Why Duke Energy, other Southeast utilities may prove more vulnerable to Covid-19 downturn

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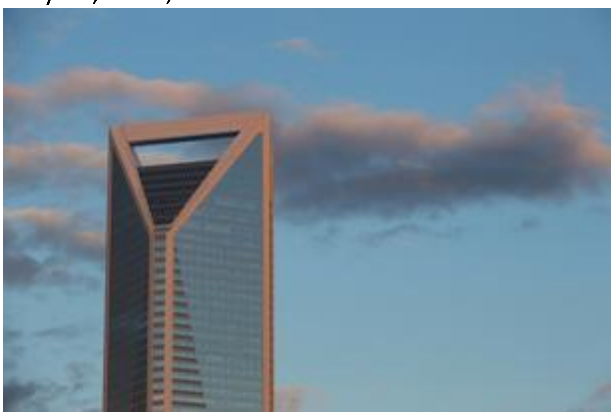

Melissa Key

As Duke Energy prepares to release its earnings this week, two analysts are warning that utilities may be too optimistic about the impact of the Covid-19 recession — and that Southeast utilities could be particularly hard hit.

Utility analysts Hugh Wynne and Eric Selmon warn utilities and investors not to underestimate the impact of the Covid-19 pandemic and the likelihood that the resulting recession will be longer than expected.

Traditional regulated utilities, like Charlotte-based Duke Energy Corp. (NYSE: DUK) and others in the Southeast and Midwest, are likely to face greater difficulties, says the pair that heads Sector & Sovereign Research's utility and renewables group. Much of their revenue comes from the large-scale commercial and industrial customers that are being hit hardest in the crisis. And that revenue is greater than in states for utilities with deregulated wholesale markets, where industrial and commercial reduction are more likely to hit merchant power producers.

And utilities currently in the midst of rate cases — as are Duke's two utilities in North Carolina — are likely to face a harder time getting the rates raised "because of the desire on the part of regulators to share the pain of the recession between shareholders and ratepayers," says Wynne.

The Northeast Energy and Commerce Association recently broadcast a virtual presentation from the pair to expand on a report they published for SSR in early April. That report looked at what impact a recession would likely have on utilities in the second quarter. For the NECA presentation, they attempted to look at what utilities should expect in the second half of the year.

And they said the utility outlooks appear to be too rosy.

“What we have seen utilities saying on their first-quarter calls so far is that they're all assuming that there is kind of a back to business and that by the summer, it's not back to normal, but mostly recovered,” said Selmon.

He notes that, as of April 30, “only one company that reported so far has changed their earnings guidance.” And he is concerned utilities “seem to be thinking that things will recover into the third quarter, so they are vulnerable.”

Recurring outbreaks?

Wynne notes that several Asian nations which were among the first to see the virus take hold and had “considerable initial success limiting the spread” are now experiencing renewed outbreaks as restrictions are eased.

The United States, he notes, has not had that kind of success in slowing the coronavirus spread. Community infections have been broadly reported in a nation with 4% of the world’s population but a third of the cases reported worldwide. That portends a serious return of Covid-19 when the flu season hits in the third and fourth quarters.

“And that would argue against what I would say is the consensus view of some v-shaped recovery, “ he says. “It would probably portend rather a slower return to normal characterized by alternating quarters of expanding and contracting GDP as lockdowns return when Covid recurs.”

The analysts said that a demand tracker for utilities showed those in the Southeast were already the hardest hit in the nation in April, with overall power demand down about 11%.

While increased residential usage is expected to offset much of the industrial drop at traditional utilities, they are still likely to take at least some hit from the economic downturn. And the longer that goes on, the bigger the hit will be.

Duke will report its first-quarter earnings on May 12, giving the first look at Covid-19's impact on that period — likely affecting just the last few weeks — and the first official word on its outlook for the impact in the future.

Neighbors report

Two of Duke’s Southeast neighbors — Dominion Energy Inc. (NYSE: D) and The Southern Co. (NYSE: SO) — have already weighed in on the first quarter and their outlook.

Dominion, which reported last week after Selmon and Wynne had their session, followed the pattern Selmon spoke of. Dominion acknowledges that the second quarter will be hit, but says that is likely to be the weakest quarter.

CFO James Chapman told analysts, “We are … affirming our annual guidance range of $4.25 to $4.60 per share.” And he said that incorporates the utility’s expectations for the rest of the year.

Dominion has an advantage in that its largest operation is in Virginia, a deregulated wholesale state. It has not been as hard hit by any commercial and industrial demand issues. But the same is not true for its South Carolina franchise, the former S.C. Electric & Gas.

And the situation there looks much more like Selmon and Wynne's view of the Southeast.

"From the time the executive (stay-at-home) order took effect on March 31, we've seen a noticeable decline in weather-normal demand as compared to the two-year historic average," Chapman told analysts. "Specifically, April's electric demand was off almost 10% on a relative basis."

"While we expect increases in residential demand, our South Carolina operations when compared to Virginia do not benefit from the same data center load stability and … are more exposed to industrial load."

Southern, which had reported when Selmon and Wynne spoke, did not cut its full-year guidance either, although CFO [Andrew Evans] noted that it traditionally does not revise full-year guidance until after the third quarter anyway.

Demand depressed longer

Southern beat analysts' earnings expectations in the first quarter and performed better than a year ago. But Evans said the second quarter is expected to see a big hit. Southern is forecasting adjusted earnings per share at 55 cents for this quarter, compared with 80 cents per share a year ago.

"It is fair to say that this quarter will have most — hopefully, the largest — COVID-19 impact of any quarter that we'll experience," he told analysts. "That's the hope and that's the expectation."

It remains to be seen if Duke will have a similar take on the impacts of the virus. But Selmon and Wynne think that, so far, utilities have been far too sanguine.

Selmon said that, even if customer companies are allowed to ramp up production later in the summer, there will be structural changes — such as the demand for social distancing — that are likely to reduce commercial and industrial output, thus continuing to hamper demand. And any recovery in the broader economy will depend on consumers being comfortable with going out and buying goods and workers feeling safe returning to work. That means it will take longer for demand to return to normal.

"I think one takeaway ... in the short to medium term is that we're probably going to have a relatively longer period of depressed commercial and industrial demand," Wynne said.

And he said that there are other impacts he thinks utilities are not taking sufficient account of.

"Generally when they talk about recessions, they say that their revenues are insulated from changes in demand because so many of the larger commercial and industrial customers have demand charges," which are minimums they must pay even if demand drops below that level, Selmon said.

He cautioned that, in most cases, those minimums are reset monthly. And if demand remains low for several months, those charges will provide increasingly less protection.

In North Carolina and a few other states, large commercial and industrial users have already petitioned utility regulators [to suspend those demand charges during the crisis](#).

'Revenues will be down'

Wynne says even without that complication, regulated utilities such as those in the Southeast "may face the most complicated panoply of challenges" among all utilities and independent power producers.

"Importantly, revenues will be down and cash flows will be down in 2020," he said. "And that's attributable to the stark decline that we saw in commercial and industrial sales which will last through the lockdowns and persist long after the benefit of higher residential demand has gone away."

It could take some time to recover those losses in future rate cases, he warned. And he said that companies currently in rate cases — as Duke Energy Carolinas and Duke Energy Progress are — face an additional problem.

He said regulators are likely to view returns on equity requested by utilities with more skepticism because those returns make up a large proportion of individual rate-hike requests.

And with demand low in the current crisis — and regulators concerned about burdens on customers who may face business closings and unemployment — rate hikes may prove more difficult to win.

"I think this possibility of lower and flatter load in the medium term is going to limit opportunities for investment in generation assets, high-voltage transmission assets on the bulk power grid," Wynne said. "And that's going to have implications for utility CapEx, for utility rate-base growth, and, as a result, for the regulated earnings growth of utilities — and, therefore, for their attractiveness as financial investments."

That could prove difficult for Duke, which is seeking in its current rate cases approval for significant spending on grid upgrades. And rate-hike opponents have already been calling for deep cuts to return on equity for its two utilities.

At the heart of the analysis by Wynne and Selmon is the belief that scenarios involving a short recession and a quick rebound are unlikely. But even within that basic argument, the analysis shows regulated utilities like Duke's could face particular issues that could make the hits they take deeper than other utilities and power producers.

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