

Utilities In The Cap And Trade Era

“You shall not crucify mankind upon a cross of carbon.” – Howard L. Simons, with apologies to William Jennings Bryan

You might think we have bigger things to worry about, such as the realization AIG was nothing more than a conduit for government transfers to other culpable financial institutions or that the Federal Reserve is engaging in what some harsh pundits might call a \$300 billion counterfeiting scheme, but no. Not when there is a planet to save.

Fetch me my cape and tights and start keeping score on the carbon emission credits, at least over the American sector of the global atmosphere. Superman was a favorite boyhood fantasy, but even I might hesitate to enlist his services in imposing cap and trade emissions control schemes on the U.S. economy at a time like this.

Let's examine the impact of all this on the cost of capital for the nation's utilities, giant businesses who produce more than 70% of the nations' electricity from fossil fuels. In brief, legislative and regulatory uncertainty has combined with the Treasury's crowding out of private borrowers to increase capital costs lower prospective returns for utilities.

Comparative Yield Curves

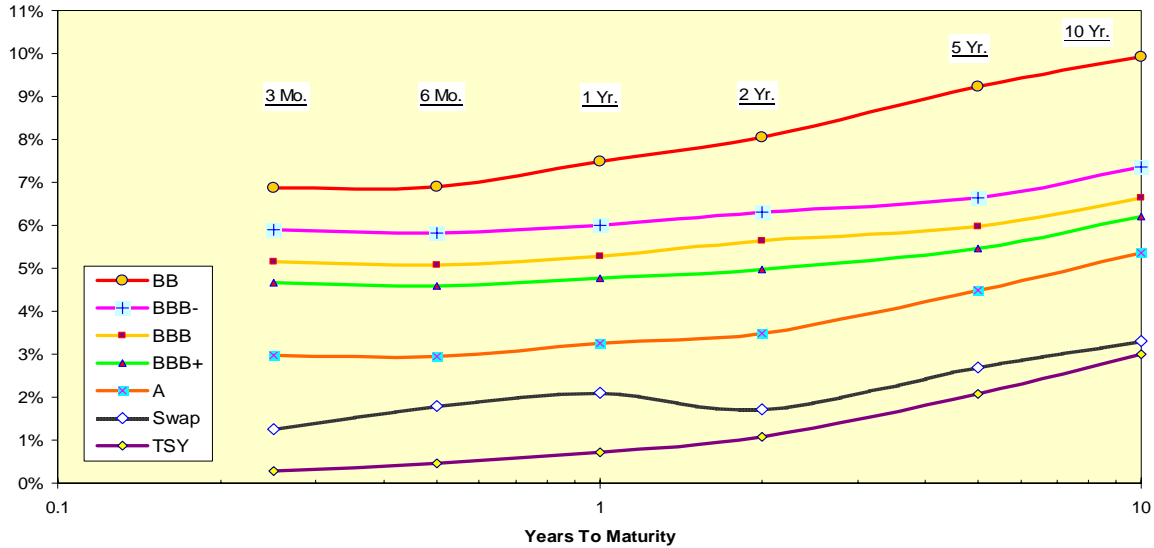
Too much attention is paid to the Treasury yield curve relative to yield curves for corporations, municipalities and even mortgage borrowers. The assumption is made widely if Treasury yields fall, then the cost of capital for all other borrowers must fall as well. As I pointed out [earlier this month](#), we have to look at the realized borrowing costs for corporations, the sum of the Treasury yield plus the option-adjusted spread (OAS) to see whether the cost of capital is rising or falling.

The OAS levels used in that analysis were for generic industrial borrowers. Let's focus below on the OAS levels and comparative yield curves for utility borrowers. We also will return to an analysis used first in [February 2006](#) to assess the perceived health of an industry, the comparative shape of its yield curve relative to the Treasury yield curve. The shapes will be compared by the difference in the forward rate ratios (FRR) of that industry between two and ten years; this is the rate at which we can lock in borrowing for eight years starting two years from now, divided by the ten-year rate itself.

The key date in the analysis is February 27, 2009. This is when the administration released its budget proposal, a document almost shocking in its hostility to American business. This included a proposal to fund much of its profligacy, a profligacy whose cost was raised by \$2.3 trillion over the next decade by the Congressional Budget Office, via revenues from the carbon cap and trade scheme. The effect of the cap and trade proposal is obvious in the charts below.

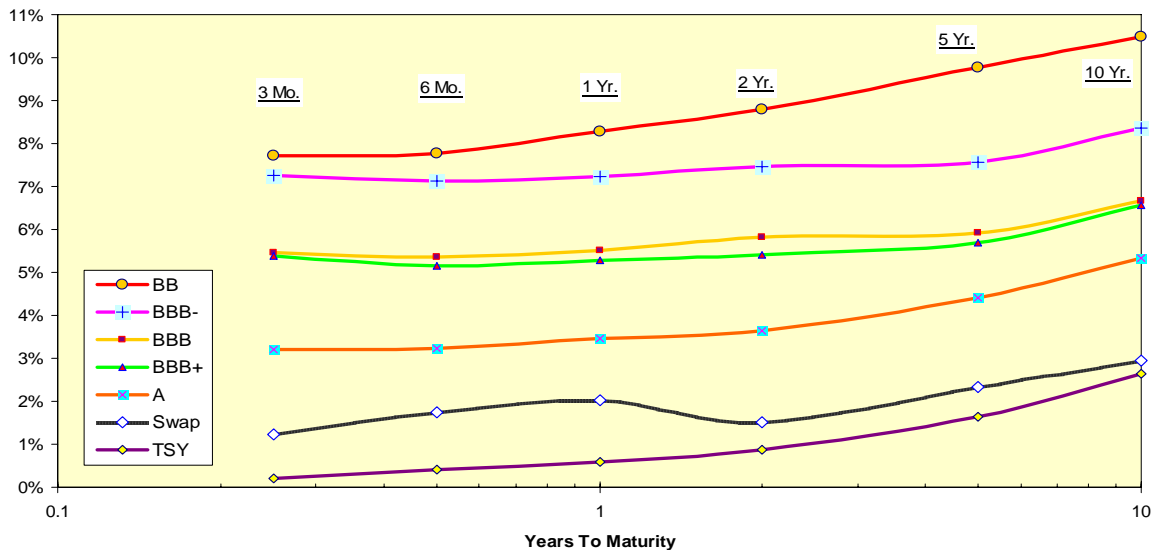
First, let's take a snapshot of the Treasury, swap and utility yield curves across a range of credit ratings from A to BB on February 26, the day before the announcement.

Comparative Yield Curves
February 26, 2009



Next, let's take a similar snapshot from last Friday.

Comparative Yield Curves
March 20, 2009



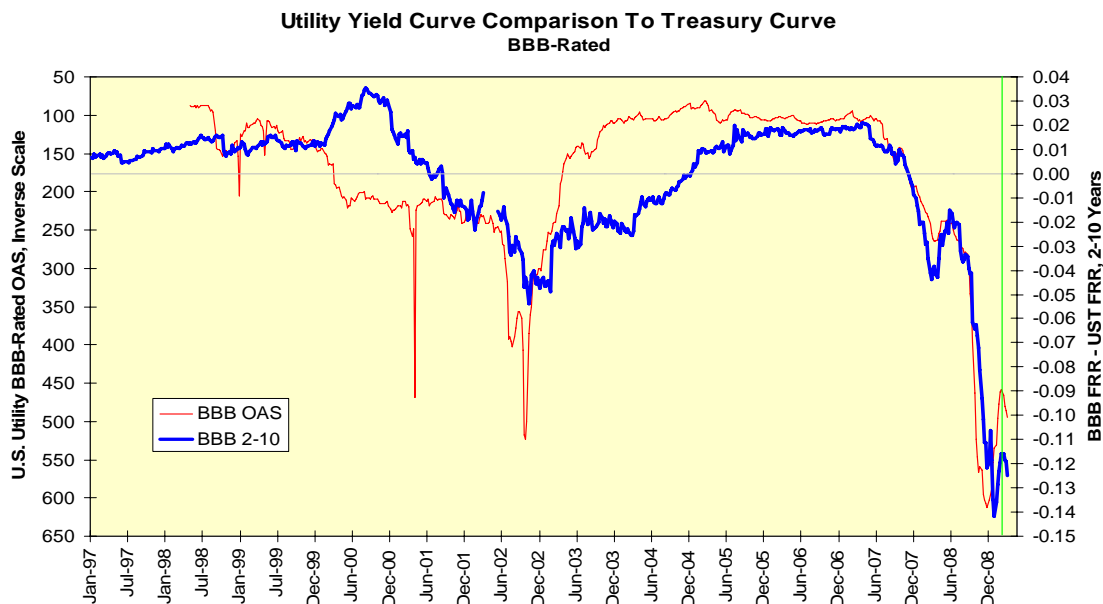
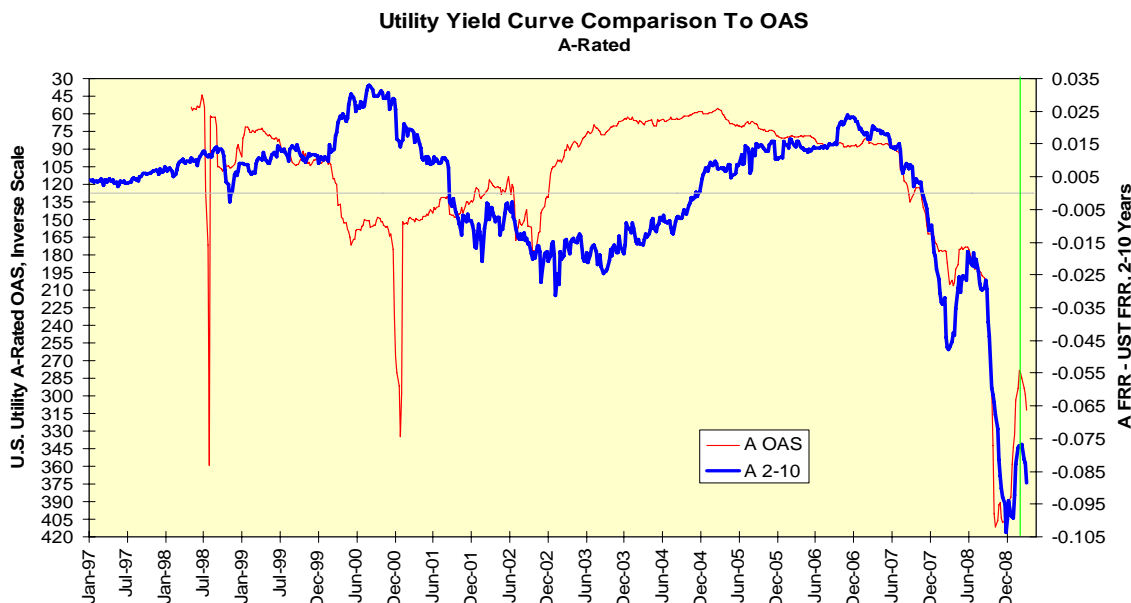
The absolute rate changes between February 26 and March 20, 2009 are presented in the table below. Yields fell across the yield curve for both the Treasury and swap curves. With minor exception, yields rose across the dimensions of both maturity and credit rating for the utilities. This is prima facie evidence of the Treasury crowding out private borrowers.

	TSY	Swap	A	BBB+	BBB	BBB-	BB
3 Months	-0.07%	-0.04%	0.23%	0.73%	0.30%	1.35%	0.87%
6 Months	-0.07%	-0.05%	0.27%	0.58%	0.30%	1.29%	0.87%
1 Year	-0.12%	-0.10%	0.21%	0.50%	0.24%	1.23%	0.81%
2 Years	-0.21%	-0.20%	0.15%	0.44%	0.17%	1.16%	0.74%
5 Years	-0.44%	-0.36%	-0.08%	0.23%	-0.06%	0.94%	0.53%
10 Years	-0.36%	-0.36%	-0.01%	0.35%	0.02%	1.01%	0.59%

Adding Credit Spreads

Now let's map the yield curve spreads and OAS levels for A- and BBB-rated utilities going back to 1997. The yield curves for the utilities started to flatten precipitously against the Treasury curve once the credit crisis got underway

in 2007. OAS levels, here plotted inversely, started to rise at the same time. In both instances, the peak of both OAS levels and relative yield curve stress peaked in mid-December. And in both cases, these stress levels were starting to abate only to have that process derailed and reversed by the budget announcement, marked here with a green vertical line.

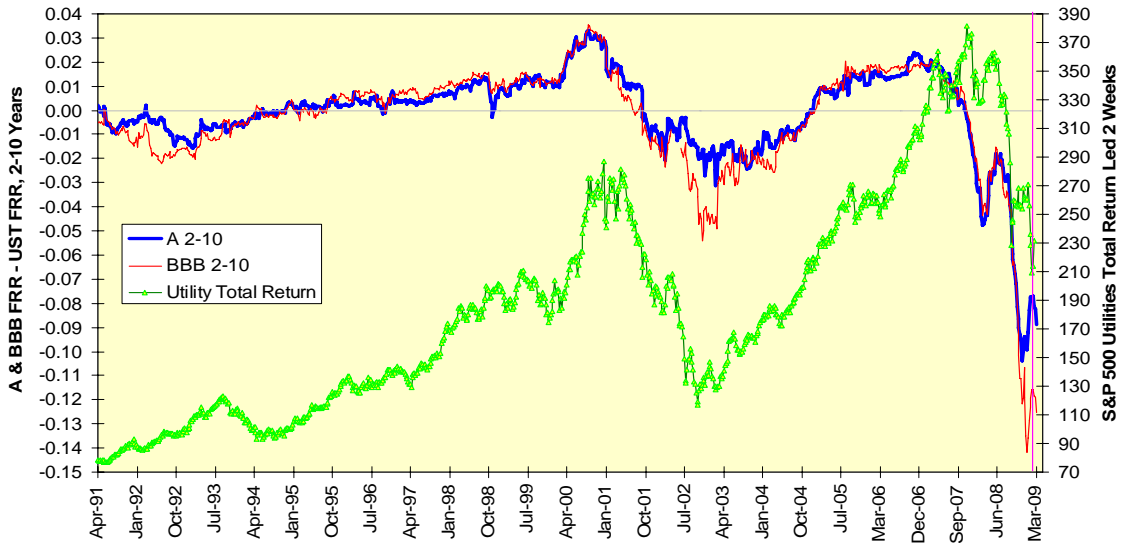


Impact On Utility Stocks

How does this esoteric analysis of comparative utility yield curves and credit spreads affect you as an investor? Utilities went from being an interest rate-sensitive regulated industry to an industry undergoing gradual deregulation in the mid-1990s. Then it turned into a highly leveraged and highly risky industry by the turn of the century as Enron, the so-called “[smartest guys in the room](#),” and other merchant energy traders rose and fell. By [April 2007](#), I could write on utilities as an economically sensitive cyclical industry.

Still it is instructive to note how the A and BBB yield curve spreads lead the total return of the S&P 500 Utility index by two weeks on average and how no utility rally over the past two decades has occurred whilst the utility FRR levels were flattening vis-à-vis the Treasury FRR levels. Moreover, once Enron’s troubles began in 2000, the rise and fall of the utility index’ total return matched its FRR spreads closely.

Utility Stocks And Comparative Yield Curves



The lesson seems too obvious, does it not? You and I have little choice if our government decides to impose a carbon cap and trade scheme upon us at an open-ended cost; it is not like we live in a democracy. But we do have a choice of whether or not we wish to invest in utilities. So long as the Treasury crowds out all other private borrowers, and that also looks open-ended, and so long as the costs of carbon emissions are internalized or threatened to be internalized to the utility sector, owning utilities will be a dubious proposition at best.