FIVE KEY STRATEGIC CONSIDERATIONS FOR THE UTILITY REGULATORY PROCESS

This paper is the first in a series addressing regulatory considerations for rate setting and other initiatives, designed to help position utilities for successful outcomes.

Of the many business functions unique to utilities, the process of setting rates is probably the most arcane and least understood by those outside the industry. While developing a financial model in support of a given tariff is relatively straightforward and formulaic, implementing it in the rate-setting process comes with myriad subtleties. The state-level regulatory context typically involves a quasi-judicial process and multiple constituents with different and often competing motivations. This paper examines some strategic considerations associated with the rate-setting process, highlighting the importance of the utility's regulatory relationships.

1 How the Regulatory Relationship Affects Access to and Cost of Capital

Utility sector investors and creditors quickly (and sometimes painfully) learn that the relationship between a utility and stakeholders in the regulatory process is of paramount importance. The determination of a utility company's "revenue requirement" has profound financial implications: the return on capital invested, credit ratings, and the ability to grow and pay a dividend, to name a few. But it's more than just numbers; the final decision in a litigated or negotiated process almost always comes down to subjective factors.

The financial community pays close attention to rate cases, the regulatory process, and the broader relationship between a utility company and its many constituents, such as customers and policy makers. Hedge funds—which seek investment returns not only by buying stocks (being "long" in Wall Street parlance) but also by short-selling stocks expected to decline in value—trace some of their roots to the utility industry, where long and short positions within a single sector were informed by research on

regulation's impact on individual company stock performance. As noted in a National Association of Regulatory Utility Commissioners (NARUC) Primer for State Regulators, "Investors evaluate regulatory risk by understanding the regulatory climate because it is an important component of assessing risk and determining the value at which they are willing to transact on investments in regulated utilities."

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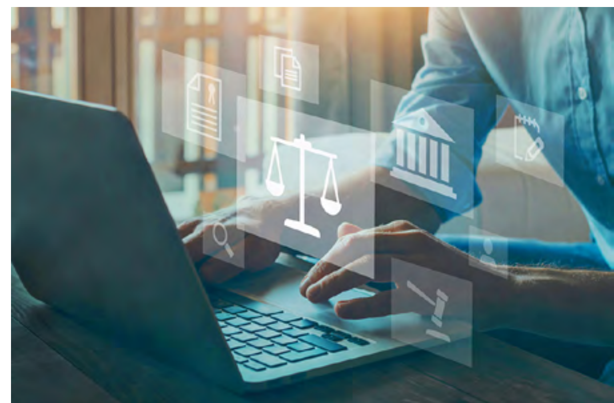
Some investors rely on research that rates state regulations on numerical factors such as allowed returns and timeliness of rulings, but also on more subjective matters such as issuance of "constructive" or "punitive" rate orders. In our experience, there is a clear correlation between regulatory tenor, equity valuation (share price) and credit ratings. Importantly, credit quality and equity valuation don't just affect investor returns, but also the utility's cost of capital. Customers benefit when the debt and equity that finances utility capital projects can be had on favorable economic terms. NARUC's primer adds: "In many ways, the interests of investors and customers are aligned and not in conflict and can become more aligned through regulatory policy."

2

Alignment With Long-Term Strategy and Future Needs

Apart from setting just and reasonable rates that fairly compensate for providing a safe and reliable service, the utility should also align its regulatory process with corporate strategy—which in successful companies also aligns with the interests of customers and public policy. Regulatory strategy should support macro issues such as environmental stewardship and community economic development while also anticipating tactical developments such as customer adoption of electric vehicles or heat pumps.



Anticipating and planning for future needs—and getting that discussion into the regulatory realm—is preferable to reacting and playing catch-up later. For example, greater electric vehicle deployment not only drives an overall increase in electricity demand, but also impacts customer usage patterns, which can improve system efficiencies. Installation and interconnection of customer-side distributed generation, combined heat and power, or energy storage raise similar issues (and potential opportunities). While current ratemaking can't incorporate future developments, utilities should actively consider possible future trends and the associated regulatory needs that may arise, and avoid short-term actions today that could compromise future flexibility.

3

Demonstrable Benefits of Capital Projects

The return of inflation and rising interest rates pose a rising challenge to large capital projects that expand the rate base. Our recent "Tailwinds" white paper noted that the past decade's growth leaned heavily on the 2-2-2 tailwinds: $2.00 natural gas, 2% interest rates, and 2% inflation. That trifecta allowed utilities to invest cheap capital into their rate base, driving unprecedented earnings growth with everything from smart meters to transmission to renewable generation. Operating cost savings and low fuel prices kept bill inflation in check.

Consumers are now facing higher prices from the grocery store to the gas pump, and utility bills have risen by double-digit percentages in some regions of the country. As a result, proposed rate-base investments are likely to see greater scrutiny and pushback, particularly in terms of how a project will benefit customers and the community.

Promised benefits—particularly for multiyear, big-ticket capital projects—must also be achievable and demonstrable. Advanced metering infrastructure, implemented by many electric utilities over the past decade, has in some cases fallen short on promised benefits of energy efficiency, work process simplification, or customer savings. Failing to deliver customer benefits risks undermining stakeholder confidence in future utility capital programs, particularly if third parties offer beyond-the-meter solutions that prove simpler, cheaper, or more effective.

4

Timing of Rate Cases

In simple terms, a utility files a rate case when its actual returns on capital fall below allowed regulatory levels (or may be compelled to defend its rates when returns appear excessive). A corporate regulatory strategy that aligns with other corporate objectives is imperative to knowing when to file a rate case. Here again, many considerations arise: macroeconomic factors such as inflation and interest rates, but also micro factors such as local employment trends and taxes. Customer bill trajectory relative to other spending also matters.

Cost management and rate-setting involve a delicate balance, and you can't simply save your way to better returns. A big cost-cutting effort on the heels of a rate increase goes beyond simply bad optics—it risks undermining trust and confidence. In similar fashion, the temptation to slash operating and/or capital costs on the heels of a disappointing rate case outcome should be tempered by a longer view focused on providing reliable service and maintaining an engaged and productive workforce. Rate cases are better thought of as part of an overall strategic regulatory progression rather than as discrete events.

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5

Communication for a Productive Regulatory Relationship

The relationship between a utility, regulators, and the many constituents in the process can generally be characterized by necessity and healthy skepticism. Ideally, the process should be imbued with trust and respect that support fair outcomes underpinned by mutual compromise. Conversely, in relationships that are politicized or undermined by mistrust or malfeasance, decisions become shorter-term, less balanced, and often punitive. Repairing a damaged regulatory relationship and lost trust can take years, and in some cases, full recovery may never be achieved.

When asked about his company's approach to regulators, the CEO of a natural gas utility once told us "my job is to make their job easier." Considering that the regulator's job is to balance the oft-competing needs of utility customers, owners, and creditors, that seems a prudent approach. In our view, communication is key to maintaining productive and cooperative relationships in any context. But how can utilities promote good and productive communication in a regulatory relationship that is also supposed to involve healthy skepticism?

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In our experience, avoiding surprise is key. Regulators and stakeholders should be kept informed about matters that drive the need for rate action, including but not limited to:

- Customer engagement through rate design options and energy-efficient opportunities
- Macroeconomic factors such as inflation, interest rates, and fuel prices
- Local factors like employment, customer growth trends, and weather
- Cost of and access to capital, credit quality, and relevant capital market trends
- Needed investments for safety, reliability, security, and resilience

While a rate increase is never going to be popular, maintaining ongoing dialogue on these issues helps prepare other stakeholders and positions them to respond to media inquiries. It also helps set expectations on both sides of the table and fosters an environment for negotiation and compromise, an approach that many—but not all—regulators prefer. Finally, regular communication identifies specific stakeholder needs and hot-button issues to avoid misunderstanding and confrontation.

Communication is also important to other constituencies, both internal and external. Because rates and regulation are integral to utility success, financial health, and workforce compensation, the process and its importance should be well understood across the utility organization. Part 2 of this series will discuss in more detail the importance of internal utility teams in understanding the details of a rate case and the regulatory processes.

Regulation and rate-setting are critical to utility success, with strategic implications that go well beyond the number crunching. The importance of relationships for success in the regulatory framework is difficult to overstate. With so much on the line, utilities should evaluate their preparedness and understanding of the five key strategic issues identified in this paper before entering the regulatory arena.

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