Financial hedging strategies for mitigating the financial risks of water scarcity for water utilities: A national perspective

WRRI Conference
Raleigh, North Carolina
March 18, 2015

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We have observed that one of the most common – but certainly not the only – reasons for a utility to miss its financial targets in a fiscal year is because of weather.

– Chapman, 2012 (S&P CreditWeek Report)
How does weather cause financial risk?

- Mild drought
  - Increases in water sales
- Severe drought
  - Decreases in water sales

Majority of variability in net revenue is from variable sales revenue

Why does weather-related financial risk matter?

- Negative net revenue
- Credit risk

What are we doing now to mitigate these weather-related financial risks?

- Increased supply capacity
- Supply transfers
- Conservation rates
- Self insurance
- Financial hedging
Index-based financial hedging

- Index-based insurance benefits
  - More transparent
  - More efficient
  - Lower administrative costs
  - Greater scalability

Financial hedging: risk pooling

**risk pooling**: many utilities, more predictable losses → lower premiums

**risk shifting**: one utility, less predictable losses → higher premiums
Risk pooling using index-based insurance

Risk pooling: many utilities, more predictable losses → lower premiums

Weather risks are spatially correlated
But if we pooled over large enough regions, the correlations could become negligible.

Risk pooling across the US to mitigate the financial risks of water scarcity

- Potential indices for index-based insurance:
  - Precipitation
Risk pooling across the US to mitigate the financial risks of water scarcity

- Potential indices for index-based insurance:
  - Precipitation
  - Drought indices
  - Streamflow
    - 2-year lag with revenue
2005 Streamflow and Revenue

2006 Streamflow and Revenue
Using a streamflow index

- 60% of water utilities → 9,000 utilities nationally

- Limitations of risk pooling dataset
  - 8-10 years of revenue data
  - Tradeoffs in more utilities: less detailed data
Can we pool these non-independent risks?

YES

with 500 miles of distance

Next steps to assessing the potential benefits of risk pooling

- Test the performance of different contracts through risk pooling
- Retrospectively evaluate the tradeoffs in risk pooling versus risk shifting for a few specific utilities
Acknowledgments

- Dr. Greg Characklis Group (UNC – Chapel Hill)
- Environmental Finance Center
  - Dr. Jeff Hughes
  - Shadi Eskaf
- NSF GRFP 2013159654

Thank You

Questions?