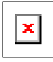

Story URL: http://news.medill.northwestern.edu/chicago/news.aspx?id=80885
Story Retrieval Date: 3/7/2008 3:35:46 PM CST

ComEd, shocked by high interest rates, may pass costs to customers

by JOHN DETRIXHE
Mar 06, 2008

The disastrous lack of liquidity in short-term lending markets has claimed another victim: Commonwealth Edison. And the fallout will probably show up in electric bills.

ComEd, a division of Exelon Corp., is obligated to service a whopping $343 million in auction-rate, tax-exempt debt—pollution-control bonds with interest rates that in some cases have jumped from about 3.5 percent to as high as 12 percent.

“We are addressing the issue and are exploring opportunities for restructuring the debt,” wrote Bob McDonald, ComEd senior vice president and chief financial officer, in an e-mail.

“In general, debt costs are passed on to customers in rates,” he added.

ComEd’s bonds were issued through the Illinois Finance Authority, a state authority that issues taxable and non-taxable bonds for Illinois entities, including local governments, non-profit corporations and businesses that need funds for projects with a public benefit.

Jim Chilsen, spokesman for the Citizens Utility Board, or CUB, said he wouldn’t be surprised if the interest rate fallout ends up in Chicago-area electric bills.

“ComEd finds many creative avenues to raise electricity rates. Given their past history, we wouldn’t be surprised if they try to use the auction-based security crisis to implement a rate hike,” Chilsen said.

ComEd already has a $361 million rate-hike request before the Illinois Commerce Commission to offset network construction costs.

CUB, a state-chartered consumer advocate organization, and Illinois Attorney General Lisa Madigan’s office in February called on the ICC to cut ComEd’s rate hike request by at least 90 percent.

Paul B. Fremont, an analyst in New York with investment bank Jefferies & Co. Inc., also thought it was likely that problems stemming from short-term debt would be passed off to customers.

“I think it’s very possible that they will,” Fremont said.

“They’re a cost-of-service company,” Fremont went on. “So in theory they will have an opportunity to ask regulators for a rate adjustment.”

Other power companies, municipalities, hospitals and other entities across the country have been scrambling to deal with high interest rates arising from fluctuations in the short-term debt market.

First to gain attention was the previously-obscure auction-rate securites market. These auction-based securities are long-term debt, but they have the benefits of short-term interest rates, which are usually lower. The rates reset weekly or monthly in blind auctions held by dealers like Citigroup Inc. and Merrill Lynch & Co. Inc.

Auction-rate securities hit a snag when bond insurer credit ratings came under fire. Companies such as MBIA Inc. had issued insurance for risky, mortgage-related debt, and the resulting write offs were threatening their balance sheets and their credit ratings.

Investors, spooked by lower credit ratings on bonds, began deserting the bond auctions—even when the underlying credit ratings of the bond issuers were sound.

The problem cascaded when dealers, lacking or unwilling to provide funds to support the auction, allowed them to fail. These auction-rate securities then reset to a much higher penalty rate, according to the bond’s terms.

Among the most famous examples is the New York Port Authority, which saw its interest rates jump from 4 percent to 20 percent last month.

“Nobody showed up to bid,” said David Kotok, chief investment officer at Cumberland Advisors Inc., a money management firm in Vineland, N.J.

“[The auction] failed because the banks didn’t want to take it onto their balance sheets,” Kotok said. “It’s a perfect example. It’s certainly a credit worthy, nationally known name. This was not a matter of credit risk.”

The New York Port Authority has a “stable” A1 Moody’s credit rating, and its bonds, many of which are insured through Ambac Financial Group Inc., have kept their Aaa rating, even though Ambac has been at risk of possible downgrade.

But lately it hasn’t just been the auction-rate securities, but also another little known class of debt, known as variable-rate debt obligations, or VRDOs. These types of debt also have "floating" rates determined by blind auctions.

The main difference between the two types of securities is that variable-rate bonds require the issuer to buy back the security if no other

buyer comes forward.

“An auction rate security is open-ended as to getting your capital back. You need to be able to sell it somebody. A variable-demand note has a put feature … somebody promises to pay at the end of the reset period,” said Kotok.

For debt issuers, however, a variable-rate debt obligation hasn’t necessarily fetched a better interest rate than its cousin, the auction-rate security.

“Those floating rates are great on one side, but they will catch up to you,” said New York analyst Daniele M. Seitz with investment bank Dahlman Rose & Co. LLC.

ComEd is among those that have floating, or variable-rate debt obligations. The power company has a BA1 credit rating, and its bonds have higher credit ratings because they are insured. But one of its bond insurers, XL Capital Assurance, a subsidiary of Bermuda-based Security Capital Assurance Ltd., had its credit rating dropped six tiers in February to A3.

That particular ComEd variable-rate note’s interest rate has marched steadily higher, with a rate of 9.75 percent on Feb. 19, and it has been carrying a 9 percent interest during the past two weeks. As recently as two months ago, the bond had an interest rate of only 3.7 percent.

In the meantime, while consumers wait to see what the impact on electric bills will be, some investors are getting in on the action and benefiting from extraordinarily high, interest-free yields—while it lasts.

Kotok noted that a lot of it his clients are among the opportunistic investors.

“We’re recommending they do it,” he said.

©2001 - 2007 Medill Reports - Chicago, Northwestern University. A publication of the Medill School.