Stock story: Xcel Energy

A US electricity and gas utility leading the drive against climate change (and other challenges).

George Floyd was choked to death under the knee of a US policeman in south Minneapolis in May last year. A few kilometres away from the murder site is the headquarters of Xcel Energy, an electricity and natural gas company that operates across eight mid-western US states.

Xcel Energy Chairman and CEO Ben Fowke, calling Floyd's death and the uproar that followed "an awakening", used his appointment around that time as chairman of the industry trade association, the Edison Electric Institute, to add racial inequality to the industry's agenda. Across the sector, 57 CEOs committed to address racial unfairness in their companies and communities. For its part, Xcel Energy added diversity, equity and inclusion metrics to management compensation.

The utility that earned US$11.5 billion in revenue from servicing 3.7 million electricity and 2.1 million gas customers who mainly reside in Colorado and Minnesota seems to like setting worthwhile goals. When it comes to its core operations, Xcel Energy is leading the transition towards clean energy.

Xcel Energy, which traces its origins to 1904, has declared it will provide 100% carbon-free electricity by 2050, making it the first large US utility to declare such an intention. While that might seem so far off as to be meaningless, by the end of 2020 about 47% of the energy Xcel Energy produced already came from carbon-free sources.

Such progress means Xcel Energy has reduced carbon emissions by 51% since 2005 and the company intends that percentage to reach 80% by 2030. To get there, Xcel Energy will retire its coal-fired plants, preserve its nuclear assets, maintain natural gas as a backup and build large renewable projects. As the company operates in a windy part of the US (the other six states are New Mexico, North Dakota, Michigan, South Dakota, Texas, and Wisconsin), the renewable focus is wind farms.

What's in these worthwhile pursuits for investors? The answer is that, while the goal to achieve racial equality is altruistic, the climate goals are driven by financial self-interest that aligns with society's desire to mitigate global warming.

To understand how this financial self-interest operates it's necessary to understand the regulatory environment that governs utilities such as Xcel Energy. The quid pro quo under the regulatory regime is that utilities are granted the monopoly right to provide their services to a defined territory in exchange for having the return on capital spending capped. The easiest way, therefore, for a utility to increase earnings is to spend more on capital works, so long as they ensure that prices stay affordable for customers. Basically, Xcel Energy is a promising investment because regulators approve capital spending that alleviates any damage from climate change.

Xcel Energy spending plans can be split into two categories, where its investments in renewable technologies is one. The company is pivoting to wind farms because the cost of electricity generated by these assets has declined by almost 70% on average over the past decade. Because the wind is free, the company is well placed to grow shareholder returns without increasing bills for customers as it spends more than US$3.6 billion building wind farms over the next five years.

The other category is unrelated to climate change but is vital for Xcel Energy to provide its essential services. The company needs to replace ageing transmission and distribution infrastructure, especially power lines, to ensure the electrical grid functions properly. Nearly 25% of the company's 32,000 kilometres of transmission lines have exceeded their useful lives and close to another 20% will need replacing over the next decade. Xcel Energy is likely to spend more than US$10 billion over the next 15 years on new lines.

The company's approved capital spending over the coming decade means that investors can be confident the utility will achieve its long-term earnings growth objective of 5% to 7%, as it has in recent years while keeping customer bills low. If all goes to plan, Xcel Energy will offer a prime example of the predictable and steady earnings growth that infrastructure and utilities stocks can offer as an investment option.

To be sure, Xcel Energy faces challenges. Solar energy and more powerful batteries could reduce the demand for its electricity. But there's little sign that many of the utility's electricity customers are disconnecting from the grid. Another risk is that regulators could always reduce its authorised returns or exclude some capital spending from their sanction. Luckily for Xcel Energy, its regulators seem onside with its drive to cleaner energy. The advanced age of Xcel Energy's network increases the risk of accidents, especially explosions from gas leaks. All the spending on modernising Xcel Energy's assets will diffuse this risk over time. Chances are Xcel Energy will stay a good investment while doing good.

Sources: Company website, 2020 annual report.

info@magellangroup.com.au +61 2 9235 4888