Strategic Decisions Group: Energy & Environment Practice

Outlook 2010: Adjusting to the "New Normal"

The course of events over the past two years underscores the perils of forecasting, as Yogi Berra said, "especially about the future." The outlook in late 2008 from nearly all industry participants could be placed on a continuum from "bleak" to "dire." In late 2008, the possibility of a depression was commonly mentioned by economic commentators in the media. In early 2009, the recently inaugurated President Obama warned Americans in a Washington Post editorial that, without the stimulus, America could slip into a crisis that "we may not be able to reverse." While the events of 2009 were certainly difficult for many, fortunately the direst of forecasts did not come to pass. After dropping below 700 in March 2009, the S&P 500 currently stands approximately 30% above its point in late 2008. Most indicators show the economy growing again and financial markets seem to have stabilized. We appear to have returned to a situation that is hard to describe as "normal," but perhaps is the "new normal."

In the energy industry, the stunning drop in industrial demand (some companies saw double digit declines in industrial electricity demand) and falling commodity prices forced many companies to make painful adjustments. The declines, combined with uncertainty about the regulatory environment, caused many companies to defer investments. But as we mentioned last year, in spite of the immediate economic downturn, the US energy industry still has capital investments to make: in rebuilding aging transmission and distribution systems; in building new generation capacity; and in environmental retrofitting, conservation, and energy efficiency. Industry observers have estimated that the industry will need to invest $950 billion over the next 15 years. In this industry, the winners will be those with the resilience and decision-making discipline to take advantage of opportunities in the downcycle.

The utility industry was more resilient than most during the crisis of 2009, but massive uncertainties and daunting challenges lie ahead. In this industry, the winners will be those with the resilience and decision-making skills to take advantage of opportunities in the downcycle.

This investment is obviously critically dependent upon access to capital. While the financial markets have been unquestionably constrained, the energy industry has been more resilient than most. Utilities sold debt throughout the crisis in 2009 in amounts approximately equal to those of 2008. Utility equity values, while well below their peak, have recovered to their levels in late 2008. As capital markets continue to open, utilities have opportunities to secure financing with rates at historical lows. And the funds from the stimulus bill are beginning to flow to the industry such as the recently announced $3.4 billion in government grants for smart grid projects.

So, as we adjust to the "new normal," it is clear that there are significant opportunities ahead for the energy industry and that the pursuit of these opportunities will continue to be complicated by the massive uncertainties in the market and regulatory environment. There are three major areas we are watching in the coming year:

- **Continued Uncertainty in Climate Change and Environmental Legislation –** With the announced delay of climate change legislation in the Senate to the "early spring of 2010," it is clear that uncertainty will continue over what environmental regulatory regime the industry may be conforming to in coming years. With continued opposition in the Senate, opinion polls showing slipping public approval, and the fact that 2010 is an election year, the odds have increased that a comprehensive climate change bill may not get passed at all in the near term. Instead, the industry could face a much more complex situation in which a variety of measures are taken at federal and state levels such as direct EPA regulations, renewable portfolio standards, state and regional climate change programs like RGGI. This situation could vastly increase the complexity of strategic decision making in 2010.



- **Rate Case Pressures** – As mentioned earlier, the utility industry needs to invest heavily to maintain today's high level of reliability. The industry is still recovering from decades of underinvestment in generation, transmission, and distribution when construction expenditures sank to as low as 10% of revenues (versus a historical average of 30%). In addition to this already considerable capital expenditure requirement, the industry is being asked to implement an ambitious public policy agenda requiring investments in areas such as renewables, smart grid, energy efficiency, and conservation. Based on projected capital expenditures in the industry, we estimate that average increases in rate base over the next four years will be 3-5% annually versus the historical average of 4-5% over a four-year period. As Moody's warned in a recent report, at some point required rate increases become politically untenable. This will put pressure on allowed ROEs, which have already been in decline for decades, and could lead to increased intervention and disallowances.

- **Rebuilding the Grid** – Implementing the public policy agenda will require rebuilding and increasing the aged transmission and distribution systems with what is collectively called "Smart Grid": intelligence to increase reliability, efficiency and security, automation, functionality to support demand participation and energy efficiency, integration of distributed and remote renewables, even, potentially, storage. While policymakers and many companies have pursued smart grid as an exercise in deploying technology such as advanced meters on their networks as quickly as possible, large questions remain surrounding what exactly is being built from the standpoint of the business model of the utility and other participants. How will value be created by these systems? What products/services is the system going to support? What changes are required from regulators (e.g. revenue decoupling, differential peak and off peak pricing)? Further, there are significant uncertainties surrounding the ability of the industry to get new transmission lines constructed to enable the integration of remote renewable resources.

Proven methodology and deep industry expertise

SDG is a strategy consulting firm dedicated to helping companies make quality decisions in their most significant and challenging problem areas. Formed in 1981, SDG serves clients throughout the world from offices in North America, Europe, the Middle East, India and Asia-Pacific.

For three decades, SDG has been a leader in helping energy market participants evaluate investment decisions, optimize the allocation of capital across their portfolios, and deal with market and regulatory uncertainty. SDG has been at the leading edge of many of the critical strategic challenges facing the energy industry.

SDG's practice is based on proven analytical techniques, deep industry expertise, and a collaborative decision making process. By combining our proven approach and our years of experience in the energy industry, we help our clients establish profitable new strategic direction and achieve lasting change.

For More Information

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