Focus on Finance

by Linda C. Byus

Financial crisis may dampen nuclear renaissance

The ongoing turmoil in the U.S. financial markets is focused on Wall Street and the banking industry, but the impact reaches all industries and businesses, including the utility industry. Stock market price performance is the most visible indication of financial health, and during the third quarter of 2008, U.S. stock market performance was dismal. What happened to the utility industry during the “crash of 2008,” and what are the longer-term implications for the industry and the nuclear renaissance?

During the three-month period of July 1 to September 30, the Dow Jones Industrial Index fell 4.4 percent, while the S&P 500 fell 9 percent, and the NASDAQ fell 9.2 percent. During the same three-month period, the Dow Jones Utility Index fell 17.79 percent. For the first nine months of 2008, the utility index decrease of 19.5 percent tracked the overall market performance, with industrials off 18.2 percent, the S&P 500 down 20.7 percent, and the NASDAQ down 21.5 percent. The loss of market value represented by the decline in utility stock price is disappointing, but it is only a “paper loss” unless an investor sells the stock at its low price. For long-term investors, the real issue is what the economic crisis means for the future of the utility industry.

The current economic crisis is a credit crisis. The underlying issue is “bad debt,” or loans that may not be repaid. Because electricity production is capital intensive, companies need cash to build infrastructure and new plants. In order to grow, utilities need access to a healthy credit market. In addition, unregulated generation and marketing businesses use credit lines and collateral to support day-to-day operations. The stock price hit to the utilities during the third quarter was driven by credit risk.

What about the nuclear renaissance? The economic and credit concerns will slow down potential new investment in nuclear plants. Earlier this year, there was significant legislative attention to energy-related issues, including climate change. It is unlikely that progress will be made on energy-related legislation until the economy stabilizes. Further, increased financial regulatory oversight will require increased government resources, which could limit the resources available to deal with energy issues. While still important to the overall economic health of the U.S. economy, energy is not the top priority. As a result, the anticipated timing of a nuclear renaissance may be delayed.

Constellation Energy, one of the companies actively pursuing the construction of new nuclear generation, fell victim to the financial crisis of 2008. In late August, the company announced an error in calculating the liquidity requirement that would be associated with a credit rating downgrade. As a result of that correction, the company secured an additional $2-billion credit line. That announcement, however, raised credit concerns with investors. In mid-September, one of Constellation’s creditors, Lehman Brothers, went into bankruptcy. While Lehman had provided only $150 million of credit out of a total of more than $6 billion, Constellation’s investors panicked and sold the stock. Constellation Energy’s stock price fell from $58.37 per share on September 12 to $24.20 per share on September 18. On September 19, MidAmerican Energy Holdings Company, led by Warren Buffett, announced the purchase of Constellation Energy for $26.50 per share. Through the first nine months of the year, Constellation’s stock price fell from $102 per share to its current trading level in the mid-$20 range.

How did Constellation Energy, the parent of regulated distribution company Baltimore Gas and Electric Company, end up in a high-risk financial situation? Very simply, the company used lines of credit to support its operations. When the credit market tightened, investors were concerned that Constellation would not have enough liquidity to support its operations. Although Constellation’s management tried to reassure investors, emotion and fear drove the sell-off of the stock and the bargain-price sale to MidAmerican.

What does the MidAmerican acquisition mean for the utility industry and for the nuclear industry? MidAmerican continues to grow as a relatively low-risk electricity and gas distribution company with a national presence. The privately owned company is a significant player in the utility industry. If the purchase is completed, Constellation’s Baltimore Gas and Electric will continue to operate without interruption, while the other businesses may be restructured or sold off. Unistar Nuclear, Constellation’s joint venture with EDF to invest in new nuclear generation, will be evaluated as part of MidAmerican’s strategy, as well as Buffett’s investment strategy. He enjoys a reputation as a sophisticated investor who is supportive of nuclear power investment if the economics fall into place. As a result, MidAmerican could lend credibility and financial leadership to the nuclear industry if it continues to pursue the construction of nuclear generating plants through Unistar Nuclear.

The financial crisis of 2008 and the Constellation Energy experience have ramifications for the utility industry, as well as the nuclear industry. While generally less volatile than the broader market, utilities play a significant role in the U.S. economy and are subject to major economic trends. Utilities are dependent on access to credit markets for growth, and a credit crisis will dampen utility investment and growth. As a result, the nuclear renaissance may be on hold while the broader economic and financial issues are sorted out.

Linda C. Byus (LCByus@aol.com) is a Chartered Financial Analyst and currently runs her own business, BYI Consulting, established in 2004. As a consultant, she provides feedback to utilities’ senior management regarding industry trends and investor concerns as a basis for their strategic discussions and planning.