

# Storm Clouds Forming

The coming cash flow and dividend stress at America's electric utilities.

BY JAMES M. SEIBERT

**A**wareness is growing that the U.S. government's fiscal, tax, and monetary policies over the past decade have significantly affected the underlying health of numerous industries, most notably in the mortgage banking, housing, and health care sectors. Policy missteps have often created perverse incentives to make specific investments that obscured an industry's economic well-being or swamped its future financial performance. There's now a growing concern that similar patterns might be at work in the electricity industry and might portend negative impacts on dividends and cash flows in the coming decade.

At issue is the quality of earnings and cash flows. While there's no strict definition of earnings quality, its fundamental principle is sustainability. More specifically, are the utility's earnings and cash flows repeatable? Are they controllable? Are they bankable?

Repeatability is the first test. Do the earnings and cash flows result from permanent increases in revenue or improved expense patterns, or are they the result of special circumstances—*e.g.*, one-time asset sales, special or temporary tax benefits, temporary shifts in expenses across periods, etc.? Controllability is the second test; it assesses management's role in realizing financial results. Were improvements the result of management action, or simply the benefit of uncontrollable factors—*e.g.*, interest rate or currency exchange changes—that are beyond management's control. Bankability is, of course, the ultimate test. Do the improvements result in real cash flows the companies can “take to the bank” and pay shareholders.

### Earnings Paradox

For the U.S. electric utility industry, assessing the quality of cash flows begins

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with a straightforward analysis of the primary sources and uses of funds. As a mature, asset intensive business, the vast majority of the industry's investments—*i.e.*, the predominant uses of funds—are made from its cash flow from operations (*see Figure 1*). As expected, during the period 1997 through 2010, the nation's investor-owned electric utilities (IOU) made cumulative investments equal to 102 percent of their cash flow from operations. The small differences in the industry's net new cash requirements were realized from financing activities such as new debt and equity obligations.

Like all capital intensive industries, the U.S. electric power sector has enjoyed the benefits of declining interest rates. The total annual interest expense for the industry's 66 IOUs has

remained substantially unchanged over the past decade at about \$22 billion, despite a 25 percent increase in the total indebtedness since 2005 (*see Figure 2*). The industry's great debt refinancing wave of the past few years helped lower the industry's effective interest rate by more than 19 percent from its peak in the past decade in 2005. These reduced costs have benefited electric systems and consumers alike. Not unlike the nation's homeowners who found themselves able to buy much larger homes through falling interest costs during the heyday of low mortgage rates and easy terms, the nation's utilities and their customers gained more modern, valuable assets at lower overall cost.

Shareholders also have benefited from this favorable environment. Despite challenging demand and energy price conditions throughout much of the U.S. in recent years, the electric power industry's reported net income and especially cash flow from operations have remained strong and improving throughout the past decade (*see Figure 3*). Each of these twin measures of financial performance have benefited from these reduced interest costs, as illustrated in Figure 2.

Nevertheless, 2009 and 2010 introduced an interesting and important paradox: net industry earnings remained substantially flat, even while cash flows from operations increased by about one-third, or about \$20 billion, to record levels. Given this paradox—stagnant earnings despite improved cash flows—a logical question arises: Are these increases in cash flows really sustainable?

Given that cash flows from operations are so critical to future investment trends, and that they're at historic high

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levels, a closer examination of the composition of these operating cash flows might illuminate new opportunities or potential concerns for the industry.

### A Growing Threat?

The recent improvement in cash flows of the nation's electric utilities has enabled steadily increasing dividend payments over the past decade to all-time highs (see Figure 4). Reviewed more closely, however, these favorable dividend and cash flow trends weren't created by improved operating income, but by investment and tax policy-related decisions. They also might also be telegraphing future corrections at some utilities.

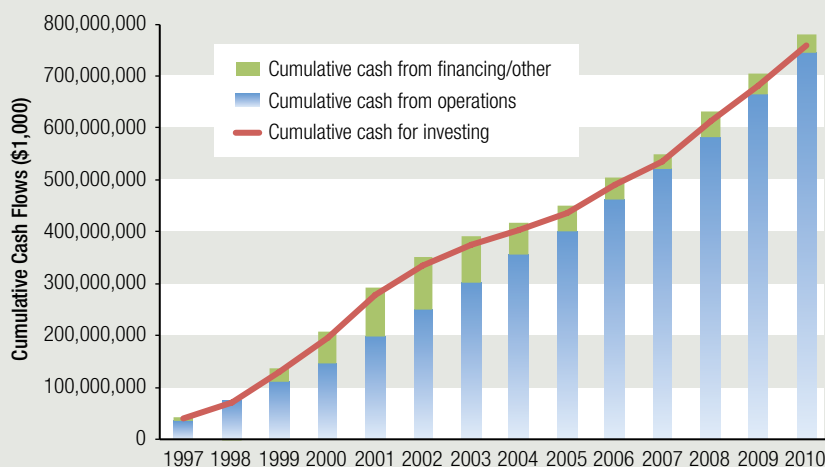
Recent major reinvestment activities at many utilities, combined with favorable tax and other incentives, have led to very significant increases in deferred taxes and tax credits across the industry. As a reminder, deferred taxes are a cash adjustment from net income to define cash flow from operations. Overall, by mid-2011 the industry's deferred taxes and tax credits are now equivalent to over 90 percent of the industry's dividends.

In fact, current levels of the industry's annual deferred tax charges and tax credits are at historic highs, well above the relative normal levels of 10 to 20 percent of dividends, and even greater than their brief peak mid-decade that resulted from Bush-era tax incentives. Is this really sustainable?

These higher levels of deferred taxes stem largely from recent growth in capital investment, beginning in 2008—investment that was often embraced by executives, because their utilities were able to deploy otherwise idled workforce resources. Thus, utilities have been able to make positive steps toward system modernization, while marginally reducing some operating expenses through transitioning some costs of the workforce into capitalized activities—and thus further improv-

**FIG. 1 CUMULATIVE CASH FLOWS**

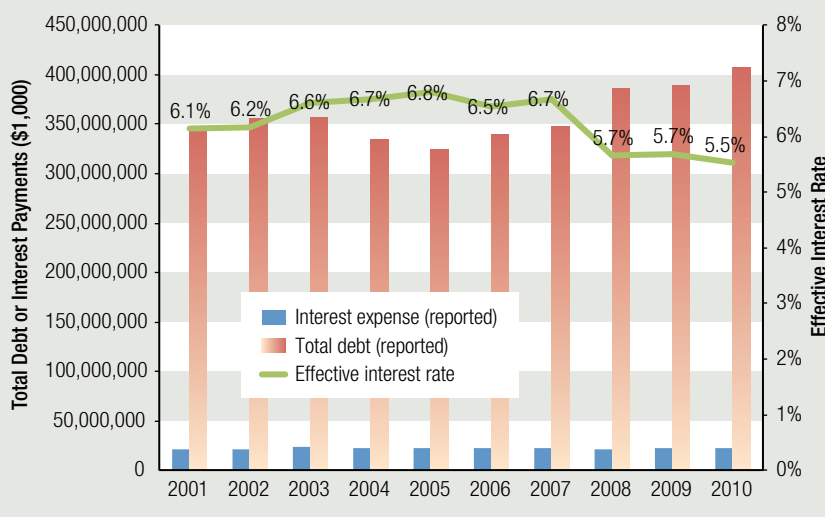
Cumulative cash flows for 66 U.S. electric utilities – 1997 through 2010.



Source: Chicago Energy Associates LLC Analysis of 66 Electric Utilities

**FIG. 2 DEBT, INTEREST, AND INTEREST RATES**

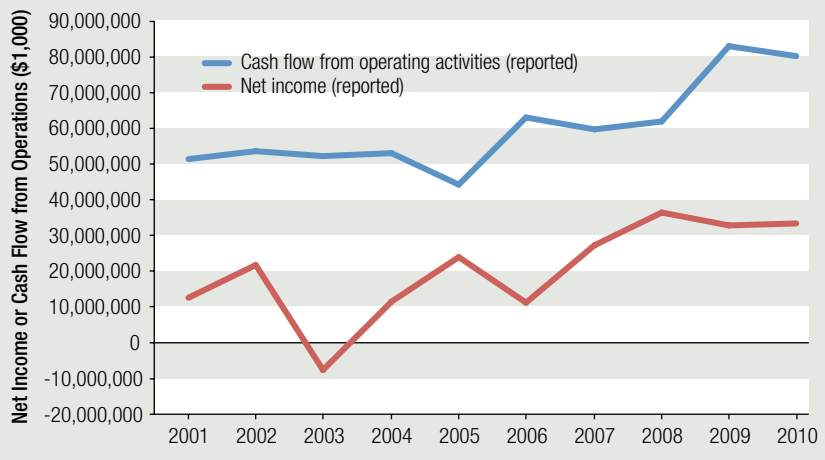
Total debt, interest paid, and effective interest rate for 66 U.S. electric utilities – 2001 through 2010.



Source: Chicago Energy Associates LLC Analysis of 66 Electric Utilities

**FIG. 3 NET INCOME AND CASH FLOWS**

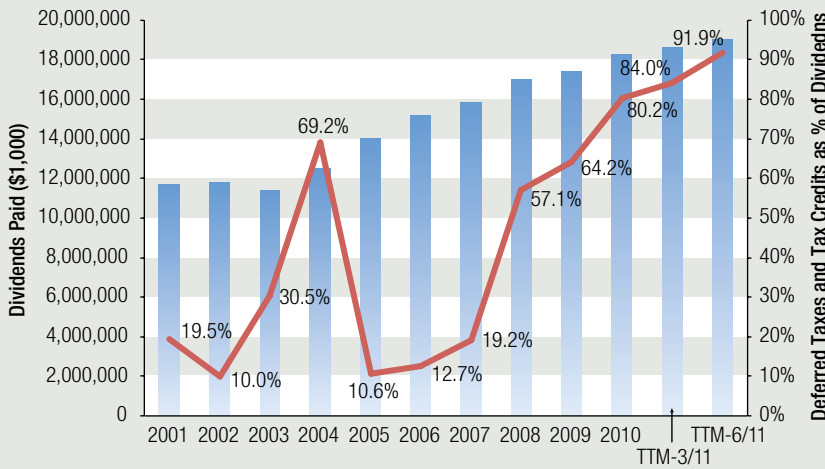
Reported net income and cash flows from operations for 66 U.S. electric utilities – 2001 through 2011.



Source: Chicago Energy Associates LLC Analysis of 66 Electric Utilities

**FIG. 4** **DIVIDENDS, DEFERRED TAXES, AND CREDITS**

Deferred taxes and tax credits as a percentage of dividends for 66 U.S. electric utilities – 2001 through mid-2011.



and they become a drag on future cash flow, investment levels, and potentially dividend payout. Thus, the large relative scale of the industry's recent deferrals (see Figure 3) foreshadows a threat to future cash flow, investment, and even dividends. Such crises have already begun unfolding in the nation's banking and insurance industries.

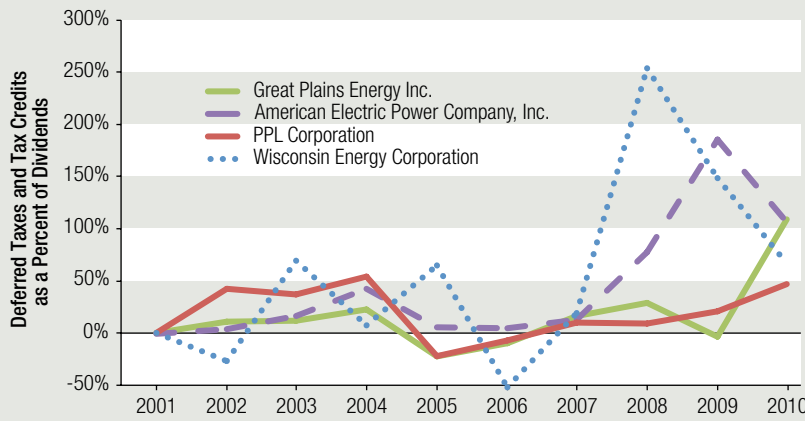
Although the overall patterns do generally forecast future negative trends in the industry's operating cash flows and net income as these deferred taxes unwind, the impact isn't uniform across the industry. Individual utilities vary widely in the effect of these recent investments and deferred taxes on their overall financial results (see Figure 5).

For example, Great Plains Energy and PPL have continued to exhibit very normal patterns of deferred taxes relative to dividends. They have remained at relatively typical levels, even turning negative in periods of recapture, as one would expect. Alternatively, utilities like AEP and We Energies have gained relatively extraordinary recent cash flow benefits from these tax effects, and ultimately will see this flow of funds reversed in future years.

To summarize, these tax policies and incentives have been bankable, but the cash flows they have enhanced aren't sustainable and they really aren't controllable. The future years of recapture might strain some utility cash flows and potentially even dividend levels absent offsetting improvements in revenue and earnings. For example, AEP had a dividend payout ratio of 68 percent in 2010, and its deferred tax and tax credit benefits were 163 percent of dividends. Moreover, it could be complicated further by potential future changes in tax rates that resulted in excess deferred taxes as occurred after the changes in tax rates in the 1980s.<sup>2</sup>

**FIG. 5** **DEFERRED TAXES AND CREDITS VS. DIVIDENDS**

Deferred taxes and tax credits as a percentage of dividends for selected utilities – 2001 through 2010.



**FIG. 6** **DIVIDEND PAYOUT RATIOS**

Electric Utility	2008	2009	2010
American Electric Power	48%	55%	68%
Great Plains Energy	110%	73%	54%
PPL Corp.	54%	128%	65%
Wisconsin Energy	47%	31%	41%

Source: Chicago Energy Associates LLC Analysis of 66 Electric Utilities

ing current period operating earnings. The deferred taxes and credits that arose along the way simply provided one additional benefit from this increased emphasis on investment.

However, by their very nature, deferred taxes represent only a temporary benefit to a utility that eventually will be recovered. Indeed, unlike

other industries where deferred taxes have had little impact on future cash flows, numerous academic studies<sup>1</sup> have shown that the utility industry is a noted exception to this general pattern. In short, in coming years these now positive operating cash flow and earnings impacts will reverse themselves as the deferred taxes become payable

### Potential Pension Pain

Like virtually all institutions with

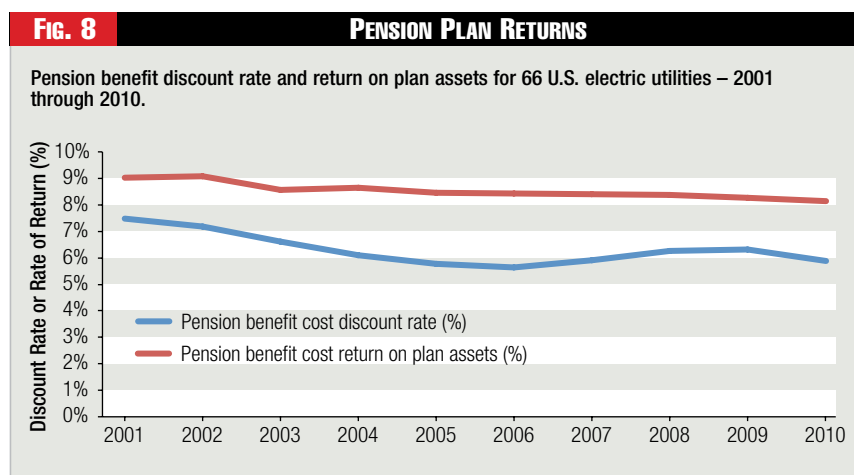
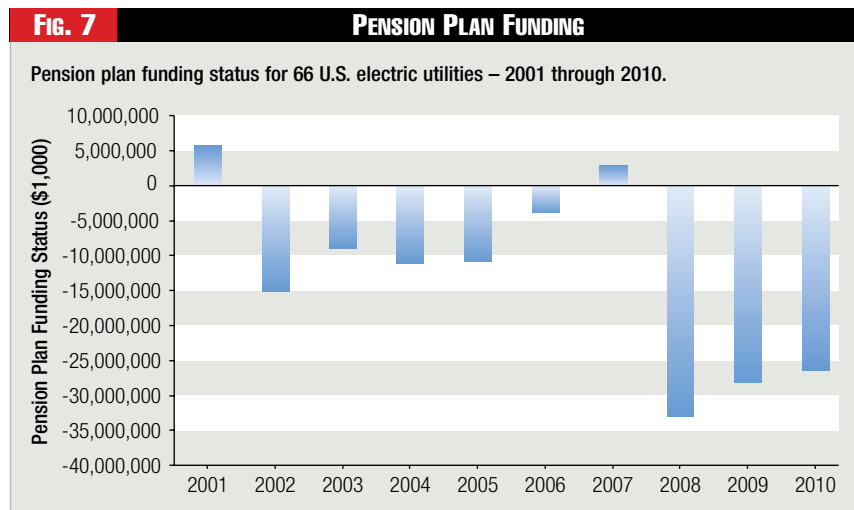
pensions and other post-retirement obligations, the U.S. utilities industry has experienced an enormous financial shock since the financial crisis of 2008. Plan asset values dropped precipitously and administrators have struggled to define appropriate long-run planning assumptions. The industry's overall funding status went from generally neutral—*i.e.*, positive and negative intermittently—to sharply negative in the post-2008 era (see Figure 7). The industry's combined funding deficit is now on the order of total industry net income, an alarming gap especially in the context of overall earnings quality.

This quiet problem might be further obscured by the planning assumptions used in plan administration. For example, the industry's assumed average return on plan assets has been slowly reduced throughout the most recent decade from slightly over 9 percent to slightly over 8 percent (see Figure 8). This forecast of future plan returns is a hotly debated topic in pension administration circles. After a decade of very low returns and threats of a long-term deleveraging process, it requires continuous analysis.

Perhaps more disconcerting is the recent increase in the industry's average plan discount rate. The discount rate is the rate used to determine the current value of future benefit costs. Increasing the discount rate has the effect of reducing the present value of the future obligations. The mid-decade improvements in overall pension funding status are much the result of these discount rate increases in 2007 and might have further obscured the true magnitude of the negative funding status of the industry's pension obligations.

### On the Horizon

The industry's growing deferred taxes and pension obligations forecast much leaner operating cash flows in com-



ing years. These constraints almost certainly will limit future investments at some utilities. Although large and growing, the industry's pension obligation and potential shortfall is likely the lesser of these two major risks, because utility regulators have a long tradition and pattern of honoring pension-related revenue requirements in rate cases, presuming utilities can gain rate relief in the context of reduced capital costs and high deferred taxes.

At those utilities that have aggressively leveraged these deferred taxes and tax credits, a confluence of forces might create a perfect storm that batters future operating cash flows. In this climate, the growing deferred taxes and tax credits can only be sustained by future increases in investment; this increased investment will only be practi-

cal through new financing—debt and equity—and the prospect of future rate cases to ensure adequate recovery. Unfortunately, these rate increases will be muted by the regulatory treatment of the utility's existing deferred taxes; deferred taxes are a reduction to rate base. The result will be the long, slow unwinding of the recapture process, with its reduced investment levels, agonizing dilution and per share dividend stress, and conflict between investment and financing cash flows. **F**

### Endnotes:

1. Chluddek, Astrid K., "On the Relation of Deferred Taxes and Tax Cash Flow," University of Cologne Graduate School in Management, Economics and Social Sciences, May 2011.
2. "Coordinated Issue Utility Industry Excess Deferred Taxes and Section 1341," Internal Revenue Service, April 24, 1995.