ELECTRIC UTILITY (WEST) INDUSTRY

All major electric utilities located in the Western region of the United States are reviewed in this Issue; Eastern-based electrics, in Issue 1; and the remaining industry participants, in Issue 5. Since our last review of Electric Utility (West) three months ago, the 36 electric utility stocks we cover in the *Value Line Investment Survey* dropped 7.5% in value on average, compared to a 7.3% gain in the S&P 500.

On a 12-month basis, the *Value Line Utility Index* has declined 10.4% versus a 15.8% rise in the *Value Line Arithmetic Index*. This underperformance is in stark contrast to a year ago when the defensive nature of utilities was prized. The rise in interest rates over the last 12 months, however, as evidenced by the one-year Treasury rate going from 3.0% to nearly 5.5%, has really hurt these stocks, as Treasuries provide a competitive investment vehicle for income-oriented investors and compare favorable to the 3.9% median dividend yield for electric utilities. A turnaround in these stocks should be in play when recession fears resurface or the Federal Reserve eventually gets around to cutting rates.

Total annual return prospects through 2026-2028 for electrics look as high as we've seen them over the past year. The median level for the group is presently 10.4%. Although there is a generally reduced risk level in owning utilities, given that they're regulated monopolies, we like to see at least 10%-11% long-term total annual return potential before recommending a specific equity to utility investors. That level is in line with historical returns for the broader market.

Utility Portfolio Considerations

Regarding the aforementioned relationship between interest rates and the performance of stocks within the Electric Utility Industry, investors should understand the risks if we have indeed entered a period of secular inflation and rising interest rates. Notably, Consolidated Edison, a bellwether stock for its industry, generally traded at a price-to-earnings (P/E) ratio that was roughly 55% of the market level, while carrying a dividend yield of 8%-10%, during the early to mid-1980s (the last secular peak for interest rates).

In recent years, ConEd has generally traded at a market-level P/E ratio with a dividend yield in the 3.5%-4.0% range. And this is a very mature utility that is at best a middle-of-the-pack performer in terms of operational growth. Hence, it's clear that over time, this group is negatively correlated to interest rates. Meaning, when rates are trending down, utilities tend to do well and vice versa.

We think utility investors can help guard against diminishing valuations by being disciplined buyers. The midpoint of the annual total return projections based on the 3- to 5-year Target Price Range should generally be at about 11% or better. It would also be a good practice to emphasize utilities with higher-than-average dividend growth prospects. We'd put the industry median at about 4.5% for that metric.

Avoiding electrics with poor regulatory environments is a good practice to follow. Those with nearly real-time formulaic pricing adjustments, which minimize regulatory lag, should be sought. A solid balance sheet is important, as well. This ought to minimize a utility's cost of capital. Ultimately, companies in reasonably high growth, affluent service areas will give a utility its best chance to flourish. Reasonably progressive-minded state leadership, in terms supporting utility-owned, non-emitting generating capacity, is a big plus, too.

INDUSTRY TIMELINESS: 66 (of 93)

Topical Considerations And Concluding Remarks

The main challenges electrics are facing include higher interest rates and upward trending wages, materials, fuel, and purchased power. Due to how the regulatory mechanisms work in this industry, some costs can rapidly be passed on to consumers, such as natural gas prices. Many cannot be and must go through a filed-rate-case process with regulators. The regulatory lag before recoupment may be as short as one year, but in some instances can drag on for a few years. Some companies are fortunate to have a very minimal lag on a reasonable percentage of outlays.

With utility bills generally higher in recent quarters, due to high energy costs, which most utilities do not profit from, it can make for an antagonistic relationship with the public. Politically motivated regulatory commissioners may be looking to make their careers on keeping rates flat.

Inflationary pressures for operating and maintenance expense can be manageable, but for some of the large-scale projects this industry is involved with, it will be increasingly difficult to achieve budgeted financial results. The transition to a renewable-energy future has many opportunities to increase long-term earnings growth, but management teams have to execute well in order to capitalize.

High purchased power costs during peak load periods out West, exacerbated as reliable and inexpensive coal generation is increasingly shuttered, is at times problematic because those open market purchases are not necessarily an automatic and quick pass through to consumers. This situation is also an opportunity, as it increasingly makes sense for renewable generating capacity to be utility owned.

At first blush, this industry appears to be fairly homogeneous. That's not the case. There are significant differences within this group that need to be considered. Investors need to be very selective here.

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