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Electricity Utility Investment Strategy

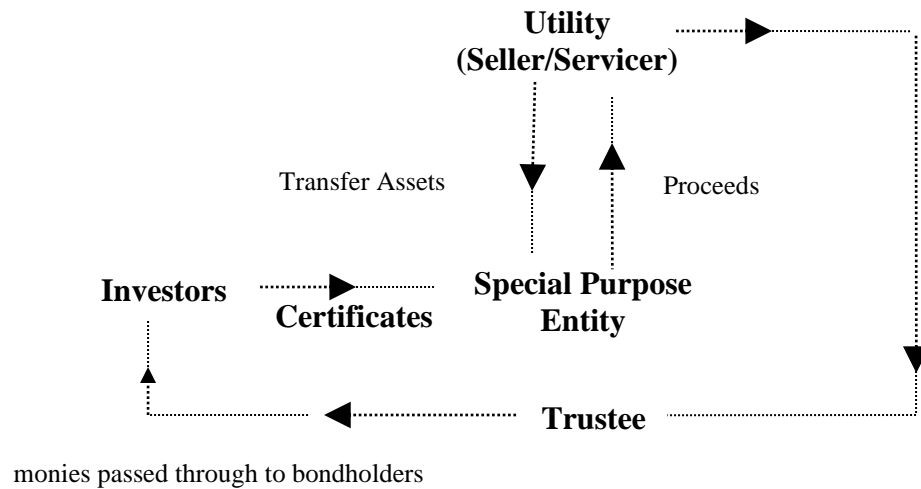
Background

- Since the passage of the Federal Energy Policy Act of 1992 allowing wholesale electric competition, a number of individual states have begun expanding the competitive process to retail level. Many utility companies across the country have spent billions of dollars over many years building capacity, including high cost nuclear plants, expecting to recapture those investments through regulated electricity rates. With the onset of competition, however, utility companies will not be able to charge rates high enough to cover their large investment, leaving the companies vulnerable to huge liabilities called “stranded costs”. Specifically, stranded cost investments are defined as assets and incurred costs that will not be recoverable in a fully competitive marketplace. The solution to recovering these stranded costs is the securitization of future cash flows into bonds, selling a portion of these liabilities, and allowing the utilities to write off their residual higher cost assets over a significant period of time.
- Though California has been the only state to date that has actually completed securitizations, totaling \$6.5 billion at the end of 1997, several states are expected to follow with an estimated \$175 billion of additional asset securitization. The inherent risk profile of the utilities will improve as the proceeds are used to refinance higher cost debt and reduce total outstanding debt.

Structure of Securitization

- Securitization starts with state legislation being passed that guarantees the recovery of most stranded costs. The bonds, backed by a special transition charge, are part of a plan to help utilities prepare for competition. Most transition charges will come out of current rates with no additional costs on the monthly bill.
- The legislation provides a guideline for each utility to devise its own competitive rate filing with state Public Utility Commissions. Given commission and legislature approval, the utility sells the intangible assets to a special purpose entity. This entity finances the asset acquisition through the issuance of rate reduction bonds. The transition charge is collected from the utilities’ customers and passed on to the entity to distribute principal and interest payments to bondholders. The utility services the transition charges and the entity is the obligor of the securities.

Asset Securitization Flow Chart



Source: Public Utilities Fortnight, January 1, 1997

Investment Opportunity

- With favorable technical support from the issuance of rate reduction bonds, spreads on **utility debt securities** are anticipated to narrow, especially for those companies in states where deregulation is likely but still pending. A key element was put in place when the IRS ruled that these bonds would be considered debt obligations for tax purposes. Without such a ruling, securitization would be considered a taxable event for utilities; in other words, proceeds from the bonds would have created an immediate tax liability. This “tax for debt” treatment will set a precedent in other jurisdictions and hasten the issuance of these rate reduction bonds.

Fundamental Case for Utilities

- In recent years, cash flow positions for many utilities have improved as capital expenditures have decreased and depreciation charges have accelerated. Capital expenditures have declined for the past four consecutive years due to increased competition and more than adequate base-load generating capacity. Actual expenditures over the 1994-1996 period were \$8 billion lower than originally forecasted. To prepare for competition, companies have accelerated depreciation to reduce the levels of stranded assets on their balance sheet. Consequently, the industry has altered its capitalization structure over the last five years, decreasing its outstanding long term debt to 47.5% in 1996 from slightly greater than 50% in 1991, with net long term debt declining by \$2.3 billion over the past two years. There is no question that this strong cash flow supports the financial health of the industry.

Forecasted YR of Survey	Period	<u>Electric Plant</u> Expenditures (\$million)	Actual (\$million)	Difference
1992	'92-'94	86,917	73,605	(13,312)
1993	'93-'95	84,081	71,791	(12,290)
1994	'94-'96	75,039	67,211	(7,828)
1995	'95-'97	65,621	--	--
1996	'96-'98	62,367	--	--

Source: Edison Electric Institute

Conclusion

- After thorough research of the Electric Utilities, Vanderbilt investment focus has been on debt securities of utilities where excess cash flow is available. Specifically, in states where we foresee favorable legislation regarding asset securitization, company balance sheets will be further strengthened through debt retirement. Hence, we have adopted a strategy that highlights a combination of these two criteria.
- Utilities securities that offer value include Commonwealth Edison, Long Island Lighting, and Texas Utilities which trade at 200 bps, 170 bps, and 182 bps, respectively in excess of treasuries. In our opinion, these holdings have the potential to narrow significantly mirroring the contraction of California Utility spreads in anticipation of rate reduction bond issuance.

Comparable Issues

Issue	Rating	Coupon	Maturity	Callable	Spread
Duke Energy	Aa3/AA-	6.75%	8/25	NC98	100
Florida P&L	Aa3/AA-	7.05%	12/26	NC03	105
So Cal Edison	A1/A+	7.125%	7/25	NC03	108
Pub Svc E&G	A3/A-	7.0%	9/24	NC03	125
Houston L&P	A3/A-	7.5%	7/23	NC03	135
Peco Energy	Baa1/BBB+	7.25%	11/24	NC98	135

Vanderbilt Research Team