permit modifications or waivers, but only with the consent of specified percentages of the holders of the securities. Obtaining a consent from holders can be time consuming, cumbersome and expensive. Depending on the circumstances, solicitations may require the assistance of specialized solicitation firms, an actual or virtual meeting of securities holders, legal expenses in connection with preparation of the documentation for the solicitation, filings with the Securities and Exchange Commission and, of course, securities holders may seek consideration for their consent. Rating agency conditions, or RACs, are provisions found in many securities transaction documents as a procedure to permit issuers to amend, supplement or obtain the waiver of terms of their agreements without having to get permission from the securities holders. Essentially the RAC is a provision that permits modifications or waivers, provided that it is demonstrated that there is no adverse impact on the rating of the securities.

Examples of RAC provision usage are particularly prevalent in utility rate reduction bond securitizations. These transactions typically involve the issuance of bonds that are to be paid by a special charge on customers of the utility. The charge is authorized by legislation and a special order of the state regulator and adjusted, or trued- up, if necessary, to meet scheduled bond service. The stakeholders in the transaction include not just the issuer and the bondholders, but also the utility regulator and the wide class of utility customers. RACs are used in significant ways to permit adjustments to the transaction and constrain other actions. Satisfaction of a RAC is often a condition to certain amendments of the indenture and other principal documents, to the merger of the issuer, to appointments of successor servicers, to adjustments in the level of the servicer's fee, to application of nonstandard true-ups, to defeasance and to sale of the utility's business. Also, it is not unusual to require the RAC to be satisfied for the utility to enter into any subsequent rate reduction bond transactions.

In its simplest form, a RAC provides that notice of the proposed action must be provided to a specified agency and that confirmation of no adverse ratings impact must be received from that agency to meet the standard for modification of the transaction without consent of securities holders. Because many transactions are rated by more than one agency, a common form requires the affirmative acknowledgement of no adverse impact from one agency and, in addition, notice to one or more other agencies rating the securities, and then the absence of adverse ratings actions from these others during a specified period, after which the proposed action can proceed.

Since 2008, and as a result of increased scrutiny placed on rating agency actions, certain agencies have become reluctant to produce writings outside the guidance in formal press releases or the initial rating advice. Rating agencies have also refined their procedures and policies to stress that, as articulated in one case, they will not "shape the structure of deals." Depending on the circumstance, agencies have either declined to provide a RAC response or made it more difficult to obtain one. In consequence, a provision that is widely used throughout ABS and corporate transactions can become a potential roadblock that can prevent an issuer from amending, supplementing or updating its documents. In addition, issuers may be precluded from taking actions they would otherwise have expected to undertake without difficulty. For an example of the latter, consider a series of utility rate reduction bond transactions that commingle collateral and that require satisfaction of a RAC for a follow-on transaction. In these circumstances, the issuer can find itself in a trap, needing to fully document a transaction to the point of launch before seeking RAC confirmation, only to find that the RAC is not available.

In our recent experience, policy changes at some of the rating agencies have made the traditionally drafted RAC problematic. Many large transactions are rated by the three principal agencies, Standard & Poor's Ratings Services ("S&P"), Moody's Investors Service, Inc. ("Moody's") and Fitch, Inc. ("Fitch"). Of these three, as of March 2012, it is our understanding that only S&P will provide a written response to a RAC inquiry. In our experience, it is now difficult to obtain a direct written response to a RAC inquiry from Moody's and Fitch, with the form of the response and the ability to obtain it in a timely fashion being an issue even when it is available.

One of the rating agencies' current policies in this area resulted in unusual drafting in a recent transaction involving a utility rate reduction bond securitization. The initial proposal was to include a RAC requiring notice to S&P and the confirmation by S&P of no adverse ratings affect. It also required notice to the other agencies rating the securities and no indication of an adverse effect from these agencies before the expiration of a specified period. This approach was consistent with a number of recent transactions in not requiring the other agencies to express a view, but giving them an opportunity to do so if the proposed action was deemed by them to be inconsistent with the continuance of the awarded rating level. One of the rating agencies objected, on the theory that inaction might imply active re-affirmance. Instead, in a convoluted result worked out with the objecting agency, the rating agency condition as to

Moody's and Fitch was deemed removed if no response was received after the expiration of the specified period. The full text of the RAC is produced below.

> *Rating agency condition means, with respect to any action, not less than ten (10) business days' prior written notification to each rating agency of such action, and written confirmation from each of S&P and Moody's to the servicer, the indenture trustee and us that such action will not result in a suspension, reduction or withdrawal of the then current rating by such rating agency of any tranche of transition bonds issued by us and that prior to the taking of the proposed action no other rating agency shall have provided written notice to us that such action has resulted or would result in the suspension, reduction or withdrawal of the then current rating of any such tranche of transition bonds; provided, that if within such ten (10) business day period, any rating agency (other than S&P) has neither replied to such notification nor responded in a manner that indicates that such rating agency is reviewing and considering the notification, then (i) we shall be required to confirm that such rating agency has received the rating agency condition request, and if it has, promptly request the related rating agency condition confirmation and (ii) if the rating agency neither replies to such notification nor responds in a manner that indicates it is reviewing and considering the notification within five (5) business days following such second (2nd) request, the applicable rating agency condition requirement shall not be deemed to apply to such rating agency. For the purposes of this definition, any confirmation, request, acknowledgment or approval that is required to be in writing may be in the form of electronic mail or a press release (which may contain a general waiver of a rating agency's right to review or consent).*

Where a RAC with this structure must be satisfied for a proposed action it will be important to plan for the 15 business days waiting period that may occur. For example, where a RAC is imposed as a condition to a follow-on transaction to avoid triggering a default with respect to outstanding securities, this timing may present a challenge. Often a follow-on transaction requiring a RAC confirmation to not violate the terms of an outstanding security is not fully negotiated or committed until the transaction is ready to move into the market, and the uncertainty built into a potential for a three-week delay, while the RAC process is completed, can be problematic unless planned for well in advance. Another potential issue results from the recent initiatives whereby in ABS transactions, the Securities and Exchange Commission requires issuers to make information provided to a rating agency available to other agencies that may choose to provide a rating for the security (see Rule 17g-5). To avoid potential delay and or an uncontrolled interaction with an agency not chosen by the issuer to rate the transaction, it is important to contractually limit the "rating agencies" to which the RAC applies to be the agencies specifically chosen to rate the securities at issuance.
One last suggestion is that, where possible, a RAC not be imposed as an absolute requirement but always as an alternative to consent of a specified percentage of securities holders. This would mitigate the risk that someday S&P joins the ranks of agencies refusing to respond to a RAC request by providing a clear alternative that would eliminate any ambiguity as to what percentage of securities holders could waive the RAC requirement.

The rating agency condition is still a practical option for most issuers and can be used effectively. It is, however, important to understand and consider what the rating agencies are willing and may in the future be willing to do before drafting and incorporating a particular condition. Addressing the inclusion and structure of a RAC early in the offering process will allow sufficient time for both issuers and the agencies to get comfortable with the process being requested and help to eliminate surprises.

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