Breckinridge CAPITAL ADVISORS

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Prepay Primer: Understanding Structure & Portfolio Fit

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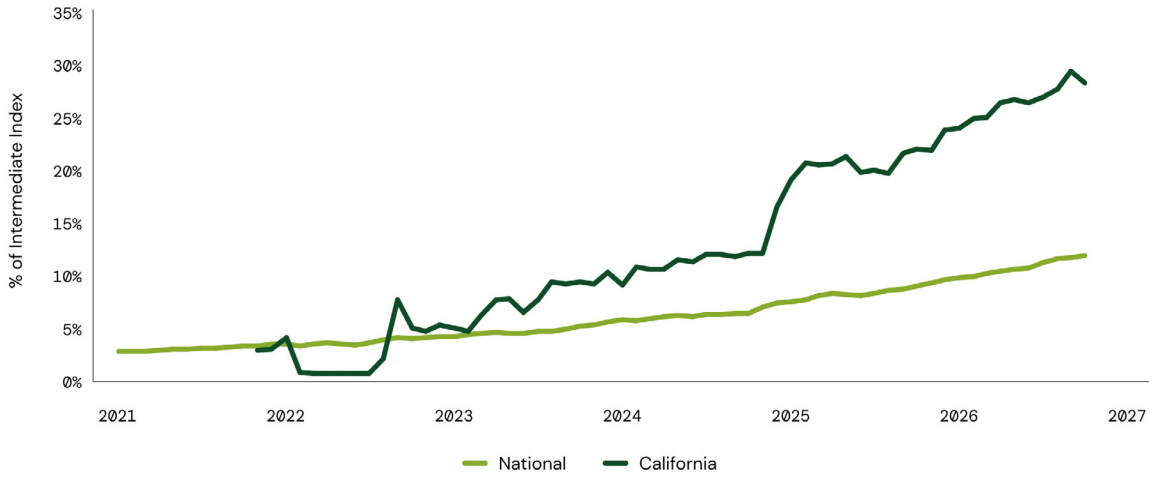
SUMMARY

- Energy prepays (natural gas and electric) are a growing portion of the municipal bond market.
- Prepays are designed to provide discounted energy prices to customers of municipal utilities.
- Wider spreads for prepay bonds primarily reflect their corporate security features, structural complexity, and weaker liquidity.
- Breckinridge believes that prepays are often more appropriate for commingled vehicles like a fund, as they may not always meet the needs of high-grade separately managed account (SMA) investors.



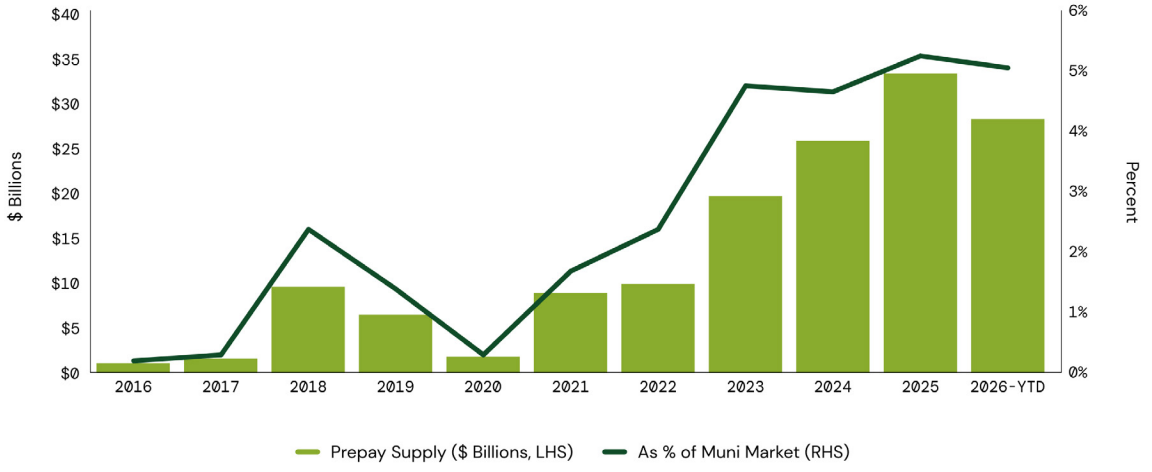
In Breckinridge's *2026 Municipal Bond Mid-year Outlook*, we highlighted the rapid growth of the energy prepay market in a discussion about growing municipal bond supply. Energy prepay (prepay) transactions involve sourcing natural gas or electricity for municipal utilities. Once a niche sub-market, prepays now comprise 12 percent of the intermediate duration Bloomberg (BBG) 1-10 Year Municipal Blend Index (the Index) and 28 percent of the BBG California Intermediate Municipal Bond Index (Bloomberg Municipal Bond: Intermediate Total Return Unhedged) (See Figure 1).[1] Prepay issuance has contributed to record municipal supply in each of the last several years (See Figure 2).

FIGURE 1: PREPAYS ARE MEANINGFUL SHARES OF INTERMEDIATE-DURATION BENCHMARKS…



Source: BBG 1-10 Year Municipal Blend Index, Bloomberg California Intermediate Municipal Bond Index, and Breckinridge Capital Advisors, Inc., as of November 1, 2026.

FIGURE 2: …AND 5% OF ANNUAL SUPPLY



Source: Bloomberg, Wells Fargo, and Breckinridge Capital Advisors, Inc., as of October 31, 2026.

1. Evestment data and cited indices, as of November 2026.

In this primer, we introduce the basics of energy prepay bonds, discuss their growth, and highlight the additional yield, spread, and risks associated with these securities. Breckinridge believes that prepays are best accessed via commingled vehicles and can potentially be appropriate for larger SMAs.

Prepays: Straightforward Purposes, Complex Structures

Energy prepay bonds serve three main purposes. First, they reduce energy costs for public utilities.[2] Second, they provide a lower-cost, additional source of capital for each deal's corporate funding recipient, typically a large financial institution. Third, prepays can offer investors a higher tax-exempt income stream than can be found elsewhere in the investment grade (IG) municipal market.

To achieve these ends, bankers and bond lawyers create a securitization-like structure that is often intimidating for investors unfamiliar with the sector. Rating agencies analyze prepays using a method akin to that for asset-backed securities (ABS). Figure 3 represents the basic configuration of an energy prepay deal.

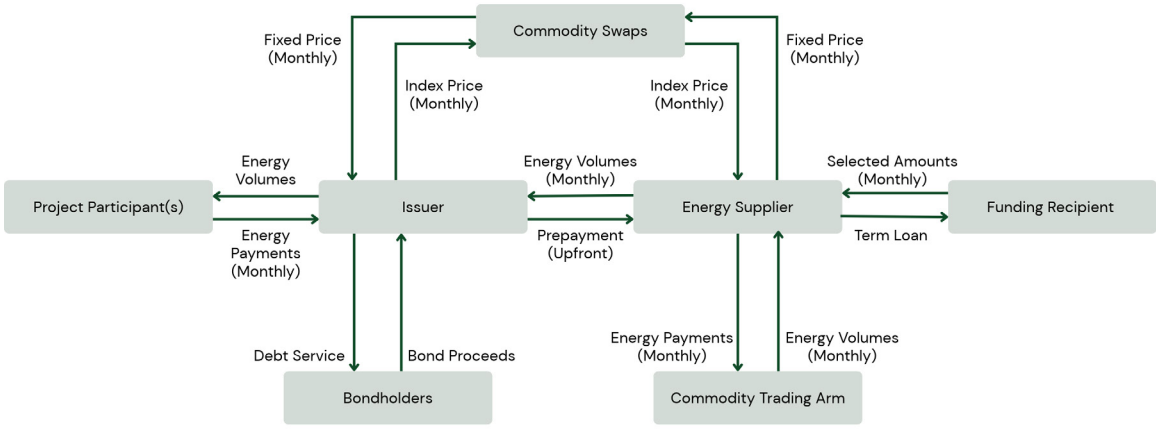
Briefly, the flow of money works as follows:

First, investors purchase the bonds and their cash passes to the issuer. In most cases, the issuer is a public pass-through entity that holds no material assets. The issuer then uses this cash to make a prepayment to the energy supplier in exchange for (1) a discounted price for energy and (2) a guaranteed long-term supply of energy, usually for 20 to 30 years.

Next, the energy supplier loans this cash to the funding recipient. Most often the funding recipient is a large bank or insurance company. The funding recipient invests the loan proceeds on its own behalf and makes scheduled payments on the loan to the energy supplier. The loan essentially shares the issuer's tax-free borrowing rate with the funding recipient, allowing it to access capital at a lower cost than would be available in the corporate bond market.

At the left side of Figure 3, the project participants are municipal electric and gas utilities taking part in the transaction. Effectively, the project participants pay the issuer a discounted market price for energy supply.

FIGURE 3: PREPAY STRUCTURES ARE COMPLICATED…



Source: Breckinridge Capital Advisors, Inc., as of October 31, 2026.

2. In addition to reducing the cost of energy, prepays can simplify the sourcing and delivering of natural gas for utilities, especially smaller and less sophisticated ones. The energy suppliers in prepay deals typically have deep expertise and energy market access that is sometimes unavailable to project participants.

Because the market price for energy can fluctuate, prepay transactions often involve commodity swaps to balance cash flows between the different entities. This portion of the structure helps ensure the municipal utility receives the benefit of an energy price discount despite changes in market prices for energy supply.

As shown in the top left of Figure 3, the issuer enters a pay-floating/receive-fixed-price commodity swap to convert the floating payments it receives for energy payments from the project participant into a fixed payment it uses to pay debt service on the bonds it issued. Likewise, the energy supplier enters a commodity swap where it pays fixed and receives the floating market price, supporting its market price (floating) energy purchase obligations from the bank commodity trading arm. The swaps mirror each other, and there is usually a centralized commodity swap counterparty between them.

Finally, the loan repayments from the funding recipient to the energy supplier are used to purchase energy and to cover obligations on the commodity swap. The energy supplier typically purchases energy from the commodities arm of the bank that underwrote the deal. The energy supplier delivers the energy volumes to the issuer who passes them on to the project participants.

Rating agencies assign their credit grade based on the lowest-rated key credit counterparty to the transaction.[3] Most often, this reflects the funding recipient's underlying credit quality.

Eligibility for Tax Exemption Heightens Prepays Value & Risk

Interest on energy prepay bonds is excluded from federal income tax. This fact sometimes surprises investors because prepays appear to side-step tax law prohibitions against: (a) reinvesting tax-exempt bond proceeds for arbitrage purposes and (b) loaning tax-exempt proceeds to private entities.[4]

However, Congress clarified in the *Energy Policy Act of 2005* that gas prepays will typically be exempt from both rules, and Internal Revenue Service (IRS) regulations exempt electric prepays from the rules.[5] In general, transactions will be exempt providing that more than 90 percent of the energy purchased flows to retail customers of a public utility.[6]

To the degree prepays may face higher tax risk relative to other municipal securities, three concerns arise (though we believe them to be low risks). First, in a future tax reform, Congress might reconsider the essential nature of prepays. They appear to benefit some large corporations and could be used in conjunction with financing the energy needs for controversial data centers.

Second, prepay deals with a Downstream Sales Contract to deliver energy to a private sector entity that buys a portion of the prepaid energy for its own operations could be subject to heighten policy scrutiny. Prepay exemptions are intended to subsidize public utilities, not private entities.

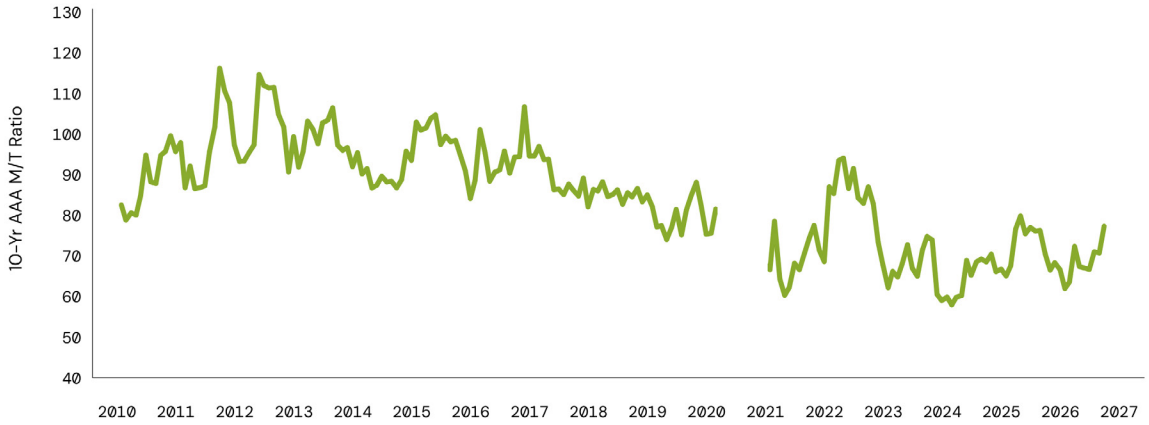
Third, prepay deals often include provisions for so-called "ledger events" which, if triggered, could result in the bonds becoming taxable or an early redemption.[7]

3. See *Moody's Investors Service* gas and electricity prepay rating methodology, May 2026.
4. The tax code's "anti-arbitrage" rules generally prohibit parties in a municipal financing from reinvesting tax-exempt bond proceeds in higher yielding assets (26 U.S.C. §148). Energy prepay bonds would appear to violate this ban because the funding recipient (corporate guarantor) effectively accesses tax-exempt money and then reinvests it elsewhere. Similarly, the code's private loan restrictions ordinarily bar lending tax-exempt bond proceeds to private entities (26 U.S.C. §141). But prepays involve a public entity borrowing at a tax-free rate and then paying upfront for future energy deliveries; the transaction has the feel of lending. However, on this last point, transactions are structured to ensure that the public entities involved are buying energy from a privately-owned energy supplier. The energy supplier merely makes a loan to another private entity (the funding recipient).
5. See: 26 U.S.C. § 148(b)(4) for gas prepays. For electric prepays, see: T.D. 9085, 68 Fed. Reg. 45,772 (Aug. 4, 2003). *Arbitrage and Private Activity Restrictions Applicable to Tax-Exempt Bonds Issued by State and Local Governments; Investment-Type Property (Prepayment); Private Loan (Prepayment)*, 68 Fed. Reg. 45,772 (Aug. 4, 2003) (T.D. 9085).
6. Ibid.
7. Ledger events can occur when unused or remarketed energy is sold to entities or under conditions that violate IRS requirements governing tax-exempt municipal bonds.

Recent Growth of Prepay Issuance Likely to Continue

The prepay sector has grown in the last several years alongside rising energy needs and generally low Municipal/Treasury (M/T) ratios[8] (See Figure 4). Low ratios make it easier to structure transactions with sufficient savings for all parties involved.

FIGURE 4: SUSTAINED LOW M/T RATIOS CREATE MORE ISSUANCE OPPORTUNITIES

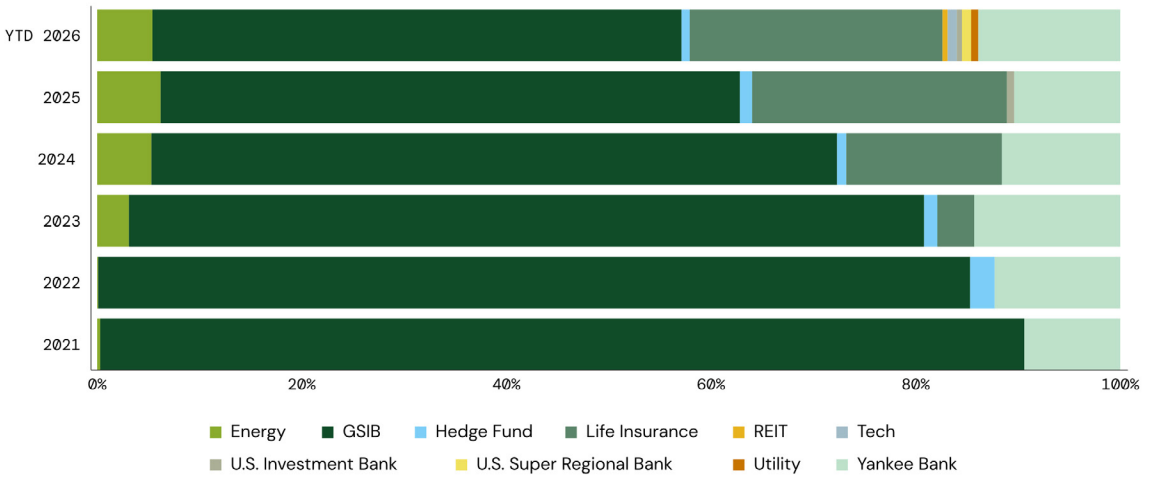


*Outlier observations from 2020 (COVID) excluded for visual simplification.
Source: Refinitiv TM3, and Breckinridge Capital Advisors, Inc., as of November 1, 2026.

Now a market greater than $130 billion, prepays include a multitude of outstanding deals across numerous combinations of issuers, project participants, and corporate funding recipients.

For perspective, in 2021, Global Systemically Important Banks (GSIBs) served as funding recipients for roughly 90 percent of prepay debt. In 2026, GSIBs comprised 52 percent of the sector (See Figure 5). Life insurers entered the market in 2023 and now take second place, at 25 percent of total sector par outstanding. Within the past year, a real estate investment trust (REIT), investor-owned utility, and major tech company have entered the market.[9]

FIGURE 5: THE COMPOSITION OF FUNDING RECIPIENTS CHANGED AS THE MARKET MATURED



Source: Bloomberg, and Breckinridge Capital Advisors, Inc., as of November 1, 2026.

8. The Municipal/Treasury (M/T) ratio compares yields of municipal bonds with those of U.S. Treasury bonds of the same maturity. M/T ratios can show the relative value of municipal bonds compared with taxable bonds, by indicating when yields for municipal bonds exceed the after-tax yields on taxable bonds.
9. Market data source from Bloomberg. Breckinridge Capital Advisors includes RBC, MS, GS, Citi, JPM, and Bank of America as GSIBs for purposes of simplicity.

Prepay issuance seems likely to grow further.

From the utilities' perspective, prepays can help lock in cheaper energy costs in an era of high inflation, and pass on the savings to ratepayers. Municipal utilities may also look to prepays to source additional energy for the artificial intelligence (AI) buildout.

For corporate funding recipients, a higher-for-longer interest rate environment will likely increase demand for lower-cost debt, including funding sources like prepays. AI-related capital needs may drive more Technology sector borrowing to the prepay market. In June 2026, Alphabet was the funding recipient for a ~$1.2B prepay bond in conjunction with corporate debt, common stock, and preferred stock — all for AI-related capex.

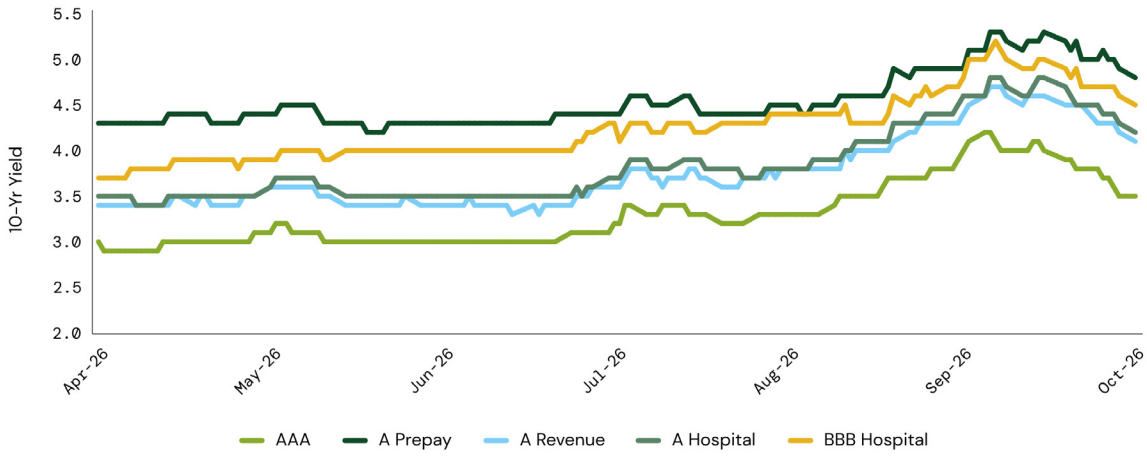
Electric prepays also seem poised to grow. Electric prepays have become increasingly common, especially in California. Long-term electrification trends, especially in states with aggressive renewable power mandates, are likely to spur issuance. Electric prepays may present interesting opportunities for sustainability-focused investors. California's prepays often involve renewable generation sources and have a green bond designation.

Yields & Spreads on Prepays Are Attractive

Prepays offer higher yields and spreads to compensate for their structural complexity, corporate security features, and weaker liquidity relative to similarly rated municipal bonds.

A-rated prepays have typically yielded more than similarly rated revenue bonds and even BBB hospital bonds. Figure 6 illustrates this trend between April and November of this year. At the time of this writing, the Bloomberg A-rated prepay index offered 34 basis points (bps) of spread pickup over the Bloomberg BBB hospital index (See Figure 6).[10]

FIGURE 6: PREPAY YIELDS OFTEN EXCEED THAT OF SIMILARLY RATED (OR LOWER-RATED)

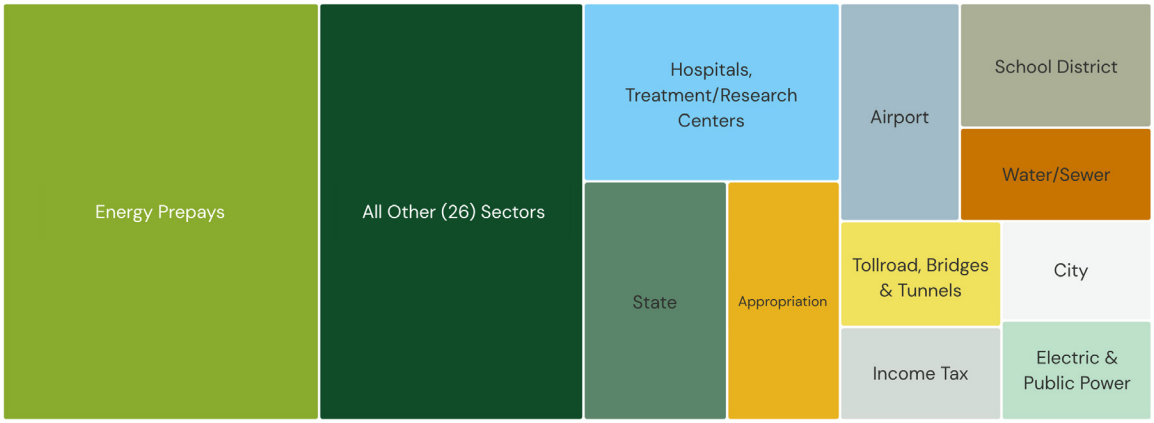


Source: Bloomberg indices, and Breckinridge Capital Advisors, Inc., as of November 1, 2026.
Past performance is not indicative of future results.

10. Data from Bloomberg indices: Bloomberg A Hospitals (BS1274), Bloomberg BBB Hospitals (BS1276), Bloomberg A Gas Forwards (BS1329), Bloomberg A Revenue (BS1208).

As of early November 2026, 28 percent of the spread in the Bloomberg 1-10 Blend Intermediate Muni Index came from prepays (See Figure 7). Managers who benchmark to the 1-10 Blend may sometimes feel pressured to buy prepays, as replacing their yield without taking other risks (duration, convexity, lower credit quality) may be challenging.

FIGURE 7: ENERGY PREPAYS COMPRISE 28% OF THE SPREAD IN THE INTERMEDIATE MUNI INDEX



Source: Bloomberg 1-10 Year Municipal Blend Index, and Breckinridge Capital Advisors, Inc., as of November 1, 2026.
Past performance is not indicative of future results.

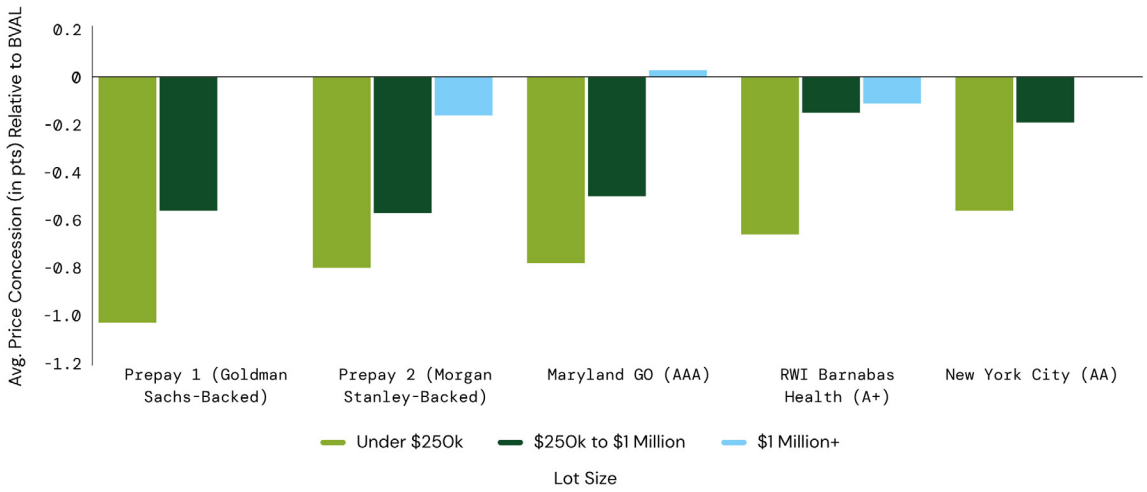
Breckinridge's Current Approach to Prepays

Presently, Breckinridge believes energy prepay securities are most appropriate for municipal investors with a slightly higher risk/return preference and are best deployed in a commingled fund structure, for at least two reasons.

First, prepays are often less liquid than traditional munis (e.g., local general obligation, water-sewer revenue). Liquidity challenges reflect complex structures and the reality that many investment mandates exclude their eligibility. Also, broker/dealer automated bidding platforms that are now widely used by municipal bond managers often do not yet bid prepays. The securities are particularly susceptible to weaker bids in small lot sizes (See Figure 8). Decreased liquidity for small trade sizes can be problematic for SMA investors, as sub-$250,000 lot sizes typically anchor an SMA portfolio.[11]

11. Note that the average municipal SMA was $2.2 million in Q2 2026, per Cerulli Associates. At that size, a $100,000 position in a prepay is just under 5% of a portfolio.

FIGURE 8: PREPAY LIQUIDITY IS WEAKER FOR SMALL LOTS, EVEN RELATIVE TO OTHER MUNIS

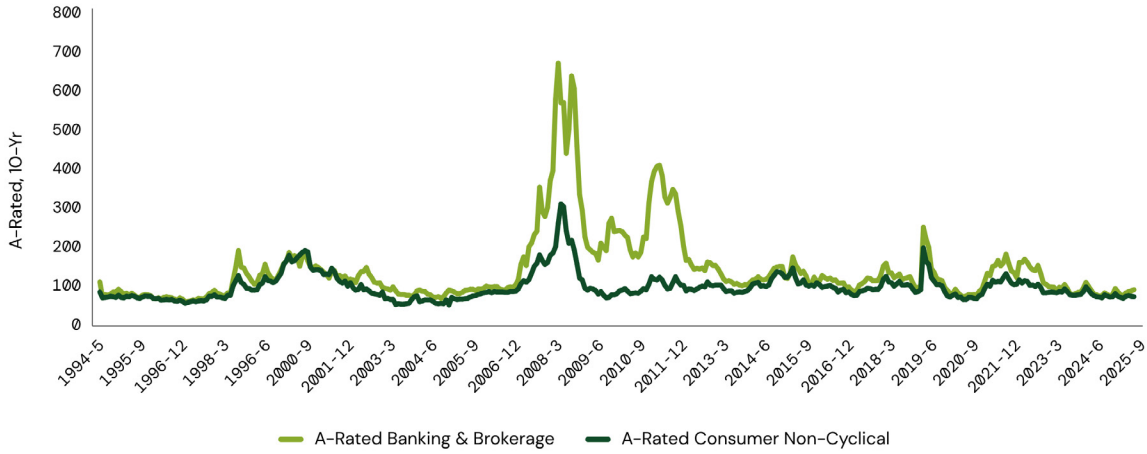


Source: Bloomberg, MSRB, and Breckinridge Capital Advisors, Inc., as of October 31, 2026.

BVAL = Bloomberg price evaluation. Methodology: calculation includes one cusip for each issuer, each cusip has a 2035 maturity, and at least 17 sub-$250k trades in the 30 trading days prior to 10/26/2026. Cusips: 292723CU5, 84136HDM2, 574193XX1, 64966SQX7, 645790VH6. These securities were selected to illustrate differences in transaction prices relative to BVAL across trade sizes and municipal security types. Other securities or periods may exhibit different results. Smaller lot transactions tend to trade at lower prices relative to evaluated prices for a number of reasons and these effects may be more pronounced for certain prepay securities. Evaluated prices are estimates of value and do not necessarily reflect prices available for an actual transaction of a particular size. Differences from evaluated prices may also reflect credit quality, maturity, structure, trade direction and timing, dealer compensation, and prevailing market conditions; they should not be attributed solely to liquidity or transaction size. The analysis does not establish that all prepay securities are less liquid than other municipal securities or predict future execution prices.

Second, prepay spreads are likely to widen in risk-off credit markets. Prepays' underlying credit quality reflects that of a bank or other corporate obligor. Bank spreads tend to be more volatile relative to their corporate peers during periods of uncertainty (See Figure 9). By contrast, municipal SMAs are often used to counterbalance riskier investments in uncertain market environments. A smaller SMA with several prepay positions could underperform client expectations precisely when a high-grade municipal portfolio is expected to meet them.

FIGURE 9: BANK SPREADS WIDEN RELATIVE TO LESS VOLATILE PEERS IN RISK-OFF MARKETS



Source: Barclays Trading, S&P Global Market Intelligence, and Breckinridge Capital Advisors, Inc., as of November 1, 2026.

Why Commingled Vehicles Are Preferred for Prepays

In our view, prepay allocations are a better fit for commingled fund structures, where investors can more easily diversify risk across several obligors and structures. A fund allows investors to consistently gain exposure to several prepays instead of just one or two names in smaller SMA positions. Breckinridge approaches prepay exposure in this way.

The exception to this approach might be larger SMAs that share more attributes of a fund and are less exposed to liquidity concerns and single-position risk. However, large muni SMAs are relatively rare. In Q2 2026, the average municipal SMA was $2.2 million.[12]

Energy prepays are a complicated but emerging topic in the municipal market.

12. Ibid. Cerulli Associates.

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