SPECTRUM
Asset Management

Key ESG Issues for U.S. Regulated Utilities

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Electric utilities are one of the leading sectors promoting the benefits of environmental, social, and governance (ESG) initiatives. Based on the industry's sound fundamentals, as well as Spectrum's sustainability-focused engagement, we believe utilities should be well positioned to manage ESG opportunities and challenges and lead the transition effort. Key topics include:

Customer Bill Pressure

Customer bill increases have been driven in part by higher energy prices, rising funding costs and inflation. As utilities continue to make record investments, social pressure is building as customers are charged higher rates. Macro headwinds may affect some otherwise constructive regulatory relationships. Nevertheless, significant tax benefits from the Inflation Reduction Act (IRA) should help utilities pay for major investments in clean energy infrastructure – such as renewables, battery storage and hydrogen. We see the IRA as credit positive for utilities as it should help to mitigate pressure on customer bills as a greater portion of capital expenditures are born by the government. Also, a greater composition of renewable energy sources lessens exposure to commodity price volatility from fossil fuels, such as natural gas.

Energy Transition Risks

The energy transition exposes firms to, for example, regulatory, legal, reputational and stranded asset risks associated with the shift to a low-carbon future. Many utilities have set specific interim targets to reach net-zero emissions by 2050. Emissions reduction targets could be achieved by retiring coal-fired generation, converting coal to less carbon emitting gas-fired generation, and investing in carbon-free renewable energy technologies. Furthermore, a greater emphasis on electrification, such as in home heating, industrial processes and transportation could create more demand for electric power. However, local gas distribution (LDC) utilities could face headwinds from electrification and may face political pressures in select jurisdictions. For example, New York City is among several cities planning to ban gas hookups in new building construction. We view such actions as something to monitor. However, most states remain supportive of LDCs.

Physical Climate Risks

Physical climate risks can damage utilities' assets and disrupt power delivery. Areas such as California, Florida and Texas have been prone to extreme weather like wildfires, hurricanes and floods, which could impact a utility's ability to provide affordable and reliable service. Grid modernization efforts should help utilities to prepare for disruptions and build resilience to guard against more frequent and destructive weather events. Failure to do so could lead to political and customer backlash.

ESG matters are not limited to the risks noted above, but also those tied to governance such as enhanced disclosure and oversight. The costs of the energy transition will likely be high, and utilities could face near-term regulatory and legislative challenges. However, Spectrum believes these ESG risks are manageable as utilities' interests are broadly supported at the state and local level, and by emerging federal government initiatives. The addition of ESG talent in senior management positions and on boards of directors helps to strengthen governance.

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