Improving Regulatory Outcomes: Reengineering the Rate Case

Richard D. Starkweather

The number of rate cases filed each year by electric and gas utilities has consistently increased over the past 10 years.

BACK TO THE WELL, AGAIN AND AGAIN…

In 2002, state regulatory commissions decided 19 gas utility cases and only 14 electric utility cases. In comparison, 35 gas cases and 57 electric cases were approved in 2012 (see **Exhibit 1**).

The reasons for the increase in rate case activity are varied. Increasing operation and maintenance expenses and capital investment needs, coupled with declining or flat sales, have negatively impacted earnings. Sales growth in recent years on the electric side have been modest at best—on average less than 1 percent a year—and natural gas consumption continues to decline on a per capita basis as the energy efficiency of new homes and space heating appliances continues to improve.

Today's electric utilities are facing investments in the following:

- New or replacement generating capacity to address increasingly stringent environmental regulations
- The adoption of different types of renewable resources to meet state portfolio standards
- Potential Smart Grid enhancements on both sides of the meter
- Renewal of aging delivery-system infrastructure

The recent press on the impact of Hurricane Sandy on electric utility transmission and distribution systems in the Northeast may also heighten the focus of state regulators, and legislators, on options to improve system resiliency and reliability.

On the gas-utility side, companies are also carefully examining their delivery systems and identifying future investment needs for asset replacement, with a critical eye toward pipeline integrity and customer safety. Tragically, the San Bruno pipeline failure in California in 2010 provides a similar focal point for regulators on the need for additional infrastructure investments.

…BUT THE BUCKET SEEMS TO BE LEAKING

While the volume of cases has been increasing, the resulting authorized returns have been steadily declining over the same 10-year period (see **Exhibit 2**).

The average awarded return on equity (ROE) in both electric and gas cases in 2002 was more than 11 percent. The results for 2012 were 10.15 percent for electric utility cases and 9.94 percent for gas-utility cases.

Utilities are increasingly concerned about the potential regulatory treatment of new rate base items, and companies looking at the possibility of filing rate cases in 2013 are faced with a dilemma: file a case seeking to increase rate base consistent with recent or planned investments, or maintain their current ROE, which may be 50 to 75 basis points higher than what might be awarded in a new case. With the

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Exhibit 1. Number of Rate Cases Approved

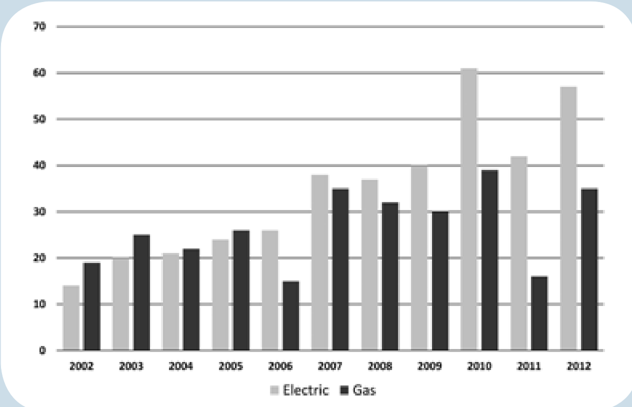


Exhibit 2. Average Authorized ROE

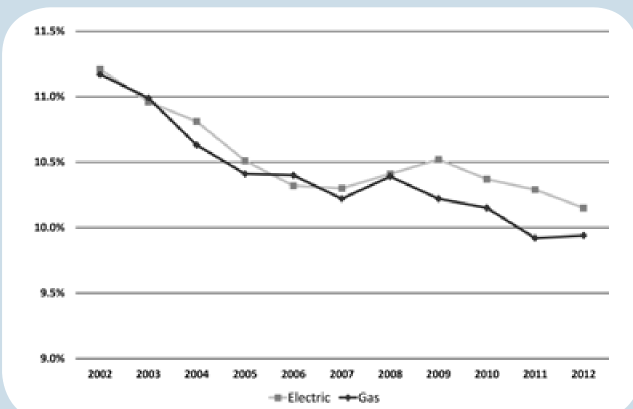
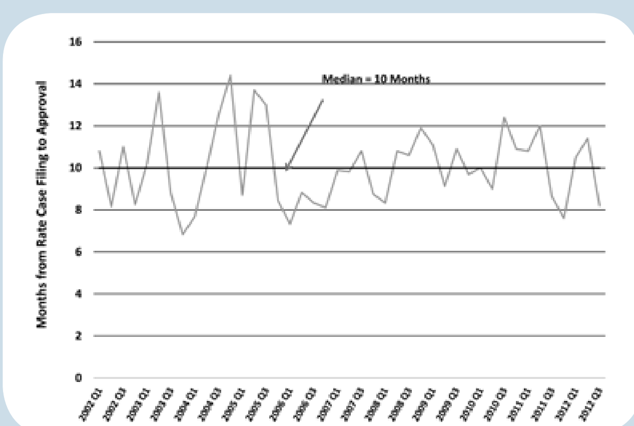


Exhibit 3. Average Regulatory Lag



national economy still not yet fully recovered, state regulators are extremely focused on maintaining stable rates for their constituents. This challenging financial environment reinforces the importance of having a sound regulatory framework.

The average lag between the filing date of a rate case and the commission approval date is about 10 months (**Exhibit 3**). Factoring in the time for the utility to develop the case before the filing date means the overall lag can be up to 16 months. For most utilities, the rate case filing process also consumes a significant amount of internal resources. Having these resources consumed by a regulatory filing over a 16-month period can seriously hamper day-to-day responsibilities—in both corporate services (accounting, finance, legal, regulatory, and other areas) and operations (for the business area witnesses involved in the case).

Exacerbating this resource problem are two regulatory trends: increasing regulatory scrutiny and the continuing demand for transparency. As a result, rate cases will continue to be more difficult to file than in previous years. There has been significant turnover among commissioners and staff in recent years; utilities must also work hard to reeducate regulators so that they better understand the utility's underlying business issues. The utilities must be able to successfully provide the context for their filing and "tell their story" in simple terms.

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WHAT DOES WALL STREET WANT?

If the commissioners want to increase transparency and improve their level of understanding, what are investors looking for? The credit rating services continue to actively monitor rate proceedings and will factor the effects of the local regulatory environment into ratings. Moody's rating methodology for regulated utilities focuses on the following key rating factors:

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- Ability to recover costs and earn returns (rate/tariff reviews, outcomes, timeliness)
- Diversification (market position, generation and fuel diversity)
- Key credit metrics (liquidity, various cash flow from operations metrics, and debt-to-equity and leverage ratios)
- Regulatory framework (consistency, predictability, supportiveness)

According to Standard & Poor's, supportive regulation is characterized by the following:

- Consistency and predictability of decisions
- Timeliness of rate orders
- Use of forward-looking measures
- Support during times of stress

In short, the financial community is looking for more predictable regulatory outcomes.

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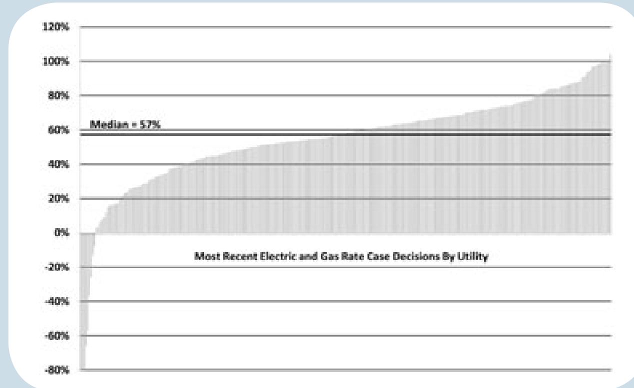
To respond to these pressures from Wall Street and the unpredictable nature of the regulatory processes in their jurisdictions, many utilities have pursued a number of initiatives, with mixed success, such as the following:

- Improving rate case fundamentals to ensure compliance with applicable administrative rules
- Exploring alternative cost-recovery mechanisms such as pass-throughs and riders
- Reenergizing regulatory relationships by working more cooperatively with commissioners and their staff

CURRENT OUTCOMES LEAVE A LOT TO BE DESIRED

Despite these efforts, the results for the industry as a whole are not good. Based on an analysis of the most recent rate cases filed by electric and gas utilities across the United States, utilities were awarded only 57 percent of the amount requested in their rate filings (see **Exhibit 4**).

Exhibit 4. Authorized Rate Increase as Percentage of Requested Increase



The median authorized rate of ROE for electrics was 91.4 percent. As **Exhibit 5** shows, it was even less for gas utilities (86.6 percent of the requested ROE). However, what Exhibit 5 also shows is that some companies are getting it right. The utilities in the upper-right-hand quadrant of the chart have higher-than-average returns and also earn their allowed rates of return.

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WHAT'S MISSING FOR MOST UTILITIES? A STRUCTURED APPROACH

Companies pass through several stages on their way to becoming top performers in rate case management. These stages of evolution can be illustrated by several factors, including the following:

- Company's value system and regulatory philosophy
- Scope of organizational understanding of the regulatory model and amount of regulatory planning that is conducted
- Types of financial planning and accounting tools available
- Efficiency of the rate case development processes and allocation of supporting resources

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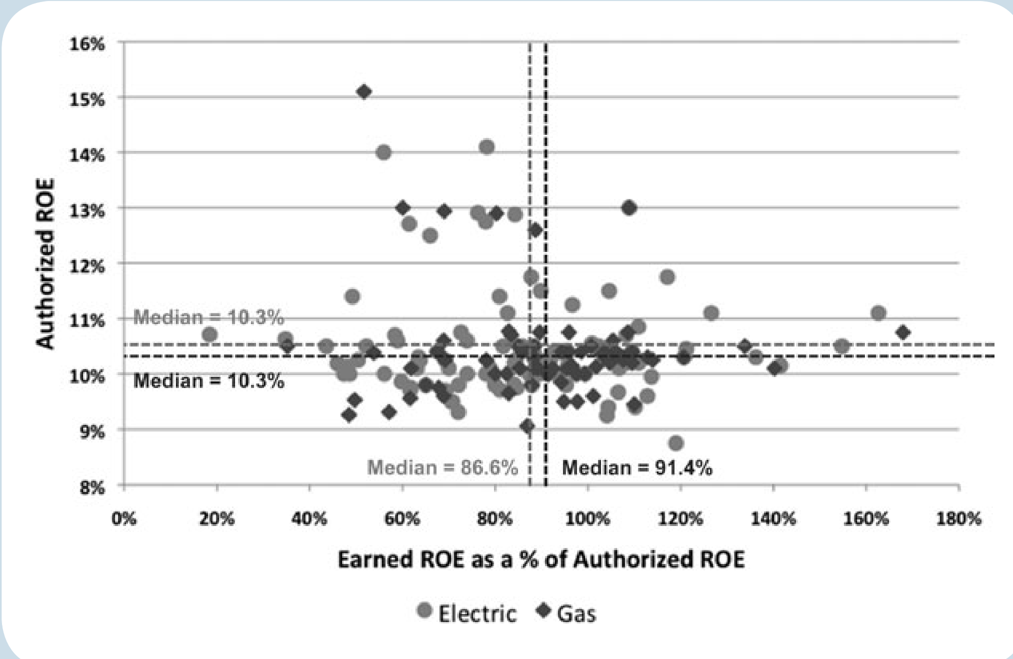
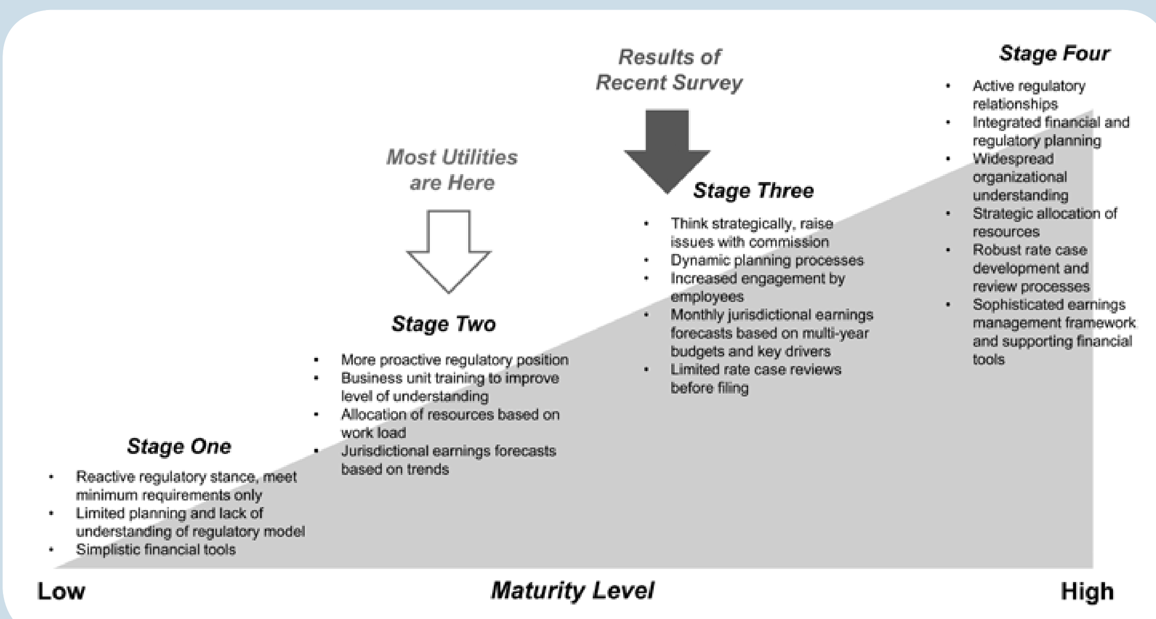
Exhibit 5. Earned vs. Authorized ROE



This type of framework (see **Exhibit 6**) can also help companies assess their progress through the various stages. Based on my consulting experience working with electric and gas utilities over the years, until recently, most utilities were at Stage Two of this "maturity model." However, in September 2012, ScottMadden conducted an informal

Exhibit 6. Rate Case Management Maturity Model



survey of 35 utilities (17 electric, 6 gas, and 12 combination utilities).

The results were quite encouraging. Based on the self-scored survey, it appears that the surveyed companies are making concerted efforts to improve their underlying financial planning, budgeting, and rate case development processes and systems to improve the outcomes of future rate cases. These companies are conducting training sessions to improve organizational understanding of how the utilities "make money" and have cultivated improved relationships with, and more proactively reached out to, the regulators when there are issues to be discussed. Financial and regulatory planning processes are being improved and better integrated (see **Case Study 1**), and underlying financial systems are being streamlined and expanded to support better business decision making (see **Case Study 2**) and more efficient rate case development processes.

Most important, utilities have begun to realize that by making sound investments in process and system improvements directly related to rate case development, significant financial gains can be realized. ScottMadden recently worked with an electric utility to examine ways that its current rate case development processes and systems could be enhanced. The objective was to reduce cycle time by 30 days or more.

With significant revenue deficiencies in the next few years, the utility was looking for ways to reduce total regulatory lag. As an example, a revenue deficiency of $60 million translates into an additional $5 million in revenue for every month that the cycle time can be reduced. Through detailed process mapping and analysis, objective evaluation of the "value" of each process step including enhanced quality control checks and management reviews, and creative development of new tools to facilitate data compilation and analysis, we were able to help the company trim five weeks from their timeline—a potential earnings impact of almost $6 million given the example above.

Case Study 1: Integrated Regulatory Plan

The basic premise: energy companies should have a strategy and plan that provides the best "regulatory" opportunity to optimize returns to investors. The solution: development of a regulatory strategy linked to the corporate financial strategy. The regulatory plan is now integrated with the business plans of the enterprise's business units and recognizes the implications of issues in several key areas:

- Customer relationships
- Governance
- Environmental restrictions
- Pricing and profitability
- Market structure
- Asset recovery
- Social obligations

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CONCLUSION

By taking a more structured approach to the reengineering of their rate case development processes, and by thoughtfully taking broader steps to improve the other attributes reflected in the maturity model described earlier, utilities can dramatically improve the outcome of future rate cases.

Case Study 2. Improved Financial Tools

The problem: corporate financial targets were set based on expected utility earnings performance, but spending levels were established by business unit, across jurisdictional and utility (electric versus gas) lines, resulting in resource allocations not linked to earnings potential. The solution: development of a new financial reporting tool to show capital and O&M by jurisdiction (and utility), model jurisdictional earnings and returns out five years. The new tool facilitates early detection of future earnings or return fluctuations and allows analysis of other cost-recovery alternatives in addition to general rate cases.

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