

Seeking Alpha α

Transmission Business Is An Important Growth Driver For Some Electric Utilities

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Disclosure: I am/we are long AEP, ITC, HIFR. (More...)

Summary

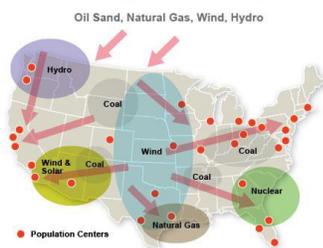
The spread between the lowest regional FERC-allowed ROE and the average state PUC-allowed ROE is shrinking, but still provides billions in added returns.

Transmission earnings will represent 41% to 49% of American Electric Power's EPS growth over the next three years.

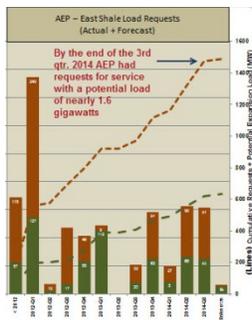
Transmission asset profiles should become an integral part of electric utility due diligence.

If you had to invest equity capital in a long lived asset and have its return regulated by the government, would you prefer to earn 9.73% annually or earn 10.74%, and possibly earn 11.74% if you were an independent company? This basic question is being asked in electric utility boardrooms around the country. The difference is the average 2nd quarter 2015 state-PUC approved return on equity ROE vs the Federal Energy Regulatory Agency's "new and improved" New England ISO allowed ROE for transmission investments.

Transmission investment is being driven by not only the need to upgrade aging infrastructure but to expand the delivery of new sources of power to population centers. The following map from American Electric Power (NYSE:[AEP](#)) AEP Transmission [website](#) outlines the current emphasis on moving electricity from its generating source to population centers.



In addition to replacing aging assets and demands from new power generation sources, there are shifts in regional end user requirements for electricity. For example, below is a chart of requests to AEP for new service in the Utica and Marcellus shale area. While some may think this is a flash in the pan from one-time drilling, the increased demand is driven by midstream operators of industrial-size natural gas processing plants, mainly in Ohio and West Virginia.



Last Oct, the FERC [reduced](#) the allowed ROE in the Northeast to a maximum of 10.74% plus an incentive of 100 basis points for independent companies. In addition to implementing a new rate structure, the FERC announced hearings to review the Midwest MISO rate structure with an eye of reducing those as well from its current 12.8% to something close to the revised New England structure. ITC Holdings (NYSE:[ITC](#)), the only FERC-regulated independent transmission company, currently earns between 12.1% and 13.8% on its regulated asset base.

While not seeming like a big deal, the difference between the average state-PUC 2nd qtr rate approvals and the reduced FERC rate is a minimum of 1.0% added ROE. The industry trade group, Edison Electric Institute [eei.org](#), [published](#) an in-depth report on various proposed transmission projects and the report identifies a total of 170 projects costing \$48 billion. While not completely inclusive of all ventures, the report identifies projects specific companies are willing to disclose. The report gives insight into the industry and which companies are moving ahead with higher transmission investments.

EI expects transmission investment in the range of \$19 to \$20 billion a year for the next several years. With an average 50% equity in these projects and an average 1% higher allowed ROE, the difference between state and fed allowed ROE could amount to an additional \$100 million a year industry-wide in additional profits from new transmission investments.

The table below outlines various utilities, their proposed budgets for new transmission projects, the number of miles of transmission lines they currently operate, and the amount invested in transmission assets over the past few years. The table is sorted by miles of transmission line. Not all utility companies revealed previous transmission capital expenditures and not all proposed projects will be approved, funded, and built, but the list allows utility investors to compare transmission proposals of their holdings and potential investments targets.

Company	Ticker	2004 - 2013		Proposed	Miles of
		Transmission Investment	CapEx		
		Bill \$	Bill \$	Bill \$	
Am Electric Pwr	AEP	\$ 4.80	\$ 2.60		40,000
Duke	DUK	\$ 4.50	\$ 0.12		32,000
Southern Co	SO	\$ 4.10	\$ 1.40		27,000
Berkshire Hathaway Energy		\$ 3.40	\$ 2.00		24,000
FirstEnergy	FE	\$ -	\$ 4.20		24,000
Xcel Energy	XEL	\$ 1.00	\$ 4.50		19,000
Pacific Gas and Electric	PCG	\$ -	\$ 0.20		18,100
Oncor		\$ -	\$ 1.40		16,000
Entergy	ETR	\$ -	\$ 1.40		15,400
ITC Holdings	ITC	\$ 4.20	\$ 2.20		15,400
Public Service NM	PNM	\$ -	\$ -		14,000
Southern Cal Edison	EX	\$ 4.60	\$ 2.00		12,000
Am Transmission		\$ 3.10	\$ 1.80		9,530
National Grid	NGG	\$ 2.60	\$ 1.80		8,900
Ameren	AEE	\$ 1.05	\$ 1.07		7,500
Iberdrola USA	IBDRY	\$ -	\$ 1.40		7,200
PPL	PPL	\$ 1.90	\$ 4.00		6,800
Exelon	EXC	\$ -	\$ 0.70		6,290
Other Tail	OTTR	\$ 0.10	\$ 0.50		5,300
Eversource	ES	\$ 4.90	\$ 3.90		4,720
Westar	WR	\$ 1.00	\$ 0.70		4,390
Centerpoint	CNP	\$ 0.90	\$ 0.30		3,750
Peppco	PEP	\$ -	\$ 0.60		3,700
SCANA	SCG	\$ -	\$ 0.30		3,650
Arizona Public Service	PNW	\$ 1.20	\$ 1.20		2,933
Con Edison	ED	\$ 2.00	\$ 0.60		1,700
PSG	PSG	\$ 4.70	\$ 4.00		1,700
Duke-American JV		\$ -	\$ 2.60		825

Source: EEI, Guiding Mast Investments

Of the 29 companies listed, the top ten firms operate 69% of the transmission lines reported and will comprise about half the proposed capital expenditures. PPL (NYSE:[PPL](#)), PSEG (NYSE:[PEG](#)), and Eversource (NYSE:[ES](#)) are expanding dramatically in their transmission footprint but are not in the top ten above.

AEP is not only the largest operator of transmission lines, they also own more extra-high voltage transmission lines, or 765 kilovolt, than all other electric utilities combined. A bit more comprehensive than the chart above, AEP outlined its transmission investment profile in its latest investor's presentation [pdf](#). From 2013 to 2017, AEP expects to invest \$14.6 billion in transmission investments, or a third of its overall cap ex budget of \$44.0 billion.

Transmission earnings are becoming an important part of the AEP story, and will be duplicated by other electric utilities as well. The chart below is also from AEP's latest presentation and shows the growth per share of transmission earnings. EPS from the transmission segment is expected to grow from \$0.07 out of \$2.60 AEP earned in 2012 to between \$0.67 and \$0.81 out of an estimated \$4.08 in 2018. Earnings attributed to AEP's transmission business represented 2.6% of EPS in 2012 and is expected to represent between 17% and 20% of EPS in 2018. More importantly, the transmission business will generate 41% to 49% of total earnings growth over the same timeframe.



(click to enlarge)

There is a potential change brewing in the transmission sector. The IRS has approved including these assets in a REIT structure, and offers an interesting potential for some companies. Hunt Consolidated recently spun off their Texas transmission assets into the first publicly traded transmission REIT, InfraREIT Inc. (NYSE:[HIFR](#)). The other interesting news is the Hunt brothers' offer to purchase Oncor, the transmission segment of bankrupt Future Energy Holdings Company, formerly known as TXU Corp. The purchase is being reviewed by the courts and the PUC of Texas, and FEHC is [suing](#) shareholders to force approval of the deal. If approved, it is anticipated Oncor will eventually become a REIT and a merger candidate with HIFR. These two events are being watched closely by the industry as they could be a glimpse into the future for transmission assets. Investors should note both Oncor and InfraREIT are state regulated. More information on HIFR can be found in a previous SA [article](#) from last March.

Regardless of being a REIT or a standalone company or part of a much larger utility, there are profitable advantages for electric utilities to step up their investments in transmission assets. Investors should take notice and evaluating a specific utility's transmission profile should become a routine part of due diligence activity.

Author's Note: Please review disclosure in Author's profile.

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