

**Thoughts on Utilities:
Notes from the EEI Financial Conference, November 2009**

We recently attended the 2009 Edison Electric Institute (EEI) Financial Conference. The conference is organized by EEI, an association of U.S. investor-owned electric companies. The conference is attended by senior executives from the EEI member utility companies, bankers, analysts, and investors. It provides a forum for us to meet with and hear from a large number of utility industry participants on the challenges and opportunities facing the industry.

Having attended these conferences for many years now, we normally detect a significant amount of “group think” at this event. Sometimes the ideas are good for us as preferred investors; other times they are bad. For example, in the latter part of the 1990s, utilities thought they should be “growth companies” to compete with then-soaring technology firms. They bought or built merchant generation (to power an ever-expanding digital economy), expanded overseas, diversified into new businesses, and generally increased leverage. This exposed preferred investors to significant new risks that in turn influenced investment strategies in utilities. The bursting of the dot-com bubble in 2000-01 and the California energy crisis in 2002 put most of those growth strategies in the ash heap. Over the following years, utilities emphasized a “back to basics” strategy that continues today. By and large, this has been good for preferred investors, and it’s one of the reasons why utility preferreds outperformed financial preferreds during the 2008-09 recession. In short, we find that attending the EEI conference gives us useful insight into investing in utilities that might be obscured when looking at companies individually.

This year, however, there was not a lot of group think – at least, there were no new industry-wide themes. We think the reason is that there is a great deal of uncertainty surrounding potential carbon regulation, federal renewable-energy mandates and the economy in general. As a result, most companies are cautious about the future and unwilling to pursue big new projects. Over the near term, utilities’ focus remains on achieving operational efficiency and solidifying working relationships with their regulators. With electricity demand down and uncertainty over future energy standards, companies are deferring discretionary capital expenditure (capex).

Looking beyond the near-term horizon, discussion focused on potential carbon legislation and the sizable infrastructure capex that will be needed to comply with it. Financing costs were also discussed, with rising costs on bank lines of credit being a particular concern. Interestingly, there did not seem to be much worry about utilities’ ability to access debt markets, despite still-fragile credit markets. The largest challenge posed by all of this is that electric rates are bound to increase: Greater investment at higher capital cost with (eventually) higher fuel costs will mean higher electric bills. The ultimate questions are, how much customers will be able to bear in terms of rate increases, and what will that mean for investors in utilities?

We summarize the main themes from this year’s EEI conference below.

Carbon and Renewables. These issues were addressed to a degree last year but were primary topics of discussion again this year. There was a consensus that demand-side management, energy efficiency, and renewable-energy portfolio standards are a key focus for current and future investment. Nuclear build was also identified as environmentally friendly (zero carbon emissions) and essential for baseload capacity by most conference participants. Environmental capex will be a major part of a utility’s future and carbon legislation will determine how they attack the issue. Most expect some form of carbon regulation to go into effect in the next two

years. Most utilities see these regulations as growth opportunities, as they will drive rate base upwards.

Utilities are embracing renewables such as wind, solar, and hydro. However, they are not always reliable: the wind does not always blow; the sun goes down at dusk; and droughts happen – but everyone expects the lights will come on whenever we flip a switch. Thus, most renewable-energy sources require backup power, and the replacement costs for purchased power (or for having a backup plant on standby) can be considerable – significantly bumping up the cost of electricity. As investors, we will need to assess what sort of recovery is being provided to companies on these investments and the impact this has on customer rates.

Big Spending, Rising Costs. The Keynote Speaker mentioned that in the next decade, there will be more than \$900 billion of capex spent by electric utilities on both new and replacement capacity (e.g., more than 100 generation plants are set to retire between 2010-15 alone). This figure is bigger than the current net plant in the U.S. power sector, and balance sheets would nearly double. Investments will be made in generation (renewables, back up generation for renewables, nuclear, etc), transmission, smart grid, distribution, and other miscellaneous items. Besides plant additions, the prices of gas and coal are likely to rise again, cost of capital may rise, and there will be a cost for carbon emissions. Price increases needed to support this capex have to be managed and in some cases may not be politically tolerable. Utilities need to manage both project costs and regulatory relations. In their individual presentations and conversations, most companies focused on those efforts.

Credit Facilities. Overall, utilities have solid liquidity profiles, with credit facilities sourced from a handful of different banks at each company. No bank makes up more than 15% of most companies' total commitments. Large multi-year credit agreements arranged in 2006-07 will expire in the next several years, with maturities peaking in 2012 (\$65 billion in 2012 across utilities, power and gas). Pricing remains elevated on new bank facilities, but tenors are lengthening from 1 to 3 years. There are no major changes in covenants. Some strategies being taken by utilities include more bond funding (less reliance on bank lines and commercial paper), lien-based or commodity-linked bank facilities, changing trading agreements to eliminate collateral, exiting from credit intensive business lines such as power trading, and hedging less of total fuel/power purchase commitments. On the latter, this reduces cash needs but could result in greater cash flow or customer bill volatility.

Financing. Generally, companies are generating enough cash to fund their maintenance capex, dividends and some of their growth capex. Many companies will have to come to market in 2010 to fund a portion of growth capex, however. This issuance should come mostly in the form of senior secured and unsecured debt. There did not seem to be any worry that financing would be unavailable. Most have plans to issue some level of equity, through DRIP plans and/or market issuances. Although utility common stock has rebounded along with the general market, it is unclear how much supply the market will bear, especially when capex ramps up more meaningfully after 2010.

The Influence of Regulatory and Political Environments. A good deal of time was spent discussing the impact of the political and regulatory environments on utilities future prospects. It will be important to watch how the regulatory commissions and politicians deal with recovery in rates for the investments is carbon reduction, renewables, infrastructure-related capex, and higher costs of capital. Having gotten used to relatively cheap electricity (inflation-adjusted electricity

prices have not risen in 30 years), there probably is a limit to rate increases that customers will tolerate. When that point is reached, it could result in deferral of cost recovery for some utilities, which would increase credit stress in the future. In the meantime, there was lots of talk about routine rate cases, which was pleasantly boring for us as preferred investors.

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