

Debt, Equity, and Dividend Restrictions

ERRA Tariff and Pricing Committee

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Examples to be Described

Poor Management Decisions

Ring Fencing

Relaxed Regulation

Poor Management Decisions

The Company

- Small regulated (water) utility is privately held
- Owner is also the president of the utility
- Regulator previously determined that \$20,000 return was an appropriate return for the capital investment
- Owner took the entire \$20,000 return as a dividend to himself -- this is in addition to a salary
- \$20,000 dividend distribution creates a negative retained earnings
- Owner claims he used the dividends to pay expenses such as maintenance
 - He was previously ordered to establish a reserve account for repairs

Poor Management Decisions

Consumer Advocate View



- Dividends should be treated as a loan needs to be repaid
- When distributed dividends exceed the net income, owner should be required to pay interest on the difference
 - Interest should be at utility's weighted average cost of debt
- Set the allowed (not guaranteed) return based on an operating ratio
 - Net Income / Revenues = 8.9% = \$15,236
- Not the first time this has happened
 - Distribution of dividends had occurred in past regardless of earned net income

Poor Management Decisions

Regulator's Decision

- Utility is not entitled to a guaranteed return or a guaranteed \$20,000 dividend
- Agreed that when dividends in excess of net income are distributed, this is really a loan to the shareholder
- Loan should be paid back with interest based on weighted average cost of debt

Ring Fencing

- What is it?
 - Methods used to separate the financial value of a utility from its parent or affiliate in order to protect it from unnecessary financial risk or instability
 - A shell is built around the utility
- What types of methods are used?
 - Financial restrictions
 - Structural separations
 - Regulatory restrictions on cash and asset transfers



Ring Fencing

Regulatory restrictions

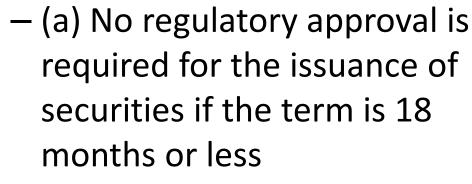
- Prohibit the use of utility debt for non-utility purposes
- Prohibit a utility from lending money to or guaranteeing any obligations of its parent or nonregulated affiliates
- Limit non-utility investments held by a public utility
- No securities issuances without regulatory approval
- Authorize a regulator to order a utility to cease paying dividends on common stock when there is a finding of capital impairment

Ring Fencing

Regulatory restrictions

- Restrict dividend payments to a parent in order to maintain financial viability of the utility
- Direct the utility to maintain a minimum common equity portion of its capital structure
- Regulatory approval for significant ownership changes
- Debt must follow the asset if it is moved to another corporate entity
- Minimum debt/cash flow ratio
- Separate books and records for the utility from other corporate operations





– (b) The regulator may exempt securities from the need for approval, if it finds that approval is not required in order to satisfy the public interest.



- Rocky Mountain Power (Wyoming)
 - Wanted exemption so it would not have to seek permission each time it issued securities
 - Uninterrupted access to securities market
 - Ratepayers benefit when there is timely access to capital markets
 - Cost of preparing each application may be \$10,000 to \$25,000 – many applications might be necessary
 - Did not ask for Commission to relinquish authority
 - Quarterly report will be filed with the details of securities issuances
 - Commission will still review financing costs in rate cases
 - Established certain limitations on specific transactions

- Quarterly Report
 - List of Long Term Debt
 - Principal, Issuance Date, Maturity Date, Interest Rate,
 Value Net of Unamortized Discount or Premium
 - Preferred Stock
 - Shares Outstanding, Stated Value, Value net of Issuance Expense, Dividend Rate
 - Revolving Credit Lines > 18 Months at Inception
 - Amount Available for Borrowing, Amount Borrowed

Quarterly Report

- Common Equity and Equity Contributions
 - Value of Shares Outstanding, Additional Paid-in Capital, Retained Earnings, Capital Contributions from Parent Company,
- Showing that Outstanding Securities do not Exceed Fair Value of Properties (Statutory Requirement)
- Statement of Use of Securities Issuances (Statutory Requirement)
- Capital Structure

Agreed Upon Restrictions

- No dividends (without approval) that will reduce equity portion of capital structure below 44%
- No dividends (without approval) that will reduce the common equity portion of *Total Adjusted Capital* below 35%
 - Total Adjusted Capital = common equity, preferred equity, longterm debt, short-term debt, and capitalized lease obligations
- No loans or transfer of funds (other than allowed dividend)
 will be made to its parent corporation
- Utility will not become guarantor of any obligation or liability of its parent corporation
- The parent will not pledge any of the assets of the utility as backing for any securities of the parent corporation

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