

Risk, its Impact on the Cost of Capital for Essential Utilities, and Opportunities for Innovative Financial Solutions

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Problem/Question Statement

Financial and economic regulators are increasingly risk-aware, particularly with respect to market risk posed by environmental issues. Capital and insurance markets also recognize environmental factors more explicitly in their assessment of risk profiles and credit quality across the infrastructure and utility sectors. The relevant risk factors are also expanding in the context of complex infrastructure systems that encompass both the natural and built environments. In the water and energy sectors, risk relates to interrelated aspects of operations, including reliability, resilience, and regulatory compliance. There is growing recognition that environmental hazards, including those associated with natural or humanmade disasters, are affecting the cost of capital. Managing and mitigating risk is a high priority for the managers and operators of essential utilities.

The following key questions are of interest:

- What risk factors are affecting essential utilities, and how are they being addressed? Examples of risk impacts include costs (such as increased capital or operations scope, reporting, and administrative effort), delays due to required environmental permits or approvals, and management and mitigation measures to ensure system and project viability.
- How do risk disclosure, reporting, and management practices compare between the U.S. and other countries and between the public and private sectors?
- How can utilities more effectively evaluate, manage, and mitigate risk, and which tools are most cost-effective for which risks (e.g., planning and scorecards)?
- How are utility credit ratings and insurance products affected by risk, and how are changing risks affecting utility capital markets, the cost of capital, and utility revenue requirements?
- How are risks and associated costs shifted between the public and private sectors and among utilities, shareholders, and ratepayers?
- How does risk-bearing relate to issues of place and environmental justice, public health and safety, and economic development?
- Examine all of the above, both opportunities for EPA to build upon its enviable record of solution-oriented financial innovation as well as broader, appropriate risk identification, in the context of a recent report by a federal financial regulatory agency¹ and the public statements of a major market participant earlier in 2020².

EFAB Mission Fit. Risk is a natural topic for the EFAB due to its implications for the financial health and viability of essential utilities. EFAB members have considerable expertise in how financial markets

¹ Federal Advisory Committee (FACA) of the Commodity Futures Trading Commission, Climate-Related Market Risk Subcommittee off the Market Risk Advisory Committee, “*Managing Climate Risk in the U.S. Financial System*,” September 9, 2020, [https://www.cftc.gov/sites/default/files/2020-09/9-9-](https://www.cftc.gov/sites/default/files/2020-09/9-9-20%20Report%20of%20the%20Subcommittee%20on%20Climate-Related%20Market%20Risk%20-%20Managing%20Climate%20Risk%20in%20the%20U.S.%20Financial%20System%20for%20posting.pdf)

[20%20Report%20of%20the%20Subcommittee%20on%20Climate-Related%20Market%20Risk%20-%20Managing%20Climate%20Risk%20in%20the%20U.S.%20Financial%20System%20for%20posting.pdf](https://www.cftc.gov/sites/default/files/2020-09/9-9-20%20Report%20of%20the%20Subcommittee%20on%20Climate-Related%20Market%20Risk%20-%20Managing%20Climate%20Risk%20in%20the%20U.S.%20Financial%20System%20for%20posting.pdf)

² Fink, L. (2020). *Sustainability as BlackRock’s New Standard for Investing*. Letter to CEOs from the Global Executive Committee, January 14, New York, NY. Retrieved from <https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter>

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perceive and process risk and how this, in turn, affects utilities, the cost of capital, and investment barriers and opportunities.

EPA Mission Fit. EPA's interest in risk relates its roles as the nation's environmental health regulator but also as a significant source of capital financing. Importantly, EPA has an established and successful track record with respect to the implementation of financial solutions to environmental challenges. Sound risk management along with innovative financial solutions has implications for the financial health and resilience of essential utilities, and thus public and environmental health over the long term.

Type of EFAB engagement. We recommend an EFAB consultation at a public meeting or an EFAB-sponsored educational workshop, similar to the successful approach recently taken with respect to the Congressionally-mandated Stormwater report, with a written summary. This topic is a chance to identify opportunities for innovative financial solutions as well as to contribute to ongoing conversations among market participants, market regulators, and environmental stakeholders regarding evolving standards with respect to financial risk.