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# Beyond the rating: energy prepay bonds explained

Energy prepay bonds provide otherwise taxable, non-municipal entities the opportunity to realize cost savings that are shared with municipal utilities through discounted long-term energy purchase contracts. From a niche product, prepays have grown to over 5% of the Bloomberg Municipal Index, surpassing \$100 billion outstanding in 2025, with 37% average annual issuance growth — making structural literacy essential for municipal investors.

## *Key takeaways*

- Prepay bonds are structured credit instruments offering tax-exempt exposure to corporate counterparties, not traditional utility revenue bonds.
- Rapid sector growth reflects favorable rate arbitrage and rising utility demand for long-term, discounted energy supply.
- Credit quality varies widely by funding recipient and deal structure, making contractual analysis essential to evaluating bondholder risk.

Prepay bonds look like municipal debt. The credit risk tells a different story.

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## Prepay bonds are structured credit, not utility debt

Prepay bonds are structured financings built on contractual agreements between multiple participants (Figure 1). A municipal bond issuer uses bond proceeds to prepay an energy supplier for a long-term supply of gas or electricity, typically over 30 years. A funding recipient – traditionally a financial services institution – receives those funds and makes scheduled payments that ultimately support debt service. Commodity swaps convert floating market prices into a fixed discount, lowering energy costs for municipal utilities. The structure essentially converts a tax-exempt borrowing advantage afforded to the funding recipient into long-dated energy savings for utilities and ratepayers.

These are not traditional utility revenue bonds. Investors are not secured by utility net revenues and do not benefit from a public utility’s rate-setting authority. The bonds are not secured by utility revenues or municipal credit, despite supporting an essential public service.

Nor are they traditional corporate-backed credits. Funding recipient credit quality typically drives public ratings, but bondholder outcomes also depend on how contracts are written and how other participants perform. Prepays are structured credit instruments and should be evaluated as such.

**Understanding the role of each participant is essential to evaluating any individual transaction.**

**Municipal bond issuer:** Conduit for tax-exempt capital; not a meaningful credit risk driver. (e.g., Black Belt Energy Gas District; California Community Choice Financing Authority)

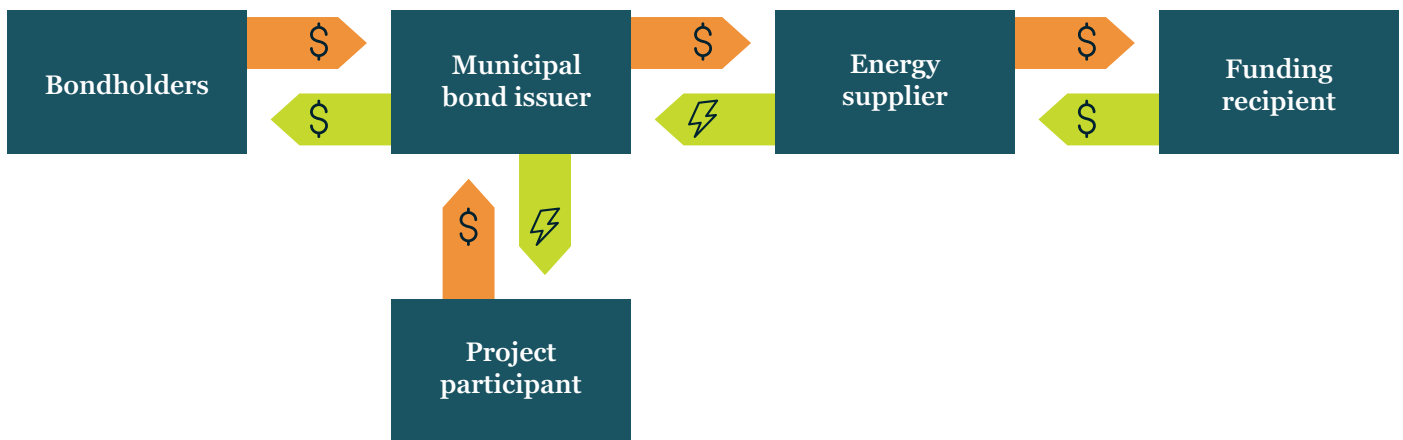
**Project participant:** Municipal utilities purchasing energy under a long-term contract, typically 30 years.

**Energy supplier:** Responsible for energy delivery and payment obligations; often a special purpose entity.

**Funding recipient:** Receives bond proceeds; makes payments supporting debt service. (e.g., Morgan Stanley; BP PLC)

**Commodity swap counterparty:** Facilitates the energy discount and hedges energy price risk. (e.g., BP Energy Company; Royal Bank of Canada)

Figure 1: Anatomy of a prepay bond transaction, a basic overview



## Utilities use prepaids to lock in savings

The prepay structure provides municipal utilities with long-term energy supply certainty and price stability. Prepaying for gas at scale secures pricing at a discount to monthly index levels, reducing commodity price exposure over time. A utility’s retail customers benefit from more predictable energy costs, and municipalities avoid speculative balance sheet borrowing.

The issuer functions as a conduit — facilitating access to tax-exempt capital without retaining meaningful financial or operating risk. Cash flows are structured to meet debt service regardless of gas price movements, provided all parties perform.

## The funding recipient drives most of the credit risk

The funding recipient, not the public utility, is the primary credit driver in most prepay transactions. It is responsible for scheduled payments supporting debt service and, in many cases, early termination payments. As the market has grown, so has the range of entities filling this role — and the range of associated credit risk (Figure 2).

**Large global banks** have historically dominated this role, bringing capital markets infrastructure, energy

trading expertise and hedging capabilities. Credit quality is generally investment grade, though investors remain exposed to institutional deterioration and guarantee enforceability risk.

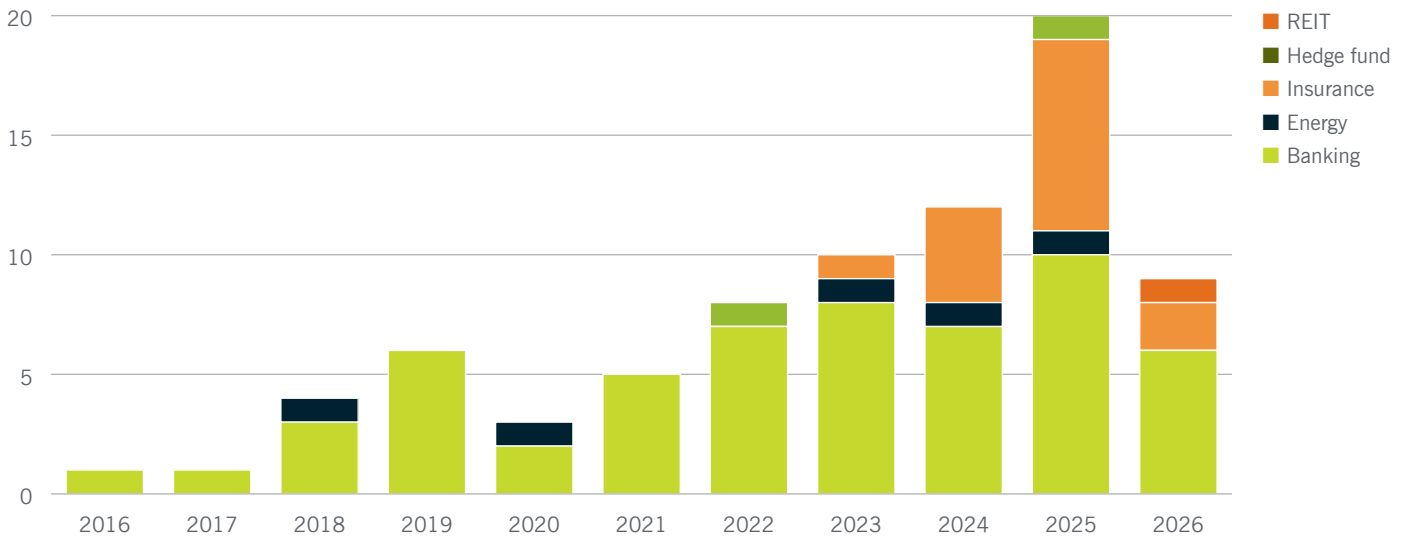
**Life insurance companies** have become major participants since 2023, drawn to long-duration, predictable cash flows. Some insurers lack direct commodity expertise, heightening reliance on structural protections and third-party energy suppliers. Spreads on insurer-backed deals often differ materially from bank-backed transactions.

**Other financial and non-financial institutions**, such as hedge funds, energy companies and REITs, remain a smaller but growing presence. These counterparties introduce sector exposures that are fundamentally different from banks or insurers, even when headline ratings look similar.

Rating agencies generally apply a weakest-link methodology, anchoring the bond rating to the lowest-rated key counterparty while considering structural mitigants. In most cases, the funding recipient’s credit quality determines the bond rating. All prepay bonds have carried investment grade ratings to date, but ratings are a point-in-time assessment. Given the structural complexity of these transactions, deterioration in any single participant can have consequences for the whole.

Figure 2: A broader funding recipient roster means wider credit risk

Number of funding recipients



Data source: Bloomberg, L.P., 07 Apr 2026.

## Prepay risks differ from traditional municipal bond risks

Prepayment bonds carry risks that look nothing like those of traditional municipal credits.

**Counterparty credit risk.** Deterioration or failure of a funding recipient, gas supplier or swap provider can disrupt cash flows. These structures have limited tolerance for payment delays.

**Structural and legal risk.** Bondholder protection depends entirely on contract language governing termination payments, substitution rights and mandatory redemptions. Ambiguous or weak terms can impair recovery. With little excess liquidity in these structures, timely payment is essential — not just expected. Reserve funds and receivables purchase provisions offer some protection but vary widely across deals and must be assessed individually.

**Commodity and energy transition risk.** Long-term declines in natural gas demand or a regulatory push toward electrification could reduce utility offtake, forcing greater reliance on remarketing and termination mechanics.

**Legislative and tax risk.** Tax-exempt status rests on federal policy. Rapid sector growth could invite

Congressional or regulatory scrutiny, and adverse changes to tax law could alter transaction economics significantly.

**Contagion risk.** A high-profile failure in a single prepay transaction could destabilize the broader sector. Given the pace of issuance, a stress event could draw regulatory attention and impair secondary market liquidity across unrelated deals.

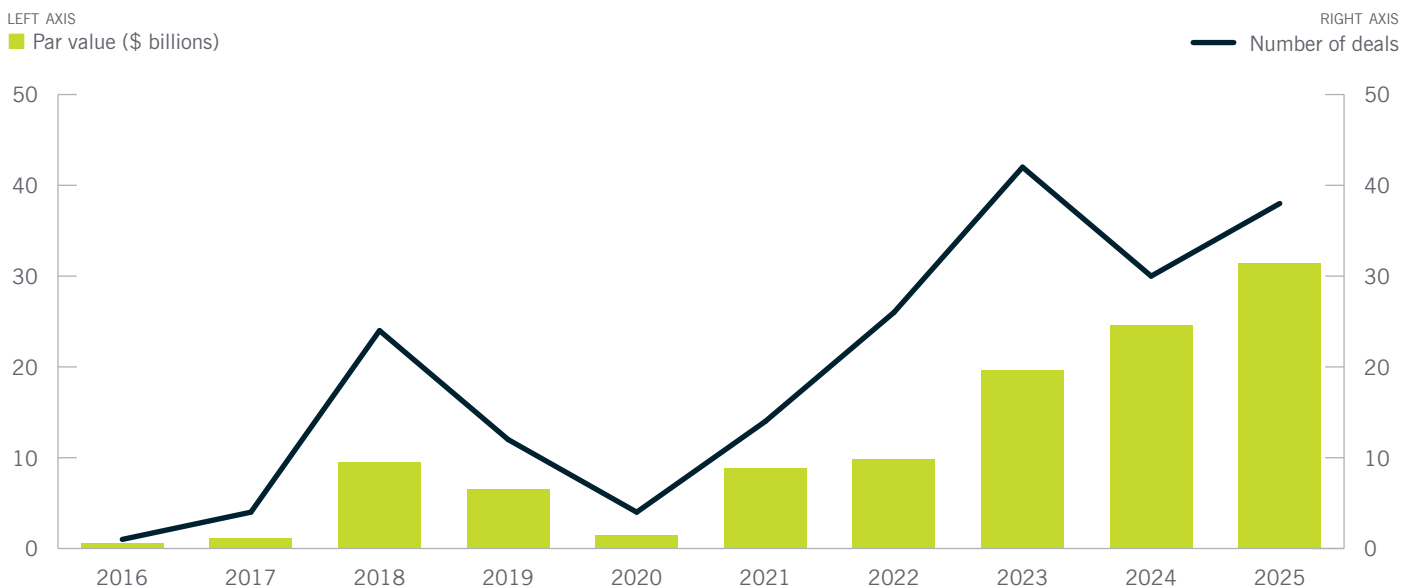
**Remarketing risk.** Most prepay bonds have put features or extendible maturities shorter than the underlying energy agreement, requiring periodic remarketing. A failed remarketing during market stress could trigger termination mechanics, increase carrying costs or disrupt secondary market pricing.

## Favorable economics have accelerated prepay market growth

Prepay issuance has surged as three forces converged: favorable municipal-to-Treasury ratios, rising utility demand for long-term energy supply and growing balance sheet participation from banks and insurers (Figure 3). When tax-exempt funding costs undercut taxable alternatives, prepay is economically attractive to funding recipients and offer utilities the ability to lock in discounted energy supply for decades.

Figure 3: The prepay market is gaining significant momentum

### Prepay issuance



Data source: Bloomberg, L.P., 31 Dec 2025.

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Structural standardization and repeat issuance — particularly among large gas districts and California electricity programs — have allowed transactions to scale efficiently into municipal benchmarks. Broader institutional participation deepened market capacity, accelerating issuance and cementing prepaids as a durable market segment rather than a cyclical niche.

## Prepaids reward discipline and deal-by-deal analysis

Energy prepay bonds are now a significant and growing part of the municipal market. Their appeal lies at the intersection of public purpose financing, structured credit

and long-dated cash flows — offering tax-exempt exposure to financial obligors like banks and insurers that is rare in traditional municipal investing.

That exposure carries a different kind of risk. Prepay investors are not secured by essential service monopolies. They are taking on financial sector risk and individual counterparty risk in a structurally complex wrapper. Ratings alone are insufficient. Rigorous evaluation of counterparties, contracts and termination mechanics is essential. When approached with that discipline, gas prepaids can play a meaningful role in a diversified municipal portfolio — but only when analyzed deal by deal.

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### Endnotes

#### Sources

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