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Utilities are not immune this time

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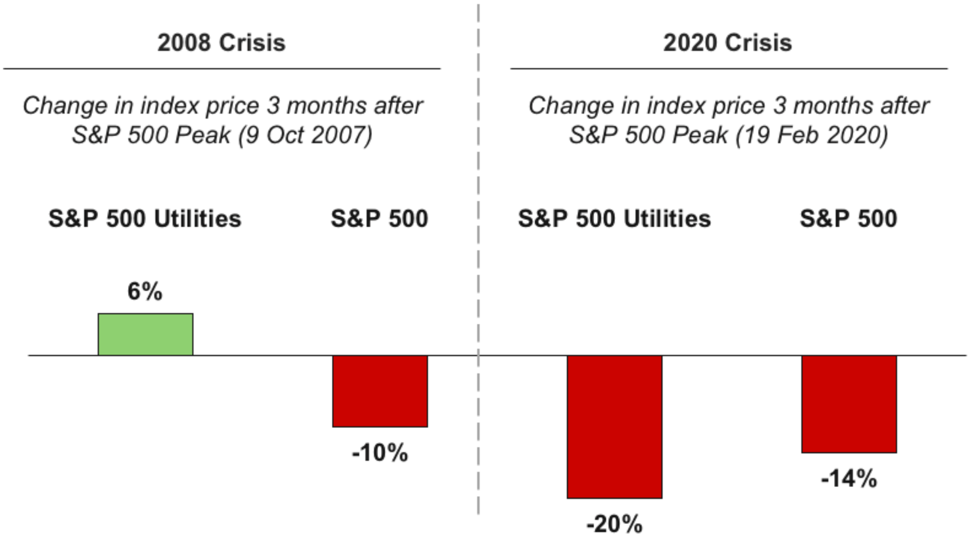
July 2020

Regulated utilities have a long track record of generating stable, bond-like returns with low volatility, even during economic downturns. Many regulated utilities have historically been insulated from the financial effects of reduced energy demand through mechanisms such as the lag effect built into the rate base, revenue decoupling, and the ability to spread fixed-cost losses from one customer group onto remaining customer groups.

However, COVID-19 appears to be impacting the utilities sector as much if not more than other sectors, as indicated by the comparison of short-term share price performance between the 2008 recession and this year's market crisis (see Figure 1). So why is it different this time?

Figure 1: Index price performance since S&P 500 peak



Source: CRA/Marakon Analysis

One explanation might be that utilities have been swept up in index selling linked to the rapid increase of passive investing over the last 10 years. However, digging deeper we find a more complex story and uncover four issues that better explain why capital markets are reacting more negatively this time relative to 2008 and past recessions.

Intense pressure on affordability

Capital markets recognize the potential ramifications of the intense pressure on affordability created by COVID-19. As bad debt expense rises, so has the pressure for utilities to limit rate increases over the near- to medium-term. The issue now is who will shoulder the additional costs: customers, governments, or utilities? In our view there's a risk that many utilities will need to share in the burden rather than being allowed to pass the costs onto customers as before.

Uncertainty in utility rate base growth

The economic downturn and work-from-home effects of COVID-19 are generally leading to lower demand, especially for commercial and industrial customers. Alongside cost recovery issues, there are questions about the timing and pacing of utility rate base growth, particularly for utilities with high exposure to commercial and industrial customers.

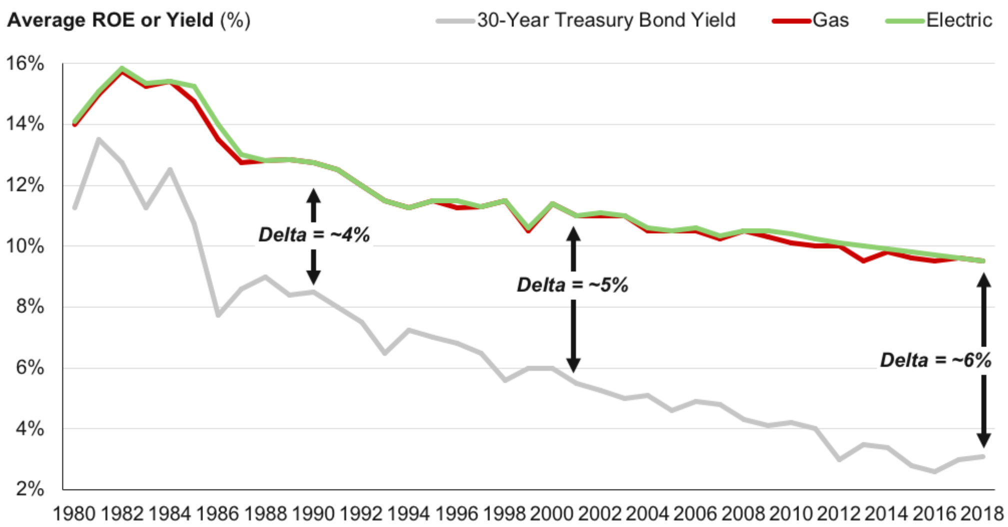
Heightened scrutiny on investments

We are observing a heightened scrutiny on investments allowed into the rate base, as regulators place greater emphasis on utilities to support customer affordability, create more customer choice, and provide customer benefits. Regulators are also wary of new technologies that increase performance or cost risks. Some utilities that have recently built out their infrastructure may face additional scrutiny, making replicating historical rates of investment more difficult to achieve.

Pressure on regulated ROEs

Finally, capital markets are anticipating pressure on regulated returns on equity (ROEs) given the widening historical “spread” between allowed returns and government treasury yields (see Figure 2). We are already observing a slow step-down in allowed ROEs, but this crisis may accelerate that, particularly if utilities are forced into rate cases for cost recovery.

Figure 2: US authorized ROEs versus government yields



Source: S&P Global

Most of these issues were already at play to some degree before the current economic downturn. The COVID-19 crisis has brought them to the fore at an accelerated pace. While the specific impacts will vary by jurisdiction and by the different business models and value chain participation of utilities, the direction of travel is clear.

Consequently, there are deep strategic implications that all utility CEOs need to consider to better weather the storm in the current crisis, be better prepared for the next crisis, and increase the odds of creating long-term business resilience; these include:

- **Rebasing the plan to prepare for uncertainties.** In the current crisis, utilities cannot rely on traditional forecasting methods, which were fundamentally designed for stable growth environments, not sharp contractions with uncertainty over when and how recovery will take place. Regaining a line of sight on performance expectations and informing appropriate mitigation tactics require the creation of scenarios grounded in stretching but plausible assumptions about the future. These scenarios need to address potential demand dynamics and load patterns within the boundaries of normal regulated economics and plausible regulatory interventions, particularly in response to the intense pressure on affordability.

- **Reassessing forward investments and portfolio shape.** Now is the time to reassess capital allocation decisions and consider accelerating some portfolio shaping actions. For many utilities, reliance on rate base growth in the core business is no longer sufficient, given the higher scrutiny on investments and pressure on regulated ROEs. Strategic choices for where to focus investments along the value chain, where to potentially recycle capital, and how to balance investments in regulated and non-regulated activities are becoming critically timely to ensure future-proofing of the business model. Accelerating portfolio reconfiguration can mitigate stranded asset risks as well as direct investments towards growth opportunities to capture new revenues in the value chain.

- **Revamping the forward advocacy agenda.** Traditional interactions between policy makers, regulators, and utilities need to be rethought considering the greater number of strategic issues facing utilities today and the regulatory pressures described above. Proactive advocacy is critical for “defense,” such as mitigating stranded asset risks and balancing the impact of affordability pressure across stakeholders, as well as for “offense,” such as promoting projects that are likely to see government support and aligned with the core competencies of utilities.

- **Tightening the linkage between “sustainability” and strategy.** While the pandemic has potentially increased investment risk to utilities due to customer affordability and heightened regulatory scrutiny, it has put a more positive spotlight on the societal role utilities can play. This provides an opportunity to broaden the definition of how utilities view environmental, social, and governance (ESG) goals and to embrace aspects of human, customer, and societal values. Net Zero goals still play an important role, but to be front-footed, utilities must view sustainability initiatives through a broader set of lenses to be integrated into the business strategy. More than ever, a tighter linkage is critical to help the organization live its purpose and engage with employees, customers, and communities while delivering long-term value creation for shareholders.

Never waste a good crisis

While the issues we highlight are real and consequential, utilities that have clear plans for responding and are front-footed in evolving their business models will emerge from the current crisis stronger than they went in. Deep understanding of the starting point, clarity on the forward trend lines, and non-incremental, creative thinking are required to take full advantage. Many of our clients are confident they have “reacted well” to the crisis and are now turning their attention back to the longer-term strategy. However, the only thing that is certain is that things will change, and that pressure on the traditional integrated utility model will continue to mount. The capital markets can get it wrong, but it does certainly feel like it is different this time. Ignore at your own peril.

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