A standardized cost recovery approach for utilities impacted by COVID-19

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The degree to which an investor-owned electric utility is financially impacted by COVID-19 will depend on its location, customer composition, regulatory construct, organizational structure, and, perhaps most importantly, the utility's response to the pandemic. We have been closely following and engaged with utilities in numerous states on their response and one thing is clear: there is a need for standardization in how utilities identify, measure, and track costs. Our concern is that if a clear and reasonable approach is not solidified today, utilities will be at significant cost-recovery risk tomorrow. In this paper, we describe what actions we believe utilities should start taking now to ensure that costs are clearly identified, accurately measured, and communicated to stakeholders.

Background

Without an effective recovery mechanism, the impact of COVID-19 on financial performance may be unlike anything ever experienced by a utility. While lower sales and increases in non-payment are common in economic downturns, simultaneous and significant increases in costs are not. From our client interviews and research, it is clear that utilities are facing higher operating- and financing-related costs as a result of the pandemic. A simultaneous decrease in revenue and increase in certain cost elements may lead to greater risk for a utility to fully recover its revenue requirement.

In the US, many state regulators have recognized the potential issue and have already suggested that utilities track the cost increases and revenue declines resulting from the pandemic. In most cases that we have reviewed, the regulators are giving utilities in their states wide latitude in how they structure these tracking mechanisms. However, this approach seems to kick the can down the road rather than resolve anything in the near term. For instance, in Texas, the Public Utilities Commission has indicated that it will review the reasonableness of tracked costs at a later date on a "case-by-case basis."[1] While this approach may be entirely appropriate given current conditions, it may not give the utility much comfort that under collected costs will be recovered.

COVID-19's impact on utility capital, operating, and financing costs

Through our client work and research over the last few weeks we have identified numerous categories of utility capital, operating, and financing costs that we expect to increase as a result of COVID-19 related issues. We summarize these costs in Table 1.

[1] Public Utility Commission of Texas, Accounting Order, Project Number 50664, March 26, 2020.

Table 1: Potential utility cost impacts from COVID-19

Cost category	Description
Field staff and vehicle costs	Utility workers and crews may be less efficient in their jobs as a result of COVID-19 related safeguards, such as worker distancing, protective gear requirements, and transport protocols. These inefficiencies may manifest as utility operational and capital cost increases associated with increased staffing levels, overtime costs, fuel costs, and asset utilization.
Protective equipment and materials	Many utility field workers will require protective equipment and materials, such as masks and cleaning solutions, to ensure a safe working environment.
New technologies	Utilities will likely need to invest in new technologies for business continuity, as a significant portion of the workforce shifts to working from home.
Call center and credit & collections activity	Utilities will likely experience a sharp increase in call center volume and credit and collections related activity, given increased unemployment and customer bill concerns.
Disconnect/ reconnect activity	Utilities will likely see cost increases related to disconnects and reconnects over the longer term, after states lift their moratoriums.
Regulatory related costs	Utilities may require more rate filings, and/or more innovative cost recovery mechanisms, as well as more proactive communication with regulators. This will likely involve greater internal and external support than typical.
Health care costs and sick time	Some utilities may experience an increase in sick time and associated health care costs (i.e., insurance premiums) as a result of the disease.
Cost of capital	Utilities may see increased borrowing costs due to worsening financial conditions. Cash flow ratios may fall as a result of greater unfunded pension liabilities and lower free cash flow.

Sudden increases in utility capital, operating, and financing costs may put recovery of a utility's revenue requirement at risk. Of course, this will depend largely on the jurisdiction and its regulatory framework. Some jurisdictions have cost riders and revenue decoupling that can, at least partly, mitigate the impact of sudden cost increases on utility financial performance. However, in general, utilities will need to go through some regulatory proceeding to request an adjustment to retail rates or an alternative recovery mechanism.

COVID-19's impact on utility revenues

COVID-19 has already led to significant reductions in electricity demand as the US economy contracts, manufacturing plants close or suspend operations, and many members of the office-based workforce shift their operations to their homes. As a result, we expect to see utility retail revenues fall considerably in 2020, based on early research. A recent survey by Bank of America (BofA) indicates that utilities are currently seeing demand reduction in the 5% to15% range, depending upon region.[2] This reduction in

[2] BofA Global Research, Industry Survey: What are Expectations for COVID? April 20, 2020. See also CRA Insights: An early view of the impact of COVID-19 reactions on electric load, http://www.crai.com/publication/cra-insights-early-view-impact-covid-19-reactions-electric-load.

sales will be accompanied by a reduction in utility power supply costs as the utility will generate or procure less power for customers. On net, however, we expect retail revenues to fall more significantly than power supply costs due to utility rate structures that tend to be more variable-based than the utility's cost structure.

In addition to load-based revenue reduction, utilities may also face significant revenue reduction due to increases in non-payment by customers. Utility rates are set based on an historical estimate of uncollectible revenue ("uncollectibles"). Effectively, the expected amount of uncollectibles is allocated to all other customers. When the level of actual uncollectibles is higher than expected it creates a revenue shortfall that is not offset by lower operating costs. With COVID-19, utilities are bracing for a significant rise in uncollectibles. Utility rates typically assume uncollectibles of approximately 0.5%. However, utilities in regions facing high unemployment could face much higher write-offs. According to the BofA survey, more than half of utility respondents believe that uncollectible rates will rise to 1% or greater. For a mid-size utility with 500,000 residential customers, that could equate to $2.5 million or more in incremental revenue loss.

This double-barrel impact of increased cost and reduced revenues may leave the utility well short of the earnings level last authorized by their regulatory commissions.

Cost recovery risk

Utilities provide an essential service that must be acknowledged through rate setting and recovery mechanisms. Ideally, regulators would ensure that utilities recover all prudently incurred costs related to COVID-19. We believe, however, that many utilities will face some risk in recovering all of their prudently incurred costs associated with COVID-19, while continuing to recover baseline costs and earning a fair rate of return on invested capital. While many state regulators have taken an important step forward in suggesting that utilities track cost and revenue deltas, few regulators have prescribed how these will be specifically reviewed or identified the recovery mechanism. As a joint Wisconsin utility filing makes clear, "There are no FERC accounts to track costs and forgone revenue resulting from a pandemic like the COVID-19 public health emergency."[3]

Utilities are effectively on their own to propose approaches for identifying impacted cost and revenue categories, then tracking those costs and revenues. This raises serious cost recovery risks for the utility in the future. A Commission order to track balances is not the same as a Commission order to recover that balance. In most cases, utilities will need to prepare more frequent rate relief requests. Regulators will then have a choice to approve, partially approve, or deny the request. Furthermore, if the US economy continues to contract or stagnates, regulators will feel more pressure to keep retail rates down. This inevitably will increase the risk of future utility recovery for COVID-19 related costs.

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3 See Wisconsin Utilities Association's Response to Notice of Investigation, Docket 5-AF-105.

A comprehensive, consistent approach to measurement, tracking, and proactive communication with the regulator will ensure appropriate recovery outcomes.

Identifying, measuring, tracking

Many utilities have begun tracking cost and revenue categories that may be impacted by COVID-19. Unfortunately, for many categories, the COVID-19 impact is not always clear-cut. For instance, is line operations expense higher because of COVID-19 or because of general productivity issues? Are call center costs higher because of COVID-19 related calls or because of inquiries related to a recent customer system changeover? How much of lower load is due to COVID-19 versus milder weather? Utility technologies and existing processes are not well oriented to track the sources of variances specifically traceable to the pandemic.

In our view, utilities need to act now to develop a highly structured, logical, and well-documented approach for identifying, measuring, and tracking COVID-19 related impacts. Time is not on the utility's side. Imagine a situation in a year or more where a utility is attempting to separate out the COVID-19 cost and revenue impacts for each tracked category as part of a cost recovery filing. If the utility did not define the "rules" upfront as to how COVID-19 impacts would be measured, they may face significant pushback from stakeholders. Stakeholders may challenge the data, the approach, and the outcomes, leading to a contentious and fully litigated set of hearings.

Alternatively, imagine that the utility has been proactive and took steps in the early days of the pandemic to truly understand the impact of COVID-19 on the organization. They interviewed office and field-based staff and reviewed financial and operational reports. They not only broke out the affected cost and revenue categories, but also identified and isolated the drivers. They created the rules and systems for measuring and tracking the drivers, then recorded the whole process in a living document that would be relied on later in a rate proceeding. They also communicated all of this to the regulator and other stakeholders and kept them apprised monthly.

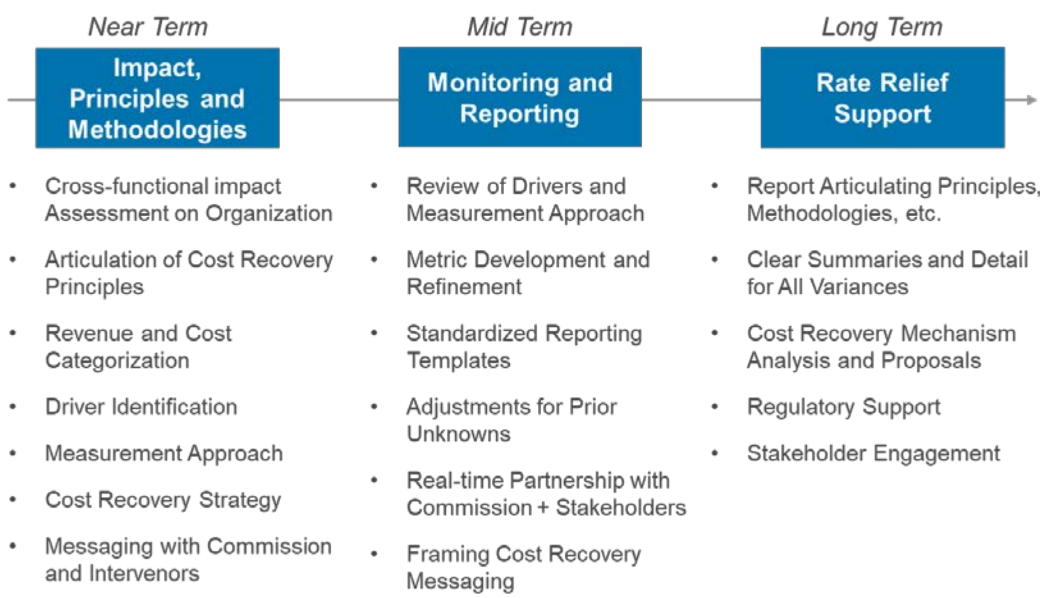
While a proactive, data-driven approach will require some upfront effort by the utility, it will pay off later. Just the cost of overtime hours or contracted staff to address COVID-19 field complexities could lead to millions of dollars in costs not contemplated in the utility's last approved rate case. Developing a rational and well-articulated approach for identifying, measuring, and tracking these costs can significantly improve recovery chances. Considering the range of impacted cost and revenue categories described earlier, the financial benefit to the utility of a more proactive approach can be significant.

Getting started

Fortunately, it is straightforward for a utility to get started on this path. In general, the resources and the information are already available. The principal task is to develop a well-structured approach with objectives and milestones that a cross-functional team can embrace and drive.

In our work with utility clients, we have developed a three-stage framework that can help orient the company to near- and longer-term priorities around identifying, measuring, and tracking affected cost and revenue categories. We summarize this framework in Figure 1.

Figure 1: Utility framework for COVID-19 cost recovery



In the near term, the priorities are to understand the impact of COVID-19 on the organization, develop a means to measure and track the impact, develop a regulatory strategy, and begin the messaging with the regulator and other stakeholders. Most utilities have a general idea about the categories of costs and revenues impacted (e.g. the list in Table 1), but probably do not know the magnitude or range of the potential impact. Also, there is not usually broad awareness of how specific costs and revenues are recovered under the current regulatory schema.

We recommend the utility assemble a working team comprising functional area leaders from at least regulatory, field and back office operations, utility accounting, and planning. These individuals collectively have the knowledge and experience to holistically identify COVID-19 cost- and revenue-related impacts and assess the recoverability of these costs under existing tariffs. Where they do not have direct knowledge, they will know where to find information within the organization and can be helpful in conducting internal interviews and data querying from internal databases. We recommend this cross-functional working team be co-sponsored by the utility's Chief Operating Officer and VP of Regulatory and meets regularly until regulatory outcomes have been achieved.

Once the potential COVID-19 impacts are identified and broadly assessed, the utility should develop an understandable approach to measure the impact over time. This requires analyzing the cost and revenue drivers, first and second order. For instance, if customer calls are expected to significantly rise as a result of COVID-19, the utility would want to clearly spell out the primary drivers, which likely would include payment issues, disconnections (if allowed), and billing inquiries (e.g., seeking clarification of higher bills). The utility would also want to describe the secondary drivers, such as increased unemployment and increased in-home activity. Impact assessment and driver identification will enable the utility to develop a reasonable measurement approach for each affected cost and revenue category. The measurement approach will not be perfect and there will always be aspects open to debate, but if the approach is logical, well-articulated and documented, and relies on the best information available, it should significantly mitigate cost-recovery risk.

In conjunction with developing a process for identifying, measuring, and tracking COVID-19 related cost and revenue impacts, the utility should develop its regulatory strategy. For many utilities, this will require analysis, input, and reaction from internal and external experts, and careful consideration of trade-offs. While every situation will be unique, one question we expect most utilities will face is whether to seek cost recovery through a general rate case or through a special purpose rider. There are potential benefits to both approaches, but also risks. For instance, while a general rate case could offer a utility a more broad-based solution to under-recovery and help define the new norm in terms of going-forward cost expectations, it could also bring risk in the form of a lower authorized return on equity. The utility working team should develop a decision framework for analyzing these types of regulatory trade-offs to use in discussions with company decision makers.

The final element of the near-term action plan is outreach to the regulator and to other stakeholders. A discussion of stakeholder strategy in the era of COVID-19 is worthy of a separate paper as utility business models will need to react to market, customer, and policy dynamics. What is critical here is that the utility messages its intentions to stakeholders early in the process and gains buy-in around the important premise that essential service providers require reasonable assurances of cost recovery. While many stakeholders may balk at providing any sort of guarantee up front, building consensus around the range of impacted cost and revenue categories, their drivers, and potential ways to measure these impacts is constructive. It is also better to surface areas of disagreement earlier in the process than later.

Longer term

Establishing a well-structured process and taking the other near-term actions described above will be important to COVID-19 related cost recovery. However, the utility will need to take actions in the medium and longer term as well. In the medium term, the utility – through its working team – should be reviewing the identified cost and revenue categories periodically to determine whether variances from expected levels are fully explained by the identified drivers. If not, the utility may need to refine its approach, again in consultation with stakeholders. The utility should also be using this period to refine its regulatory strategy, which may need to evolve based on circumstances. Some of the questions the utility may be considering include the timing of a cost recovery filing, the appropriate cost recovery mechanisms, and broader strategic questions about how costs can be fairly allocated among customer and rate classes.

If the utility has done a good job of (1) structuring an upfront approach to identify, measure, and track COVID-19 affected costs and revenues, (2) refining the approach along the way as conditions merit, and (3) communicating the approach and any changes with stakeholders, it will have made life much easier when it comes time to filing for cost recovery. The cost and revenue information should be available, well documented, and easily incorporated into testimony. The utility can also reference stakeholder interactions, describing any objections and explaining how the utility responded. Where settlement discussions are required, the utility will already know the stakeholder positions. This can lead to early consensus on key issues and substantially reduce the risk of negative regulatory decisions.

Conclusion

COVID-19 has led to significant cost and revenue impacts for utilities as a result of lower loads, the inability of an increasing number of customers to pay their bills, and operational changes at the utility, among other factors. Utilities face the potential for a large under collection when revenue falls short of covering costs. This is compounded when an increasing number of customers are unable to pay their bills. While some utilities may be partly insulated through decoupling and rate riders, most utilities will be seeking some form of rate relief for COVID-19 related impacts in the future.

Many regulators have suggested that their utilities begin to track COVID-19 related cost and revenue impacts for potential cost recovery. However, in the cases we have reviewed there is uncertainty as to how the regulators will ultimately evaluate a utility’s cost recovery petition. We believe utilities can significantly improve the likelihood of cost recovery and reduce risk through a highly structured, logical, and well-documented approach for identifying, measuring, and tracking COVID-19 related impacts.

Our three-phase approach encourages the utility to take aggressive and proactive steps immediately within their organizations while communicating their progress externally to the regulator and other stakeholders. The approach is both continuous and dynamic, requiring the utility to reevaluate its approach throughout and regularly engage with stakeholders. A clear, well-documented, and stakeholder-socialized approach to tracking, measuring, and communicating the impacts of COVID-19 will significantly mitigate cost recovery risks, and maximize recovery outcomes.

Contacts

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