

The electric utility sector has not previously experienced a viable disruptive threat to its service offering due to customer reliance and the solid economic value of its product. However, a combination of technological innovation, public/regulatory policy, and changes in consumer objectives and preferences has resulted in distributed generation and other DER being on a path to becoming a viable alternative to the electric utility model. While investors are eager to support innovation and economic progress, they do not support the use of subsidies to attack the financial viability of their invested capital. Utility investors may not be opposed to DER technologies, but, in order for utilities to maintain their access to capital, it is essential that the financial implications of DER technologies be addressed so that non-DER participants and investors are not left to pay for revenues lost (and costs unrecovered) from DER participants.

Finance 101 - Introduction to Corporate Finance

Investors allocate investment capital to achieve their financial objectives consistent with their tolerance for risk and time horizon. Fixed-income (i.e., bond) investors seek certainty as to (investment) returns through a guarantee by the debt issuer of timely payment of principal and interest. Equity investors seek a higher expected return than debt investors and, accordingly, must accept increased risk. “Expected” return refers to the distinction that equity investor returns are not guaranteed; therefore, equity investors bear a higher level of risk than bondholders. The expected return on equity investment is realized through a combination of dividends received and expected growth in value per share (which is achieved through a combination of growth in earnings and dividends and/or a rerating of return expectations as a result of investment market forces).

Corporate financial objectives focus on enhancing shareholder value through achieving long-term growth consistent with the preservation of the corporate entity. Corporations develop financial policies to support the access to capital to achieve their business plans. For utilities, these financial policies are consistent with investment-grade credit ratings. Since practically all utilities have an ongoing need for capital to fund their capital expenditure programs, the industry has developed financial policies intended to support the access to relatively low-cost capital in (practically) all market environments. Under traditional cost-of-service ratemaking, customers benefit through lower cost of service and, therefore, lower rates.

In order to retain the financial flexibility required to maintain investment-grade credit ratings, the rating agencies prefer policies that promote the retention of corporate cash flow and provide a liquidity cushion to support fixed obligations. Prudent corporate financial management disdains significant fixed commitments to investors—since such commitments limit management flexibility and increase capital-access dependency and risk. While paying dividends to equity investors is not a legal obligation, the rating agencies and investors view dividends as a moral (or intended) obligation that management will not reduce unless it has no viable alternative to preserve long-term corporate value. The corporate financial objective of retaining cash from operations to support credit quality limits the potential to pay dividends to investors. Thus, growth of investment value is required by equity investors (as discussed above) to achieve return expectations warranted by the increased risk taken and investment return expectations relative to fixed income investors.

It is important to highlight that the rating agencies’ rating criteria and associated target corporate credit metrics reflect the credit risk of the industry environment of the corporation being rated. Thus, due to the benefits of a stable regulatory environment, utilities are able to maintain (for a given rating category) significantly more debt relative to cash flow than competitive industries. However, if business risks were to increase for utilities in the future, as we will discuss in the next sections, it would be likely that utility debt leverage (i.e., debt relative to cash flow) would need to be reduced in order to retain credit ratings.