



# Financial Issues Facing Natural Gas Companies

## AERS and Pennsylvania PUC Partnership



Steve Klick (Klickovich)  
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# Regulation



- Price setting for monopolies
- Cost of service based
- Return set to reflect investment of similar risks
- Designed to mirror a competitive market



# Ratemaking Objectives



- Set rates to provide ADEQUATE and RELIABLE service at REASONABLE prices.
- Set rates which provide the OPPORTUNITY for Shareholders to earn a fair return on invested capital.



# Example



## BRIEFING SHEET

### **Pennsylvania – American Water Co. Rate Increase Request**

<u>Filing Date:</u>	April 27, 2007
<u>Test Year:</u>	12 Months Ended December 31, 2006
<u>Future Test Year:</u>	12 Months Ended December 31, 2007
<u>Increase Requested:</u>	\$59.2 Million
<u>Percentage Increase:</u>	14.7% in overall revenues
<u>Effective Date:</u>	January 26, 2008 (based on full suspension)
<u>Rate of Return:</u>	8.64% on rate base; 11.75% ROE

<u>Type of Capital</u>	<u>Proportion of Total</u>	<u>Cost Rate</u>	<u>Weighted Cost</u>
Debt	53.31%	5.99%	3.19%
Preferred Stock	.80%	8.11%	.06%
Common Stock	<u>45.89%</u>	11.75%	<u>5.39%</u>
Total	<u>100%</u>		<u>8.64%</u>

#### Elements of Increase:

	<u>Required Revenue (\$ in thousands)</u>
Capital projects (Rate Base)	\$25 Million
Revenue and Expenses net	17
Return on Equity	<u>17</u>
Total	\$59 Million

6 Q So you would agree that this number has been  
7 jumping around a bit?

10 A May I comment on that?

11 Q I'm certain even if I said no that you would  
12 anyway.

18 A I have two responses to that question. I'll try  
19 them both and we'll see which one you like.

20 Q I just want the truth, Mr. Klick.

5 Q To the extent that it doesn't go over your head,  
6 could you explain the difference between EDR and the CRR?

18 Q It's perfectly obvious you're not a lawyer,  
19 isn't that right?

20 A That's correct, yes.

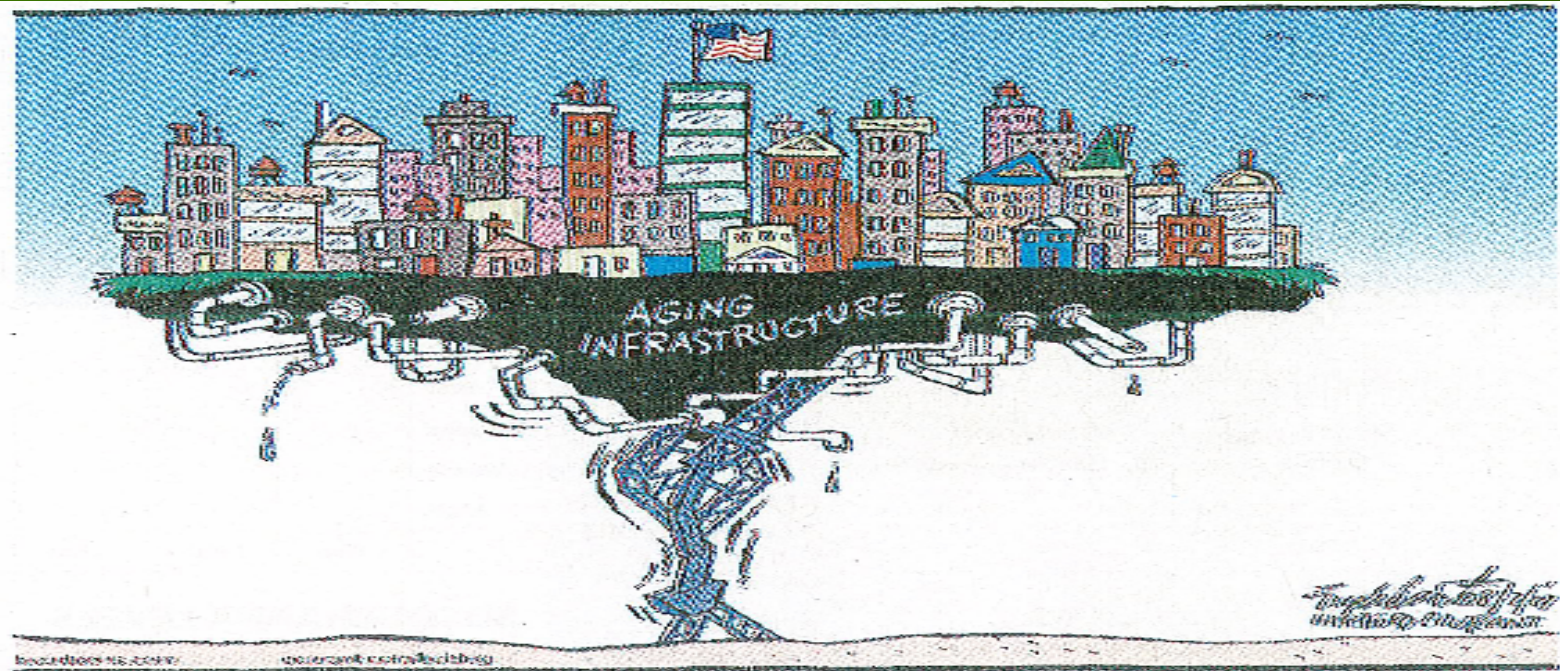


# Jargon Equality?



Revenue Requirements	= ≠	Cost of Service
Rate Increase	= ≠	Twice What We Need
"In Rates"	= ≠	"In Rate Base"
Authorized RoR	= ≠	Guaranteed RoR
Pa Future Test Year	= ≠	Rate Year
Regulatory Lag	= ≠	Suspension Period
Cost of Capital	= ≠	Rate of Return





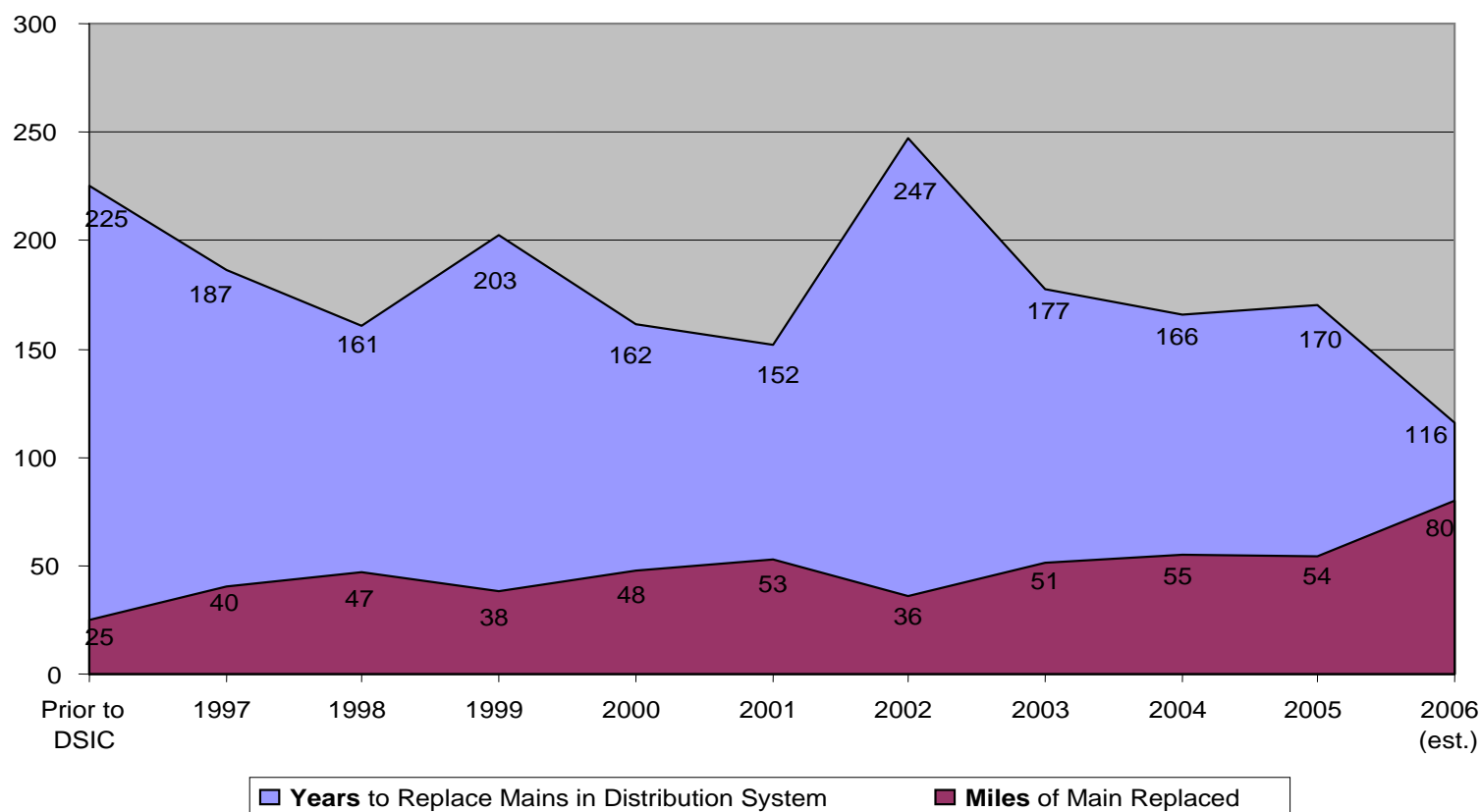
BOB ENGLEHART, The Hartford Courant



# Main Replacement Program



**Pennsylvania American Water Company**  
**Miles of Main Replaced and Years to Replace Mains in Distribution System**







# DSIC Cap Increase from 5% to 7.5%



- PUC-Approved citing:
  - Economic Effects
  - Environmental Impact
  - Infrastructure Needs and Goals.
  - “Model Legislation”
  - NARUC – “Best Practice”



# CFO Meetings



- Early 2009
- Economic Slowdown
- Volatile Financial Markets
  
- Informal Meetings
- Electric, Gas, Water
- Focus:
  - Financial Health
  - Capital Structure
  - Operations



# Financial



1. Wall Street's consolidation of banking institutions.
2. Access to capital markets.
3. S-T/L-T Financing: credit ratings, terms, rates, availability.
4. Liquidity, collateral requirements, funding of exploration and production.
5. Financing or refinancing plans, 2009-2012.
6. Ring fencing protection for utility.
7. Dividend practices and policy (internal and external).
8. Actual and target Debt/Equity Ratio.
9. Restoration of long-term confidence to capital markets.



# Earnings



1. Revenue streams given economic slowdown.
2. Financial stability of large customers.
3. Uncollectible amount expense/efforts.
4. Earnings given prolonged drop in natural gas prices.
5. Hedging activities: limiting downside and/or upside.
6. Pension and OPEB: funding status/plans and accounting expense.
7. Short-term earnings growth expectations of Wall Street.



# Operations



1. CapEx budget, 2009-2012, and plans to scale back or postpone, if any.
2. Position on a natural gas DSIC.
3. Expense budget and reductions, if any.
4. Workforce planning, staffing levels, including use of contractors.
5. Changes to organizational structure and affiliated interest agreements.
6. Position on revenue decoupling mechanisms.



# Capital Markets



- Little to no impact from banking consolidations
  - Monitor developing situations
- Successful bond issues (late '08)
  - One of the most difficult periods for financing
  - May have been the first fixed rate issue after the initial crisis
- No change to bond ratings
- Short-Term: current facilities provide low-cost working capital
- Long-Term: financing costs have risen over the past 12 months





# Liquidity & Collateral



Liquidity & Collateral Requirements: Minimal on average but material at any given point in time.

Hedge purchases may require collateral based on mark-to-market.

- Purpose:
  - Reduce volatility and impacts from price peaks.
  - Add certainty/stability to customers' gas prices/bills – not guarantee a lower price.



# Financing / Refinancing



## Financing or Refinancing Plans, 2009-2012

- Internally generated funds
- Planned capital expenditures
- Planned dividends
- Debt maturities
- Equity issuances
- Working capital needs



# Dividend Practices and Policy



Dividend Practices and Policy – Internal  
No formal internal dividend policy.

- Review includes analysis of historic/projected rate base and capitalization.
- Goal is to balance anticipated rate base and capitalization.
- Result is dividend recommendation and identified needs for future financing applications.
- Maintain a 50/50 Debt Equity Ratio for permanent capital.



# Pension



- Fair Value of Assets \$250
- Accumulated Benefit Obligation \$350
- Projected Benefit Obligation \$400

	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>	<u>2013</u>	<u>2014</u>
FAS 87 Expense	\$8	\$10	\$15	\$17	\$16	\$16 (million)
Minimum Cont.	\$ -	\$15	\$25	\$30	\$35	\$30



# Ring Fencing



- **Corporate Structure**
  - Separate Board of Directors
  - Separate Book of Accounts
  - Separate debt instruments
  - Codes of conduct, fiduciary responsibility
- **PUC Oversight**
  - Approval of debt and equity offerings
  - Approval of sales of assets
  - Reporting requirements
- **Financial Controls**
  - SEC and FERC reporting
  - SOX Audits
  - Rating agencies



# Earnings



- Economic downturn is resulting in significant slowing of new business.
- Existing Commercial/Industrial loads are clearly impacted.
- There have been more, generally smaller, C/I businesses that have ceased operation than in recent years.
- Health of major firms within our territory appears to be generally good but clearly under stress.
- A prolonged drop in natural gas prices is good for customers.





# Uncollectibles



Uncollectible account expense and efforts:  
Increasing uncollectibles despite mitigating circumstances

- Lower gas costs help to keep this increase lower than it might have been otherwise.
- More outbound phone calls to work with customers.
- Customer Assistance Programs (CAP)
  - Increased enrollment
  - Customers in programs are consistently paying bills



# Revenue Decoupling Mechanisms



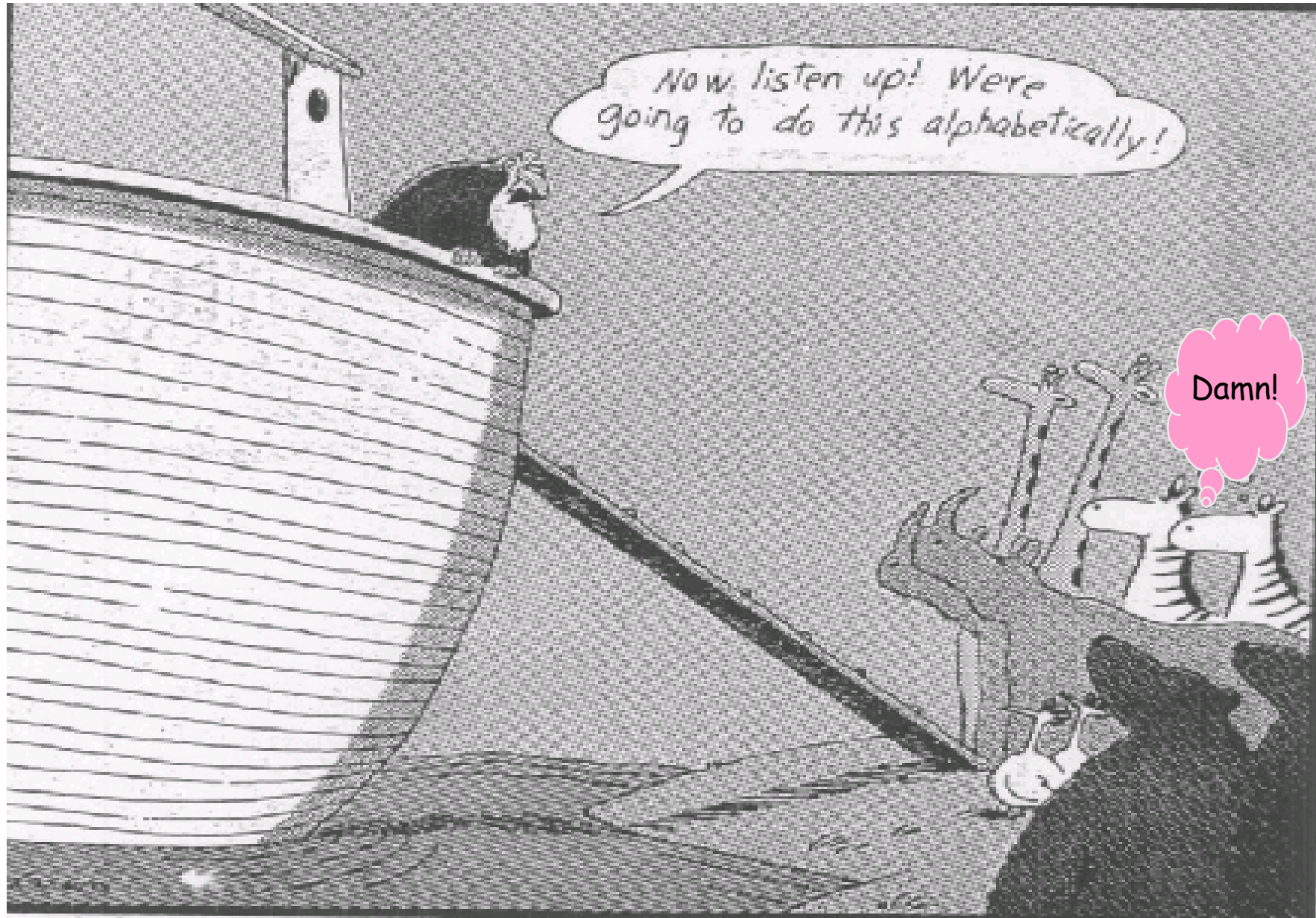
- Customers are using less natural gas and we expect this trend to continue.
- Rate mechanisms that rely less on usage are permitted under existing statutes and should be encouraged.
- The mechanism should not discourage the expansion of gas systems or the enhanced use of natural gas by existing customers where, as is the case generally, natural gas usage is more efficient than competing energy sources.



# CFO Meetings: Utility Reactions



- Relatively informal communication path
- Opportunity to explain utility perspectives
- Facilitate understanding of issues important to the PUC
- Productive Dialogue



Damn!

