American Gas Foundation

Regulatory Policy of Return on Equity

Review and Analysis of the Natural Gas Utility

The continued success of the utility sector to deliver natural gas safely and reliably depends upon a strong and viable infrastructure that will meet growing local distribution company (LDC) customer demands. The infrastructure development needed to address new and aging infrastructure relies heavily upon the ability of the industry to attract strong capital investment. As such, the American Gas Foundation (AGF) engaged Navigant Consulting Inc. (NCI) to examine the current processes utilized by the state public utility commissions to determine allowed returns on equity (RoE) for natural gas utilities in an effort to determine if the RoE rates being approved and established are adequate and sufficient to address U.S. pipeline and distribution infrastructure needs.

Given the diversity of state jurisdictions and policies, the effort undertaken for this study examines all state decisions over an extended period of time and relies upon statistical examinations of that large population of cases, informed by extensive interviews with financial analysts and senior industry executives, to identify and interpret trends and reasons for those trends and determine whether there is a perceived problem within the financial community. The core question posed by the study's mission statement and objectives, the impact of RoE decisions and policy on LDC infrastructure adequacy, is largely addressed through the interview process. it observes various trends, impacts, and reasons for those impacts, it is up to other efforts to support the need for specific changes in individual proceedings. The study is intended as a backdrop to inform such efforts.

Summary of Findings

- Equity analysts expressed concern that when allowed returns drift below 10 percent, financial markets see that as a "red flag" that could turn substantial investment away from the industry. This risk is particularly valid now, according to the analysts, since changes in the population of large investors toward a greater weight of hedge funds and private equity firms allows large blocks of money to move much faster than in the past in departing from an industry.

- Equity analysts also stressed that if there are other indications of a favorable regulatory environment, one of mutual trust with collaborative development of comprehensive service and rate structures by the LDC and the regulator, the perception that low allowed returns indicate an unfavorable regulatory environment is largely ameliorated. However, there is a strong concern that a jurisdiction will work to develop such balanced, collaborative approaches, use that as a basis for low returns, and then, over time, erode the quality of the balanced approaches without revisiting return. This concern strongly validates the importance of open and honest dialogue between the utilities and their regulators, such that a mutuality of trust can stay in place long-term.

- Uniformly, the executives running LDCs are committed to safety and reliability of service, and thus will strive to invest what is required to maintain those objectives, as long as they are in the LDC business. However, low returns create incentives for them to avoid discretionary investment, and for their holding companies to exit the LDC business.

- It is only in jurisdictions where allowed returns have remained at higher levels more consistent with history, or where the LDC and its regulator have developed collaborative, more holistic approaches to services and rates supplanting traditional usage-based and cost-based regulation, that these incentives are not creating negative pressure on investment.

- Except for the jurisdictions where returns have remained higher, or where other arrangements have successfully supplanted more traditional regulation, the LDCs are experiencing increasing difficulty in competing for capital. The measure of such difficulty is not the relationship to debt cost, but the relationship to alternative equity investments.

- To date, much investment and even some merger and acquisition consolidation of the LDC industry have continued, but the continuation does not mean there is not a deep concern over allowed returns – rather, the various businesses are seizing opportunities as they present themselves, with the expectation that currently depressed allowed returns are a short-term phenomenon – the managers trust the system to "self-correct" over time. If that turns out not to be the case, the risk the industry and regulators run is a fundamental loss of trust in the regulatory system, one that would have a strongly negative impact on investment.

- Thus, although low returns have created a negative pressure on investment in LDC infrastructure, little impact has been seen to date. Public markets for capital have still been accessible for LDCs, in the opinion of the analysts and senior executives because of two factors: (1) the faith in the regulatory system recited above; and (2) the currently favorable tax treatment of dividends. However, continuing downward trends in allowed returns undermine the first rationale, and political uncertainty undermines the second. In addition, the recent large concentration of equity investment in such vehicles as hedge funds is expected to make financial markets quicker to react negatively if the current negative perceptions of LDC investment persist. In short, the threat to infrastructure adequacy is a looming threat, exacerbated by low returns, a threat that could be ameliorated by some corrective action.

- Various rate-design changes, in particular "decoupling," can provide some stabilization of LDC revenues, if properly applied. However, there is concern that regulators accord inordinate weight to these mechanisms' impact on risk when setting returns. Further, it is believed that many times there is a potential double-counting of the effect, since regulators apply a decrement to returns developed by reference to proxy companies that have similar de-risking mechanisms. Uniformly, the interviewees believed such decrements were ill-advised and unfair.

- At the same time, other risks of the LDC business have been increasing– specifically unfunded government mandates, precipitous run-up in the cost of critical materials such as steel and in the cost of contract labor, the regulatory risk of cost disallowance, especially in periods of rapid gas-cost increase, and asymmetric regulation of uncollected gas cost (e.g., paying interest on overcollections but collecting no interest on undercollections).

Additionally, in the competitive, unbundled world of today's interstate pipelines, the risk of bypass for LDCs' highest-volume loads is pervasive. Thus, to the extent that decoupling might tend to stabilize revenues and thus ameliorate that area of risk, these other evolving risks offset or even reverse that effect. Further, unlike the revenue volatility addressed by decoupling (which volatility could go either way – reducing earnings or increasing earnings, depending on weather), these evolving risks are "one-way," strictly acting to the detriment of the LDC.

- The debt rating community is generally not deeply concerned with allowed return on equity, unless it gets low enough to threaten required debt coverage. That coverage cushion may be relatively smaller if the whole regulatory scheme enhances stability of revenues.

- However, the debt analysts do become concerned when allowed RoE drops to a level that forces company management to reorient investment into riskier areas to meet Wall Street expectations of growth. In other words, the allowed returns for the LDC must meet a risk-adjusted comparison with alternative investments, or the company's stockholders will tend to push reorientation to the point that its overall revenue profile becomes more volatile, and thus its corporate debt becomes less secure.

- There is much more depth in these and other observations in the body of the AGF Study. Overall, it is fair to say that there is widespread concern over the industry's ongoing ability to raise and retain capital. Generally senior executives feel that in the current market, returns below 10 percent are very problematic, that returns in the mid-10s are adequate to keep the businesses on an even keel, but not to win contested capital in competition with investments in other businesses with similar risk, and that returns in the low 11s, e.g., 11.25, can generally reach risk-adjusted parity with the investments with which LDCs must compete for capital.

- Clearly, the concerns raised by both financial analysts and senior executives in the industry have grown a great deal in importance in the current credit and financial turmoil. The rapidly evolving difficulties in raising all types of capital, both debt and equity, would suggest that any negatively perceived factor, such as inadequate or declining allowed rates of return, could exacerbate an already problematic situation in funding new infrastructure.