CRA Insights: Energy

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Driving value growth in the evolving electric utility landscape

Delivering performance while managing industry uncertainty

Many industry observers have commented on a broad range of trends reshaping the regulated utility industry. While some trends are evolutionary, others have the potential to be fundamental change catalysts (Figure 1).

While the external market and competitive landscape are undergoing significant change, investors are beginning to see the industry through a different lens. Regulated utilities traditionally have been viewed as low risk, strong cash flow generating investments. However, for the last several years, the industry has started to exhibit similar performance volatility and risk to other industrial sectors with a widening gap in performance between top and bottom performers.

Figure 1: Major recent trends shaping the industry

Supply	• Major shift in the supply and production of natural gas resulting in a sustained low price environment • Shift away from coal generation primarily driven by regulatory pressure and declining economics • Growth in renewables generation due to policy support and ongoing cost declines
Demand	• Low load growth resulting from continuing cost and technology improvements • Build-up of distributed energy resources (DER) driven by economics, policy backing and business model innovation (e.g., growing new third party financing models) • Changing customer mix, needs, behaviors, and perceptions of value
Regulatory/ Competitive	• More competitive transmission sector open to new non-traditional investors/developers • Infrastructure investment requirements related to grid modernization and resiliency • Changes in technology including the rise in smart meters and big data

Challenges for senior management in regulated utilities

In this environment, industry executives have to make increasingly larger bets and complex value chain participation choices in order to drive growth and deliver on investor expectations. As economic conditions continue to evolve within the regulated utility industry, investors are rethinking opportunities and risks of investing in these companies.

In a series of articles, we aim to provide perspectives on major key challenges, with a specific focus on strategy to deliver leading value performance. We start with an analysis of the financial performance of utility holding companies over the past 10 years. In this article we will concentrate on key questions informed by evidence from historical performance and industry changes:

- How have utility holding companies performed relative to the broader market?
- How have they performed relative to one another?
- What does leading performance look like?
- What are common attributes of leading performers?

Additional articles will take a forward looking perspective of an evolving industry.

Our approach

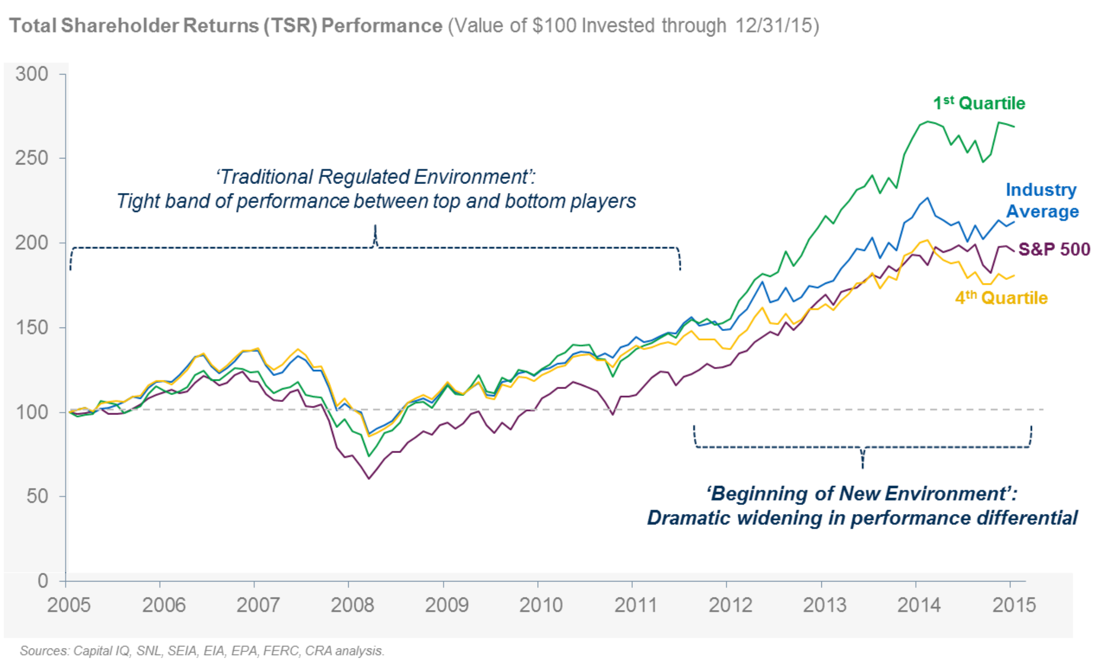
We evaluated 48 US investor-owned electric utility holding companies and examined the underlying economic performance for each company over several time periods. We then examined each utility's TSR (total shareholder returns = stock price appreciation + dividends) and searched for trends in the performance of the sector as a whole, the performance of top and bottom quartile performers, and the companies that consistently outperformed, aiming to explain key drivers.

We examined a range of financial metrics and then, based on our analyses, focused on revenue growth and return on invested capital (ROIC) as these tended to be the most significant drivers and best predictors of TSR performance over time. To better understand the impact of evolutionary industry change, we looked at both short-term and long-term TSR performance.

Key observed insights

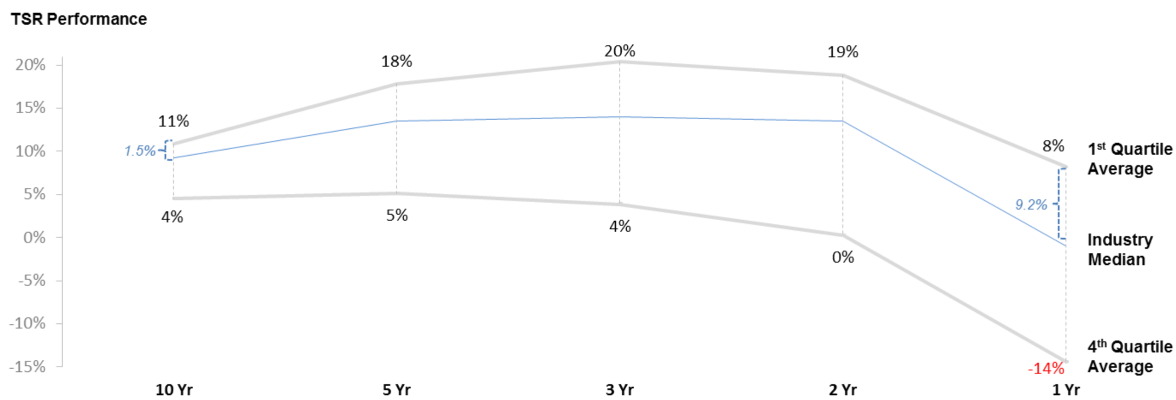
Our analyses show that, over the last 10 years, the average utility holding company has consistently outperformed the overall stock market (Figure 2). However, the evolution in the performance dynamics over time is most notable. Prior to the 2011–12 time frame, there was limited variability in TSR performance between top and bottom performers, supporting the traditional investor perception that utilities are low-risk / moderate-return / high-dividend investment vehicles.

Figure 2: A significant shift in relative performance



Despite consistently outperforming the broader market (i.e. S&P 500), a major industry transition began in 2009–10, reflected in an increasing differential between 1st and 4th quartile TSR performance. Prior to this juncture, there was a tight band of performance between top and bottom performers (Figure 2). Before 2011, TSR spreads between top and median performance in the utility sector were between 100–200 basis points (bps), implying very low relative performance risk across industry players.

Figure 3: An industry in transition



Sources: Capital IQ, SNL, CRA analysis.

In comparison, spreads in the last five years have been steadily increasing, now surpassing 900 bps between the average top and median industry performer. The regulated utility sector is beginning to resemble broader (not rate regulated) industrial sectors that typically have demonstrated 400–600 bps differentials between top and median performers (Figure 3).

The timing of this relative performance differential widening closely follows several major market shifts. Starting around 2009, improved extraction technologies started to dramatically increase the supply of natural gas resulting in a sustained low price environment – in turn, greatly impacting electric prices and overall generation (supply) economics. On the demand side, following a slow recovery after the 2008 financial crisis, load growth has remained relatively flat (according to the US Energy Information Association, total US electricity consumption has grown less than 1% per year since 2009) compounded by advances in energy efficiency and rising distributed generation (e.g., rooftop solar) competition.

Moreover, major regulatory changes have occurred in the same time frame impacting industry competitiveness and economics (e.g., raising environmental compliance costs), examples include:

- FERC Order 1000 – transmission project development opened for competitive bidding
- Cross State Air Pollution Rule (CSAPR) – ozone and particulate matter emission controls
- HAPS/MACT – hazardous air pollutants and mercury emission controls
- ELG/CCR – effluents and coal ash disposal rules

Interestingly, many utility holding companies have been able to achieve consistently high performance. In fact, nine of the twelve 3-year top performers were present in the first quartile over five years, while seven of twelve were present in the first quartile over a 10-year period (Figure 4). The examples of these serial top performing companies provide some evidence that management teams with superior strategy and execution capabilities can drive performance and value growth despite critical industry challenges and rising uncertainty. In ensuing articles, we will further assess the role of strategy vs. market influence in driving top performance.

Figure 4: Companies ranked by TSR performance – 3 and 10-year time horizons

	3 Year	10 Year
Top TSR Performers *1st Quartile*	**NI**	**CPK**
	CPK	**NI**
	TE	ES
	NWE	WEC
	IDA	CNL
	WR	**NEE**
	AVA	**CMS**
	NEE	LNT
	CMS	**IDA**
	PNM	**WR**
	VVC	**AVA**
	AEE	XEL

These initial findings highlight a number of questions to explore further. What is driving the increasing disparity between top and bottom performers? How have so many top performers been able to maintain their position over time? We will also investigate strategic choices that have impacted performance and growth:

– Regional vs. multiregional footprint focus
– Regulated vs. unregulated participation
– M&A and organic growth strategies
– Operational and capital cost strategies

In our next article, we will examine historical performance drivers from portfolio mix and operating efficiency to growth strategy. We will also investigate whether serial top performers benefitted from market conditions or other external factors; or if they executed strategies that delivered consistently strong results. We also consider how these strategies address or will challenge emerging issues and possible new considerations for utilities.

About CRA's Energy Practice

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