Power Surge? AI's Influence on Utility Markets

AI's burgeoning demand for power has ignited enthusiasm for the utilities sector, as investors anticipate a proliferation of electricity-hungry data centers. Data centers compete with other electricity consumers such as green buildings, electric vehicles, crypto mining, and surges in demand from volatile climate conditions. The utilities sector is currently outperforming all other sectors in the MSCI ACWI Index this quarter, having returned 6.8%[1].

Steve Nguyen
Fundamental Portfolio Manager
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"Everyone is looking for the next quick play on AI and data centers, but the fundamental impact on most utilities is more nuanced," says portfolio manager Steve Nguyen, who heads Causeway's utilities and renewables fundamental research.

We asked Steve to outline the AI opportunities for US and European utilities for our clients.

[1] from March 31, 2024-June 10, 2024. Source: FactSet

Key Beneficiaries: US Independent Power Producers (IPPs)

The most notable beneficiaries of the increased electricity demand are the US independent power producers (IPPs) such as Vistra, Constellation Energy, and NRG. These are merchant utilities, meaning they sell power into deregulated or competitive electricity markets. These companies have seen their share prices double or triple over the past year for the following reasons:

1. **Higher Power Prices:** Because they sell into deregulated markets, merchant utilities are highly sensitive to power prices. Both spot and forward power prices in the US have risen, as have contract prices for data center Power Purchase Agreements (PPAs). Since merchant power sales are a large portion of total profits, small changes in power prices have significant impacts on total company cash flows.
2. **Valuation Multiples:** Traditionally, IPPs have traded at significant valuation discounts to other utilities, given their gas and power price sensitivity and limited growth opportunities. Lower valuations provided more room for their multiples to expand to reflect bullishness on the AI/data center theme, while still appearing inexpensive versus broad market multiples.

Regulated US Utilities: Incremental, Not Transformative

For regulated US utilities, the benefits of increased electricity demand from AI data centers are likely to be more modest.

Regulated Rate Base Growth
Regulated utilities are permitted to earn a specified return on their rate base, or the value of their assets. All else equal, increased electricity demand from AI data centers generally require power generation and network infrastructure investments, driving incremental rate base growth and, consequently, higher revenues.

Growth Limitations: Customer Rates and Funding Capacity
Regulated utilities' growth rates are generally constrained by the rate increases they can pass along to customers and their ability to secure funding for investments and expansion projects. For these reasons, we do not expect significant increases in earnings-per-share growth rates across the US utility sector from data center demand.

Multiple Expansion Potential
Increased electricity demand, or load growth, increases the utilization of existing power infrastructure, allowing fixed costs to be distributed across a larger customer base for improved per-customer affordability. A more favorable affordability landscape reduces risks associated with future investments and growth, which, in combination with historically low multiples for US regulated utilities, sets the stage for earnings multiple expansion.

European Utilities: Underappreciated Beneficiaries

In Europe, enthusiasm for AI's impact on utilities has been more subdued. Furthermore, the share prices of European utilities have been under pressure due to rising yields this year and a decline in power prices from previously high levels. This contrasts with the US, where power prices have been rising from lower starting points. We think the market is underappreciating multiple ways that European utilities may benefit from AI demand for electricity. The Causeway Global Value strategy currently has positions in Enel and RWE; the Causeway International Value strategy also holds these positions and has an additional position in Iberdrola.

Opportunities:

- **Support for Power Prices in European Merchant Businesses**: Increased power demand from data centers should benefit European utilities' merchant generation businesses. However, data center growth in Europe is not expected to match the dramatic rise in the US, potentially leading to a smaller price impact.

- **Positive Impact on Prices and Volumes for European Renewables**: Causeway's European utility holdings have significant renewable development businesses. Greater demand for green power from data centers should boost both the prices these renewable projects can secure through PPAs and the capacity additions needed to meet the increased power demand.

- **Tailwinds for European Regulated Networks**: European utilities with regulated electricity distribution and transmission businesses should benefit from increased investments to connect renewables to the grid. And unlike pure-play (fully) regulated US utilities that require external capital for growth, Causeway's European utilities holdings have a mix of merchant and regulated business exposure, which allows them to use cash flows from unregulated businesses to fund growth in regulated networks.

- **Cross-Atlantic Exposure**: Causeway's European utility holdings have substantial US renewable development businesses that, we believe, are likely to benefit from rising power prices and increased demand for green power in the US.

Growing AI usage presents a positive structural trend for utilities, but we believe bottom-up, fundamental research is essential to avoid overpaying for these benefits. We continue to diligently cover the universe of global utilities to understand the specific dynamics of each company and its exposure to AI-driven power demand.

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