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**Equity Units in the Utility Capital Markets: Overview and Practical Advice**

In recent years, a number of utility issuers have looked to equity units to meet their equity needs. An equity unit transaction is a mandatory convertible product (typically having a stated amount of \$50) that is initially in the form of a corporate unit, consisting of (1) a purchase contract issued by the issuer and (2) a fractional undivided beneficial ownership interest in a \$1,000 principal amount debt security of the issuer (although, as described below, the debt “host” is not always debt). Interest on any host debt security will accrue at an annual rate and typically will be paid quarterly until a successful remarketing occurs. “Contract adjustment payments” will also be paid periodically with respect to the underlying purchase contract.

One upside to the issuer is that it locks in cash proceeds and locks in a share price of an equity offering today while avoiding the dilution from the offering for a few years. In exchange for a high yield, investors face an unfavorable asymmetry in terms of participating in stock price appreciation.<sup>1</sup>

Often the underlying debt security (often referred to as the “host”) will be remarketed within three years after the initial issuance of the equity units. The proceeds of the remarketing (often referred to as an “early remarketing period”) are then used to fund the purchase of replacement debt (US Treasury STRIPS or “treasury portfolio”) within the equity unit. The treasury portfolio matures on or just prior to the date that the holder of the equity units is required to purchase the issuer’s common stock. Such purchase is calculated using an agreed-upon formula determined at the time of initial issuance of the equity units. The issuer will use the funds from the maturity of the treasury portfolio in order to settle the purchase of the common stock.

Issuers can choose between senior or subordinated debt or preferred stock as the underlying host for the equity unit. In the past several years, a number of utility issuers have utilized senior debt as the underlying host, including NextEra Energy, Inc. (September 2019 and August 2016), The Southern Company (August 2019) and DTE Energy Company (September 2016). Other issuers have used underlying subordinated

<sup>1</sup> Fotios Tsarouhis, *To avoid dilution, big US utilities turning to mandatory convertible issuances*, S&P GLOBAL MARKET INTELLIGENCE (Sep. 20, 2019).

debt, including American Electric Power Company, Inc. (March 2019), South Jersey Industries, Inc. (April 2018), Dominion Energy, Inc. (August 2016), Black Hills Corporation (November 2015) and Exelon Corporation (June 2014). Lastly, an issuer may also use preferred stock, as Dominion Energy, Inc. did in their June 2019 equity units offering, with each equity unit included an undivided beneficial interest in 1/10th of a share of cumulative perpetual convertible preferred stock.

In the case of Dominion's 2016 offering and Southern Company's 2019 offering, both issuers structured their equity units offering with two different series of underlying senior debt securities, each with a different maturity. In those instances, each \$50 equity unit included a 1/40 undivided beneficial interest in each series of underlying senior notes, instead of a 1/20 undivided beneficial interest in a single series of underlying notes like the other transactions identified above.



## Tax and Accounting Considerations

Tax and accounting considerations play an important role in why an issuer chooses to offer equity units. Such considerations also impact the holder of the securities. Because of the analysis the issuer must conduct and the related disclosure, issuers should start this process early, involving their internal and external audit teams, as well their own counsel and counsel for the underwriters.

The prospectus supplement for the offering will generally describe an equity unit debt host as treated for US federal income tax purposes as either (1) a variable rate debt instrument or (2) a contingent payment debt instrument. If an issuer treats the underlying host as a variable rate debt instrument, a holder will be required to take into account

interest payments on such security at the time the interest is paid or accrued in accordance with the holder's regular method of tax accounting. However, if an issuer treats the underlying host as a contingent payment debt instrument, a holder would generally be required to (A) accrue interest income based on a projected payment schedule and comparable yield and (B) treat any gain recognized on a sale, exchange, redemption or other taxable disposition of such security as ordinary income. The disclosure typically describes the tax treatment as unclear and that the issuer will treat the contract adjustment payments as taxable ordinary income.

In addition to including relevant disclosure regarding tax treatment in the prospectus supplement, in our experience, an issuer will also request a letter from the lead underwriter (or lead underwriters) regarding the likelihood of successful remarketing of the host and the valuation of each component of the equity unit—(1) the purchase contract and (2) the applicable ownership interest in the underlying host. Typically, per \$50 equity unit, the purchase contract is valued at \$0, while the applicable ownership interest in the underlying host is valued at \$50. This representation letter, delivered to the issuer, supports the issuer's tax disclosure as well as issuer counsel's tax opinion. While each representation letter contains the same basic elements, each underwriter may have its own form and different analysis, so it is important to allocate ample time to preparing and negotiating such letters (and the associated indemnity therein).

## Regulation M

Regulation M prohibits certain activities by distribution participants that could manipulate the market for an offered security. A "distribution participant" under Reg M includes any person who has agreed to participate in or is participating in a distribution of securities, such as an underwriter. While the issuer's common stock underlying the equity unit is likely an actively traded security for purposes of Regulation M (satisfying the average daily trading volume exemption) and thus exempt from compliance with Regulation M, such exemption does not flow up to the equity unit. Thus, the equity units are subject to the restricted period pursuant to Rule 101 of Regulation M, which begins on the later of five business days prior to the pricing date or such time that a person becomes a distribution participant, and ends on the completion of such person's participation in the distribution.

## Considerations for Closing of Equity Units Offering

Once the transaction has successfully launched and priced, the issuer, legal counsels and the underwriting syndicate must begin preparing for settlement and listing of the equity units. Given the unique nature of this product and the number of associated securities (i.e., the underlying host and the ability of holders to create treasury units), special consideration should be given to the settlement process with DTC and the lead billing and delivering underwriter. Note that this process is typically handled by the underwriter's equity operations team. Early communication with the lead underwriter's operations team, DTC and the purchase contract agent (which will issue the corporate units at closing) are crucial to avoiding any hiccups the morning of closing.

The subsequent listing process for the equity units with the NYSE is similar to the process for other structured products. The issuer should aim to have a completed application into the NYSE prior to closing so that trading of the corporate units can begin shortly after closing. In our experience, assuming all deliverables with the NYSE are properly met, trading will typically begin three business days after closing. In order to bridge the several day gap between closing and the commencement of trading on the NYSE, some offerings are assigned an OTC trading symbol by FINRA. This measure is temporary. Once trading begins on the NYSE, the OTC symbol will be "inactivated" by FINRA.

At pricing, the underwriters will obtain CUSIP numbers for: (1) the corporate units, (2) the underlying host and (3) the treasury units. For the corporate units and treasury units, the underwriters will obtain equity CUSIPs and for an underlying debt host, the underwriters will need to obtain a debt CUSIP. At settlement, only a closing for the corporate units CUSIP will occur, as the remaining two CUSIPs will have a \$0 balance at closing. It is important that the CUSIPs for the underlying host and treasury units be set up correctly with DTC at the time of initial issuance of the equity units.

In our experience, because settlement of equity units is somewhat uncommon (compared to other "plain vanilla" debt securities or equity), other last minute issues may arise. One item we encountered on several transactions is a request from DTC that the issuer provide an attestation form regarding Section 871(m) of the Internal Revenue Code of 1986, as amended. Section 871(m) (which was initially effective in 2017) generally treats "dividend equivalents" under certain contracts as US source dividends that are subject to withholding for non-US persons. In our experience, although the issuer already intends to treat contract adjustment payments as subject to withholding, DTC may nonetheless request a rider from the issuer at closing.

Because of the US federal income tax treatment of an equity unit as two components, with interest payments on the underlying debt host treated as interest and contract adjustment payments treated as ordinary income (thus subject to withholding in a manner similar to dividends), we have also encountered some confusion with Euroclear. Because ongoing payments on the equity units are derived from these different components, we have received clarification requests from Euroclear on how such equity units should be classified in the Euroclear system.





### Considerations for the Remarketing

Until the remarketing of the underlying host, the host CUSIP and the treasury unit CUSIP will likely retain a zero balance (or minimal balance). Issuers can run into trouble at the time of a remarketing when such host CUSIP is not DTC eligible, lists incorrect interest payment intervals (e.g., quarterly instead of semi-annual) or has been dormant for a long enough time such that DTC has temporarily put a “chill” on the CUSIP on its system. In these instances and others, both issuer’s and underwriter’s counsel will work with DTC to make the necessary updates on DTC’s system for proper settlement of the remarketing. In some instances, an issuer may be asked by DTC’s General Counsel’s office to provide a letter from the issuer requesting such a change to the information on DTC’s records with respect to such CUSIP.

Despite being approximately three years out from the time of initial issuance of the equity units, proper planning for the remarketing is crucial at the time of initial issuance. The remarketing (and settlement thereof) must not occur within the issuer’s black-out period, as standard deliverables (comfort letters, legal opinions, etc.) are required at the time of closing. And the issuer will also want to ensure it has adequate time to conduct an optional remarketing (discussed below) during an ideal window.

At the time of issuance of the equity units, the issuer agrees to enter into a remarketing agreement to remarket the underlying host. Such optional remarketing will sometimes require a remarketing agent to use its “commercially reasonable efforts” to obtain a set price for the underlying host. Such language is important. The issuer’s tax counsel will likely want considerable efforts to be made in order to ensure a successful remarketing. At the same time, it is beneficial to have some flexibility built into the remarketing procedure in the event that the remarketing period chosen by the issuer turns out to be a particularly bad time to market the host for sale.

Settlement for the remarketing is a multi-step process. The parties involved will benefit from a detailed funds flow memo prepared well in advance of closing that includes step by step instructions for each wire and the responsibilities of each participant (issuer, remarketing agent, trustee, purchase contract agent and collateral agent).

The first step of the remarketing closing is the settlement of the treasury portfolio. The remarketing agent will settle on its prior purchase of the treasury portfolio and deliver the treasury portfolio via “DWAC” (Deposit/Withdrawal At Custodian) to the collateral agent. At the same time, the remarketing agent will allocate the funds from investors for the remarketed underlying host for such treasury portfolio purchase. Before the trustee (or transfer agent) can transfer the remarketed underlying host to the remarketing agent, however, the purchase contract agent must receive the pledged host from the collateral agent. The issuer must also separately pay any accrued interest (or dividends) on the underlying host. All of these steps need to occur quickly, as multiple DWAC closings will need to occur. While DTC’s DWAC system closes at 5:30 pm (ET), the remarketed securities must be transferred to the remarketing agent’s account at DTC earlier in the day so as to permit ample time to allocate the remarketed securities to the new investors.

## If a Downturn: Utility Capital Markets in Times of Stress

The headlines in the past year have often discussed the possibility of a coming economic downturn. We thought it might be helpful to briefly discuss what the utility capital markets looked like 10 years ago during the “great recession” and offer some thoughts (and even more questions) about what the next downturn may mean for the utility capital markets.

The recession in 2007 through 2009 certainly prompted a “flight to quality” in the capital markets. The investor owned utilities benefited from this flight in some respect given their relatively lower risk profile vis-a-vis certain other market sectors. While a regulated rate of return (from the state PUC or FERC) is not particularly sexy during boom years, it looks very attractive amid a global downturn and increasing corporate bankruptcies. During the recession, the utility industry remained active in the capital markets due to the capital intensive nature of the business. To some extent, utility financings are countercyclical with a slowing economy. A large portion of each utility’s finance work each year are refinancings and as such, are relatively immune to a slowdown in the market.

At the same time, even some utility issuers were impacted by the volatile capital markets. Several utilities that had been issuing unsecured debt or “fallaway mortgage bonds” reverted to traditional mortgage bonds. This was an effort to find their most marketable debt instrument at the time. As the credit markets tightened, there was renewed focus on the value of a mortgage bond secured by the assets of the issuer.

A high profile casualty of the great recession was the mono-line insurers. In fact, in the utility industry, the market for insurance on utility tax exempt bonds disintegrated. After losing their AAA rating, many of the bond insurance companies could no longer provide a marketable product. Up to 57% of newly issued municipal bonds carried insurance in the years before the global collapse.<sup>2</sup> In recent years, it hovers around 5%. This is approximately one-tenth of the pre-crisis level.<sup>3</sup> Utility treasury departments spent years stripping off bond insurance from thousands of series of tax exempt bonds.

<sup>2</sup> Aaron Weitzman, 10 years later: After the fall, muni insurers rebuilding market relevance, THE BOND BUYER (Oct. 24, 2018).

<sup>3</sup> *Id.*



Despite the depressed prices in the equity markets, many utilities were forced to sell equity in order to shore up their balance sheets. As an alternative to the traditional marketed secondary offering, many utility issuers established at-the-market equity programs in order to permit sales of equity as market opportunities would permit. Although these “ATMs” were historically found mainly in the utility industry, the popularity of ATMs in the great recession transcended industry barriers. General industrials, REITs, retail and alternative issuers adopted the programs.

### Looking Ahead

Looking ahead to the next downturn, we expect it to be the same and, of course, different. One interesting aspect of the current capital markets landscape is the negative yields on many government treasuries throughout the world. Even the 30 year German treasury has a yield trading in negative territory over recent months. If the difference in rates between the US and certain other countries continues, we wonder if utility issuers will put renewed focus on exploiting that differential. See “Utilities See Japanese Demand for Reverse Inquiry Debt Financings” in the November 2016 *Baseload*. It is possible that a wave of “Euro bonds” lies ahead for the utilities. See the July 2016 *Baseload*, “Euro-Denominated Bonds: A Quick Guide for US Utility Issuers.”



It is also possible, of course, that negative rates will come to the United States in time. In a negative interest rate environment, an investor purchases a bond for \$100 today and such issuer will give \$99 to the investor a year from now. An interest rate of negative 1 percent. Should this development come to the US, there will likely be work to go around as finance executives, auditors, lawyers and tax lawyers all get up to speed on the required legal, regulatory and tax framework.

Utilities have been undergoing ambitious capital expenditure plans over the past 10 years. Many projects, including generation and transmission, have lifespans that are presumably longer than any particular market cycle. But any prolonged downturn could cause the utilities to forgo certain capital improvements and perhaps delay some of the generation transitions that have been making headlines over the past decade.

Finally, with any slowdown we would expect a concomitant slowdown in the utility M&A market. In boom times, high valuations and easy capital facilitate combinations. See

the November 2016 *Baseload* article, “Consolidation, Gas Assets and Canadian Acquisitions Drive Power and Energy Capital Markets.” Some of the largest deals to come to market over the past 5 or 6 years have been driven by merger and acquisition activity in the utility industry. These include Exelon’s merger with Pepco Holdings, The Southern Company merger with AGL Resources and NextEra’s acquisition of Gulf Power.

Finally, our experience suggests that in times of stress, what is old (and straightforward) can sometimes become new (and popular) again. That may be first mortgage bonds, ATM programs or fully marketed equity offerings. As noted in our lead article for this issue, highly sophisticated products such as mandatory converts are a popular flavor of the day. It remains to be seen whether a market downturn would lead to renewed popularity of more “plain vanilla” securities.

## Green Bonds: Popularity Among Domestic Utilities Continues

As noted in the November 2016 article of *Baseload*, the popularity of “green bonds”—bonds issued to raise funds for new and existing projects with environmental benefits—has continued to grow and feed increased investor demand. Global sales of green bonds exceeded \$135 billion in 2018, driven by strong demand from European investors.<sup>4</sup> Additionally, according to Moody’s, issuers brought \$47.2 billion principal amount of green bonds to market in the first quarter of 2019.<sup>5</sup> Green bonds accounted for 2.5% of total first-quarter global bond issuance.<sup>6</sup>

The “exponential growth” in the appetite for green bonds has largely been driven by demand from investment funds that are looking for investments with environmental or social impact.<sup>7</sup> This sales boom has also been driven by corporations and governments raising capital for initiatives to help them cut fossil fuel use in accordance with the guidelines of the Paris Agreement on climate change.<sup>8</sup> For example, the government of France has issued approximately \$4 billion in green bonds year to date in 2019 alone.<sup>9</sup>

The foundation of green bond issuance, the “Green Bond Principles,” were launched by the International Capital Markets Association (ICMA) in 2014 as the first set of principles for verifying the credentials of green bonds.<sup>10</sup> These principles identified the components of what constitutes a green bond and have been updated and developed over the last several years.<sup>11</sup> The ICMA’s Executive Committee for the Green Bond Principles recently published (1) the Green Project Mapping document,<sup>12</sup> (2) the Guidance Handbook<sup>13</sup> and (3) the Impact Reporting Handbook.<sup>14</sup> The Green Project Mapping document includes a table mapping the categories of projects against the five environmental objectives referenced in the Green Bond Principles. The Guidance Handbook is a 17-page guide containing a number of general FAQs regarding green bonds and includes a “Core Components” section, exploring the use of proceeds, issuer transparency, project eligibility, management of proceeds and reporting obligations. Finally, the Impact Reporting Handbook includes reporting recommendations, information regarding the allocation of proceeds and recommended impact report content.

As noted by Moody’s and Bloomberg, green bond issuances in 2019 have continued at a significant pace. Notable domestic green bond issuances by utilities in 2019 include (i) Public Service Company of Colorado \$550 million



principal amount of first mortgage bonds (August 2019); (ii) Southwestern Public Service Company \$300 million principal amount of first mortgage bonds (June 2019); (iii) Eversource Energy \$400 million principal amount of debentures (BofA Merrill Lynch as Lead Green Structuring Agent)(May 2019); (iv) Avangrid, Inc. \$750 million principal amount of notes (Credit Agricole CIB as Green Structuring Agent)(May 2019); (v) Duke Energy Progress, LLC \$600 million principal amount of first mortgage bonds (March 2019); (vi) DTE Electric Company \$650 million principal amount of general and refunding mortgage bonds (February 2019); and (vii) MidAmerican Energy Company \$1.5 billion principal amount of first mortgage bonds (January 2019).

4 Alice Gledhill and Alexander Weber, *Wall Street's New Battleground Is \$136 Billion Green-Bond Market*, BLOOMBERG NEWS (September 18, 2019).

5 Allison Good, *Moody's: Green bond issuance rises by 40% in Q1 on corporates, Europe*, ENERGY FINANCE DAILY (May 10, 2019).

6 *Id.*

7 Gledhill and Weber.

8 *Id.*

9 *Id.*

10 ICMA, *Voluntary Process Guidelines for Issuing Green Bonds* (June 16, 2016), available at <http://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/green-bonds/green-bond-principles/>

11 *Id.*

12 Available at <https://www.icmagroup.org/Green-Projects-Mapping-Document-100619>.

13 Available at <https://www.icmagroup.org/Guidance-Handbook-June-2019-120619>.

14 Available at <https://www.icmagroup.org/assets/documents/Regulatory/Green-Bonds/June-2019/>

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