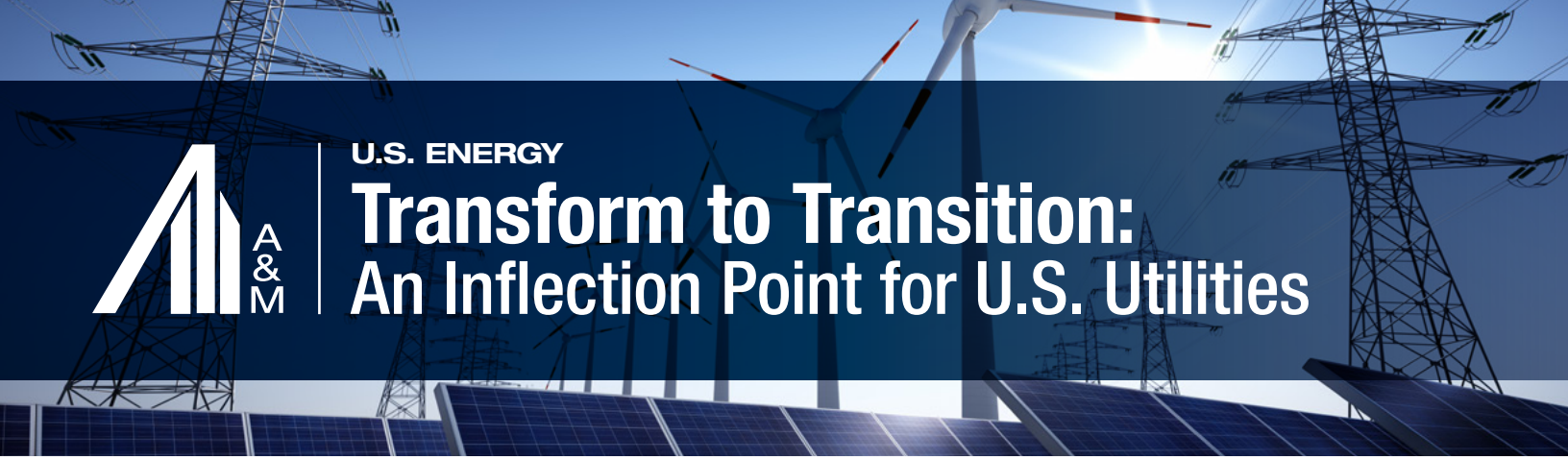


U.S. ENERGY

Transform to Transition: An Inflection Point for U.S. Utilities

With the macro landscape changing rapidly, transformation of electric utility operating models and capital allocation strategies will be required in order to address pressures on cash flow, balance sheets, returns and equity valuations while delivering on reliability, affordability and energy transition commitments.

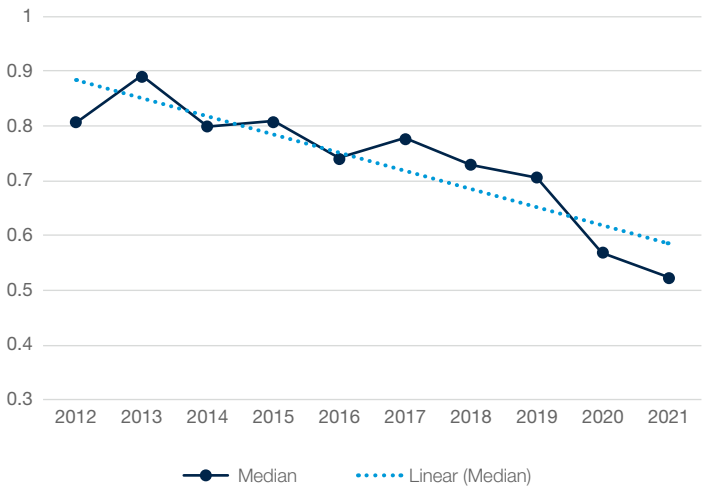
One key trend highlights this inflection point for U.S. electric utilities. Figure 1 on the right reflects the ratio of Operating Cash Flow to CapEx plus Dividends (cash coverage ratio) for over thirty publicly traded U.S. utility companies. Over the past decade, this ratio has steadily declined by around 40 percent, from 0.8x to 0.5x.

Modest inflation and a declining cost of capital has allowed utilities to lean more heavily on capital markets to grow dividends, fund increasing CapEx needs and manage revenue requirements, without significant rate increases.

These lower coverage ratio strategies work so long as there is an accommodating economic backdrop.

OCF/(Dividends + CapEx)

Figure 1: Ten-year trend of Operating Cash Flow to Dividends + CapEx



Sources: Alvarez & Marsal Analysis, Company SEC Filings, S&P Cap IQ

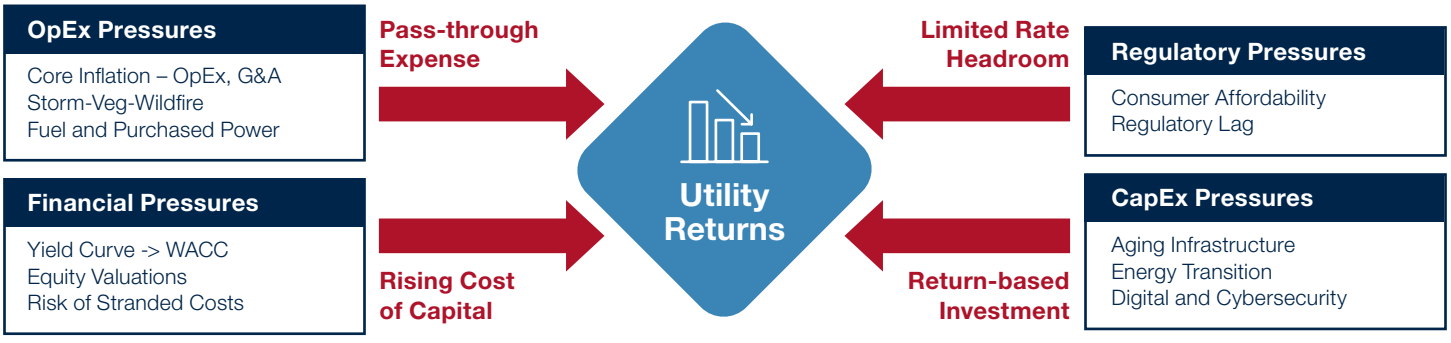
Tailwinds Turn to Headwinds

This backdrop has changed abruptly. Operating and financing costs are increasing while consumer affordability concerns are limiting utility "rate headroom." Full recovery of increasing costs and deferred regulatory assets is less certain in this environment. At the same time, CapEx budgets are expected to increase along with energy transition commitments.

Alvarez & Marsal's Market Pressures Model below (Figure 2) illustrates the combined pressures that set the stage for an even larger funding gap in an increasingly expensive capital market environment.

Figure 2:

Alvarez & Marsal's Utility Market Pressures Model



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Transform to Transition

Leadership teams need to move aggressively now to address near-term pressures while transforming operating models and capital strategies. This will require a very different playbook and a capital efficiency mindset.

We see four key moves to address near-term challenges while re-positioning for the future:

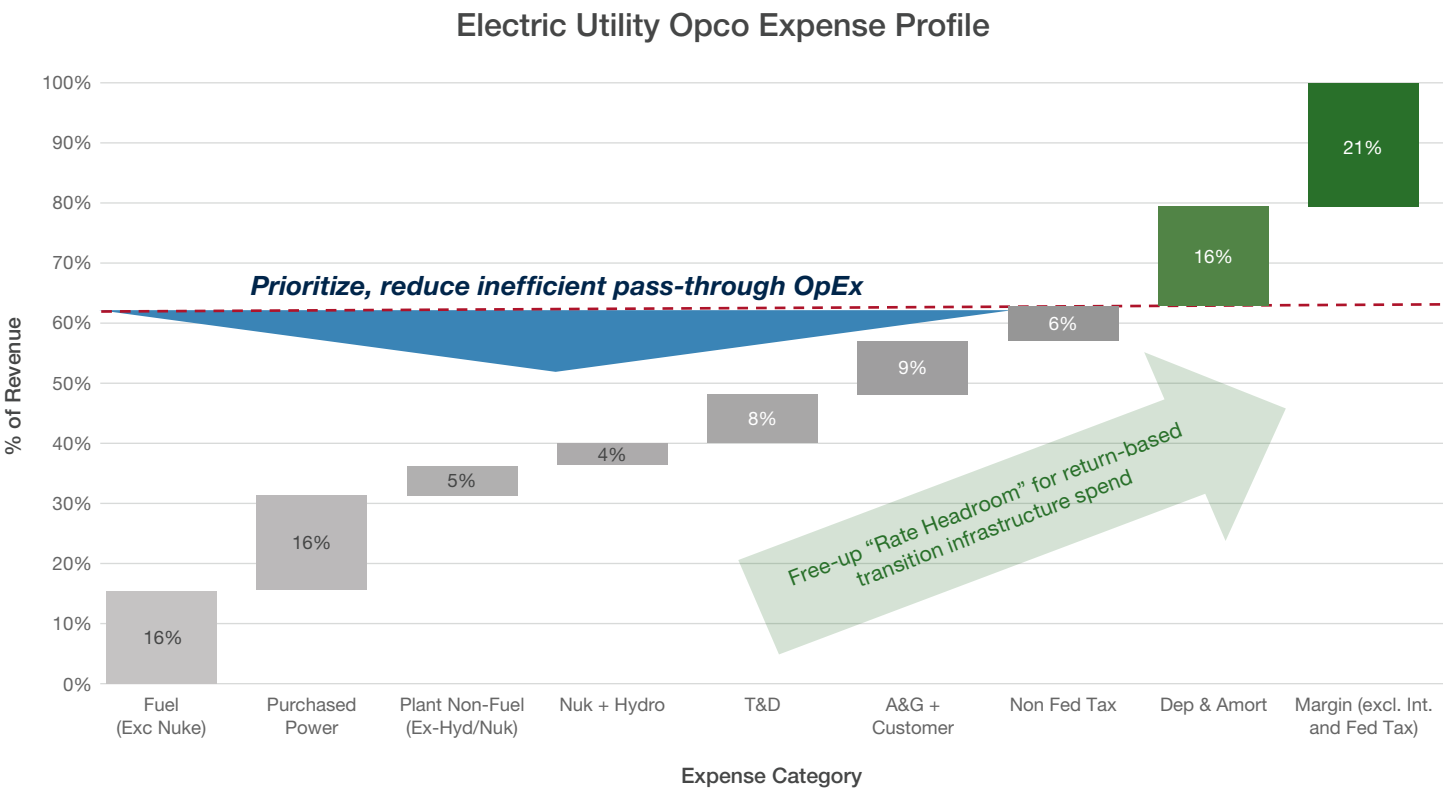
1. Accelerate the transition to a structurally lower-OpEx business model
2. Source and allocate capital to fund increasing infrastructure investments
3. Grow billing determinants
4. Re-set the strategic growth narrative

1. Transform the Cost Structure to a Structurally Lower-OpEx Business Model

Utilities are already working to unlock operating efficiencies and mitigate near-term revenue and ROE shortfalls. This will need to be more than an incremental, around the edges exercise.

Over the longer-term, a capital efficiency mindset will be needed to structurally reduce OpEx spend and free up "rate headroom" to fund more productive, lower-OpEx capital infrastructure projects. OpEx represents an expense that utilities pass through directly to consumers. Utilities do not earn a return on this spend. Pass-through OpEx expenses represent greater than 60 percent of revenues on average across sampling of about 30 electric utility Opcos. Fuel, purchased power and plant O&M represent the majority of this expense. (Figure 3)

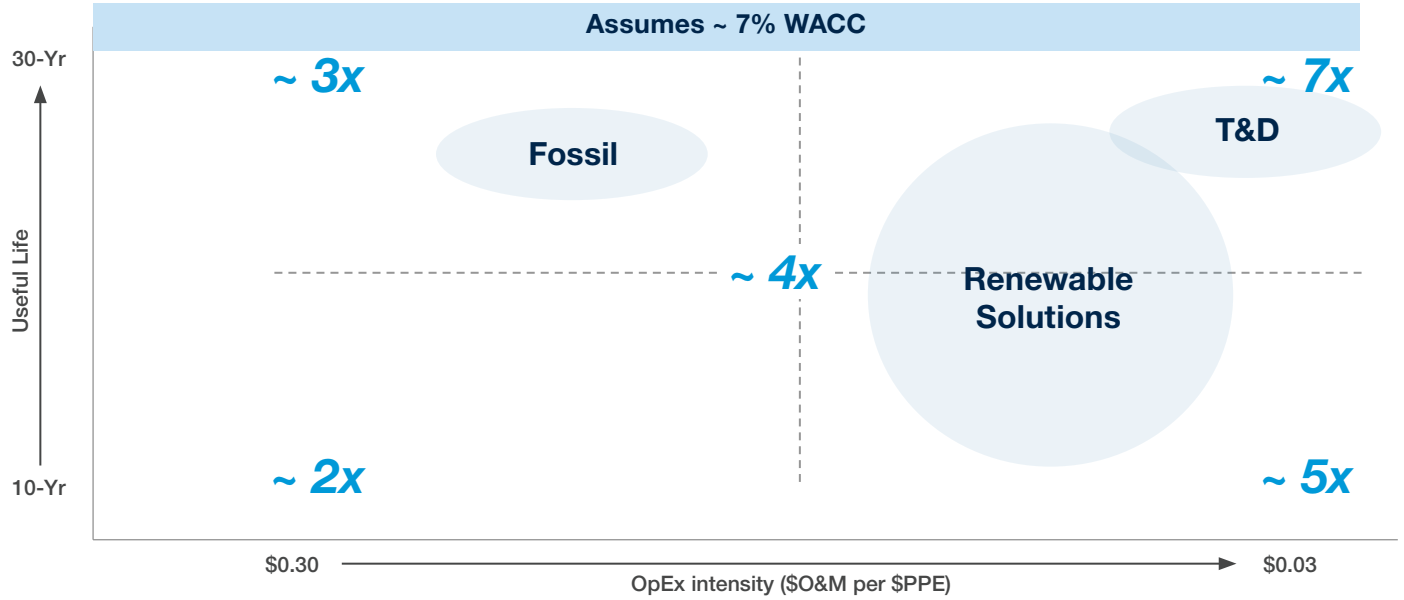
Figure 3:



Source: 2021 FERC Form 1, Alvarez & Marsal analysis

Capital spend shows up in utility PPE and is reflected in rates over time through depreciation, supporting OpEx, interest expense and a return on equity component. Depending on financing costs and the asset profile, a dollar of OpEx spend can have the equivalent impact on rates of around 5x or more of capital investment. This relationship is illustrated below in Figure 4.

Figure 4
Illustrative Rate Equivalent ($s CapEx to $1 OpEx)



Source: Alvarez & Marsal analysis

Volatility and commodity price increases have driven the OpEx cost per MWh higher for purchased power and fossil fuel resources. At the same time, expanded incentives under the Inflation Reduction Act are reducing the capital cost of alternatives with lower-OpEx profiles including renewables, storage and grid enhancements.

From a capital efficiency perspective, this creates an opportunity to accelerate the shift away from volatile purchased power and high-OpEx fossil assets to re-invest in stable, lower-OpEx infrastructure solutions. This shift has the potential to reduce volatility and consumer rates over time and increase the share of return-based expense.

Alvarez & Marsal's capital efficiency framework can help a utility refine and accelerate this process. The framework brings a comprehensive approach to assess the trade-offs across varying criteria and dimensions including short- and long-term rate impacts, balance sheet and financing requirements, technical and reliability characteristics, and timing.

2. Sourcing Capital to Fund Increasing Infrastructure Investments

A shift to a low-OpEx resource model will require sizeable up-front investment. This call on capital comes at a difficult time.

Alvarez & Marsal's capital efficiency framework can be extended to capital sourcing and the prioritization of infrastructure and technology investments.

A strategic process should be in place to identify and prioritize non-traditional capital sources. In this process we explore the potential to drive working capital efficiencies and opportunities to divest non-core or underperforming assets. Joint venture arrangements and bringing in minority interest partners are other avenues that can free up capital.

Sustainability-linked financing instruments along with expanded incentives under the Inflation Reduction Act can be leveraged to secure funding, reduce up-front costs and mitigate rate impacts of energy transition investments.

This capital sourcing assessment is incorporated into a broader capital availability and allocation strategy to fund infrastructure projects and accelerate the shift to a lower-OpEx model.

3. Grow Billing Determinants

Billing determinants represent customer demand, or throughput: the units over which revenue requirements are spread to arrive at a per unit rate.

The ability to impact billing determinants can play a significant role in addressing revenue shortfalls, managing consumer affordability concerns and accelerating the payback period for certain energy transition investments. A focus on billing determinants is another key element of the capital efficiency approach to investment decision-making.

Consumer adoption of electric vehicles (EV) is an example of a shift underway today that will have a meaningful and positive impact on future billing determinants.

Alvarez & Marsal works with participants up and down the EV value chain to unlock constraints, develop commercial business models and accelerate this shift. The broad objective is common across participants, but the approach remains very fragmented as entities pursue opportunities to establish competitive advantage in an emerging market.

Utilities are in a natural position to play a lead role in the acceleration of EV adoption. This role will include collaboration and facilitation across customers and providers, including OEMs, charging, storage and technology providers. Advanced rate designs and educating consumers on available incentives under local, state and federal programs are also in scope.

Developing a strategic approach to facilitate and accelerate residential charging along with a storage solution has the potential to increase throughput, levelize load and mitigate costly, and slow, distribution-level infrastructure upgrades.

This is an example of how the capital efficiency framework applies beyond OpEx, infrastructure and capital allocation to include an assessment of opportunities to impact demand and billing determinants in the most capital efficient manner.

4. Re-set the Narrative

Alvarez & Marsal's "Transform to Transition" approach can serve as a framework to re-set the strategic narrative.

Markets have taken notice of the challenges facing utilities. Year-to-date, U.S. utility indices have outperformed the broader market. The noticeable divergence occurred in February, in sync with the Ukranian conflict, indicating a flight-to-quality. More recently this relationship has reversed, with inflation, yield curve and consumer affordability concerns making headlines.

Without decisive action, this combination of revenue shortfalls and a widening funding gap will put pressure on dividend policy and equity valuations. These near-term headwinds will detract from the long-term growth story for utilities.

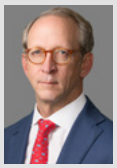
Alvarez & Marsal's "Transform to Transition" strategy and capital efficiency framework can be used to anchor strategic decision-making, align objectives and guide communications with internal and external stakeholders.

There is also a powerful opportunity for utilities to re-set the narrative around the "Transform to Transition" strategy in a manner that addresses near-term challenges and guides energy transition commitments and accelerates a path to renewed growth.

Some stakeholders question whether transition commitments will be achieved in a manner that fits within the constraints of consumer affordability, reliability, balance sheets and returns. Near-term headwinds will amplify these concerns.

The "Transform to Transition" vision and capital efficiency model provides an economic and strategic framework that brings the near-term and long-term narrative together. The same principles that guide strategy through the near-term headwinds should accelerate the path to energy transition, decarbonization and future growth opportunities.

Contacts:



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