As the Revenue Tide Falls:
Regulatory strategies and ratemaking mechanisms to deal with declining consumption patterns in gas, electric & water

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Investor View

Consider this investment proposition:

• Company A: Customer demand is declining, but capital costs needed to run the business are increasing. The company is raising prices to offset revenue declines and maintain sufficient profits to make these necessary investments. But, these higher prices are further depressing demand, and it is increasingly difficult to keep up with revenue and profit forecasts.

Sound pretty good so far? No? Well, there is some good news:

• Luckily, Company A provides a critical service that customers, while using less, can’t entirely do without.
• Luckily, Company A is overseen by regulators who understand the need for financial stability in critical consumer services.
• Luckily, Company A is a regulated utility with a decoupling mechanism...
Big D: Decoupling Deals with Declining Demand

- Revenue decoupling is a form of regulated rate mechanism that separates, or decouples, cost recovery from changes in the amount of electricity, gas, or water the utility actually sells.
- The basic concept is that utilities have a high level of fixed costs no matter whether volumes go up or down.
  - To compensate, a revenue requirement to cover these costs is established.
  - If actual sales fall short of forecast, the utility adds a charge to recover its costs.
  - Or, if sales exceed forecast, the utility refunds over-recovery of fixed costs to ratepayers.
- The idea isn’t new – decoupling was first adopted in some states for electric and gas utilities about 30 years ago, though it is newer for water.
- **The question is whether the mechanism in its various forms is keeping pace with policy and usage trends in the utility sectors**
Decoupling for Water Utilities in California

- California water utilities offer an ‘extreme example’ of the impact of declining consumption and the effort to devise a regulatory response
- In a drought-prone desert state, water conservation is critical
- In 2008, as part of California Water Action Plan, the CPUC adopted Water Revenue Adjustment Mechanism (WRAM) and Modified Cost Balancing Accounts (MCBA), designed to:
  - Sever the relationship between sales and revenue to remove incentive to implement conservation rate structures
  - Ensure cost savings are passed on to ratepayers
  - Reduce overall water consumption

- Implementation
  - WRAM: allows recovery or crediting of differences between actual and authorized quantity charge revenues
  - MCBA: allows recovery or crediting of differences between actual and variable costs - purchased water & purchased power costs
  - Scheduled 3-year general rate cases, with settlements retroactively effective to start date
  - Forward test year
How Has it Worked?

- From a water conservation standpoint, the WRAM worked fabulously. From a utility shareholder standpoint, not so much.
- From the start, under-collections were significant, as volume usage dropped sharply, as much as 20% in year 1. Why were revenue forecasts so off?
  - Combination of economic conditions, drought, state water conservation goals (20% by 2020), and increasing block rate design – exacerbated in smaller, poorer districts
- This created a substantial cash flow crunch for affected utilities; although revenues were made whole, there was a lag of as much as 3 years
- By 2012, with under-collections ranging from 10-27%, CPUC acknowledged that the “mechanisms are not working as intended.”
- CPUC revised collection procedures, removing the 10% threshold requirement before recovery, and approving an accelerated amortization schedule allowing recovery within 18 months in most cases
- However, high surcharges under the recovery mechanism have not been popular, giving customers the perception they are being penalized for conserving
- California water rate cases have become arduous, a “riddle inside a mystery wrapped up in an enigma”, frustrating investors
Back to that Investment Proposition...

• One “Company A” that has lived through “as the revenue tide falls” is California Water Service Group (CWT)
• It underperformed the Dow Jones Utility Average in 2007-2008 amid revenue pressures, outperformed in 2009 when decoupling was approved, but lagged again during a rocky implementation period, and has only caught up in the past year

Source: Yahoo Finance
“Water service providers are facing new challenges in forecasting and preparing for future water demand, staying fiscally solvent while providing fair prices, incorporating conservation and efficiency, and communicating clearly to customers about rates and service.” – Pacific Institute, June 2013

- “The new normal” – customers will have to pay more for less
- Importance of continuing to attract capital to pay for necessary infrastructure investment remains high
- Customer education regarding the cost and value of the service provided will be key to political support
- More accurate demand forecasting can soften the blow