

Financing the Capex Cycle: A Wall Street Perspective

**Maryland – District of Columbia Utilities
Association**

84th Annual Fall Conference

September 26, 2008

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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**

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