Global Power
North America
Special Report

EEI 2008 Wrap-Up: Cost of Capital Rising

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Related Research

- *20th Annual Global Power Breakfast: Investing in an Unpredictable World, Nov. 14, 2008*

Clouds Gathering

The 43rd Edison Electric Institute Financial Conference convened Nov. 9–12, 2008, in Phoenix, Ariz. The storm clouds rolling through Phoenix on Sunday, the first day of the assembly, provided a gloomy backdrop, matching the subdued sentiments of investors, analysts and corporate officers. The uncertainties facing the electric utility and power generation industry reflected the ongoing financial crisis and a deepening U.S. and global recession. Aside from credit market dislocations and worsening economic indicators, conference participants speculated about the potential policy directions of a new Obama administration and Democratic majority in the U.S. Congress in such areas as taxes and dividends, energy conservation and renewables, coal and nuclear power.

Five key themes that appeared repeatedly in management presentations were:

1. Weakening trends in unit sales of electricity.
2. Increased focus on liquidity positions and capital market access.
3. Higher cost of capital.
4. Regulatory lag affecting the ability to recover higher cost of capital.
5. Initiatives to reduce discretionary capital spending and external financing needs.

The outlook is considerably sunnier for the FERC-jurisdictional electric transmission subsector, a business with cash flows that are immune to variations in sales volumes and insulated from regulatory lag.

Representative Rick Boucher (Democrat, Virginia's 9th District) delivered the clear message at the plenary session keynote on Monday that enactment of legislation restricting carbon emissions will be a priority of President-elect Obama's administration and the U.S. Congress in 2009, second only to the top priority of stabilizing financial markets and fixing the economy, no small task. Rep. Boucher sought the support of the utilities present for his bill to fund the development and deployment of carbon capture and sequestration technology through a nongovernment corporation that would receive its funding from a fee collected upon sales of electricity.

The biggest news story of the conference happened off-site. On Monday Nov. 10, NRG Energy Inc. (NRG, IDR 'B', Rating Watch Evolving) invited conference attendees to an investor meeting to discuss NRG management's rejection of a $6 billion stock-for-stock merger offer from Exelon Corp. (EXC, IDR 'BBB+', Rating Watch Negative). On Tuesday, Nov. 11, EXC announced it would take its takeover offer directly to shareholders, without any change in the exchange ratio. The announcement of the hostile bid is a rarity in the power sector. Fitch Ratings placed EXC's ratings on Ratings Watch Negative when the original offer for NRG was announced on Oct. 20, 2008. In Fitch's view, the change to a hostile bid has no incremental affect on EXC's rating or Negative Watch status.

Investing in an Unpredictable World

Fitch's 20th Annual Global Power Breakfast theme was "Investing in an Unpredictable World." Michael W. Howard (Senior Vice President of Research and Development, Electric Power Research Institute [EPRI]) provided an overview of recent developments and expectations regarding plug-in and extended range electric vehicles. Ellen Lapson and Glen Grabelsky, both Managing Directors with Fitch Ratings, discussed salient credit trends affecting the power and gas sector, including the implications of the ongoing credit and capital markets on a sector that invests in long-lived and long lead-time infrastructure assets and relies heavily upon access to new debt and equity markets.

Lapson as moderator observed that Stable Rating Outlooks dominate Fitch's universe of issuers, but downgrades and Negative Outlooks have outpaced upgrades and Positive Outlooks in 2008 year to date, a distinct change in trend from the more favorable ratios in 2004–2007. The ratio of Positive to Negative Outlooks is now 0.8:1; however, 87% of Rating Outlooks in this sector are Stable.

Grabelsky discussed the major themes currently shaping credit in the power and gas sector, including the deleveraging in financial markets, decelerating growth in unit sales of power, high capital investment budgets, inadequate equity returns in some jurisdictions, and regulatory lag. A substantial decline in natural gas, coal and other commodity prices since peaking at the end of June is a constructive development for the power and gas sector. However, Grabelsky noted that the extreme volatility in gas prices poses a real problem for the sector, and despite the steep recent drop, the trend continues to show progressively rising troughs. Meanwhile, funding costs for new debt for a 'BBB' utility, in the range of 9% and higher, are now bumping up against authorized returns on equity, which average 10.25%–10.5% for the industry, and are as low as 9.1% in New York and New Mexico. He opined that if the cost of new debt remains at this level, significantly higher regulated returns will be required to attract equity capital.

Despite the challenges facing the electric utility industry, Grabelsky acknowledged that the sector benefits from relatively stable underlying cash flows vis-à-vis other industries and should benefit in relative terms as investors seek safer investments in a difficult macroeconomic environment. Utilities have demonstrated continued access to commercial paper and term debt markets throughout the market turmoil, albeit at higher cost. Lapson noted that the utility power and gas sector is better positioned today than in the sector crisis of 2000–2003, when many if not most companies had profound business problems due to failed diversification strategies. Today, companies are more prudently capitalized and have simplified their businesses, but must adapt their business strategies to the challenging financing environment.

In a different vein, Mike Howard of EPRI provided an update on the nascent market for plug-in electric vehicles. Howard forecasted that by 2030, plug-in vehicles would aggregate 16 million cars on the road, or roughly 5% penetration. Howard said that the introduction of electric vehicles was unlikely to drive incremental capital investments needs for new generation facilities at any time soon, but the impact could be more stressful on local distribution circuits and substations. The estimated annual load of a plug-in hybrid vehicle with a 40-mile range was estimated by Howard at 2,500 kilowatt-hours (kWh) per annum, about the same as the load of three plasma TVs along with three set-top boxes. Electric utilities will need to get their distribution networks, meters, pricing and billing systems ready for drivers charging their cars at home, at work and on the road.

General Session

Rep. Boucher discussed draft legislation expected to be introduced in the next Congress (Boucher-Dingell bill) to reduce carbon dioxide emissions by up to 80% later this century, and emphasized that the economic impact of such regulations would be more manageable if the implementation is consistent with the available control technology. Therefore, carbon dioxide reductions are back-end loaded under the proposed legislation to allow technology to catch-up with the proposed carbon reductions. Boucher has introduced another bill to create a separate funding mechanism to finance carbon capture and sequestration technology, targeting development by 2020. This initiative recognizes the crucial role of coal-fired generation in meeting the nation's power requirements without undue reliance on natural gas.

Rep. Boucher's request for comments on the discussion draft for the planned cap and trade bill was a clear call to arms for the industry to actively join the debate regarding the energy policy and carbon-related issues in particular. He pointedly noted that carbon regulation will be implemented either legislatively or administratively through the Environmental Protection Agency (EPA). Unlike the EPA, a legislative approach is more likely to weigh economic considerations. Rep. Boucher favors a cap-and-trade approach along with a distribution of allowances, eschewing the auction approach, to reduce carbon emissions. Free allocation of allowances would be favorable for utility cash flows, but may not meaningfully reduce emissions.

Rep. Boucher also indicated that President-elect Obama views the greenhouse gas issue as second in importance only to efforts to right the nation's ailing financial markets and economy.

Rep. Boucher proposes creation of a one mill (that is, one-tenth of a cent) per kWh charge that would raise approximately $1 billion to fund the development of carbon capture and sequestration technology by 2020. This is a bill that has united the interests of utilities in coal-producing states, the coal industry and unions.

Fitch notes that it is difficult to handicap at this time the likelihood of the 2009 passage of either bill, given the significant economic challenges that will capture the immediate attention of lawmakers. If the new Democratic administration and legislative majority succeed in passing a carbon control regime, whether cap and trade or a carbon fee, the carbon costs would be credit neutral to those utilities able to pass through the associated costs in customer rates in a timely manner and could affect ratings of utilities with less efficient recovery mechanisms or nonregulated generators that cannot recover the costs in existing power purchase agreements or through higher market power prices.

Smart Grid Panel

The first panel on Monday, Nov. 10, 2008, directly followed Rep. Boucher's remarks and discussed the evolution and future of the smart grid. The panel was moderated by Ron Insana (Managing Director, SAC Capital Advisors) and included Richard C. Kelly (Chairman, President and Chief Executive Officer [CEO], Xcel Energy, Inc.), Philip Mezey (Chief Operating Officer, Itron North America), David M. Ratcliffe (Chairman, President and CEO, Southern Co.), Robert S. Shapard (Chairman and CEO, Oncor Electric Delivery) and Barry T. Smitherman (Chairman, Public Utility Commission of Texas).

The panelists did not provide a definition for "smart grid," and it was clear that the term had different meanings for each panelist. For the record, Fitch understands "smart grid" to mean a transmission and distribution system that uses advanced sensing, communication and control technologies to generate and distribute electricity more effectively and securely. The enhancements are expected to detect and address emerging problems on the system before they affect service; provide extensive measurements, rapid communications, centralized diagnostics and feedback control; and support interactions with customers or with sensors on customers' appliances.

The panel participants generally agreed that investments in a smart grid will facilitate energy efficiency as well as integrating more renewable energy mandates in coming years. Two panelists expressed the view that the cost associated with these investments would be offset in part by operating savings. For other panelists, the benefits would come from better fulfilling consumer needs and expectations for high quality of service and interaction with their electricity supply and costs. We learned about cyber-security risks created by any new portal into the electric grid, as well as about privacy risks created by the utility having such detailed information about its customers' consumption patterns.

Carbon Regulation Panel

Participants in the second panel discussion included Rep. Boucher, as well as William D. Johnson (Chairman, CEO and President, Progress Energy, Inc.) Kevin McCullough (CEO, RWE Innogy GmbH), James Miller (Chairman, CEO and President, PPL Corporation, and Richard Sandor (Chairman and CEO, Chicago Climate Exchange). Boucher reiterated that his proposed legislation would provide the industry with the means to fund and develop new technology to burn coal cleanly, as summarized above.

Miller noted carbon capture would reduce plant efficiency and that the timing of the new technology remains uncertain. Johnson wondered if experimental technology available today would indeed be effective in large-scale application and about the cost to build the necessary infrastructure to transport and store carbon.

According to Sandor, sending the proper price signals regarding emission credits would be a crucial aspect of the overall solution, agreeing with Rep. Boucher that cap and trade is the best approach. Rep. Boucher asked for utility and power company input and support on the discussion draft. He expects a final version of draft carbon control legislation to be introduced early next year and that the bills would move to the Senate in the fall of 2009.

The panelists agreed that a rush to natural gas as the fuel of choice for new generation is problematic and should be avoided, but with coal out of favor and significant cost hurdles to nuclear construction and permitting timelines, natural gas appears to be the de facto fuel of choice. From a credit viewpoint, Fitch agrees that the likely increased dependence on natural gas is troubling, given the extreme volatility and the rising trend in gas prices, as evidenced by progressively higher prices at each trough.

Company Strategies and Tactics

External Capital Requirements

Liquidity and efforts to reduce external capital requirements were high on investor and management agendas. Slowing growth of unit sales as the result of economic weakness should provide utilities with an opportunity to reduce planned capacity additions commensurately. However, in Fitch's view, decelerating growth is likely to provide relatively modest utility capital investment reductions, with the possible exception of certain historically high-growth states such as Nevada, Arizona and Florida, where the greatest reversal in demand has occurred. For example, Pinnacle West Capital subsidiary Arizona Public Service Co. (APS) has cut capital expenditures meaningfully, with the large majority of the savings reflecting a sharp slowdown in customer growth to an expected 1% rate in 2008 and 2009 from its historical 4% per annum customer growth rate.

Fitch believes the majority of utility investment is focused on reliability, renewable energy and related transmission or environmental projects that are, for the most part, not discretionary. As a result, management is likely to defer, not cancel, long-lived projects.

New investments in FERC-jurisdictional transmission facilities remain an attractive investment opportunities even in the face of constrained capital markets, and for the most part, companies intend to stay the course. However, we learned that some transmission projects may be delayed if their purpose was to connect new wind-fired capacity to the load centers; wind projects in the planning stage may not get built in today's lower gas price environment.

Management of PEPCO Holdings affirmed its intention to continue its aggressive build-out of transmission projects, despite the poor market reception for PEPCO's recent capital issuance. Northeast Utilities provided a new five-year forecast with significant transmission investment and an impressive projection of earnings growth. NSTAR also expects its earnings growth, projected at 6%–8%, to be driven by significant transmission investment opportunities; there are five competing projects under review by ISO New England, each of which terminates in NSTAR's service territory. Allegheny Energy, AEP and Dominion continue to pursue major transmission projects in the PJM region. However, permitting remains a time-consuming challenge.

Nonregulated competitive generation subsidiaries may cut back their capital spending materially. Companies that announced reductions to discretionary capital expenditure in their competitive businesses for 2009 include Ameren, FPL Energy, PPL Energy, and Public Service Enterprise Group. Some generators or integrated utilities plan to delay air-quality control investments to the extent that they were driven by Clean Air Interstate Rule (CAIR) requirements that have been remanded to the EPA by the appellate court, while other companies said that they must continue their environmental spending to meet state standards that remain in force.

Regulatory Considerations

Jurisdictional regulatory practices promise to be a key element in determining the ultimate impact on issuer creditworthiness given the sharp increase in the cost of capital as a result of the ongoing financial crisis. Utilities in states that have authorized reasonable returns on equity and adopted balanced regulatory mechanisms, including forward test years and automatic fuel and other tariff adjustment mechanisms are more likely to come through this period of stress without undue deterioration to current creditworthiness.

In general, vertically integrated utilities in the Southeast U.S. tend to have more constructive regulatory environments. California electric utilities Pacific Gas & Electric, San Diego Gas & Electric, and Southern California Edison have tariff decoupling mechanisms that insulate their credit from a downturn in sales as well as the potential for annual adjustments to the return on equity (ROE) component in their rates. Cost of capital reviews are conducted on a three-year cycle but adjusted if a particular bond index yield increases by more than 100 basis points (bps) in a given year. If the index rate changes by more than 100 bps, the cost of debt is reset and ROE is adjusted to reflect half the change in the index.

Conversely, the ratings of utilities operating in states with relatively low authorized ROEs and significant regulatory lag are more likely to suffer future credit deterioration, in Fitch's view. States with challenging regulatory environments include Arizona, Missouri, New Mexico, New York and Vermont.

Transition to market-based generation rates continues to be an issue in Ohio and Pennsylvania. The Public Service Commission of Ohio is expected to rule imminently on FirstEnergy Corp.'s Ohio operating electric utility subsidiaries' filed proposal under Ohio Substitute Senate Bill 221, which could result in adoption of the company's Electric Security Plan (ESP) or a market-based plan effective in 2009. In Fitch's view, the adoption of an ESP is the more likely outcome. In Pennsylvania, Fitch anticipates that the policymakers may seek to extend utility rate caps, which are scheduled to terminate in 2010–2011 for Metropolitan Edison, Pennsylvania Electric, Pennsylvania Power & Light, West Penn Power, and Philadelphia Electric Co.