Power & Utilities

Capital Complications

SECTOR VIEW

Rating: 3 - NEGATIVE

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This year's study of regulated electric utility companies examines emerging earnings, cash flow, and regulatory trends in the industry. We have concluded that expanding capital programs and increasing cash shortfalls threaten company and shareholder returns. With average valuations for regulated names at all-time highs as compared to the broader equity market and treasury yields, we see complications ahead.

- A robust capital spending program throughout the industry exacerbates cash flow issues, as capex levels look to settle above $50 billion a year, almost double the levels of 2004. FCF appears negative by as much as $16 billion a year post-dividend, and negative $4 billion predividend, in the next few years.
- The need for external capital to fund dividends and capital programs is beginning to grow. We estimate that approximately $60 billion of external debt and equity funding will be necessary by the end of 2010.
- Complicating this picture further for regulated utilities will be the need to seek more frequent rate increases to fund rate base growth. Historically, more trips to the regulator, coupled with rate increase requests to fund larger capital budgets, have resulted in a compression of allowed returns and significant effects from regulatory recovery lag.
- We believe that the quality of regulation will play a larger role in stock selection, as this capital cycle wears on. We focus on jurisdictions that favor settlement over litigation, performance-based regulation over traditional ratemaking, and those in which infrastructure growth is incentivized with healthy returns.
- We are therefore defensive in our view of the regulated group for the coming year, and we expect more selective stock-picking to be rewarded. We are currently favoring AEP, DPL, DUK, and ITC, all 1-Overweight, as names whose combination of favorable regulatory oversight, current valuation, and earnings visibility offer attractive total return potential relative to the group.
- We would specifically avoid 3-Underweight-rated PNW and XEL.

PLEASE SEE ANALYST(S) CERTIFICATION(S) ON PAGE 85 AND IMPORTANT DISCLOSURES BEGINNING ON PAGE 86

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factors in the mid-80s and a license extension is now under discussion. Mr. Eddington has testified before the ACC regarding the changes needed to fix the operational issues at Palo Verde. We would anticipate the commission to still be very reluctant to grant prudency to any costs related to any further issues at this plant.

Currently, the ACC staff has recommended that $17.4 million (pretax) of replacement power costs related to 2005 shut downs at Palo Verde be disallowed. The ALJ recommended a disallowance of $13.4 million (pretax) related to the 2005 Palo Verde outages. There are an additional $79 million in 2006 outage costs before the commission in another docket. Applying a similar ratio to these costs as recommended by the staff would lead to a further disallowance of approximately $44 million (pretax). The company maintains that all costs related to the 2005 and 2006 Palo Verde outages were prudently incurred and are eligible for full recovery. The ACC has not yet made a determination in either case, but will make a determination on the 2005 costs commensurate with the 2007 GRC decision.

We continue to view Arizona as a challenging regulatory environment, although with the addition to the commission of Gary Pierce and the election of William Mundell into the chairman's role, we believe there is some space for improvement in tone. The ACC is composed of five full-time commissioners who are elected in statewide elections to staggered four-year terms. The electoral process for the commissioners of the ACC leads to a more consumer-oriented focus. Vacancies are filled by the governor, with a term ending at the next scheduled general election. The chairman is elected by the commissioners and typically serves in that capacity for two years.

PNM Resources (PNM)

Figure 59: PNM Regulatory Calendar

		Regulatory Timeline			Regulatory Request					Traditional
Subsidiary	State	Filing	Staff Rec.	Final Order	Rate Base	Equity %	ROE	Rev. Increase	EPS	Rate Case?
PSNM (Elec.)	NM	02/22/07	3Q07	Dec-07	$1,240	51.37%	10.75%	$68.9	$0.58	Y
PSNM (Gas)	NM	05/15/06		Apr-07	$401	48.50%	11.00%	$21.0	$0.18	Y
TNMP	TX		No case pending							

Source: Company filings, Regulatory Research Associates, and Lehman Brothers estimates

PNM is at the conclusion of its gas case at PSNM and the early phase of its electric case. The company had expected a ruling in the gas case in March, but the NM PSC has not yet proffered its ruling. We have modeled a 10.5% ROE outcome resulting in a $14 million revenue increase—approximately $0.12 in full-year EPS. In February, PSNM filed for $69 million in rate relief for its electric subsidiary. We model a 10.25% ROE outcome which would increase revenues by $61 million, or $0.52 on a full-year EPS. This case will also address the joint-dispatch status of the company's New Mexico plants, which currently serve the retail and wholesale loads. By separating these assets, the company paves the way for both assured regulated recovery on new plant building and a pathway for contributing unregulated assets into the EnergyCo joint venture. The case will also likely incorporate a fuel adjustment clause and a decoupling mechanism.

Portland General Electric (POR)

Figure 60: POR Regulatory Calendar

		Regulatory Timeline			Regulatory Request					Traditional
Subsidiary	State	Filing	Staff Rec.	Final Order	Rate Base	Equity %	ROE	Rev. Increase	EPS	Rate Case?
PG&E	OR	03/02/07		Dec. '07	2.3B (avg.)	50.00%	10.10%	$13M		Y
PG&E	OR	03/07/07		Mid-year '07	N/A	50.00%	10.00%	$13.4M		Y

Source: Company filings, Regulatory Research Associates, and Lehman Brothers estimates

POR's general rate cases utilize a forward-looking test year. The company calculates AFUDC on CWIP, and when capital projects are placed into service, both capital investment and AFUDC are included into rate base. POR adjusts its rates annually to reflect updated forecasts of net variable power costs in an Annual Power Cost Update Tariff filing. POR also is able to recover power costs as part of its power cost adjustment mechanism (PCAM). The company also has the ability to file deferred accounting applications with the OPUC for unforeseen costs, such as the Boardman outage (2005–06).

Recent Rate Case Filings

On March 2, POR filed UE 188, seeking approximately $13 million of increased revenue requirements associated with the build-out of phase 1 (125 megawatts) of the Biglow Canyon Wind Farm. Rates are anticipated to go into effect in January 2008.

UE 189 was filed on March 7, 2007, seeking approximately $13.4 million of increased revenue requirements associated with the implementation of advanced metering infrastructure (and includes associated savings). The project cost is approximately $130 million–$140 million. The proposed tariff would be effective from July 1, 2007, through December 31, 2009, which is the period POR plans to deploy the AMI system throughout its service territory. No rate impact is proposed for the first six months of the tariff because of POR's exercising previously approved credit offsets.

Recap of January 2007 GRC Decision

On January 12, 2007, the OPUC issued an order in POR's general rate case approving an overall price increase of 1.3%., premised upon a 50% equity capital structure and a 10.1% ROE on a total average rate base of $2.009 billion, including Port Westward, which is scheduled to go into service in June 2007.

Resource Valuation Mechanism

POR's RVM tariff mechanism was used to update the company's net variable power costs for inclusion in base rates from 2003 through January 16, 2007. It utilized a combination of market prices and the value for the company's resources to establish power costs and to set prices for energy services. Based upon projections in POR's 2007 RVM filing, which