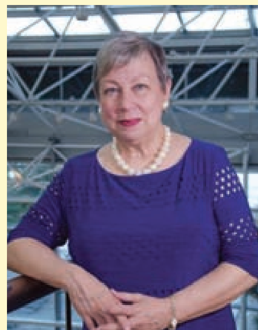
Local Financing Benefits U.S. Utilities

Banks, Utilities Find Natural Fit

By Julie Cannell



merican utilities have always placed a great deal of emphasis on the economic development of their service territories, including partnerships with local banks.

During earlier decades, prior to the formation of the global financial giants, utilities typically raised capital from sources close to home. However, the U.S. banking industry has consolidated over the past several decades.

This has resulted in the transfer of much utility commercial bank financing to global banking giants. They are typically headquartered hundreds if not thousands of miles away from those utility service territories.

Regional and local banks have a large share of the 9.5 trillion dollar U.S. bank deposit base. An overwhelming amount of their capital is drawn from local depositors. Our research has shown regional and local market shares ranging from roughly half, in a few cases, to a hundred percent in several states with no global bank presence. That stands in sharp contrast to the global banks that finance a significant share of their capital needs from the overnight wholesale loan markets overseas.

Some innovative American utilities have been complementing their global commercial banking facilities with fully competitive regional and local bank syndicates.

Financial Crisis Sparks Changes

In 2009, the near collapse of some globally systemically important banks (those called too big to fail) suggested the time was ripe to revisit the global banking paradigm. From the outset, the idea never was to replace all the credit facility financing underwritten by the global banks. Rather, the regional or local banks would have the capability to provide financing complementary to that of the larger institutions.

The regional and local banks are often healthier than the big banks, according to financial scoring done by the Federal Reserve. Further, the non-global banks typically don't have the same opportunity to put their funds to work with investment grade credits.

At that time, five of us with experience in the utility business formed CFSD Group LLC (Complementary Funding Source Development). We were motivated by the convergence of two important trends.

The prospective capital demands facing utilities were coupled with the permanent changes underway in the global banking arena as a result of the financial crisis. The partners envisioned a return to fulfilling some of the industry's financing needs by tapping the resources of local and regional banks.

Because of our diverse backgrounds within the utility industry and outside it, we felt we could offer a unique set of advisory skills in helping utility companies tap local and regional banks. We had collectively worked as utility general counsel, chief financial officer, chief strategic officer. Externally, we had served as counsel, consultant, investor, state regulator.

Julie Cannell is a partner in CFSD Group LLC, and president of J. M. Cannell, Inc., an advisory firm providing investor-related services to the electric utility industry. Cannell spent two decades with investment manager Lord Abbett & Co. as a securities analyst and portfolio manager. She is a Chartered Financial Analyst.

Regional and local banks are often healthier than big banks, according to the Federal Reserve.

An initial meeting was held at Con Edison's headquarters in New York to introduce the financing concept and to assess interest. A good cross section of electric utilities from across the country was represented.

One of the companies contacted the group a few weeks later, saying it wanted to move forward with financing. That's how CFSD Group became a reality.

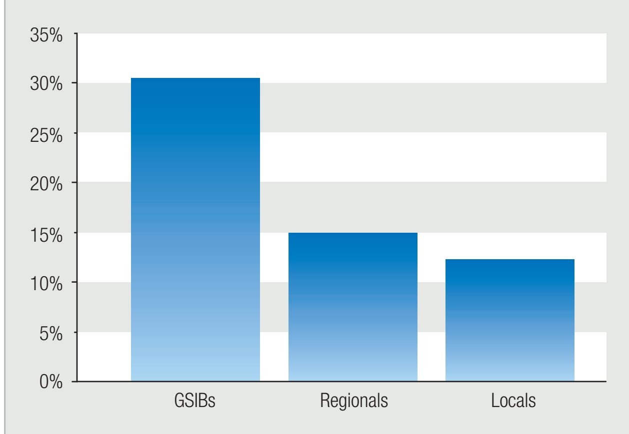
Benefits of Local or Regional Financing

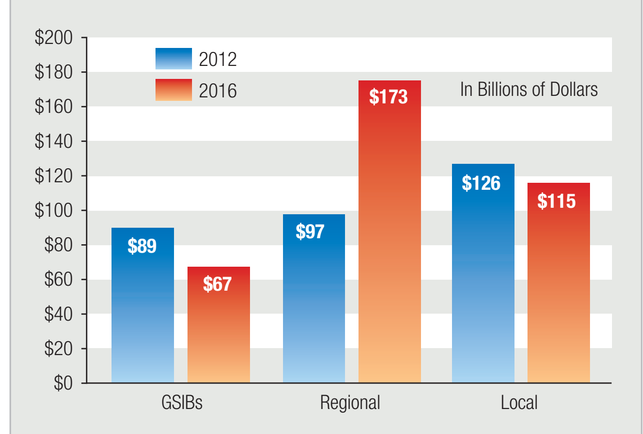
From the outset, our work confirmed that the local or regional financing path is a natural fit for utilities.

This type of collaboration represents a virtuous circle. By borrowing locally, utilities would help bolster their local economy, which in turn could create job growth. This would demonstrate to regulators their desire to support customers, perhaps resulting in the utilities being awarded recognition in the regulatory arena in the form of "atta boy" points.

Tapping the strong local financing resources would further serve to diversify utilities' commercial banking resources. Accordingly, it would strengthen their risk management posture, a positive move in the eyes of credit rating agencies.

The banks would be loaning to an investment grade credit, a benefit many local banks had not previously enjoyed. That credit boost would serve to enhance a bank's capital adequacy,





asset quality, management, earnings, and liquidity score, on a system utilized by the Federal Reserve.

Last but certainly not least, the partnership formed between the utilities and their local banks could extend beyond the immediate financing to other community endeavors.

Finance Advice Worth $1.1 Billion

To date, we have advised on over 1.1 billion dollars in financing for utilities around the nation. These have included American Electric Power (separately, Indiana Michigan Power; Kentucky Power; AEP Texas), Duke Energy, Exelon, Madison Gas & Electric, PNM Resources, and PPL Corporation.

Deal sizes have ranged from forty million dollars to three hundred seventy-five million dollars. All the financings have been on competitive market terms. They were over-subscribed and generally completed within ninety days from inception, unless regulatory constraints extended the process.

In addition to our financing advisory work, we performed credit-monitoring services for Pepco Holdings prior to its merger with Exelon. We are now serving as a confidential advisor on non-investment grade financings for infrastructure investors in the energy industry.

Utilities have used these local or regional financings in a variety of ways. All have been structured as classic liquidity facilities, usually as mirror images of major revolvers, whether funded or liquidity.

Many have been funded entirely or in part to finance different capital expenditure needs, including nuclear refurbishments, environmental requirements, or for general corporate purposes. Local or regional facilities can also be used to fund bond or other debt redemptions coming due in the short term, building up to a large enough amount to support a major bond issuance.

Software pinpoints the locations of banks within the client's service territory, as well as within any distance from its physical assets. It can also calculate the capital adequacy, asset quality, management, earnings, and liquidity score for each bank using the Federal Reserve methodology, and provide key financial metrics for the institutions.

We also coordinate arrangements with regional banks with the potential to lead the syndicated financing, and organize the information and follow-up meetings with the qualifying local banks. Most of the regional banks in the U.S. have participated as agents in the financings. Several have participated multiple times.

Banks would be loaning to an investment grade credit, a benefit many local banks had not previously enjoyed.

Evolution of Banking Industry

The banking world has continued to evolve. In the first quarter of 2011, we analyzed one hundred eighty-nine U.S. electric utility revolving credit facilities, aggregating one hundred eighteen billion dollars of commitments. That research yielded several points.

Almost all the facilities had a LIBOR – Fed Funds – Prime Rate pricing menu. Most of the facilities were extended and amended to strengthen the Dodd-Frank and Basel III cost pass-through provisions, regardless of the date when those provisions were promulgated.

Some very recent extensions now permit banks to suspend their LIBOR commitments with no advance notice. With the continuing tightening of regulations under Dodd-Frank and Basel III, utility chief executive and financial officers are encouraged to ask their legal advisers and cash managers for an assessment of the potential impact of these cost pass-through measures on their current agreements.

The use of LIBOR rates has dominated the pricing of major commercial bank credit facilities for the utility industry for decades. This critical pricing benchmark has shown considerable volatility over its thirty-year history.

After a long period of very low levels, it has begun an increasing trend of late. Recent developments regarding the manipulation of LIBOR have suggested that an alternative pricing benchmark is needed for short-term rates. One is likely in the offing.

Utilities have been informed by some global banks currently in their liquidity facilities that those banks will not be participating in renewal or new facilities. This is due to the increased Tier 1 capital coverage requirements imposed on the banks under the Basel-III regulations, with an expected attendant negative impact on earnings.

When the cost of lending for credit facilities was essentially free for too big to fail banks, those banks were willing participants in those facilities. But times have changed.

Though the new regulations have affected the global banks in a major fashion, the local and regional banks are impacted to a materially lesser degree. The explanation for this largely lies in the extent to which different categories of banks are dependent upon the wholesale market (such as LIBOR-based) for their deposits.

The globally systemically important banks typically see twenty-five to forty percent of their capital structure financed from the short-term wholesale markets. In contrast, local and regional banks usually have minimal short-term wholesale borrowings. The overwhelming majority of capitalization comes from local bank deposits. See Figure 1.

At the present time, local banks are still an under-utilized lending resource for electric utilities, despite the role these banks played historically in providing financing for the industry. Our research has demonstrated consistently that this segment of banks has ample money to lend.

In a typical banking market, we have discovered that residential retail, commercial, and industrial customers have two to four times as much money deposited with local and regional banks as with the local branches of global banks. See Figure 2.

Rating agencies have expressed an interest in utility liquidity facilities. In answer to rating agency concerns, several utilities have viewed regional and local financing as an additional tool to assure liquidity in times of market stress.

Local banks are still an under-utilized resource for electric utilities, despite the role these banks played historically.

One rating agency asked us for guidance. The agency sought to make sure that utilities had considered regional and local banks in their liquidity planning.

Conclusion

In a time of persistent turmoil in global banking, we realized that turning to banks that were limited to domestic transactions made sense. That paradigm has proven to be increasingly accurate.

Several large foreign banks have already withdrawn from U.S. liquidity facilities, not because of ratings issues, but because they are allocating the balance sheet back home to Europe.

Local and regional banks will not supersede global banks in servicing the utility industry's need for credit facilities. However, our research consistently has confirmed that these local institutions have a great deal to offer.

They generally bring to the table strong credit metrics. They're ready, willing, and able to lend, particularly to investment grade credits. Above all, they're in utilities' own backyards. Indeed, the virtuous circle persists. PUF

The Kilowatt Sentinels, March 2, 1959 PUF

Wisconsin Power & Light Board of Directors Meeting at New Boiler, May 25, 1950 PUF