Electric Utilities May Need Policy Help For COVID-19 Losses

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COVID-19 has fundamentally altered how and where Americans work. As a result, it has created unforeseeable challenges for electric utilities across the nation. In particular, it impacts utilities' ability to recover their authorized revenue requirement.

The nationwide closure of nonessential businesses, schools and government agencies, and the shift to working from home for social distancing reasons, risks decreasing electric utilities' revenue at a time when they are already facing acute economic challenges.

Because regulated utilities often set rates and budgets based on a typical operating year, 2020 as a markedly atypical year has the potential to create under-recovery and rate design challenges that no one could have reasonably anticipated. The atypical nature of this dislocation makes it challenging for a utility to recover this lost revenue through a typical rate case analysis.

Potential solutions may address these challenges, but each comes with its own pros and cons. We recommend that regulators and utilities address such issues proactively. Possible solutions include regulators arranging for the utility to recover lost revenues through a rider modeled on natural disaster or hurricane riders, with prospective changes to billing determinants and rate design in an upcoming general rate case. The goal is to maintain utilities' financial health in these difficult times.

COVID-19 and the efforts to contain it significantly reduce electricity usage, given the required limitations local and state governments have placed on nonessential businesses and the complete temporary closure of others. As a reference point, according to the Electric Power Research Institute, Italy experienced an 18% to 21% reduction in peak demand and energy use on a year-over-year basis in the five to seven days after its lockdown began. U.S. utilities are beginning to report similar reductions in load as a result of containment measures to fight COVID-19.

Most regulated utilities rely, at least in part, on volumetric rates, i.e., the utility charges more as the customer uses more service, to recover the revenue authorized by the regulator. If usage falls below what is anticipated, the utility does not receive as much revenue from the volumetric rate as it and its regulator projected, leaving it short of the amount of revenue authorized by the regulator to operate its business and earn a return on its investment.

This creates an under-recovery problem for a utility. Some states, such as California, Arizona and New York, decouple utility sales from revenues, which mitigates the impact of declining electric sales over time. However, utility rates in such states still use a cost-of-service model to design rates based on the utility's forecasted sales for its test year.

Without a remedy, a crisis like the current one could still lead to financial difficulties for electric utilities. COVID-19 has led to reduced or ceased operations for innumerable businesses nationwide — and therefore, a reduction in electricity usage by these businesses. Some businesses may never reopen. Depending on the degree and duration of this reduction, utilities may face a significant problem with under-recovery, impacting their sustainability.

Perhaps more than any other single prior event in history, COVID-19 has prompted temporary closures of many businesses like restaurants and offices. As a result, it has shifted countless workers away from offices and into their homes. While this may boost incrementally the amount of electricity consumed in homes, by reducing commercial and industrial usage, it has a significant net impact on overall usage and the amount of revenue the electric utility recovers from its commercial and industrial customers.

These load losses for which the utility would normally be compensated cannot be fully offset by increased residential revenue. For instance, some investor-owned utilities may charge a lower rate for residential electric service than for commercial service. In fact, many regulators deliberately set rates for investor-owned utilities such that commercial rates subsidize residential rates.

Shifting loads away from the commercial rates and on to residential rates creates a two-pronged problem: (1) The amount of revenues from the commercial and industrial classes drops, and (2) the amount of load receiving the subsidy of below-cost service increases. Apart from reductions in the total amount of electricity sold, the sudden change in loads among customer classes also creates the risk of under-recovery for a utility.

It should be noted that providing electric utility service is largely a fixed cost enterprise — the utility cannot scale down its costs to match lower demand because its costs are tied up in maintaining the system that delivers electricity, regardless of how much electricity is flowing and to whom.

The response to the COVID-19 pandemic also has affected electric utilities' revenues in other ways. Recognizing the necessity of electricity service, many utilities and regulators nationally have decided to reduce or eliminate service disconnections in response to the virus and the economic fallout that it has caused. In California, the Public Utilities Commission required regulated utilities to suspend service disconnections for nonpayment, and suspend proof requirements for low-income energy programs.

Colorado, Connecticut, Illinois, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Mississippi, New Hampshire, New Jersey, New York, North Carolina, Ohio, Pennsylvania, South Carolina, Virginia and Wisconsin have issued similar orders. In Maryland, the state has prohibited accrual of late fees as of March 16. Wisconsin requires utilities to reasonably attempt to reconnect service to residential customers who were disconnected.

The vast preponderance of service disconnections relate to past due bills. The amount of a past due bill amount increases as service is continued unless payments are made. Much like

disconnection moratoria related to extreme weather events, it is highly likely that the disconnection moratoria associated with COVID-19 will increase the uncollectable balances for utilities. Absent a remedy in rates, higher uncollectable balances further increase the risk of under-recovery for a utility.

Utilities will likely seek to recover the lost revenue, but the typical rate case used to set forward-looking rates may not fully address the unique situation. Rate cases, in general, analyze a utility's costs and investment to determine what rates going forward will reasonably cover the utility's costs and give it an opportunity to recover a reasonable return on its investment.

Because rates are forward-looking, and based on a utility's costs during a typical rate period, regulators often eliminate from recovery any nonrecurring costs. For instance, if a utility experiences a momentary increase in labor costs or reduction in load during the rate year, the regulator will often exclude those costs from rates because they are not expected to continue after the rates are set.

The loss in revenues due to COVID-19 are hopefully nonrecurring, but could greatly affect the financial health of electric utilities if they are left unrecovered. There are also practical and logistical problems with using rate cases to address an industrywide problem. State regulators and consumer advocates only have so many resources to process rate cases, and those resources would be severely constrained if all electric utilities came in for a rate case at the same time.

Finally, a typical rate case examines all aspects of a utility's costs, and resetting rates in the current market would likely reduce utilities' cost of debt and equity, thereby lowering their return on investment. That would make liquidity a problem for utilities, as they need to regularly access capital markets to finance their operations. When the market recovers, the utilities would have to come in again to reset those rates of return, further constraining regulators' limited resources.

In many ways the COVID-19 pandemic resembles a large-scale natural disaster like a hurricane. While COVID-19 will not destroy physical infrastructure like a hurricane would, it has the potential to materially reduce load, increase uncollectible accounts and cut revenue on a systemwide basis. Also like a hurricane, the event is nonrecurring.

State regulators previously used disaster riders or surcharges to address short-term cost and revenue anomalies. These disaster riders typically are approved more quickly after the disaster than a rate case would, and with far fewer issues for consideration. As it is a temporary cost recovery tool, a disaster rider more closely matches the hopefully short-term and one-time event of the COVID-19 pandemic.

For the utility, a disaster rider provides more immediate cost recovery than other mechanisms — i.e., it has minimum regulatory lag. For a regulator, a temporary disaster rider ensures that the utility does not recover added revenue longer than it should, and it places a lesser burden on the regulator's resources to process these cases.

The authority for these riders usually flow from a natural disaster declaration, which would likely be necessary for a COVID-19 rider as well. For instance, the Public Utilities Commission of Texas just implemented a pandemic rider that adds a volumetric surcharge to current rates, intended to mitigate the effects of lost revenue caused by prohibiting utilities from disconnecting customers for nonpayment, and it relies for its authority on the governor's natural disaster declaration.

While this rider will not address the lost revenues from shifts in load due to social distancing, it demonstrates that the Texas Commission has the authority to issue such a rider. This may be a model that could be followed in other jurisdictions.

While rate cases may not be the best mechanism to address immediate revenue shortfalls, they may be necessary to address any long-lasting impacts from this crisis. Some have suggested that COVID-19 may affect how society functions well after the pandemic ends. For example, it may materially increase the use of telecommuting in the U.S., particularly during flu seasons.

Rate cases primarily seek to address reasonably anticipated future costs of service. To the extent that long-term, systemic changes in electricity usage result from the COVID-19 pandemic, a rate case may be necessary to provide needed permanent changes to rate design and to update the cost of service for a typical test year in the future. A rider or another cost recovery mechanism likely would not be able to address rate such design changes.

In theory, a rate case could include a temporary rider, like a disaster rider. However, a comprehensive rate case is much slower and more difficult for a utility to prepare than a standalone rider docket. Recovery of lost revenue would be delayed until the conclusion of the more complicated and time-consuming full rate case.

COVID-19's effects touch every electric utility in the U.S. and beyond. Regulators and utilities need to work together to ensure that COVID-19 will not impair the ongoing provision of electricity service at reasonable rates. Given the enormous effect that COVID-19 has on electricity usage, this coordinated work should begin as quickly as possible.

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