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UPDATE »

WILL **MILD Q1 WEATHER** COMPOUND THE LOSS OF THE TRIPLE-2 TAILWINDS FOR UTILITIES?

As noted in a recent S&P article, many utilities are expecting first quarter financial results to be challenged by mild weather that depressed sales of electricity and natural gas across much of the eastern two-thirds of the country. Some locations experienced heating degree days 22% below normal, and a couple of companies cited the mild weather in connection with their reported weak Q1 results. Utility companies also cite the added pressure of rising financing costs as well as inflation in operating and maintenance expenses. That said, the mild weather has come with the silver lining of lower natural gas prices, mitigating pressure on customer bills when the price of everything else has been going up.

Many utility companies have regulatory mechanisms such as weather normalization or volume decoupling that smooth the financial impact of mild weather by effectively “borrowing” revenues from periods of favorable weather to supplant shortfalls like early 2023’s. Utilities lacking such regulatory protection often adjust spending levels to the same effect, leaning on the “fat” years to fund lean ones.

Mild weather compounds the financial pressures of inflation and higher interest rates, but the utility’s **need to invest** remains.

Our April 2023 white paper “Now for the Hard Part” discussed the fading of what we termed the 2-2-2 tailwinds—low inflation, interest rates, and commodity prices—that allowed utilities a decade of investing capital in the rate base without unduly pressuring customer bills. Mild weather is likely to compound the effects of higher costs, but we expect most companies will affirm their long-term earnings growth guidance, while highlighting the mitigation of bill pressure that came with a mild winter.

While regulatory revenue protection and timing of expenditures can mitigate quarterly anomalies, the longer-term secular challenges of inflation, higher interest rates, and globally linked commodity price volatility remain. So does the need for utilities to invest in reliability, resilience, physical security, cybersecurity, and the transition to cleaner fuels. The U.S. economy is historically dependent on the

reliable supply of electricity and natural gas, which regulated utilities have an obligation to provide.

While the combination of rising interest rates, inflation, and commodity price pressure remains mild compared with the situation in the 1970s and early 1980s, that period holds some cautionary tales many in the industry have not experienced. Then, as now, utilities were investing heavily to ensure a reliable energy supply that was threatened by overreliance on imported oil. Large-scale power plants, high voltage transmission lines, and pipelines combined to form a highly resilient, reliable, and diversified energy delivery system. However, many of those projects were plagued by cost overruns in an inflationary and high interest rate environment. In many cases, regulators pushed back on rate recovery, forcing large write-downs, credit downgrades, and financial stress that ultimately drove utility restructurings and bankruptcies.

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As we observed in our April white paper, today's energy transition is a generational opportunity for utilities, but the industry must develop solutions protecting customers and earning a bigger share of their energy wallet while maintaining access to capital for needed investments.

One opportunity to make that happen is to intelligently manage operating and capital costs with sophisticated techniques incorporating risk as a key element of cost reduction. MCR first developed risk informed budgeting for the nuclear industry, and these techniques can be applied to all utility operations.

At its core, risk informed budgeting requires budget owners to justify all budget requests while considering risks of not performing the activity. In our experience, an effectively implemented risk informed budgeting program has produced budget savings of 10% to 15%, excluding straight time labor—even after implementation of other cost-reduction initiatives.

For more information, see the MCR white paper "Achieving Significant O&M Reduction with Risk Informed Budgeting."

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