Stock story: Alliant Energy

Powering the US Midwest in a greener way.

A US utility that has provided power since the 1920s will likely have some coal-fired generation in its energy mix. However, decarbonisation goals and falling costs of alternative, clean energy sources, such as wind and solar, are driving a shift away from coal-fired power.

Alliant Energy, a near-century-old utility that provides power to nearly one million electricity and 420,000 gas customers in Iowa and Wisconsin, foresaw the demise of coal-fired generation more than a decade ago. Alliant realised that to satisfy climate change goals, it needed to eliminate coal as a source of power.

The utility that earned revenue of US$3.4 billion in 2020 (85% from electricity and the remainder mainly from gas) set up 'Clean Energy Blueprints' to green its services in the two Midwest states where it operates. The blueprint for Iowa is about building state-of-the-art wind and solar energy capabilities to replace two coal-based facilities. For Wisconsin, the blueprint entails retiring two large coal-fired plants with solar-based assets that will provide clean energy to over 175,000 Wisconsin homes.

Alliant Energy is on track to hit its targeted 50% reduction in carbon emissions by 2030 (on 2005 levels), having achieved a 42% reduction in 2020. Alliant's success to date in reducing emissions seems to have accelerated its ambition to go green faster. Through industry-leading efforts in wind expansion, coupled with plans to add new solar and battery storage, the utility expects that by 2025, half its resource mix will be renewable.

Alliant Energy says it intends to eliminate all coal generation by 2040 but may achieve this feat earlier. Achieving this would help the company meet its aspirational goal of net-zero carbon emissions from the energy it generates by 2050.

Replacing coal-fired generation with cleaner power assets requires capital investment. Alliant Energy is expected to spend US$5.9 billion from 2021 to 2024 and another US$7 billion to US$9 billion in the following five years on going green. Investors may normally be wary of a company that needs to invest vast amounts to upgrade its production facilities to meet modern requirements. To understand why Alliant Energy's spending builds a case for investing in the utility, it helps to understand how utilities are regulated.

The distinguishing aspect of utilities is that they are monopolies in their immediate surroundings because most of their customers have no choice but to buy the essential service they need from the local provider. These utility monopolies operate under the 'regulatory compact'. This means the utility is responsible for serving a particular territory under regulated terms. The utility is required to invest significant amounts of capital to ensure effective, efficient and reliable service to its customers. In return, the utility has the right to recover its costs and earn a fair rate of return on the capital invested. The regulator defines which costs can be recovered, which assets can be included in the utility's "rate base" (on which it earns a return) and what the fair rate of return on these assets will be.

Capital expenditure is the key driver of rate base growth and hence earnings for US regulated utilities. Therefore, utilities generally seek to maximise capital expenditure. While the regulator encourages this investment to maintain and improve customer service, it also aims to mitigate excessive bill inflation by limiting such investment to prudent spending.

Alliant Energy operates in favourable regulatory jurisdictions where regulators support investment in renewable energy. The company expects to grow its rate base (on which it can earn regulator-approved returns) from about US$11 billion in 2020 to about US$14 billion in 2024. About 20% of Alliant Energy's rate base is renewable generation, a percentage that is expected to increase to 24% by 2024.

Another attractive feature of Alliant Energy is that it's a well-run company – witness the effort when the winds of a derecho slammed the US Midwest in August 2020. The largest storm in the company's history left more than 250,000 of its customers without power. Alliant Energy employees, alongside more than 2,000 line and tree-trimming crews from across the US and Canada, in just over a week replaced 3,000 power poles – the equivalent of 10 months of work – to restore power to its customers.

For investors, Alliant has delivered 5% to 7% underlying earnings-per-share growth over the past decade. The utility's green journey has the potential to deliver similar returns in coming years. Alliant Energy is thus a good fit for the infrastructure strategy that seeks to invest in stocks that provide regular income with the potential for some capital growth.

The key risk, inherent in all regulated utilities, is a deterioration in the regulatory environment that leads to lower allowed

returns. However, Alliant Energy has a constructive relationship with its regulators and its decarbonisation plans are viewed favourably. An acceleration of electrification in home heating could pose a threat to Alliant's gas distribution network. However, Iowa and Wisconsin experience freezing winters when natural gas heating is still preferred. While alternative electric heating technology will likely improve over time, natural gas appears well supported for some time. In any case, this risk is limited for Alliant given gas distribution represents under 10% of its rate base. Furthermore, Alliant has received favourable regulatory treatment when retiring coal plants in the past, so this precedent bodes well in the potential situation of forced retirement of gas distribution (or gas-fired generation) assets in the future.

Higher interest rates would add to the cost of Alliant Energy's investment in renewables. All utilities come with the execution risk of how they manage the bills of their customers while they recover the costs of their investments. Cyber attacks are also a risk for utilities but any impact should be short term in nature. Even allowing for these risks, the future is bright for a company that is going green as it approaches its second century.

Sources: Company website, annual report, Bloomberg, Dunn & Bradstreet.

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