

# Where Did It All Go?

*The Mystery of Vanishing Bondable Property Under Utility Mortgage Bond Indentures and How to Get It Back*

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## The Question

A recurring question pondered by utility finance personnel is why mortgage records as to bonded and bondable property don't seem to match the company's balance sheet. More precisely, assuming the company can issue mortgage bonds to the extent of a percentage of Unbonded Property, net of retirements (take, for example, a 60% Bonding Ratio), why do the company's mortgage accounting records indicate an amount of Unbonded Property that is often substantially less than an amount equal to the company's net utility plant minus 166 ⅔% of the sum of (a) the aggregate principal amount of bonds then outstanding and (b) the aggregate principal amount of retired bonds available as a basis to issue new bonds? One would think that, if the original deal between the company and the bondholders was that the bondholders would get a 40% collateral cushion, this cushion should approximate 40% of net utility plant. But it is often far more.

There are several factors that contribute to the discrepancy. This note will discuss them in summary fashion and explore possible solutions to the problem.

It should be noted as a preliminary matter that, under current accounting principles, utility plant includes items that do not represent physical facilities that are owned by the utility, such as facilities that are leased and not owned. Accordingly, in any comparison of mortgage accounting records to utility plant in the general accounting records, items that do not represent physical utility facilities that are owned by the company should be excluded and are assumed to be so excluded for purposes of this note.

In this note, the following terms are used with the indicated meanings:

Authorized Purpose	– the purpose for which property is certified to the mortgage trustee – generally, the authentication of bonds, the release of property or the withdrawal of cash.
Bondable Property	– property that is eligible to be used as a basis for the authentication of bonds or other Authorized Purposes.
Bondable Value	– as to an item of Bondable Property, the lower of the cost and the Fair Value to the Company of such property.
Bonded Property	– Bondable Property that has been used as a basis for an Authorized Purpose.
Bonded Value	– the Bondable Value of an item of Bondable Property at the time such item was used as a basis for an Authorized Purpose.
Bonding Ratio	– ratio of the maximum principal amount of bonds that may be issued on the basis of an item of

	Bondable Property to the Bondable Value of such property.
Fair Value (or “FV”)	– as used but not defined in the Trust Indenture Act of 1939 (the “1939 Act”). See definition in Generally Accepted Accounting Principles. <sup>(1)(2)</sup>
Fair Value to the Company (or “FVC”)	– as used but not defined in the 1939 Act (“fair value to [the obligor]”). Different from Fair Value. <sup>(2)</sup>
Unbondable Property	– property that is not Bondable Property – i.e. not eligible to be used as a basis for an Authorized Purpose.
Unbonded Property	– Bondable Property that has not yet been used as a basis for an Authorized Purpose.

### **The Original Funding**

At the time the mortgage was originally prepared for the initial issuance of bonds, it is likely that the company and the initial purchasers (or underwriters) agreed on the size of the initial series of bonds after reviewing the Company’s results of operations and financial condition (including its utility plant assets), as well as the company’s capital requirements. The amount of the company’s net utility plant at that time may well have exceeded the amount that would result in a collateral cushion of 40% (assuming a 60% Bonding Ratio), and such excess collateral cushion survives through the ages. The initial purchasers (or underwriters) permitted the issuance of additional series of bonds if, but only to the extent that, the company had constructed or acquired additional property *after* the date of the execution and delivery of the mortgage and only to the extent permitted by the Bonding Ratio. Thus, while the Bonding Ratio is applicable to additional bonds, it may not have been relevant to the initial series.

The only solution to the problem would appear to be to amend the mortgage, with the consent of bondholders, to

- increase the Bonding Ratio (which would not reclaim the initial built-in cushion) and/or
- reclassify the company’s Bonded Property, as discussed herein, under “Amendment of the Mortgage”.

### **Unbondable Property**

Under some mortgages the set of property that is subject to the lien exceeds the set of property that is Bondable Property. While it is common for the lien of the mortgage to cover certain types of interests in property such as easements and licenses, which are normally not Bondable Property, some mortgages actually extend the lien to hard assets that are Unbondable. For example, one particular utility company had a water utility business in addition to electric and gas utility businesses, but, while the lien of the mortgage covered the water facilities, only assets used in connection with the electric and gas businesses were Bondable Property. This can lead to distortions. For example, while the proceeds of a mortgage bond issue could be used for the

acquisition or construction of Unbondable Property, such property could not be used as a basis for the issuance of the bonds or any other Authorized Purpose, thus using up Bondable Property for the financing of Unbondable Property.

Similar problems arise in connection with the release of Unbondable Property from the lien of the mortgage, as discussed herein under “General Release Provisions – Unbondable Property”.

The only solution to this problem would appear to be to amend the mortgage, with the consent of bondholders, to either

- release Unbondable Property from the lien of the mortgage or
- provide that some or all Unbondable Property constitutes Bondable Property.

## **Retirements**

In determining an amount of property to be used as the basis for the authentication of bonds or other Authorized Purposes, mortgages generally require the deduction of property retirements – that is, the effectuation of an Authorized Purpose is generally based upon property additions net of retirements.

The first issue is what constitutes a retirement. Generally, while there are significant variations in the language of different mortgages, a retirement refers to property that is abandoned, destroyed, removed, disposed of or discontinued or that otherwise has ceased to be used and useful. The language of some older mortgages is somewhat ambiguous as to whether the write-off or write-down of the cost of property due to, for example, the non-recoverability of investment, constitutes a retirement. Newer mortgages expressly provide that such a write-off or write-down on the company’s books does not constitute a retirement for mortgage purposes (even if the write-off or write down occurs after the property is used for an Authorized Purpose) and some older mortgages have been amended to so provide.

Another issue is what property is relevant for purposes of determining retirements. While most mortgages ignore Unbondable Property for this purpose, some older mortgages take all Bondable Property into account, whether or not Bonded. On the other hand, other older mortgages, like most newer mortgages, look solely at retirements of Bonded Property. Calculating retirements on the basis of Bonded Property alone is entirely logical since only Bonded Property was used as a basis for an Authorized Purpose – the bondholders’ agreed-upon cushion established by the Bonding Ratio is maintained (but not increased) if retirements are limited to Bonded Property. However, Unbonded Property was never so used and the retirement thereof has no effect on the agreed-upon cushion. Logic would then dictate that retirements of Unbonded Property should not be taken into account. The inclusion of Unbonded Property in the calculation of retirements would seem to unfairly increase the bondholders’ collateral cushion by sacrificing otherwise Bondable Property on account of the retirement of Unbonded Property. By extension, the inclusion of Unbondable Property in the calculation of retirements would be even more unfair to the company.

The only solution to these problems would appear to be to amend the mortgage, with the consent of bondholders, to both

- clarify what does and does not constitute a retirement for purposes of the mortgage and

- limit the deduction for property retirements to retirements of Bonded Property.

See Endnote (3) for discussion of the disconnect between book depreciation and mortgage retirements.

### **Aging Out of Property Additions**

Under some “accounting”-style mortgages, some or all available property additions as of a certain date may be determined, with the cost and FVC certified, from time to time, and any such property additions in excess of the amount necessary for the authentication of bonds or other Authorized Purpose constitute an “unapplied balance of property additions” (or similar terminology) and are eligible for the next application to an Authorized Purpose. However, many of these mortgages provide that any property additions that were acquired or constructed more than a specified number of years (typically five) prior to such proposed subsequent application must be excluded from the unapplied balance of property additions and can no longer be used for any Authorized Purpose. These property additions go to waste. The purpose of this exclusion may have been suggested, by the staff of the Securities and Exchange Commission (“SEC”) or prospective bondholders, to keep the FVC of these property additions, as of the time actually used for an Authorized Purpose, reasonably current – i.e. so that the property additions cannot be so used more than such number of years after the certification of their FVC.

This problem does not arise under mortgages that are not “accounting” style mortgages, such as the mortgages of companies that were direct or indirect subsidiaries of The Electric Bond and Share Company (“Ebasco”). Under Ebasco-style mortgages, the company does not certify all available property additions as of a certain date – rather, the company certifies only the amount of property that, net of retirements, is necessary for the Authorized Purpose. The FVC of such property additions is certified as of such time, so that it is current, and there is no unapplied balance of property additions.

There is no practicable way to amend an “accounting”-style mortgage to convert it into an “Ebasco”-style mortgage. The mortgage would have to be entirely replaced. However, an “accounting”-style mortgage could be amended to (1) eliminate the time limit on the use of property additions included in the unapplied balance of property additions and (2) require that the FVC of such property additions be certified again at the time of the application thereof as the basis for an Authorized Purpose (if more than a specified time has elapsed since the original certification of FVC).

### **Maintenance and Replacement Fund**

Many older mortgages contain covenants as to the annual expenditure of amounts for the replacement of depreciable property. In many cases the covenants are expressed as being applicable only so long as bonds of a specified series are outstanding. These covenants were generally required for companies subject to the Public Utility Holding Company Act of 1935 (the “1935 Act”), as expressed by the SEC in 1956 in its Statement of Policy Regarding First Mortgage Bonds for companies subject to the 1935 Act. While all mortgages are different and the specific language of the relevant mortgage must be examined, the required expenditure is usually a specified percentage of either gross utility plant or of gross revenues. The requirement is satisfied by the delivery to the trustee under the mortgage of documentation demonstrating sufficient expenditures for replacement purposes made in the current period or excess expenditures made in prior periods.

If the company has failed to make the required expenditures in full, it must deposit with the trustee cash in an amount equal to the deficiency; provided, that the amount of cash required to be delivered may be reduced by retired bonds or the property additions acquired or constructed during a previous period. Subject to the provisions of the particular mortgage, cash so delivered could be applied to the redemption or purchase of outstanding bonds. The covenant in some mortgages requires amounts to be expended for maintenance and repairs in addition to replacements and renewals, but, in general, all these funds operate in the substantially same way and are herein referred to, without distinction, as “M&R Funds”.

Many mortgages are silent as to the status of property additions that are certified in connection with the satisfaction of M&R Fund requirements, and presumably such property additions are treated as Bonded Property, with the same effective result for retired bonds so used. However, some mortgages that have, or had, M&R Funds expressly provide that property additions applied to satisfy the requirement of the fund nevertheless are *not* treated as Bonded Property and remain available to be used as a basis to issue bonds or for another Authorized Purpose. The same may hold for retired bonds so applied. Further, in some cases in which a utility has amended its mortgage to eliminate an M&R Fund, the amendment specifically provides that all property additions and retired bonds that were theretofore applied to satisfy the M&R Fund become available for the issuance of bonds or other Authorized Purposes upon the effectiveness of such amendment. This does not render the covenant nugatory or effectively convert it into an accounting covenant because the company is nevertheless required to actually expend funds to replace or maintain its property, to retire bonds or to make a cash deposit with the trustee.

Any mortgage that has, or had, an M&R Fund should be examined closely to determine whether property additions or retired bonds used as a credit retain their ability to be used as a basis for an Authorized Purpose. This provision is sometimes obscure and can be overlooked.

A degree of caution should be exercised when resurrecting old property additions to be used for current purposes – as noted above, some older mortgages have a limit on the number of years after acquisition or construction property additions may be used for bonding or other Authorized Purposes and, in any event, the FVC of such property, at the time used for such purposes, would likely take depreciation into account. See “Aging Out of Property Additions”.

Covenants for an M&R Fund appear to be no longer required by investors. Companies that still have M&R Fund requirements should consider taking steps to not include them in new series of bonds. This is easy to do in cases where the initial covenant was stated to apply only so long as bonds of a specific series remained outstanding.

The Company could also amend the mortgage, with the consent of bondholders, to eliminate the M&R Fund currently. Depending on the language of the original mortgage and/or supplemental indentures creating individual series, the series of bonds whose consents are required may include series that are not specifically benefited by the covenant but nevertheless enjoy the benefit indirectly.

### **Sinking Fund**

Many older series of bonds are benefited by covenants to maintain a sinking or improvement fund for such series. These covenants were contained either in the original mortgage indenture or in supplemental indentures creating the respective series. Generally, the covenant would require the

company to deposit with the trustee annually an amount in cash equal to a percentage (typically 1%) of the initial aggregate principal amount of the bonds of a series, which cash would then be applied to the redemption or purchase of the bonds of that series. This has the effect of “improving” the security for the bonds of that series by reducing the principal amount outstanding, not by maintaining or replacing the collateral. However, the company could apply property additions or retired bonds of that series to satisfy the obligation to deposit cash, whereupon such property additions and retired bonds would become unavailable for the issuance of bonds or other Authorized Purposes. If the covenant had been drafted properly (from the point of view of the company), such unavailability would continue in effect only so long as any bonds of that series remained outstanding – upon the retirement of all bonds of that series, all property additions and retired bonds so applied to the satisfaction of the sinking fund for that series would become available for Authorized Purposes.

The original mortgage indenture and each supplemental indenture that created a series of bonds, whether or not still outstanding, should be examined to see whether, if there is or was a sinking fund, property additions and retired bonds used to satisfy the requirements of the sinking fund may again be used for Authorized Purposes after the retirement of all bonds of such series. Note the above caveat in the discussion of M&R Funds with respect to using older property additions for current purposes.

As in the case of M&R Funds, sinking funds appear to be no longer required by investors, and companies should consider taking steps to not include sinking funds in new series of bonds.

If the sinking fund is contained in the original mortgage, the Company could also amend the mortgage, with the consent of bondholders, to eliminate it or, at least, to provide for the resurrection of property additions and retired bonds as described above.

### **General Release Provisions**

General provisions for the release of property from the lien of a utility mortgage, especially in older mortgages, are frequently skewed so as to result in additional benefits to the bondholders. There are many differences in the mechanics of individual mortgages, and the mortgage of any particular company has to be carefully examined. However, older mortgages commonly require, in connection with the release of property, the delivery to the trustee of an amount of cash equal to the current Fair Value of such property. Alternatively, the Company can certify property additions having a Bondable Value, or retired bonds having an aggregate principal amount, equal to the current Fair Value of the property to be released. Several issues are apparent:

1. Effect of Bonding Ratio. The amount of cash required to be delivered is typically equal to the Fair Value of the property to be released. This does not take into account the effect of the Bonding Ratio. If bonds had been issued on the basis of the property to be released, such bonds could only be issued to the extent of the product of the Bonding Ratio and the Bondable Value of such property. With a Bonding Ratio of 60% and a Bondable Value of \$100, only \$60 of bonds could have been issued on the basis of the property to be released. Assuming no appreciation or depreciation, it appears illogical to require the deposit of \$100 in cash when only \$60 of bonds were issued on the basis of that property. Logically, the mortgage should require the delivery of \$60 in cash or retired bonds or the certification of \$100 in Bondable Value of property.

2. Appreciation and Depreciation. These provisions are structured so that the bondholders effectively get the benefit of any appreciation in the Fair Value of the property to be released but are held harmless from any depreciation. In newer mortgages, the benefits and burdens are shared equally. The release provisions of any particular mortgage, and the integration thereof with the mechanics of accounting for retirements, are complex and somewhat unique to that mortgage, so that a detailed illustration in this note is not practicable. However, the overall effect is generally that, in order to obtain a release of property, the company must relinquish bondable value equal to the *higher of* the Bonded Value and the current Fair Value of the property to be released.
3. Unbonded Property. The general release provisions of many older mortgages do not distinguish between property that has been used as a basis for the issuance of bonds or other Authorized Purpose and that which has been not so used. If no bonds have ever been issued on the basis of a piece of property, logically, subject to certain limitations, it would seem that no price should be payable to obtain the release of such property. Presumably, all outstanding bonds were issued, directly or indirectly, on the basis of other property and within the constraints imposed by the Bonding Ratio. This is what maintains the essential deal with the bondholders as to the collateral cushion. The sacrifice of Bondable Property to obtain the release of Unbonded Property appears to be an unbargained for benefit to the bondholders.<sup>4</sup>
4. Unbondable Property. An extension of the problem of Unbonded Property is the problem of Unbondable Property – which is not only unbonded but never can be bonded. A prime example of this problem involved an electric and gas utility that also had a water business that it had discontinued, mentioned above. The company’s mortgage covered essentially all its utility properties, but only electric and gas facilities constituted Bondable Property. When selling the water business, the company was sorely disappointed to learn that it had to deliver cash, or sacrifice Bondable Property or available retired bonds, in order to obtain the release of the water properties that could never have been used as a basis for the issuance of bonds or any other Authorized Purpose in the first place.

The problems described in paragraphs (3) and (4) above could probably be dealt with in amendments to a mortgage, with the consent of bondholders. The problems described in paragraphs (1) and (2) above involve so many interrelated provisions of the mortgage that it may, depending on the particular mortgage, be impractical to attempt to deal with them on a piecemeal basis due to the ripple effect. The only practical solution may well be the implementation of a new mortgage, either immediately or prospectively.

### **Amendment of the Mortgage**

The solutions to most of the problems discussed above require amendments to the mortgage. Except in the case of specified amendments that may be made without the consent of bondholders, amendments to the mortgage require consent of varying cohorts of bondholders including the following:

- some newer mortgages require the consent only of the holders of a majority in principal amounts of bonds of the series affected by the amendment then outstanding, considered as one class;

- older mortgages require the consent of the holders of a specified percentage (ranging from 60% to 75%) in principal amount of bonds of all series then outstanding (whether or not affected), considered as one class; and
- some older mortgages go even further, requiring the consent specified in the immediately preceding clause and, in addition, the consent of the holders of a specified percentage of the outstanding bonds of each affected series or of each outstanding series, whether or not affected.

The difficulty in obtaining the required consents, whether by bondholders' meeting or consent solicitation, especially in the case of older mortgages, is readily apparent.

In any case, the language of the particular mortgage must be analyzed. The first question is what percentage, and of what cohort or cohorts, is required for the particular amendment. Another question is whether the particular amendment must be approved at an actual meeting of bondholders or whether a consent solicitation is permitted. Other questions include whether the mortgage requires or permits a record date for determining the bondholders eligible to vote or consent, whether the mortgage (or any related document) limits or otherwise may affect the company's ability to employ an exit consent procedure with respect to the bonds of some or all series (in addition to state law that may be relevant) and the ramifications of such amendment procedures, or the amendments themselves, under federal and state law.

Assuming that the foregoing issues can be satisfactorily dealt with, there are certain techniques that, depending on the nature of the amendments and the language of the mortgage, may be employed in order to facilitate and/or expedite the making of the proposed amendments. These techniques include, without limitation, setting forth the proposed amendments in a supplemental indenture (with or without the simultaneous creation of a series of bonds) and providing in that supplemental indenture that:

- such amendments will become effective automatically when all bonds, of all series, then outstanding have been retired;
- such amendments may be made without the approval or consent of the holders of the bonds of the series created in such supplemental indenture, if any, or any subsequently created series; or
- the holders of the bonds of the series created in such supplemental indenture, if any, and of any subsequently created series will be deemed, without further act, to have consented to such amendments.

As aforesaid, the language of the particular mortgage and other considerations may affect the particular technique used. Of course, while the amendment process is under way, any prospectus or other offering document, as well as the bonds themselves, should reflect the prospective amendment to the mortgage, to the extent material, and any technique being used to facilitate or expedite the making of such amendment.

In addition, or as an alternative, to amending specific existing provisions of the mortgage, it may be possible for the bondholders to approve or consent to an amendment of the mortgage to insert a

new provision to the effect that, notwithstanding any and all prior certifications of property additions, from and after a specified date, the company's Bonded Property shall be deemed to consist of, and shall be limited to, certain specified properties that have a then Bondable Value not less than a specified percentage (the reciprocal of the Bonding Ratio) of the aggregate principal amount of bonds then outstanding and available retired bonds. This would reclaim all excess Bonded Property as of a certain point in time, although the provision, in and of itself, would not fix problematic mortgage provisions that contributed to such excess. As noted above, however, when certifying older property, FVC would likely have to take depreciation into account.

For completeness, it is noted that some older mortgages permit the bonding of property owned by subsidiaries, either directly by the subsidiary joining in the granting clauses or indirectly by the parent pledging the subsidiary stock. Discussion of these mortgages is beyond the scope of this note, except to observe that the amendment of an existing mortgage to permit the direct or indirect bonding of subsidiary property would clearly require the consent of bondholders, would be so complex that it might be more practicable to accomplish the objective by replacing the entire mortgage and would involve issues of corporate, utility regulatory and securities law that would not otherwise be present.

It should be emphasized that many proposed changes to a mortgage have a ripple effect and require changes in many places throughout the document. For example, a simple increase in the Bonding Ratio would likely require changes in almost a dozen provisions. However, some modifications require changes to so many interrelated provisions that it is simply not reasonably practicable to attempt to amend the existing mortgage. In these cases, the only feasible alternative is to:

- embark on a process to amend and restate the existing mortgage in its entirety through a bondholders meeting or consent procedure;
- put in place a "general and refunding mortgage", effectively a second mortgage, and stop issuing bonds under the first mortgage (which would eventually be discharged when outstanding bonds are retired, allowing the second mortgage to ascend to first priority);  
or
- embark on a process to replace the existing mortgage in the future with a new collateral trust mortgage, put in place currently, using a procedure that would give bonds issued currently under the new mortgage the benefit of first priority status and could accelerate the retirement of the old mortgage.

Comprehensive discussion of the methodologies of replacing a mortgage is beyond the scope of this note.

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This note is intended to provide only limited introductory information. All mortgage indentures are different, as are the applicable laws of the various jurisdictions in which utility companies and their properties are located. Rigorous analysis must be performed in each case.

## ENDNOTES

- (1) See Topic 820 – Fair Value Measurement of the Accounting Standards Codification (“ASC”) of the Financial Accounting Standards Board. ASC 820-10-20 defines “fair value” as:

the price that would be received to sell an asset ... in an orderly transaction between market participants at the measurement date.

In explaining “fair value”, ASC 820 emphasizes, among other things, that “fair value” is the “exit price”, not the “entry price”, so that the reporting entity’s entry price is not relevant. (See ASC 820-10-05-1B, 820-10-30-2 and 820-10-35-9A).

- (2) See [\*“Fair Value” and “Fair Value to the Obligor – The Mysteries of TIA Section 314\(d\) Under the Utility Mortgage Bond Indenture”\*](#), by J. Anthony Terrell (September 20, 2022).
- (3) There is a built-in disconnect between net utility plant for general accounting purposes and net property additions for mortgage accounting purposes. As discussed, for mortgage purposes, the retirement of an item of Bonded Property occurs only once, when the asset is “retired”. Ordinarily (a) the depreciation of that property over time is not required to be recognized for mortgage purposes until the asset is “retired” and (b) other than through the operation of an M&R Fund or the like, there is no mandatory reduction in the outstanding principal amount of bonds (whether those issued on the basis of that property or otherwise) on account of the book depreciation of that property. On the other hand, for general accounting purposes, the asset is depreciated over its assumed useful life. Due to this timing difference, the amount of available net Bondable Property suggested by the balance sheet may be different from that indicated by the mortgage accounting records. Of course, the valuation of Unbonded Property, considered alone, is likely to be the same for general accounting and mortgage purposes since, when eventually certified for an Authorized Purpose, such property will be so certified at the lower of cost and FVC (presumably reflecting depreciation).
- (4) Some older mortgages contain provisions to the effect that, subject to certain conditions and limitations, if released property was not Bonded Property immediately prior to its release, then property additions made the basis of such release are not deemed to be Bonded Property. These provisions differ by mortgage, are very complex and in some cases are unfair to the company.

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This note was prepared by J. Anthony Terrell, with the assistance of Stephen C. McNamara, as of December 31, 2025. Mr. Terrell is Of Counsel to Bracewell LLP, and Mr. McNamara is an Associate in that firm, both resident in the New York office. However, the views expressed herein are those of Mr. Terrell and Mr. McNamara only and do not necessarily reflect the views of the firm. Messrs. Terrell and McNamara are members of the American Bar Association (and various sections and committees thereof) and the Association of the Bar of The City of New York. This note does not necessarily reflect the positions of any of such bar associations, sections, or committees.

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