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Dewey & LeBoeuf

VOLT: an update on recent energy capital markets developments

SEC Proposes Amendments to S-3 Eligibility

Dodd-Frank Act

On February 9, 2011, the Securities and Exchange Commission (the "SEC") proposed amendments to certain rules and forms pursuant to the provisions of Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") relating to the use of credit ratings in existing SEC regulations as a measure of credit-worthiness.[1] These changes would amend certain rules and forms under the Securities Act of 1933 (the "Securities Act") and the Securities Exchange Act of 1934 to replace references to credit ratings with alternative criteria. The amendments being proposed are substantially the same as those proposed by the SEC in 2008.[2] One perhaps unintended consequence is that many utility subsidiary issuers would no longer qualify for the shelf registration process.

Proposed Amendments to Form S-3

Of particular interest to utility issuers in an industry with wide use of the holding company structure are the proposed changes to the eligibility requirements for use of Form S-3. Form S-3 is the "short form" used by eligible issuers to register securities offerings under the Securities Act. A company that qualifies for short-form

1. *See* SEC Proposed Release Nos. 33-9186; 34-63874 (February 9, 2011), available at http://www.sec.gov/rules/proposed/2011/33-9186.pdf.
2. *See* SEC Proposed Release Nos. 33-8940; 34-58071 (July 1, 2008), available at http://www.sec.gov/rules/proposed/2008/33-8940.pdf.

registration is allowed to rely on its annual, quarterly and other reports filed with the SEC to provide historical and future information about itself, rather than repeating the information in the prospectus or amending the prospectus as future reports are filed. Form S-3 eligibility for primary offerings also enables such issuers to conduct primary offerings "off the shelf" under Rule 415. Issuers that are eligible to register these "shelf offerings" under Rule 415 may register prior to planning any specific offering. Once a registration statement is effective, these issuers may issue securities from time to time without further SEC action. To be eligible to use Form S-3, an issuer must meet both the Form's eligibility requirements as to registrants and at least one of the Form's transaction requirements. One such transaction requirement permits registrants to register primary offerings of non-convertible securities in short-form if they are rated investment grade by at least one Nationally Recognized Statistical Rating Organization ("NRSRO"). The SEC's proposed amendments would replace the NRSRO investment grade ratings condition with the requirement that the company seeking to qualify for short-form registration has issued at least $1 billion of non-convertible securities, other than common equity, for cash in registered, primary offerings within the previous three years.

The proposed standard is modeled on the standard used to determine whether an issuer is a well-known seasoned issuer (a "WKSI"). The three year period would be measured as of a date within 60 days of the filing of the registration statement. Moreover, calculating the amount of non-convertible securities issued would be done in a manner consistent with the calculation for determining whether an issuer is a WKSI.

Impact of Proposed Amendments

The SEC has conceded that the proposed amendments would cause a significant number of utility issuers that have relied or that could rely upon the investment-grade criteria to lose eligibility for Form S-3. In particular, the SEC has requested that, in light of the comments received on the 2008 proposal, comments be provided related to the effect of the proposals on

utility companies, among others.[3] Based on a review of non-convertible securities issued in the United States from January 1, 2006 through August 15, 2008, the SEC estimates that approximately 45 issuers that were previously eligible to use Form S-3, and who had made an offering during the review period, would no longer be able to use Form S-3 for offerings of non-convertible securities other than equity securities. This data did not measure the effect of the proposed amendments on issuers who were previously eligible to use Form S-3 but did not make a public offering during the review period. According to the comment letter with respect to the original 2008 proposal submitted by the Edison Electric Institute on September 5, 2008, "…at least 25 to 30 electric utilities would be negatively affected, including the largest utilities in a number of states, and many more could be adversely impacted in the future given the cyclical nature of utility capital expenditure requirements and evolving state and federal regulatory requirements."[4] The SEC agreed in the recent release, noting that, "Our staff review of filings between January 1, 2006 and August 15, 2008 indicates that an estimated 29 utility companies that used Form S-3 during the relevant period would be ineligible under the proposed amendments."[5]

The amendments, if adopted in their present form, are likely to affect a large number of utility subsidiary registrants.[6] Despite the amendments, many non-subsidiary registrants will still be able to qualify for Form S-3 pursuant to Transaction Requirement B.1., which permits the Form's use where "Securities are to be offered for cash by or on behalf of a registrant… provided that the aggregate market value of the voting and non-voting common equity held

3. SEC Proposed Release Nos. 33-9186; 34-63874 (February 9, 2011), p. 19.

4. Comments of Edison Electric Institute, September 5, 2008, p. 3.

5. SEC Proposed Release Nos. 33-9186; 34-63874 (February 9, 2011), p. 19.

6. A subsidiary registrant with a class of securities registered pursuant to Section 12(b) or 12(g) of the Exchange Act or required to file reports pursuant to Section 15(d) of the Exchange Act will likely meet the "Registrant Requirements" of Form S-3 but will no longer be able to rely on the "investment grade" Transaction Requirement. Likewise, a subsidiary registrant which, pursuant to General Instruction I.C.2, relies on its parent to meet the "Registrant Requirements" will also not be able to rely on the "investment grade" Transaction Requirement.

by non-affiliates of the registrant is $75 million or more." A wholly owned subsidiary is unable to take advantage of Transaction Requirement B.1., and therefore is much more likely to be excluded from using Form S-3 pursuant to the proposed amendments.

Comments to the Proposed Amendments

Various commenters have proposed alternatives to the SEC's proposal. These include, among others,

1. lowering the debt issuance threshold from $1 billion;
2. extending the look-back period for a period greater than three years;
3. providing an exception for companies which are subject to state or federal regulation with respect to securities issuances;
4. eligibility based on asset size;
5. eligibility for subsidiaries of WKSI's;
6. eligibility based on a registrant's "debt float;" and
7. eligibility for issuers with debt securities that are traded on a national securities exchange.

In 2008, the SEC proposed the amendments to Form S-3 in part out of concern that credit ratings had placed an "official seal of approval" on securities that could adversely affect the quality of due diligence and investment analysis.[7] But it is unclear whether eligibility based on the amount of prior-registered non-convertible securities serves as an appropriate replacement for the investment grade condition. The original standard was grounded in a judgment as to credit quality. Perhaps the revised eligibility standard should continue to have an element which keys off certain measures of profitability and liquidity, similar to the investment grade metrics used by the rating agencies. We can imagine, for example, a standard of eligibility that would allow issuers the continued flexibility of short-form registration to the extent the issuer (1) met such profitability/liquidity metrics or (2) meets the type of "widely-followed" standard currently proposed by the SEC.

The SEC has requested extensive comment on

7. SEC Proposed Release Nos. 33-8940; 34-58071 (July 1, 2008), p.4.

both the appropriateness of "grandfathering" provisions for issuers which currently qualify for use of Form S-3 and also for comment on possible phase-in dates for the amendments.[8] Comments to the proposed amendments are due on or before March 28, 2011. We would encourage all registrants that may be affected by the proposals to participate in the comment process.

Recent Financing Trend: 144A Coupled With Subsequent Exchange Offer

Energy and utility company issuers are always looking for alternative ways to access the capital markets. We have recently noticed an increase in the popularity of the 144A debt offering coupled with an immediate exchange offer. In each case the issuer executes a 144A debt offering. Later the same day, the issuer is able to use the pricing established in the 144A offering to launch a private exchange offer for one or more series of the issuer's outstanding debt. PSEG Power LLC ("PSEG") (March/April 2010), Oncor Electric Delivery Company LLC ("Oncor")(September/October 2010), CenterPoint Energy Resources Corp. ("CenterPoint") (January/February 2011) and Targa Resources Partners LLP ("Targa")(January/February 2011) have all completed similar transactions over the past year.

Two of the transactions were "fixed spread" tenders and two were done as "fixed price" offerings. In a fixed spread offer, the values of both the old debt to be tendered in the exchange and the new debt to be offered in the exchange are established by discounting the remaining payments of principal and interest on each by the yield on a relevant Treasury security. The pricing time for the fixed spread exchange occurs at some point after the exchange is launched, usually immediately prior to or after the expiration of a designated early exchange period during which tendering holders are due additional compensation. In a fixed price exchange offer, the compensation to be offered is established up front. As

8. SEC Proposed Release Nos. 33-9186; 34-63874 (February 9, 2011), p. 23, 38.

such, there is no need for any subsequent “pricing time”.

Compensation for exchanging bondholders varied among the four transactions. In some cases, compensation was strictly new bonds, while in others holders were offered a mix of bonds and cash. In each case there was some sort of early participation payment for holders who tendered during the early exchange period.

Even though each of the issuers had an effective S-3 registration statement on file with the Securities and Exchange Commission (“SEC”), each of the offerings and subsequent exchange offers was done as a Rule 144A private placement. This method was presumably used because the issuers did not want to wait for an S-4 registration statement to become effective before launching the exchange. These offerings were driven largely by the ability to lock in at current interest rates. Waiting for an S-4 exchange offer registration statement to be prepared, filed and go effective would prevent the issuer from executing on the two different offers in the immediate interest rate environment. By completing both the 144A offering and the exchange within a short period of time, the issuers were able to effectively “double-down” on current rates.

In each case, the 144A offering was only available to qualified institutional buyers (“QIBs”) as defined in Rule 144A or persons other than US persons, as defined in Regulation S. Similarly, the subsequent exchange offers were only available to eligible holders of the outstanding debt who were either QIBs or pursuant to Regulation S. Any existing debt not held by QIBs or offshore investors was not eligible to be tendered and remained outstanding following completion of the exchange offers.

One significant difference among the four structures was whether the debt offered in the exchange was to be a new series of debt versus a reopening of the series that had been recently established in the issuer’s 144A offering. A reopening may provide at least one advantage to holders tendering in the exchange. If the recently

established series was of a principal amount of $250 million or more, then the series would already be "index eligible". "Index eligible" refers to a series of bonds that is eligible to be included in the Barclays Capital Aggregate Bond Index. A bond of a series that is eligible will arguably be more readily traded and generally more liquid than a bond which does not qualify for this treatment. This is a meaningful difference where an exchanging bondholder cannot know the overall volume of bonds to be exchanged and the size of the series which would result in the absence of a reopening. Unfortunately, the liquidity benefits of a reopened series can be lost for bonds with different tax treatment. This can occur if the bonds offered in the exchange as a reopener of the recent series have original issue discount for tax purposes. Such bonds may be treated as a separate series for purposes of Index Eligibility even though they are the same series for other legal purposes. One potential structural element of the exchange to deal with these uncertainties is to make the tax fungibility of the reopened series a condition of the exchange offer. Another alternative is to time the two offerings such that the closing of the exchange occurs within 13 calendar days of the closing of the 144A, thereby accessing a safe harbor under US federal tax law for the avoidance of original issue discount.

Each of the exchange offers was subject to the tender offer rules set forth in Regulation 14E of the Securities Exchange Act of 1934 ("Exchange Act"). Any issuer contemplating a similar transaction would be well-advised to consult with counsel early in the process of structuring the exchange. Although the Exchange Act requirements for the exchange are relatively limited in number, each exchange presents unique structuring requirements and requires counsel to confirm that the exchange structure at hand is in compliance with the Exchange Act and the SEC's relevant no-action letters.

Given the significant number of these offerings by energy/utility issuers during such a limited time period, we have no reason to believe this financing structure will not continue to be popular in the near future.

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