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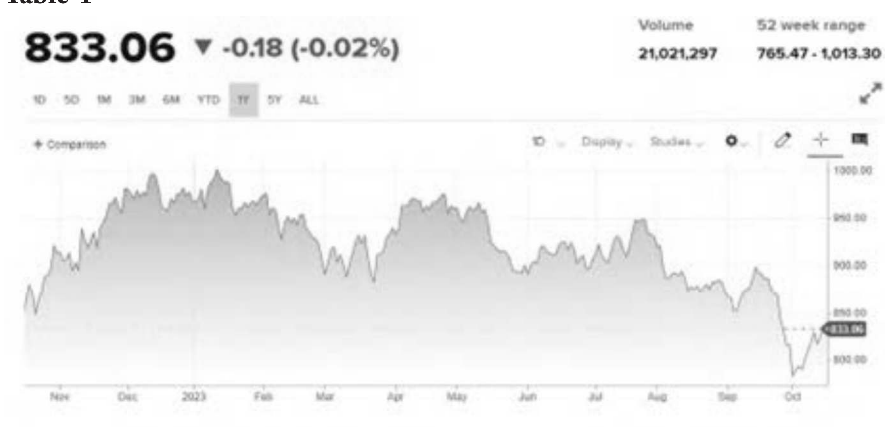
Utility Share Prices Under Pressure

By Peter K. O'Brien, Steven C. Friend, Patrick C. Jamieson and Michelle G. Chan*

In this article, the authors discuss the implications of the depressed stock prices for utility companies traded in the United States.

Table 1[1] shows the performance of the Dow Jones Utility Average, which tracks the performance of 15 prominent utility companies[2] traded in the United States, for 2023 to the date this article was prepared. As indicated, the index is down by approximately 17% since the index's high in January 2023.[3]

Table 1



Depressed stock prices have had a meaningful impact on capital markets activity – and strategic plans – for many in the industry. First and foremost, the drop in share price has put pressure on many utilities' balance sheets.[4] The low

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1 Courtesy https://www.cnbc.com/quotes/.DJU.

2 The DJU is comprised of 15 publicly traded utility companies in the United States: The AES Corporation, American Electric Power Company, Inc., American Water Works Company, Inc., Atmos Energy Corporation, Consolidated Edison, Inc., Dominion Energy, Inc., Duke Energy Corporation, Edison International, Exelon Corporation, FirstEnergy Corp., Public Service Enterprise Group Incorporated, Sempra Energy and Xcel Energy Inc.

3 Good, Allison, US utilities, renewables stock selloff underscores concern over spending plans, Energy Finance Daily (Oct. 9, 2023).

4 While the drop in share price alone does not immediately impact an issuer's balance sheet, the decline in stock price will pressure the balance sheet going forward nonetheless.

stock price makes it more expensive to add equity to the balance sheet by selling shares into the market. At the same time, from a credit metrics perspective, a significant share price decline will also gain the attention of the ratings agencies. One important question, then, for many issuers, will be how to "manage the balance sheet" going forward.

SELLING EQUITY

With depressed share prices, utility issuers are going to be reticent to execute large equity deals in this market. With a few notable exceptions – including a ONE Gas, Inc., forward in September 2023 and a Spire Inc. forward under its ATM in June 2023 – the equity markets in the electric and gas utility space have (not surprisingly) been very quiet in 2023.

While most industry participants have existing ATMs, the question is whether such issuers will use them when stock prices are so low. Table 2 shows electric and gas utility issuers which have filed ATMs since October 1, 2020.

Table 2

Issuer	Most Recent Filing Date	Amount Registered	Forward Component
Ameren Corporation	November 10, 2022	$1,000,199,028	Yes
American Electric Power Company, Inc.	November 6, 2020	$1,000,000,000	Yes
Alliant Energy Corporation	December 14, 2022	$225,000,000	No
Atmos Energy Corporation	March 31, 2023	$1,000,000,000	Yes
Avista Corporation	August 2, 2023	4,844,787 shares	No
Black Hills Corporation	June 16, 2023	$400,000,000	Yes
Duke Energy Corporation	November 10, 2022	$1,500,000,000	Yes
Edison International	August 4, 2022	$500,000,000	Yes
Entergy Corporation	August 9, 2022	$1,116,396,318	Yes
Eversource Energy	May 11, 2022	$1,200,000,000	No
Exelon Corporation	August 4, 2022	$1,000,000,000	Yes
NextEra Energy Partners, LP	April 26, 2022	$300,000,000	No

NiSource Inc.	**February 22, 2021**	**$750,000,000**	**Yes**
Northwest Natural Holding Company	**August 13, 2021**	**$200,000,000**	**No**
NorthWestern Corporation	**April 23, 2021**	**$200,000,000**	**Yes**
PNM Resources, Inc.	**November 10, 2022**	**$200,000,000**	**Yes**
PG&E Corporation	**April 30, 2021**	**$400,000,000**	**Yes**
Portland General Electric Company	**April 28, 2023**	**$300,000,000**	**Yes**
Spire Inc.	**May 9, 2022**	**$200,000,000**	**Yes**
The Southern Company	**November 5, 2021**	**50,000,000 shares**	**No**
Xcel Energy Inc.	**November 5, 2021**	**$800,000,000**	**No**

With respect to the ratings agencies, one way to get "equity credit" without selling equity is to issue "hybrid" securities with equity-like features. Table 3 provides examples of certain hybrid securities. The examples on the left side of the chart are more "debt like." And on the right side of the chart, the securities are more "equity like."

Table 3

	Convertible Debt	Junior Subordinated Debt	Perpetual Convertible Preferred	Mandatory Units	Mandatory Equity (Tangible) Units	Mandatory Convertible Preferred
Description	• Debt security with investor option to convert into a fixed number of shares in the future	• Long dated subordinated debt with Company option to defer interest payments	• Preferred stock that the Company can force into a fixed number of shares in the future	• Debt security plus a forward purchase contract to issue a variable number of shares in the future (typically 3 years or less)	• Amortizing note plus a pre-paid forward purchase contract to issue a variable number of shares in the future (typically 3 years or less)	• Preferred stock that will mandatorily convert into a variable number of shares in the future (typically 3 years or less)
Rating Agency Equity Treatment [1]	• 100% debt	• Moody's: 25% **Likely increases to 50% as Basket M**	• Moody's: IG - Basket C (50%) **Likely stays 50% as Basket L** Non-IG – Basket E (100%)	• Moody's: IG - up to Basket B (25%) **Likely increased to 50% as Basket M if debt host has at least a 30 year maturity, otherwise drops to 0% as Basket L** Non-IG: 0%	• Moody's: 80% **Likely reduced under new Moody's methodology**	• Moody's: Up to Basket E (100%) **Likely unchanged under new Moody's methodology**
		• S&P: Up to 50%	• S&P: Up to 50%	• S&P: Up to 100% (must convert within 1-2 years for Non-IG)	• S&P: 80%	• S&P: Up to 100% (must convert within 1-2 years for Non-IG)
		• Fitch: Up to 50%	• Fitch: Up to 50%	• Fitch: 0%	• Fitch: 80%	• Fitch: Up to 100%

1. Issuer rating could impact the amount of equity credit received. S&P's methodology also requires a maximum of 2 years to conversion for BB rated issuers and 1 year to conversion for B rated issuers. This represents the agencies' stated methodologies, but there can be variability depending on several factors, including the analyst, etc.

One trend from 2022 was convertible debt. With the recent runup in interest rates, the coupon rates on converts are lower than on plain vanilla debt because investors in the convert have exposure to equity upside. But, as indicated in Table 3, the rating agencies typically do not award any equity credit at the time of a convertible debt issuance.

Also, as noted in Table 3, Moody's has proposed an update to its hybrid methodology for investment-grade issuers in September 2023. Moody's previously maintained a "five basket" scale, attributing equity content in 25% increments from 0% to 100%. The proposed methodology at Moody's would shift to a three basket scale: Basket L (0% equity credit), Basket M (50% equity credit) and Basket H (100% equity credit). (High yield issuers will remain on a binary scale at Moody's, with only Basket L and Basket H.)

One item to note among the changes at Moody's is that junior subordinated debt would likely receive 50% equity credit at Moody's, rather than 25%

previously. This would bring Moody's in line with the other two agencies with respect to junior subordinated debt. That said, even with higher equity credit expectations from Moody's, issuers will need to also consider the higher coupons of subordinated debt (versus senior debt).

ASSET SALES

One trend in this volatile environment has been to raise proceeds through sales of minority interests as a substitute for accessing the capital markets. Several in the industry have recently explored the sale of minority interests:

- Duke Energy Corp. agreed to sell a 19.9% interest in its Duke Energy Indiana subsidiary to an affiliate of GIC Private Limited, Singapore's sovereign wealth fund;
- FirstEnergy Corp. sold a 19.9% stake in FirstEnergy Transmission, LLC (FET), the holding company for FirstEnergy's three regulated transmission subsidiaries, to Brookfield Super-Core Infrastructure Partners (Brookfield) for $2.4 billion; and in February 2023, FirstEnergy Corp. announced that it entered into an agreement to sell an additional 30% ownership interest in FET to Brookfield;
- NiSource Inc. announced it would sell a 19.9% interest in Northern Indiana Public Service Co. to a Blackstone Infrastructure Partners affiliate; and
- Sempra Energy sold a 10% non-controlling interest in Sempra Infrastructure Partners for $1.73 billion in cash to a subsidiary of the Abu Dhabi Investment Authority.

But the pace of these minority interest sales has slowed. Outside of the sale of "minority interests," some utilities have turned to selling certain assets in order to raise proceeds. See, for example, the recent news regarding American Electric Power Company, Inc.'s strategic review of (1) AEP Energy retail business, (2) AEP OnSite Partners, which is AEP's unregulated distributed resources business; and (3) certain non-core transmission joint ventures.

In March 2023, RWE, a German energy company, announced that it had closed its $6.8 billion acquisition of Con Edison's clean energy businesses.

More recently, NextEra Energy, Inc. announced Florida Power & Light Company entered into a definitive agreement to sell Florida City Gas to Chesapeake Utilities Corporation. In addition, Dominion Energy has announced that it had concluded a sale process and executed three separate definitive agreements to sell Dominion's three natural gas distribution companies to Enbridge.[5] The transactions are valued at $14.0 billion – all cash consideration of $9.4 billion plus the assumption of debt.[6]

And, on October 4, Duke Energy Corporation announced it had completed the sale of its commercial distributed generation portfolio to an investment fund managed by ArcLight Capital Partners, LLC.

But the above activity aside, and despite consolidation in the energy space more broadly, M&A activity in the electric and gas utilities sector may be muted given the current state of share prices.

REDUCE CAPEX

Many utilities were providing updated capex numbers at the Edison Electric Institute financial conference in Phoenix. Investor-owned North America regulated utilities (electric, gas, and water) have increased their spending exponentially over the past two decades at a compounded annual growth rate of about 9%.[7] And S&P Global Ratings expects that the industry's capital spending for 2023 will reach a record at about $200 billion.[8]

According to S&P Global, over half of medium-term spending from electric utilities is expected to be focused on transmission and distribution (T&D) infrastructure.[9] Outside of T&D, spending in the renewable generation and storage segments collectively accounts for approximately 15% of expected capital investment. Some companies have indicated increased appetite for spending in this segment following last year's passage of the Inflation Reduction Act (IRA).

Recent share price pressure may be, in part, a concern about companies' abilities to attractively raise the capital needed to finance spending.[10] But while one "lever" to manage the balance sheet is presumably a reduction in planned capex – for a regulated utility, capital expenditures are central to the business.

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[5] Dominion Energy, Inc., Dominion Energy Advances Business Review; Announces Agreements to Sell Gas Distribution Companies to Enbridge (Sept. 5, 2023).

[6] Id.

[7] Gosberg, Gabe, The Outlook For North American Regulated Utilities Turns Stable, S&P Global Ratings (May 15, 2023). The S&P report notes several risks confronting regulated utilities including, among others, (1) inflation risk, (2) record levels of capital spending, and (3) physical risks such as exposure to wildfires, storms, extreme temperature events and hurricanes.

[8] Id.

[9] DeLucia, Chris, North American power: Electric utility capex growth is expected to remain robust, but where is the investment going?, S&P Global Commodity Insights (July 17, 2023).

[10] Good, Allison, US utilities, renewables stock selloff underscores concern over spending plans, Energy Finance Daily (Oct. 9, 2023).

A utility's rate base is essentially the company's "prudent" capital investment, as determined by the applicable regulatory authority net of accumulated depreciation.[11] Stated differently, it is the net asset base from which the utility provides electric, gas or water service, and upon which the utility is allowed to earn a rate of return. Thus, the rate base value is a key variable in the determination of a utility's revenue requirement. For vertically integrated electric utilities, rate base generally includes generation, transmission and distribution infrastructure.

Given the importance of future capex to a regulated utility – especially with the ongoing transition from fossil fuels to clean energy – we expect issuers will be hard pressed to downsize existing plans to any great extent.

REDUCE DIVIDEND GROWTH

Electric utilities tend to have high dividend payout ratios – often 65% or more.[12] And historically, U.S. regulated utility dividend cuts have been infrequent, only occurring[13] during times of significant distress.[14] While any reduction in dividend levels or dividend growth estimates is bound to be unpopular with investors, in some scenarios, conserving cash may be necessary to manage credit metrics at a particular level.

TAKE THE DOWNGRADE?

While a reduction in share price may not necessarily affect certain of the standard credit metrics used by the rating agencies in order to rate the issuer and its debt securities, any significant pressure on share price is nonetheless going to gain the attention of the rating agencies. After all, the share price presumably captures the market's expectations of the issuer's expected future earnings prospects.

To the extent a company's credit metrics remain under pressure, one (likely unpopular) option would be to accept that a downgrade from the ratings agencies may be in the cards. While this will surely increase a utility's borrowing costs going forward, some utilities may decide that a potential downgrade is a more palatable option than:

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[11] Ernst, Russell, Rate Base: Understanding A Frequently Misunderstood Concept, S&P Global Market Intelligence (Mar. 3, 2017).

[12] Bary, Andrew, Utility Stocks Have Been Big Winners This Year. Why It's Time to Lighten Up, Barron's (Sept. 21, 2022).

[13] Cox, Charlotte, US utility dividends stay the course despite pandemic, S&P Global Market Intelligence (Sept. 9, 2020).

[14] Singh, Arshreet, Hawaiian Electric suspends dividend after Maui wildfires, shares fall, Reuters (Aug. 24, 2023); Kilgore, Tomi, Algonquin Power to cut dividend by 40%, provides downbeat profit outlook, MarketWatch (Jan. 12, 2023); NextEra Energy Partners (NEP) Cuts Distribution Rate, Units Drop, Yahoo Finance (Sept. 28, 2023).

(1) Selling equity at depressed prices;

(2) Selling off assets;

(3) Reducing planning capital spending; or

(4) Reducing future dividend growth.

CONCLUSION

The first nine months of 2023 were challenging for utility share prices. A historical runup in interest rates has created challenges throughout the business model, among others:

(1) Refinancing risk and expense;

(2) The additional costs of capital spending; and

(3) Working with regulators to approve such higher expenses.

Likely, some difficult decisions lie ahead. And in some cases, the decision may be to choose among a series of unappealing options.