The impact of an uncertain economic outlook on electric utilities

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An important disclaimer

“The future, though imminent, is obscure.”
Winston Churchill
## Countervailing forces occlude the economic outlook

<table>
<thead>
<tr>
<th>Positive forces</th>
<th>Negative forces</th>
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<tbody>
<tr>
<td>5% growth in gross domestic product (GDP)</td>
<td>Slow productivity growth</td>
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<tr>
<td>5.6% unemployment rate</td>
<td>Shrinking employment-to-population ratio</td>
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<td>Rising consumer confidence</td>
<td>Weak wage growth</td>
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<tr>
<td>Strong dollar</td>
<td>Pervasive inequalities</td>
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<tr>
<td>Falling oil prices</td>
<td>Weak global economy</td>
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</tbody>
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Real GDP increased by 5% in 2014 Q3
Unemployment fell to 5.6%

Unemployment rate (seasonally adjusted)

Note: Cross-hatched area represents recession.

Source: U.S. Bureau of Labor Statistics
Consumer sentiment has been rising

Source: Surveys of Consumers, University of Michigan
But actual GDP remains below potential GDP, raising concerns about “secular stagnation”
Prominent economists stand on both sides of the stagnation debate

Harvard’s Summers and Mankiw Square Off in Debate Over Stagnation

By Rich Miller - Jan 5, 2015
The investment rate is not at its pre-recession levels, but some predict it will get there soon.

Source: International Monetary Fund (IMF)
Labor productivity growth is tepid

Source: Bureau of Labor Statistics
The employment-to-population ratio is shrinking
Income inequality is pronounced

Income Share by Income Group

Source: Board of Governors of the Federal Reserve System, Survey of Consumer Finances
Income in the bottom 50% continues to stagnate
Oil prices plunged by 50% in the last six months – that is a mixed blessing

Source: Nasdaq
In the sweep of history, this should not come as a surprise

Source: U.S. Energy Information Administration
Normal electricity sales growth has not resumed five years after the Great Recession

- According to Dr. John Caldwell of the Edison Electric Institute, normal growth usually resumes within five months after the recession ends; the longest it has ever taken has been twelve months

- The EIA's January 2015 Short-Term Energy Outlook (STEO) estimates that electricity retail sales grew by 1.3% in 2014 (based on actuals through October) and projects 0.8% growth in 2015
  - The corresponding numbers for the residential sector are 1.7% and 0.2%
Declining sales growth has been the norm since 1950

Source: EIA, 2012 Annual Energy Outlook
Electric use per capita is projected to decline

**U.S. Residential Per-Capita Electricity Consumption**

- **Historical**: Average Annual Growth (1994 - 2012) = +0.9%
- **EIA Forecast**: Average Annual Growth (2012 - 2024) = -0.3%

Source: EIA, 2012 Annual Energy Outlook
Besides the belt-tightening due to the recession, three new forces are shaping the future of sales growth

- First, consumer psychology has shifted as a new generation of consumers has arrived with new values and norms
  - Some call it “organic conservation”

- Second, utilities are stepping up their spending on energy efficiency programs
  - This is often prompted by new legislation

- Third, state and federal governments are continuing to push ahead with aggressive enhancements to codes and standards
Organic conservation plays a large role in residential lighting efficiency improvement

- OC is the difference between the AEO forecast and NSP’s projected impact of codes and standards and DSM programs.
- Including the impact of free-ridership, organic conservation will account for roughly 65% of the total efficiency improvement between 2012 and 2015.
Several states have passed laws either requiring or promoting energy efficiency

Source: American Council for an Energy-Efficient Economy.
Impact of Codes and Standards on U.S. Electricity Consumption

Source: Institute for Electric Efficiency (December 2009)
Two new forces loom on the horizon

- **Distributed generation**
  - Rooftop solar generation
  - Wind generation
  - Combined heat and power

- **Fuel switching toward natural gas**
  - Triggered by the fall in oil and gas prices due to fracking and the subsequent price war with Middle Eastern oil exporters
The audience at a major electricity conference was surveyed through a live poll to opine on the outlook for sales growth.
Conference participants in a live poll identified the following sources of the slowdown in sales:

- The economy: 56% in the Opening Poll, 53% in the Lunch Poll, 55% in the Closing Poll.
- Shifting demographic trends: 3% in the Opening Poll, 7% in the Lunch Poll, 4% in the Closing Poll.
- Behaviors changes in end-users relating to energy: 5% in the Opening Poll, 10% in the Lunch Poll, 8% in the Closing Poll.
- Adoption of energy efficient technologies: 22% in the Opening Poll, 19% in the Lunch Poll, 25% in the Closing Poll.
- State and national energy policies: 10% in the Opening Poll, 8% in the Lunch Poll, 6% in the Closing Poll.
- Electricity prices: 2% in the Opening Poll, 0% in the Lunch Poll, 0% in the Closing Poll.
- Something else: 2% in the Opening Poll, 3% in the Lunch Poll, 2% in the Closing Poll.
The long term outlook for electric sales

- Growth is likely to be <1% per year, about half of the 2% rate that was observed prior to the recession and significantly lower than the 7% a year growth rate that was the norm prior to the first oil shock of 1974.

- In some parts of the country, electricity sales growth may be higher while in other parts of the country it may be lower.

- In countries such as Australia and Germany, negative growth rates are being observed.
Electric utilities need to rethink their strategy

- Stay the course
  - Assume that the slowdown will go away

- Push electrification
  - Hope that heat pumps, electric cars and electric storage will be adopted by customers rapidly

- Becomes a wires company
  - Focus on the transmission and distribution business

- Become an energy services company
  - Begin selling heating, cooling and lighting rather than kilowatt-hours
And regardless of which strategy they pick, they need to reinvent their tactical toolkit

- **Upgrade rate design**
  - Align rates with the principal of cost causation by introducing demand charges, raising fixed charges and time-varying volumetric charges

- **Repurpose load and market research**
  - Gain insights into changing customer preferences and behavior

- **Refocus sales forecasting**
  - Capture the effects of new technologies, impact of utility programs and governmental codes and standards
Conclusions

- While some indicators suggest that the economy has finally pulled out of the Great Recession, doubts remain about the longevity and robustness of the recovery because of concerns about secular stagnation.

- The weak economic recovery has caused electricity growth to slow down; even if the economy recovers, electricity growth will stay under one percent due to a number of factors:
  - Organic conservation
  - Utility energy efficiency programs
  - Governmental codes and standards

- At a time of sub one-percent sales growth, electric utilities will have to redefine their corporate strategy and reinvent their business tactics.
Dr. Ahmad Faruqui is a Principal with The Brattle Group whose practice is focused on understanding and managing the needs of energy consumers. It encompasses demand forecasting, rate design, energy efficiency, demand response, and cost-benefit analysis of new end-use technologies. He has worked for more than three dozen utilities around the globe and testified before a dozen state and provincial commissions and legislative bodies. His work has been cited in *The Economist*, *The New York Times*, *The Washington Post* and *USA Today*. He has appeared on Fox Business News and National Public Radio. The author, co-author or editor of four books and more than 150 articles, he holds a Ph.D. in economics from The University of California at Davis and B.A. and M.A. degrees in economics from The University of Karachi, Pakistan.

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References


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