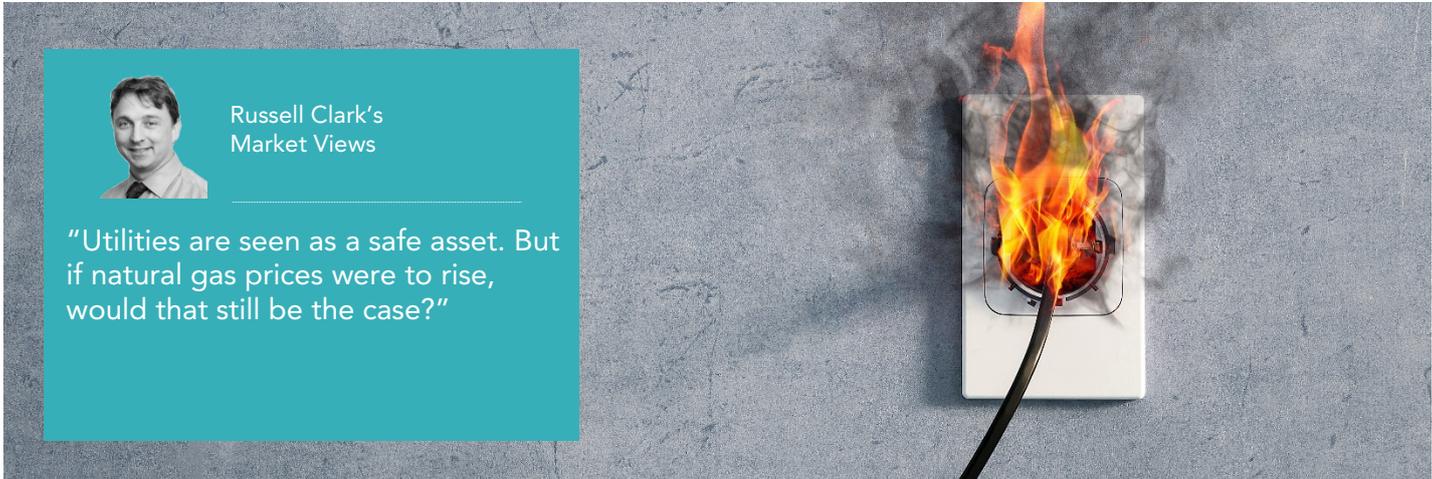


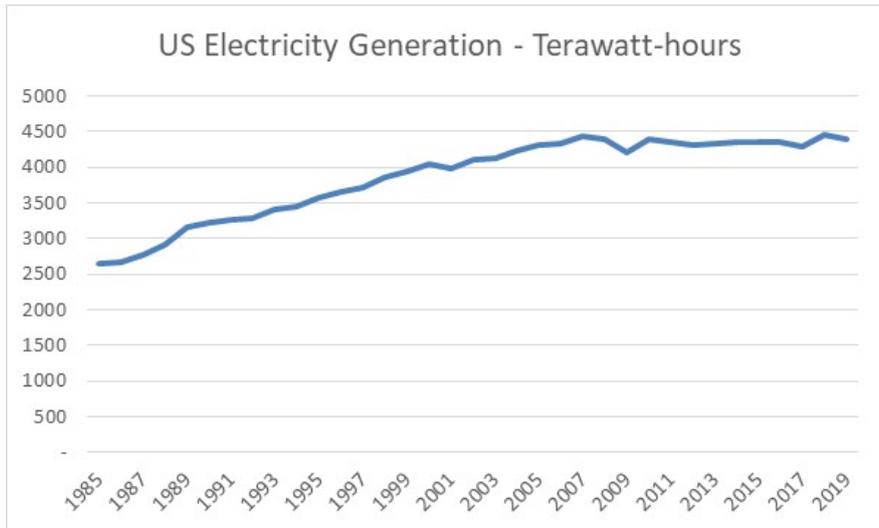
**REGULATED ASSETS,
UNREGULATED PROFITS**



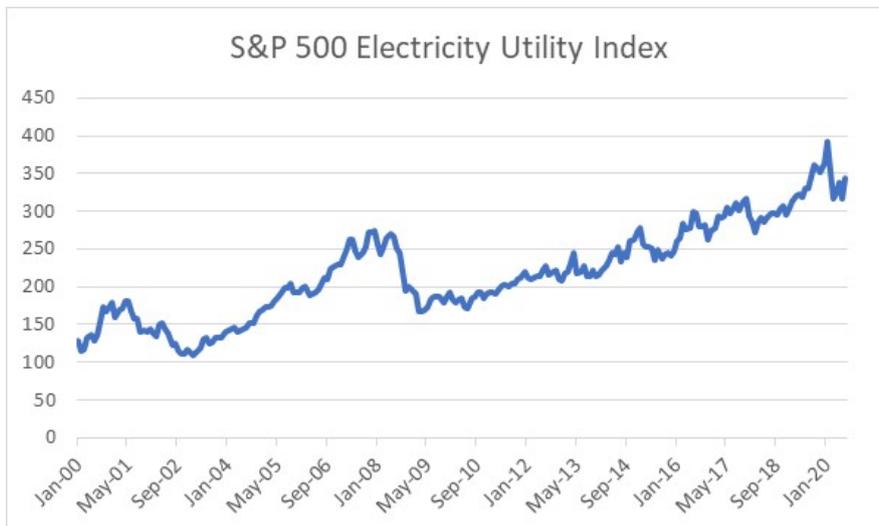
Russell Clark's
Market Views

“Utilities are seen as a safe asset. But if natural gas prices were to rise, would that still be the case?”

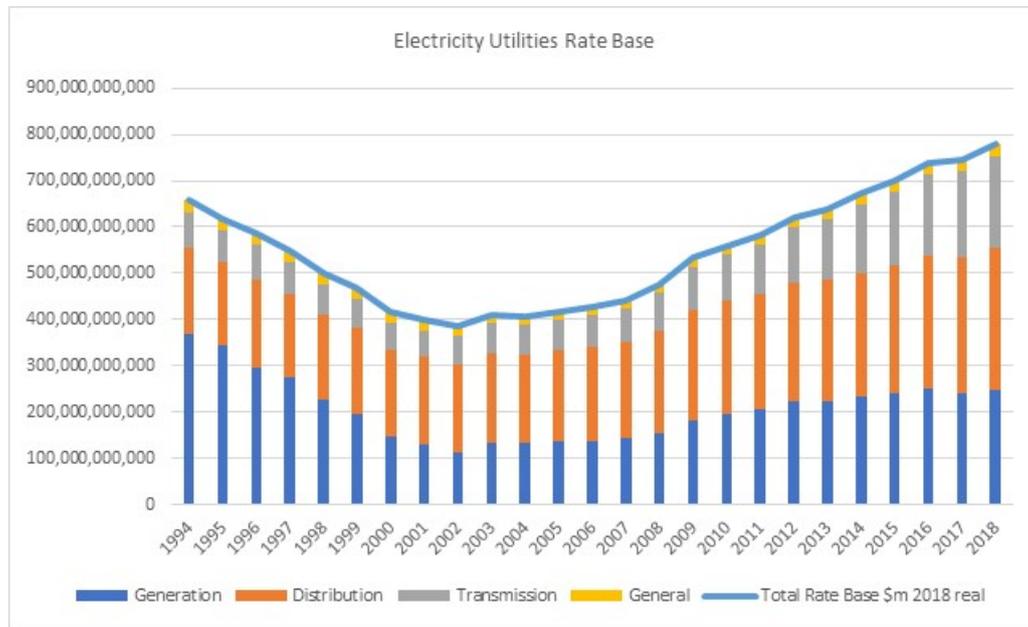
US electricity generation has a decidedly mature feel to it, as an industry where total generation has been flat for more than 10 years.



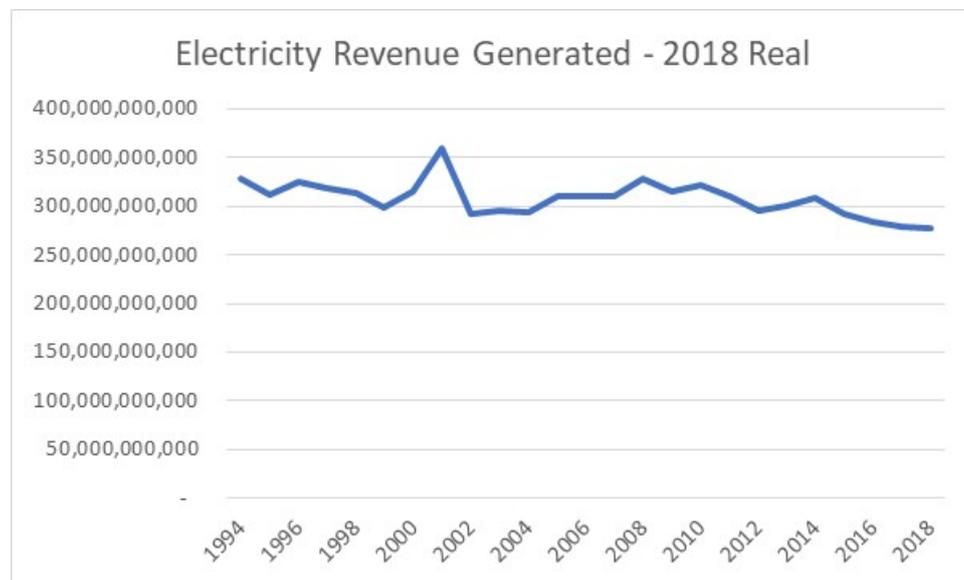
Despite tepid to falling growth, the S&P 500 Electricity Utility Index has performed reasonably well over this period.



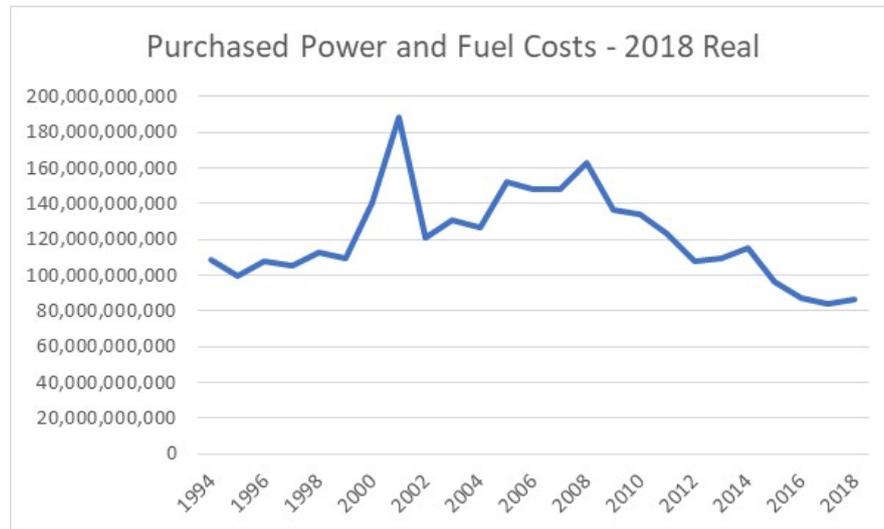
Part of this impressive performance of electricity utilities has been their ability to grow investments ie capex financed by debt. Utilities are a regulated industry, and so they earn a regulated or negotiated return on assets invested. So the more that is invested, then potentially the more they can earn. The rate base (being the total of investments x regulated rates +overheads) for the industry has double since 2002, despite generation remaining flat.



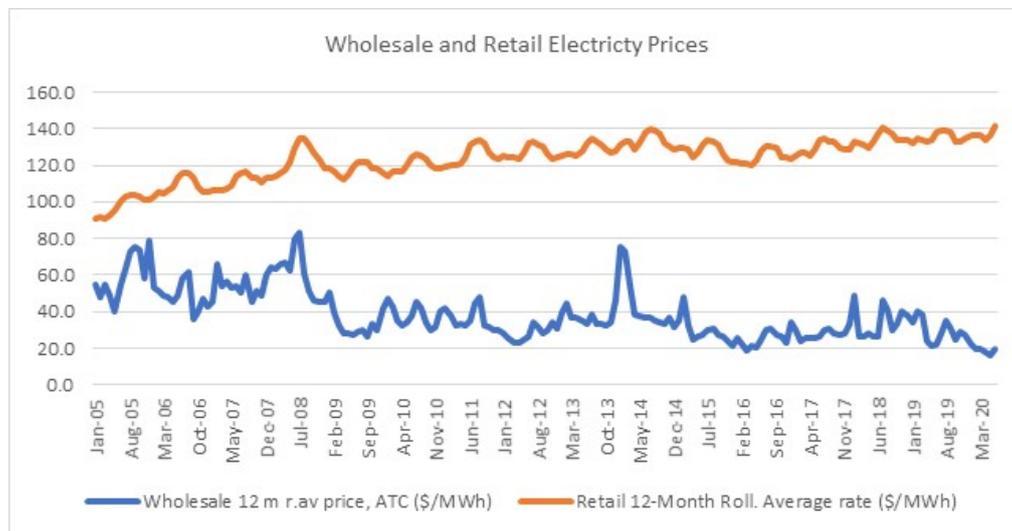
Despite the rising rate base, revenues earned have been falling in real terms since 2001.



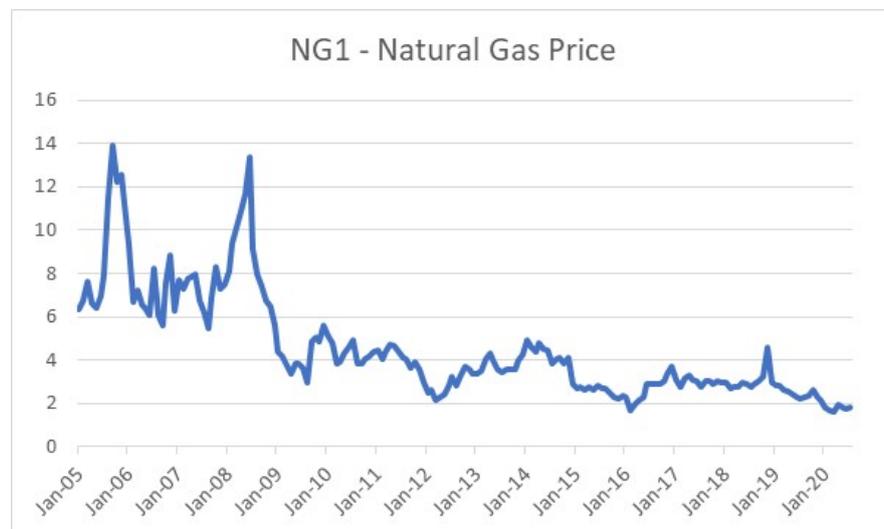
Utilities having invested heavily have seen a steady increase in profits, but revenue generated has been falling, so how have they done this? Well I think the fall is almost entirely from falling fuel and power costs.



I believe that the utilities have been able to capture all these profits from falling wholesale power prices without passing them onto retail customers.



Perhaps the utilities have convinced the regulators that the falling prices have been caused by the efficiencies made from their capital expenditure (to grow the asset base/rate base). But its hard not to notice that wholesale electricity prices tend to follow natural gas prices pretty closely.



If natural gas prices were to rise, it would be likely that retail electricity prices would need to rise in order to maintain the regulated returns on the rate base. But in periods of recession it can be politically difficult to raise prices, leading to a squeeze on margins for the utilities that would be problematic, as they have been increasing debt (to finance all the extra capex) as percentage of sales for many years now.



Utilities are seen as a safe asset. If natural gas prices were to rise, it is likely they would be anything but safe.

INFORMATION

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