HUNTON
ANDREWS KURTH

# BASELOAD

**Current Topics in the Power and Utilities Capital Markets**

**April 2021**

## Contents



## ESG Frameworks: Taking Green Bonds and Social Bonds Off the Shelf

As noted previously in the October 2020 edition of *Baseload*, the capital markets have seen explosive growth in the issuance of ESG debt in recent years. The advantages to utilities have been generally twofold: (1) provide access to a larger investor base than would otherwise be available (i.e. those investors with ESG-focused criteria) and (2) provide evidence of good corporate citizenship regarding certain of the issuer's projects.

ESG encompasses three individual (but highly overlapping) elements: environmental criteria, social criteria and governance. The environmental element has been a mainstay of the capital markets since the late 2000s and has steadily increased since the International Capital Market Association (ICMA) first published its "Green Bond Principles" in 2014 and last updated them in 2018.[1] Debt issued in this category is designed to support specific climate-related or environmental projects and includes investments related to clean energy or pollution reduction. The social criteria, described in the "Social Bond Principles"[2] published by ICMA and last updated in 2020, focuses on projects "that address or mitigate a specific social issue and/or seek to achieve positive social outcomes."[3] The third criteria of ESG is governance – the internal system of rules, policies and procedures that govern the management of a company. The individual elements of ESG are, by their nature, intertwined.

1 International Capital Market Association, Green Bond Principles: Voluntary Process Guidelines for Issuing Green Bonds (June 2018), available at https://www.icmagroup.org/sustainable-finance/the-principles-guidelines-and-handbooks/green-bond-principles-gbp/.

2 International Capital Market Association, Social Bond Principles: Voluntary Process Guidelines for Issuing Social Bonds (June 2020), available at https://www.icmagroup.org/green-social-and-sustainability-bonds/social-bond-principles-sbp/.

3 Bonds that are issued pursuant to both the Green Bond Principles and the Social Bond Principles are often referred to as "sustainability bonds". Note the confusing distinction with "sustainability-linked bonds," whereby the issuer includes certain financial and/or structural characteristics in the debt instrument that are linked to whether the issuer achieves predefined sustainability objectives. The principal difference between sustainability-linked bonds and green or social bond issuances is that the bond documentation for "sustainability-linked bonds" is directly tied to the issuer achieving certain predefined targets. One domestic example is NRG Energy Inc.'s December 2020 bond sale tied to its goal to achieve a 50% reduction of absolute greenhouse gas (GHG) emissions by 2025, and reach net-zero GHG emissions by 2050. Issuers typically incur an interest rate penalty for failing to meet defined targets.

Broadly speaking, when domestic utility issuers began issuing green bonds several years ago, the debt was usually intended to finance a specific project or group of projects (i.e., a utility financing the construction of a wind farm). In such offerings, many issuers did not engage a third party to opine on the alignment of the project with the Green Bond Principles. Several utilities have recently shifted from this "one-off" green bond strategy. Issuers are increasingly opting to establish a broader ESG-focused framework (or, in the case of certain issuers, solely a "green bond framework"), effectively serving as the issuer's "shelf" for future ESG offerings. We have seen an increase not only in this "framework" structure for obtaining a second party opinion, but also an increase in the issuance by power issuers of "social bonds" (aligned with the Social Bond Principles) and also "sustainability bonds" (where proceeds are being devoted to uses in line with both the Green Bond Principles and the Social Bond Principles).

A number of domestic issuers have put in place "frameworks" over the past 3 or 4 years. Note that a few of the issuers in the list below have in place a "green-only" framework.[4]

| Issuer | Type |
|---|---|
| HSBC Holdings plc (2017) | ESG |
| Apple Inc. (2019) | ESG |
| Citigroup Inc. (2019) | Green |
| Pfizer Inc. (2020) | ESG |
| Verizon Communications Inc. (2020) | Green |
| Toyota Motor Credit Corporation (2020) | ESG |
| Alphabet Inc. (2020) | ESG |
| National Rural Utilities Cooperative Finance Corporation (2020) | ESG |
| Oncor Electric Delivery Company LLC (2020) | ESG |
| Truist Financial Corp. (2021) | ESG |
| AFLAC Incorporation (2021) | ESG |
| The Southern Company (2021) | ESG |

4 Note, too, that Avangrid, Inc. has in place a Framework for Green Financing but has opted to obtain a Vigeo Eiris second party opinion for their inaugural and follow-on green bond issuances.

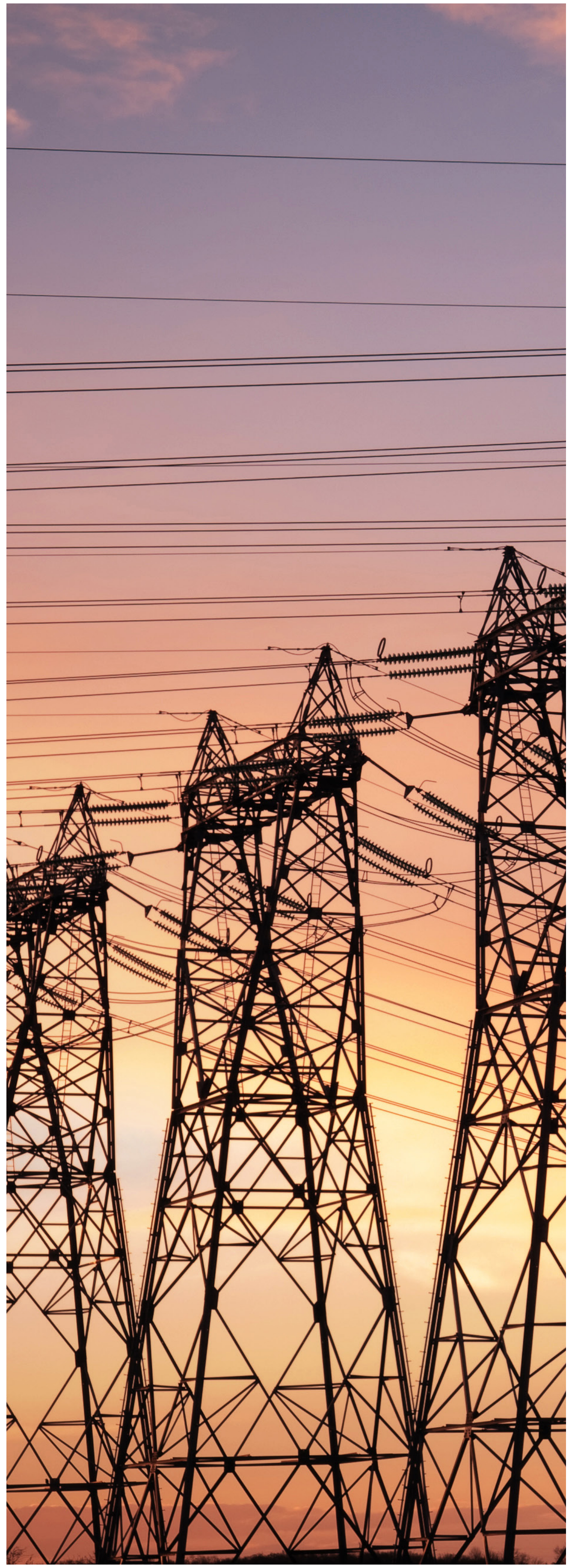
Both ICMA's Green Bond Principles and Social Bond Principles provide guidance on the same four components: (1) use of proceeds; (2) process for project evaluation and selection; (3) management of proceeds; and (4) reporting. Note that the use of proceeds, reporting and any second party opinions do not form part of the terms and conditions of the bonds and typically do not create specific contractual obligations. However, these elements are referenced in the disclosure documents.

Counsel to the issuer and underwriters will often be involved in drafting the framework, working closely with the issuer's investor relations and finance teams, along with ESG specialists at the underwriters. An issuer's framework will reside on its website – typically found on the investor relations page and will follow the four components of the Green Bond Principles and Social Bond Principles. The framework is often posted on the issuer's website prior to marketing an ESG bond transaction. The second party opinion with respect to the framework will reside on the website of the second party opinion provider for investors to review. Subsequent opinions are typically not provided for each issuance of bonds from the framework "shelf." Note also that the second party opinion is in addition to the other reporting the issuer will provide, such as a website detailing use of proceeds, management's assertion as to the use of any remaining proceeds and an attestation from the issuer's independent auditor regarding the use of such proceeds.

One issue of which issuers should be aware when looking to launch an initial ESG bond offering is timing for posting their framework and second party opinion or other guidance to their websites. While some issuers already regularly disclose ESG-focused information on their website, and maybe even an annual sustainability report, other issuers might not have previously disseminated such information publicly. Issuers pursuing a registered offering should be mindful of Rule 168[5] to ensure that any information posted to their websites immediately prior or during the offering regarding their framework or attestation will fall within the safe harbor and not be considered part of the offering.

Another somewhat related issue to this new structure is the ability to reopen an ESG bond. There have been several reopeners of "green bonds" that were issued to fund specific projects. A number of green reopenings have also funded additional green projects that have been developed since the time of the original green issuance. In each of these cases, we believe there would be a conversation about the Use of Proceeds of the reopener to ensure that the additional projects were in line with the original offering. However, under the new "framework" method of issuing ESG bonds, it would seem an even clearer call that (absent any non-ESG hurdles) the particular series could be reopened. But a similar analysis would still be advisable—making sure that the "Eligible Projects" in the reopener were in line with the "Eligible Projects" of the original series.

As ESG issuances become a more dominant feature of the investment grade debt world, we predict that ESG-related disclosure will also become more commonplace (and eventually could be required). While some issuers already voluntarily disclose progress toward achieving ESG-related goals in their 1934 Act disclosure, some investors argue that a lack of uniformity among such disclosures complicates their analysis and are increasingly demanding standardized corporate ESG disclosure.[6] The UK government recently proposed mandatory climate-related financial disclosures by 2022 for certain issuers and the SEC recently created a new ESG-related enforcement task force and indicated that comprehensive disclosure framework could be imposed in the future. Market participants should stay tuned as both this market, and market practice, continues to evolve and mature.



5 Rule 168 provides an exemption from the prospectus requirement under the 1933 Act for certain communications of regularly released factual and business information and forward looking information.

6 Declan Harty, Top SEC official signals ESG disclosures are coming, S&P Global Market Intelligence (March 15, 2021).

## Compound SOFR Has Arrived: More Non-Bank Issuers Adopt SOFR as LIBOR Phase-Out Continues

In the last few months, issuers and underwriters alike have been getting increasingly comfortable using "SOFR" to issue floating rate debt. While many of the large bank issuers had been issuing SOFR-based floating rate debt for the past year, many other issuers have now done the same. SOFR, the "Secured Overnight Funding Rate", is a rate published daily by the Federal Reserve Bank of New York and is intended to reflect the cost of borrowing cash overnight collateralized by U.S. Treasury securities. SOFR is a rate based on observable transactions – namely, those in the overnight U.S. Treasury repurchase agreement market. SOFR's arguably stronger link to the market via actual transactions is considered one of its advantages as compared to LIBOR.

On November 30, 2020, the ICE Benchmark Administration, the administrator of LIBOR, with the support of the United States Federal Reserve and the UK's Financial Conduct Authority (the FCA), announced plans to consult on ceasing publication of USD LIBOR after December 31, 2021 for the one week and two month USD LIBOR tenors, and after June 30, 2023 for all other USD LIBOR tenors. On March 5, 2021, the ICE Benchmark Administration and the FCA confirmed that USD LIBOR will no longer be published after December 31, 2021 for the one week and two month USD LIBOR tenors, and after June 30, 2023 for all other USD LIBOR tenors, consistent with the ICE Benchmark Administration's November 2020 announcement.

The Alternative Reference Rates Committee (ARRC) subsequently confirmed that in its opinion the March 5, 2021 announcements by the ICE Benchmark Administration and the FCA on future cessation and loss of representativeness of the LIBOR benchmarks constitutes a "Benchmark Transition Event" with respect to all USD LIBOR settings pursuant to the ARRC's existing "fallback rates" language. Note, however, that the Benchmark Transition Event does not trigger an immediate transition to the replacement rate.[1]

Since January 2021, the following registered floating rate transactions have come to market using compound SOFR rather than LIBOR:

| | |
|---|---|
| **Toyota Motor Credit Corporation** | **January 2021** |
| **Enbridge Inc.** | **February 2021** |
| **Verizon Communications Inc.** | **March 2021** |
| **NextEra Energy Capital Holdings, Inc.** | **March 2021** |
| **AT&T Inc.** | **March 2021** |
| **Southern California Edison Company** | **March 2021** |

Because SOFR is based on observable transactions, it is necessarily a backward-looking rate, unlike LIBOR, which is forward-looking. Thus, in a floating rate deal with interest paid in arrears using LIBOR as a benchmark rate, the issuer would know at the beginning of an interest period what the payment due at the end of that period would be. With SOFR, the issuer would look at the SOFR rates over the course of the interest period in order to determine the payment due at the end of that period.

The SOFR rate being used is "compounded SOFR", whereby the daily SOFR rate is compounded over the course of the just-completed interest period and then added to a transaction-specific applicable spread to determine the interest payment due. One point to note is that "compound SOFR" is actually the second "fallback rate" provided in the form language provided by the ARRC. The first fallback rate had been "term SOFR", but given that term SOFR remains unavailable, most issuers have chosen to opt instead for compounded SOFR.


1 Under the ARRC language, the rate replacement occurs on the "Benchmark Replacement Date," which, now that the Benchmark Transition Event is known, will generally be the applicable end date listed above (assuming no further regulatory changes in end date).

In addition to using the same variables to calculate the interest payment due, all of the issuers above have also chosen to shift the interest "observation period" over which the SOFR rate is compounded by two business days prior to the end of the applicable interest period. Shifting the observation period in this manner gives issuers some wiggle room to calculate the interest payment in advance of the interest payment date.

This "observation shift" approach seems to be the preferred method among issuers. Two other potential (though less common) approaches are the "payment delay" convention and the "suspension period" convention. Applying the former, the SOFR would be calculated for each day of the applicable interest period and the resulting interest payment would be delayed, to be paid out a certain number of days after the end of the interest period. The "suspension period" convention instead offers some predictability by using the same SOFR for the last two days of the interest period as the recorded SOFR the third business day prior to the end of the interest period.

While many issuers had been delaying the transition to SOFR until there was more clarity from regulators and in the market, it appears that much clarity has now come. We expect these deals to proliferate for the remainder of 2021.

## PUC Filings and Regulation FD

One question that arises from time to time is whether a company's filings with its respective public utility commission is subject to Regulation FD.[1] Recall that Regulation FD generally provides that when an issuer[2] discloses material nonpublic information the issuer must also make public disclosure of that information. But Regulation FD only applies to the disclosure of such information to certain categories of recipients. The rule only proscribes disclosures to the following individuals:

- securities market professionals, such as brokers, dealers, investment advisers, institutional investment managers, and sellside and buy-side analysts; and
- shareholders who it is reasonably foreseeable would trade on the basis of the information.

In the SEC's adopting release for Regulation FD, the SEC clarified that certain disclosures were not meant to be covered by the rule:

> Thus, as a whole, Rule 100(b)(1) will cover the types of persons most likely to be the recipients of improper selective disclosure, but should not cover persons who are engaged in ordinary-course business communications with the issuer, or interfere with disclosures to the media or communications to government agencies.[3]

> 27 While it is conceivable that a representative of a customer, supplier, strategic partner, news organization, or government agency could be a security holder of the issuer, it ordinarily would not be foreseeable for the issuer engaged in an ordinary-course business-related communication with that person to expect the person to buy or sell the issuer's securities on the basis of the communication. Indeed, if such a person were to trade on the basis of material nonpublic information obtained in his or her representative capacity, the person likely would be liable under the misappropriation theory of insider trading.[4]

Providing the information to the PUC isn't a Regulation FD problem because the PUC isn't a covered recipient under Rule 100(b)(1) of Regulation FD. However, if the public can access the filing, practically speaking, an issuer may want to manage the release of the information. So, to the extent the filing with the PUC contains material information for investors (and will be made publicly available by the PUC), an issuer may want to consider first releasing any material information via Form 8-K (or some other Regulation FD-compliant method of dissemination).

1 17 CFR Part 243.

2 Regulation FD applies to all companies that have a class of securities registered under Section 12 of the 1934 Act or that are required to file reports under Section 15(d) of the 1934 Act, including any closed end investment company (as defined in Section 5(a)(2) of the Investment Company Act of 1940), but not including (i) any other investment company, or (ii) any foreign government or foreign private issuer.

3 Release Nos. 33-7881, 34-43154 (Aug. 15, 2000).

4 *Id.*

*BASELOAD* is prepared from time to time to provide general information about selected power and utilities capital markets developments and issues for attorneys at Hunton Andrews Kurth LLP, and is provided to clients and friends of Hunton Andrews Kurth LLP. It is not intended to provide legal advice or legal opinions and must not be relied on as such. If you have questions related to any of the articles in this issue, please contact any of the below members of the Power and Utilities Capital Markets group at Hunton Andrews Kurth LLP:


Michelle Chan
Associate
+1 212 309 1350
mchan@HuntonAK.com

Michael F. Fitzpatrick, Jr.
Partner
+1 212 309 1071
mfitzpatrick@HuntonAK.com

Steven C. Friend
Partner
+1 212 309 1065
sfriend@HuntonAK.com

Brendan Harney
Associate
+1 212 309 1255
bharney@HuntonAK.com

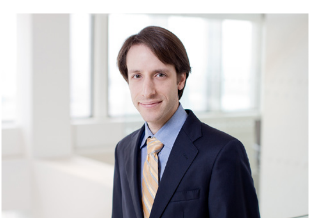
Matthew Hayes
Associate
+1 212 309 1274
mhayes@HuntonAK.com

Ashley Jaber
Associate
+1 212 309 1105
ajaber@HuntonAK.com

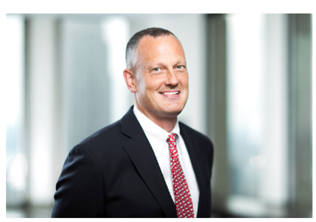
Patrick Jamieson
Associate
+1 212 309 1049
pjamieson@HuntonAK.com

Mae Ji
Associate
+1 212 309 1272
mji@HuntonAK.com

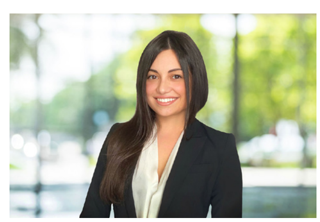
S. Christina Kwon
Partner
+1 212 309 1089
ckwon@HuntonAK.com



Adam O'Brian
Partner
+1 212 309 1043
aobrian@HuntonAK.com



Peter K. O'Brien
Partner
+1 212 309 1024
pobrien@HuntonAK.com



Flavia Vehbiu
Associate
+1 212 309 1355
fvehbiu@HuntonAK.com


HUNTON
ANDREWS KURTH