

# Impact of the Financial Crisis on Technology Spending in the Utility Industry

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**PERSPECTIVE**

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## IN THIS PERSPECTIVE

This Energy Insights Perspective analyzes the current impact of the global financial crisis on the U.S. utilities industry, especially as it relates to technology spending, and provides predictions of how technology spending is likely to be impacted in both the short term (3–6 months) and the long term (1–2 years). Technology spending includes information technology as well as renewable and distributed energy technologies.

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### The Merchant Segment

The financial crisis that originated in the United States and is now a global phenomenon has certainly dealt a major blow to the financial services industry. Initially, most utility industry insiders believed that utility companies would weather the storm without much adverse impact. However, with the surprise announcement on September 18th that Constellation Energy Group would be acquired by Warren Buffet's MidAmerican Energy Holdings for \$4.7 billion, the confidence began to erode. Constellation's stock had plunged 60% over the preceding three days on fears about the company's exposure to bankrupt Lehman Brothers and its overall liquidity situation. Two weeks later, Reliant Energy, after its stock nose-dived on news that it was losing a credit arrangement with Merrill Lynch and was raising \$1 billion in new, more expensive capital, announced that it had formed a special committee to review strategic alternatives. This could mean that Reliant already has an acquisition offer in hand — only time will tell. For these companies and other players in the merchant segment of the industry that are at risk of being acquired, technology spending will be determined by the integration and consolidation plans between the former company and its new owner. Most likely, we will see a slowdown in IT spending as these companies rationalize business processes and IT systems. Energy technology spending on projects already initiated is less likely to be impacted.

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## **The Rest of the Industry**

Despite the media attention on Constellation and Reliant, the merchant segment contains a relatively small number of companies relative to the overall market. The majority of U.S. investor-owned utilities are still vertically integrated and are dominated by their regulated operations. These companies have little or no credit risk from trading activities and are unlikely to fall victim to the problems that beset Constellation and Reliant. We believe the financial crisis will impact these companies in the ways described in the sections that follow.

### ***Short Term (3–6 Months)***

Most of the utility CIOs that we spoke with over the past week have been told to conserve cash by freezing or slowing down all external spending for the next 3–6 months, primarily due to the tight commercial paper market, which makes short-term cash difficult and costly to raise. This will have the greatest impact on utilities with less cash on their balance sheets, but even utilities with a strong cash position may choose to reign in technology spending to preserve their cash positions or to use cash for other purposes. In at least one documented case, the cuts in the IT organization will include layoffs of existing staff. Overall, we expect IT spending to decrease dramatically until the commercial paper market recovers. Spending on existing energy technology projects may slow down but, due to the nature of the projects, is less likely to be frozen.

### ***Long Term (1–2 Years)***

Although utilities have traditionally been able to raise long-term capital at favorable rates, the credit crisis will probably make the cost of capital more expensive, even for utilities with good credit ratings. At the same time, regulators are becoming increasingly reticent to approve large capital expenditures given the already existing risks associated with the rising costs of labor and materials, the uncertainty surrounding the cost of carbon in an almost inevitable mandatory carbon cap-and-trade program in the United States (at least for fossil fuel plants), and the unknown impact of a recession on-demand growth. This means that utilities will likely delay raising capital to build new large power plants and transmission lines, which can cost billions of dollars.

Despite this expected slowdown in spending for large capital projects, energy demand will continue to grow (albeit at a slower rate) and regulators will continue to enforce renewable energy, CO<sub>2</sub> reduction, and energy efficiency goals. This situation alone will make distributed energy, demand response, and energy efficiency technology investments more attractive. Enter the Emergency Economic Stabilization Act of 2008 (aka the financial "bailout package"), passed by Congress and signed into law by President Bush on October 3rd. In

an effort to make the legislation more palatable to Congress, a number of energy provisions were tagged on, including:

- One-year extension of the production tax credit (PTC) for wind (through 2009)
- Two-year extension of the PTC for other renewables (e.g., biomass, geothermal) that already qualified for the PTC (through 2010)
- A new PTC for marine and hydrokinetic renewable energy (through 2011)
- Eight-year extension of the 30% investment tax credit (ITC) for solar energy and fuel cells (through 2016)
- A new 30% ITC for small wind (defined as those turbines with a nameplate capacity not greater than 100kW) with a cap of \$4,000
- A change in the depreciation rate for smart meters and smart grid technologies from the current 20-year period to a 10-year period

Given the rising cost of capital for new power plants and transmission projects and the regulatory uncertainty surrounding approval of these projects; continued regulatory pressure to meet renewable energy, CO<sub>2</sub> reduction, and energy efficiency goals; and the incentives contained in the Emergency Economic Stabilization Act of 2008, we believe that spending on renewable energy, distributed energy, smart metering, and smart grid and related technologies will increase over the next 1–2 years.

## **LEARN MORE**

- *Renewable Energy Update: October 6, 2008* (Energy Insights #EI214545, October 2008)
- *Distributed Energy Update: September 26, 2008* (Energy Insights #EI214443, September 2008)

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