Financing the Capex Cycle: A Wall Street Perspective

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Financing the Capex Cycle: Overview

- Profile of Institutional Investors
- Investors’ Concerns
- Pathway to Financing
Financing the Capex Cycle: Institutional Investor Profile

- Who are Institutional Investors and Why They Matter:
  - Mutual funds; pension funds; commercial banks; insurance companies; hedge funds; investment arms of investment banks; research boutiques
  - Institutions currently comprise roughly 60% of utility common stock, an estimated 80%-90% of debt ownership
  - Significant capital will be required in the evolving construction cycle
Financing the Capex Cycle: Institutional Investor Profile

- The institutional investor’s job is to maximize the return on an investment for the benefit of the client, within a given level of risk.

- Wide range of investment choices exist; typically, there is no requirement to be invested in a specific industry or a particular stock or bond.

- Hedge funds now a major presence in the utility investment arena; can introduce investment volatility.
Financing the Capex Cycle: Institutional Investor Profile

➢ Where do the credit rating agencies fit in?

- Credit rating: an assessment of a company’s ability to pay its fixed income obligations on time and in full

- Independent assessments

- Rating agency actions can impact a utility’s access to the capital markets
Financing the Capex Cycle: Investor Concerns

- Reprise of the 70s and 80s?
- Financial market turmoil
- Regulation, regulation, regulation
Financing the Capex Cycle: Investor Concerns – Historical precedent

Déjà vu all over again?

- Present time holds striking similarities to the 70s and 80s

- Earlier decades characterized by:
  - Rising cost, slowing economy environment
  - Massive nuclear construction problems
  - Altered regulatory paradigm
  - Excess capacity
  - Severe financial stress
  - Enormous losses to debt and equity investors
Financing the Capex Cycle:
Investor Concerns – Financial Turmoil

- Unprecedented turmoil in the financial markets
  - Volatility
- Major contraction of Wall Street
  - Fewer analysts = less attention = more opportunity for valuation error
- Liquidity worries
- Financial quality matters
Financing the Capex Cycle: Investor Concerns - Regulation

- Importance of regulation has resurged dramatically in recent years
  - Expanding capital expenditure programs (new capacity, upgrades)
  - Environmental compliance requirements
  - Dearth of rate cases in the 1990s, early 2000s
  - Large amounts of new equity capital will be required by the industry

- Major factor in the investment decision-making.
Financing the Capex Cycle: Investor Concerns - Regulation

- In the view of investors, regulators:
  - Have authority over majority of the industry’s returns, which determine earnings and cash flow, and thus valuation.
  - Control a lot of economic value: rates of return, equity allowed, rate base growth.
  - Make the rules; utilities must play by them.
Financing the Capex Cycle: Investor Concerns - Regulation

Investor Regulatory Wish List

- Regulatory climate characterized by:
  - Fairness
  - Stability
  - Predictability
  - Consistency

- Regulatory flexibility/mechanisms:
  - Future test year
  - Incentives/disincentives
  - Performance-based rate making
  - Fuel and purchased power expense recovery
  - Sharing mechanisms
  - Investment pre-approval
  - CWIP in rate base
Financing the Capex Cycle: Investor Concerns - Regulation

Investor Regulatory Wish List (continued)

- Reasonable allowed ROEs; ability to earn is critical
- Minimal regulatory lag
- Settlements versus litigated proceedings
Financing the Capex Cycle: Investor Concerns - Regulation

- Assessment of final decisions:
  - Balanced outcomes benefit all parties
  - Return (and ability to earn it) must compensate for risk assumed in an investment

- Presence of hedge funds can introduce added volatility during a case

- Investors vote with their pocket books or their feet
Financing the Capex Cycle: Pathway to Financing

- Capital markets outlook
- Important financing determinants
Financing the Capex Cycle: Pathway to Financing – Capital Markets Outlook

Environment of mounting uncertainties

- **Short-term choppiness**
  - Lack of liquidity at present time
  - Increased debt and equity financing costs
  - Rising risk levels
  - Competition from many sources for existing capital

- **Longer-term equilibrium**
  - Flight to quality
  - Utilities a solid investment due to long-term assets, solid cash flows
  - More differentiation between strong/weak companies
  - Need to finance opportunistically
  - Inflationary/recessionary environment?
Financing the Capex Cycle: Pathway to Financing – Important Determinants

- Financial strength and flexibility a key focus
  - Investors will steadily have less tolerance for risk

- Quality of regulation will be critical

- Need security of generation
  - Near-term: Energy efficiency, renewables
  - Intermediate-term: Natural Gas
  - Long-term: Coal, Nuclear

- Rising utility rates are inevitable
Financing the Capex Cycle: Summary

- Utility industry’s significant investment needs are coinciding with a period of great financial uncertainty
- Competition for capital from many sources will intensify
- Companies with financial strength will have greater access to capital
- Quality of regulation will be an important determinant of financial certainty