KPMG

KPMG CFO power and utilities roundtable: 2nd edition

Trends and insights from industry leaders

July 2021

Severe climate events and customer bill pressures. How can utilities meet these challenges?

In February 2021, Texas was hit with winter storms that brought record-low temperatures, snow, and ice, freezing the state's power grid and leaving millions without access to electricity.

The extreme weather could be seen as a black swan event, since the frosty temperatures were extremely rare for the region's more temperate climate and caught the state's utilities off guard. Recent history has seen a number of such severe weather events: wildfires in California, flooding along the Mississippi, and Superstorm Sandy that walloped the East Coast. These environmental calamities can significantly hamper utilities' ability to deliver services to their customer and impose millions of dollars in unexpected costs.

The question is how utilities can adapt to the changing climate and the impacts of extreme weather to better protect their operations of the power grid. At the same time, utilities are under increasing pressure to pursue green-energy initiatives, as well as other modernization projects.

KPMG recently assembled chief financial officers (CFOs) from the power and utility industry to discuss how they were affected by recent storms and what steps they are taking to deal with future extreme weather. They also discussed how to keep rising costs and increasing pressure for new investments from impacting customer bills. These CFOs represented some of the major gas and electric utilities in the Southwest and Pacific Northwest.

An increase in black swans

Attendees discussed how their organizations were affected by this year's winter storms and how they were meeting the challenges of those disruptions.

Addressing spike in natural gas costs: The February storms knocked out electricity throughout much of Texas and other parts of the region, with the Electric Reliability Council of Texas (ERCOT) ordering utilities in the state to curtail electric supplies to maintain the integrity of the grid. The curtailments began with rolling blackouts, but then expanded to 24- to 36-hour blackouts for some customers. The pressure became so severe that Texas came within five minutes of total blackout within the ERCOT area.

But the storms also dramatically affected natural gas pricing. With natural gas exploration and production (E&P) companies forced to halt production due to ice and freezing temperatures, one natural gas distributor was forced to buy gas on the spot market, rather than at first-of-month price. That resulted in skyrocketing gas costs, with the distributor paying about double their typical annual gas costs over the course of five days.

Passing that increase to residents would have amounted to about $1,000 per customer in Texas, which would have been untenable. Instead, the gas distributor issued unplanned debt to roughly cover the increase in gas cost. In a further effort to manage the increase, the distributor and other local distribution companies (LDCs) are working with state lawmakers and regulators to pass a securitization statute for the companies. The aim of the law would be to allow the costs to be spread over several decades to keep the impact on customers' bills as low as possible. Nevertheless, smaller municipal gas utilities may have to file for bankruptcies, one CFO predicted.

> "I think we're going to see a fair number of bankruptcies among the co-ops on the electric side. I think some of these gas utilities at the municipal level are going to have to file for bankruptcies."

Regional impacts: The effects of the storms weren't limited to Texas, with utilities in New Mexico also seeing a rise in natural gas prices. A gas utility operator in Las Vegas recounted a similar situation about a decade ago when low temperatures limited gas availability and thousands of customers were without natural gas. In response, the utility built a multi-million dollar liquefied natural gas storage facility to provide additional reliability for their gas supply. During the recent frigid cold in Texas, the Las Vegas utility was able draw upon that natural gas to provide sufficient supply to its customers. Even still, the utility has issued debt to offset unexpected costs.

Portland, Oregon, also experienced a rare wave of severe ice storms earlier this year, resulting in outages over 14 days. The state power plants were winterized, but one utility executive said his company had to rely on fossil generation and hydro-electric, since solar and wind generation was impacted by the extreme weather, as well as borrow electricity power and gas from other suppliers.

Preparing for the unexpected: Extreme weather and other environmental events seem to be happening more frequently. The question is how do power companies and utilities respond to these occurrences as well as mitigate their risks. To put it another way: Is it better to spend $4 billion to harden the grid than spend $8 billion in five days on natural gas prices?

> "We did go to our regulatory bodies to just let them know that, hey, we kept the gas flowing, things are okay, but there's a price that we'll have to pay for that."

How California responded to the effect of wildfires may offer some insight into how utilities can better prepare for unexpected environmental events. The state enacted its Risk, Assessment, Mitigation and Phase (RAMP) regulations, requiring utilities to file statements on how they are preparing themselves for specific risks. While Texas is still in crisis mode and specific regulations haven't been proposed, utilities executives indicated they expect regulators to begin requiring they provide them information on how they managed the recovery from the storms and the costs incurred. One executive said he expects utilities to have to begin modeling some impacts associated with severe weather events and maintain adequate reserve margins.

Customer bill pressures and sustainable cost takeout

Pressure to spend mounts: Customers want inexpensive electricity and natural gas, and forum participants acknowledged that impacts on customer bills are part of their strategic planning and multiyear spending plans. However, power and utilities are facing increasing pressure to invest in projects that could potentially raise customer billing rates. Here are a few:

— Achieving renewable and green-energy targets and decarbonization

— Maintaining aging assets and implementing asset refresh cycles

— Pursuing reliability and safety outcomes

— Implementing new technologies around the storage, delivery and usage of energy.

> "Whether it's gas or electricity, people just seem to want to have it better, cleaner, cheaper.… But at the same time, you're asked to make a lot of investments in a very long-lived business where you have to normalize those costs over a period of time. It's just getting to be too much."

Achieving balance will be a challenge: Participants said that keeping customer rates low, while meeting rising operation and maintenance costs as well as increasing pressure for capital investments around sustainability and modernization will be a challenge. For example, utilities may need to trade cuts in operation and maintenance expenses on mature systems to pay for sustainability projects that the market is demanding. Said one participant: "You have to look at … how to balance the mandates that we have to deal with from an environmental perspective, versus reliability, versus gas pipeline safety programs, versus all of that, and making sure that you take a scoreboard of performance to the regulators that you can actually justify and make sense of."

Utilities may need to find innovative approaches to keep customer impacts to a minimum. For example, transitioning to green energy will have long and short-term benefits, but utilities will face significant upfront costs as they retool their production facilities to consume renewable fuels. One utility was given permission by the state to securitize some of its coal plants as they were shut down, allowing the utility to minimize the impact on customer rate as well as enabling it to reinvest the some of the cash in the grid modernization project.

Historically low interest rates and gas prices: In addition to increasing pressure to invest in capital and sustainability projects, utilities are facing other factors that could affect their customer billing. For instance, the current market is experiencing historically low interest rates and gas prices. Eventually, interest and gas prices will likely rise, affecting utilities' cost profiles.

Participants discussed ways to address rising costs: for example, various M&A strategies to achieve economies of scale. One suggested that acquiring an LDC could expand the customer base while keeping the cost profile low.

Another participant mentioned that utilities seeking acquisitions are being challenge by private equity firms that are aggressively driving up multiples, although regulators may be more amenable to strategic buyers. If, on the other hand, a utility can't afford an acquisition it can consider aligning with a strategic partner that could, for example, provide it with access to renewable energy operations.

How KPMG can help

Unexpected environmental events. Increasing costs. New technologies. Expectations for more renewable energy.

Power and utility companies are balancing a competing set of demands from customers, regulators, and employees. And the way forward is beset with challenges.

That's where KPMG can help.

Our team of more than 700 industry professionals has deep experience across the various disciplines necessary to help power and utilities reinvent themselves for the future. We can help organizations create robust, sustainable and flexible strategies, teams, and operating models that can quickly adapt in a rapidly unfolding future.

Key takeaways

— Severe climate and environmental events may become the new normal. Utilities will need to seek ways to absorb the sometimes significant costs of these black swan events. This effort may require utilities to work with regulatory and legislative bodies to come up with financing methods to spread out or reduce the impact of these unexpected expenses on customer bills.

— Regulators will likely require utilities to begin modeling the impacts of extreme events and to have plans in place to deal with them when they strike and the financial reserves set aside to help mitigate unexpected costs.

— Utilities will have to balance keeping customer rates reasonable with increasing pressure to invest in sustainability and other modernization efforts while maintaining existing infrastructure. That may require innovative financing arrangements, as well as acquisitions or strategic partnerships.

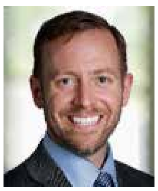
Related Services

- **Regulatory Strategy and Planning Services**
- **Rate and Securitization Modeling Services**
- **Enterprise Risk Planning and Modeling**
- **Capital and Operations Planning and Budgeting Services**

Contact us

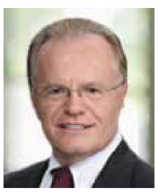
Karen Schreiber
Principal, Advisory, Finance Transformation
T: 312-665-3981
E: karenschreiber@kpmg.com

Julie Fults
Director, Advisory, Finance Transformation
T: 312-665-3847
E: jfults@kpmg.com



Brad Stansberry
Energy Industry Consulting Lead, Finance Transformation
T: 214-840-6026
E: bstansberry@kpmg.com

Kyle McNamara
Director, Advisory, Finance Transformation
T: 612-741-4885
E: kylemcnamara@kpmg.com



Thomas Peterson
Managing Director, Advisory, Finance Transformation
T: 818-852-6131
E: thomaspeterson@kpmg.com

Some or all of the services described herein may not be permissible for KPMG audit clients and their affiliates or related entities.

kpmg.com/socialmedia