Gas Utility Infrastructure Investments

Overview and Recent Developments

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Introduction

- The need for local distribution companies (LDCs) to invest in infrastructure improvements has placed tremendous pressures on capital expenditures in recent years
  - Total capital expenditures from 2011–2015E are 37% higher than the total from 2007–2010
- This upward trend is driving more frequent rate cases
  - Utilities are pursuing alternative rate mechanisms to support investment requirements
  - However, LDCs are earning less on their investments—ROEs are down almost 200 basis points in the last 12 years
- Infrastructure capital expenditure needs will remain high. Despite low gas prices that mitigate the impact, significant cost pressures will persist, especially due to safety regulations
- Utilities should recognize that an effective regulatory framework is critical for addressing these issues. ScottMadden can help in a variety of ways, including development of a regulatory strategy, planning and preparing for a rate case, and improving regulatory processes

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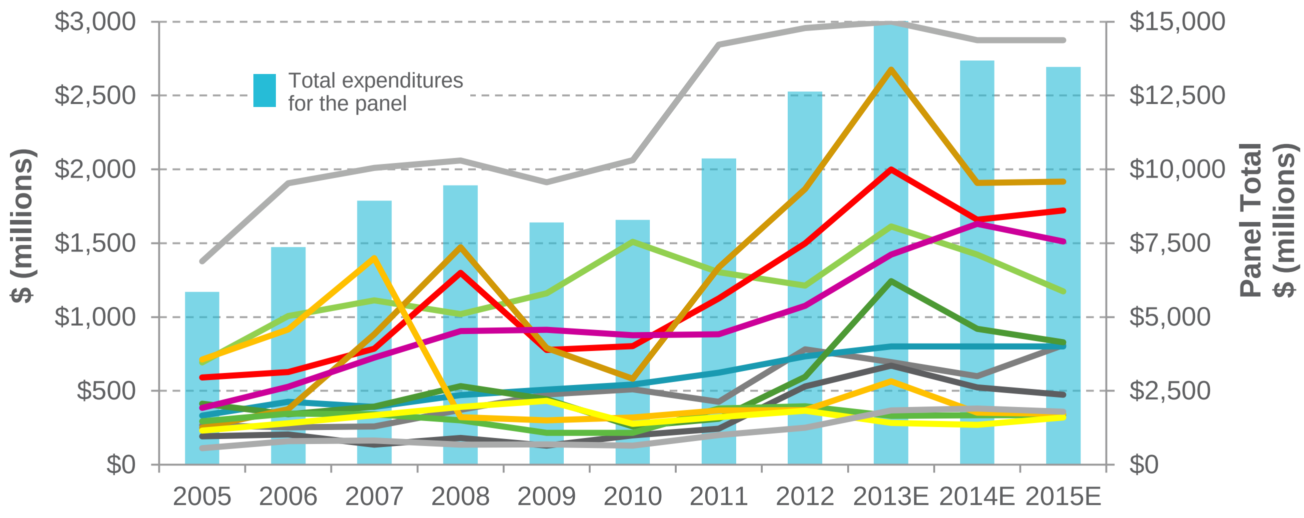
Infrastructure Investment Trends

Natural gas utility capital expenditures for new plants have increased steadily since 2005

- The chart below shows actual and forecasted capital expenditures for 13 natural gas utilities
  - The average compound annual growth rate (actual expenditures) for these companies was 11%
  - After a prolonged growth period, forecasts indicate capital expenses will decline slightly after 2013

Total Capital Expenditures



- These investments, which include pipe replacement, system upgrades, and gas storage systems, provide important benefits
  - Increased safety and reliability due to a reduction in leaks
  - Lessened environmental impact also due to a reduction in leaks (i.e., methane emissions)
  - Potential higher operating pressures which support growth
  - Expansion of infrastructure that delivers gas from production areas to end-user markets

Source: SNL

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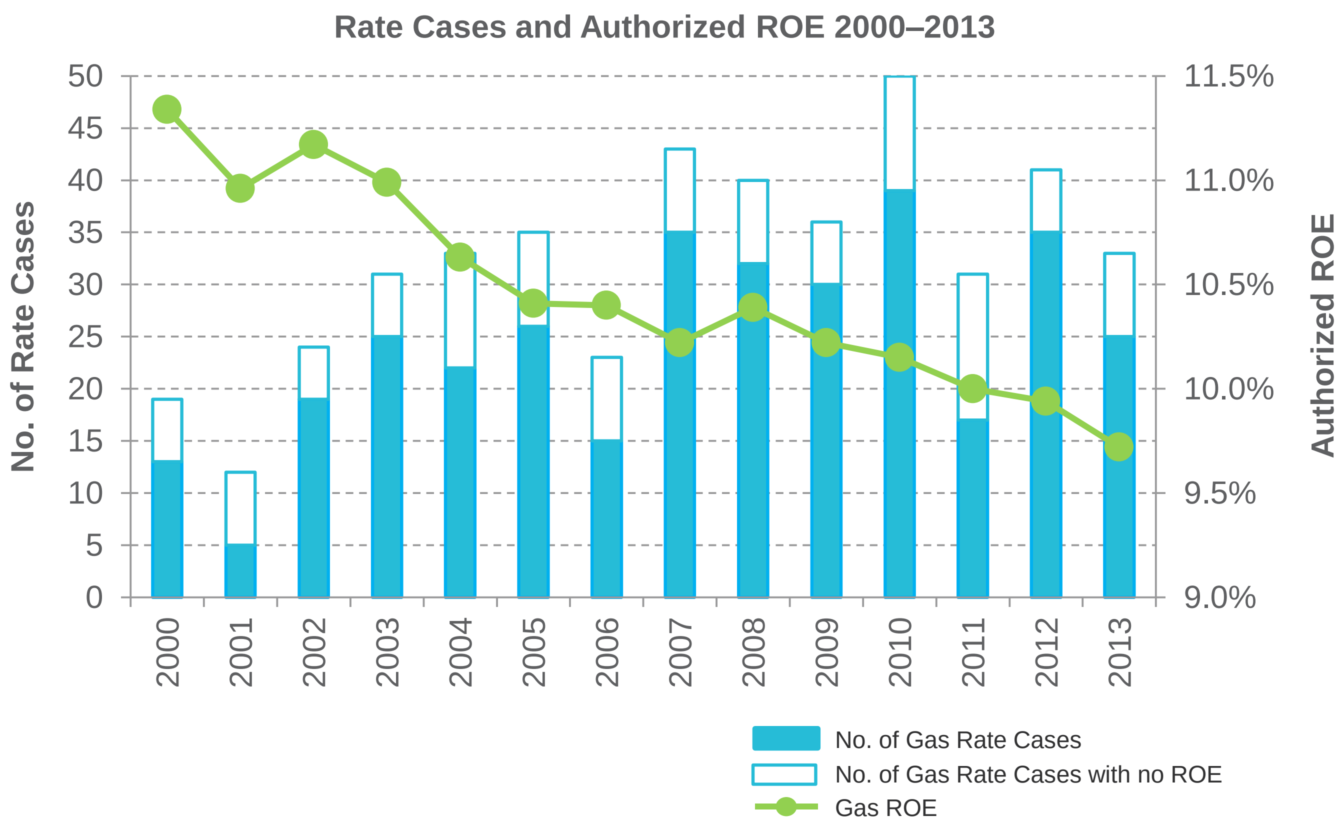
Regulatory Landscape

Since 2000, rate case activity has been high in most years, with required infrastructure investments a key driver for the filings

- The number of rate cases has increased overall during the past 14 years
- In recent years, LDCs have been confronted with declining ROEs. For cases where ROE is available, 2013 average authorized ROEs are about 160 basis points lower than those reported in 2000
- Contributing factors for the declining ROE trend include:
  - Efforts by regulators to mitigate rate increases which would otherwise occur due to the increased levels of capital expenditures and rising operating costs
  - Implementation of innovative ratemaking mechanisms granted “in exchange for” lower ROEs (e.g., revenue decoupling)



Sources: SNL; Wiley Periodicals

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Regulatory Landscape (Cont'd)

Many states allow some type of innovative ratemaking that provides an alternative method for recovering costs outside of a traditional rate case.

Mechanism	Description
Revenue Decoupling	■ Separates the utility's recovery of fixed costs from gas volume delivered to its customers ■ Adjusts rates between rate cases as sales volumes fluctuate, basing revenues on cost ■ Is employed as a way to address declining usage per customer
Straight Fixed-Variable Design	■ Is an alternative to decoupling ■ Collects fixed costs through a fixed monthly charge to customers
Cost Trackers and Riders	■ Allows adjustments outside of a rate case ■ Can include costs for specific investments, those that vary from a baseline (e.g., higher than expected bad debt), or for expenses such as efficiency promotion or storm cost recovery ■ Is often used when historical costs are inadequate to predict what will be incurred in the future ■ Is designed to provide stability to utility earnings
Enhanced ROEs	■ Incorporates higher costs and/or increased risk that may be associated with a project ■ May incorporate a return on CWIP (if allowed) ■ Provides incentive to invest in projects such as capacity additions, system improvements, etc. ■ May enable access to competitively priced capital
Multiyear Plans	■ Establishes rates and cost recoveries for a specified duration. May include provisions for increases or refunds as business conditions change ■ Reduces filing frequency and mitigates regulatory lag

Source: The Brattle Group, RRA

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Implications for Utilities

- Several factors will continue to drive infrastructure investments for LDCs
  - Pipeline safety a top priority
  - Existing bare steel and cast iron pipe that needs replacing
  - A rate-making environment generally supportive of LDCs upgrading their distribution systems
- Low natural gas prices will continue to support increased investment levels by mitigating the overall rate impact to utility customers
  - However, if natural gas prices increase over the next several years as many forecasts predict, cost recovery for infrastructure improvements may become more difficult
- Recent events have increased scrutiny of pipeline safety from the federal level. This is resulting in additional regulations designed to strengthen safety practices and mitigate future incidents
  - Cost increases and schedule delays are possible and may impact plans to expand, replace, or maintain pipeline infrastructure
- There are important considerations for any planned rate case filings to recover infrastructure costs
  - Prior to filing, regulatory organizations should develop a detailed communication plan for the utility commission, customers, and other stakeholders that clearly explains the need for the additional infrastructure investment
  - Utilities should compare the pros and cons of a base rate case to any proposed innovative ratemaking mechanisms and weigh the potential of a lower return

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How ScottMadden Can Help

- Development of effective long-term regulatory strategies that integrate the corporate, financial, and operational strategies necessary to successfully manage the regulatory compact
- Analysis of preliminary revenue requirements, modeling of the cost of service impacts of various business scenarios, and development of appropriate rate base and O&M adjustments to ensure compliance
- Management of the rate case process, including the development of required financial schedules, supporting information, and the necessary work papers to optimize regulatory outcomes
- Documentation of current rate case development processes, identification of areas for improvement, definition of future processes, and implementation of process and technology initiatives to close performance gaps and reduce regulatory lag, producing significant financial benefits
- Conduct of base rate case and rate rider audits for our clients to ensure credible, error-free filings that meet administrative rules and other regulatory requirements
- Development of operating expense and capital budget reporting templates and the critical review of client information to support future test-year rate case filings. Our approach minimizes commission staff concerns, addresses likely intervener issues, and reduces rate case preparation time
- Facilitation of client employees through a simulated rate case filing. This workshop provides hands-on experience for employees whose involvement in previous rate case efforts may have been limited
- Development of financial and operational benchmarking studies designed to ensure true "apples-to-apples" comparisons to support regulatory filings, including base rate cases and rate rider filings

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