Stock story: Dominion Energy

The US electricity and gas company's strategy is regulated green power.

Dominion Energy, a US regulated electricity and gas company, first invested in solar power in 2013. Now the utility that services nearly seven million customers in 16 US states has, at 2,300 megawatts, the third-biggest solar generation capability in the country. In home state Virginia, Dominion is building a further 3,700 megawatts of solar capacity as part of a drive to create another 16,000 megawatts of this renewable source of power by 2035.

Commencing in 2023, the company is spending US$10 billion to build wind turbines more than 40 kilometres out to sea off the Virginia coastline. By generating 2,640 megawatts of power, the offshore wind farm is expected to power 650,000 homes and businesses.

Such steps and others are part of Dominion Energy's commitment to achieve net-zero emissions by 2050. The company, which earned US$14.2 billion in revenue in fiscal 2020, has already reduced its carbon footprint by 42% over the past decade or so.

The other relevant timeline that helps explain why Dominion Energy is a worthwhile investment is a shorter one that shows how a company owning regulated and unregulated power assets largely turned itself into a highly regulated utility company. This was done through two mergers with utilities and by selling most of the unregulated assets.

The metamorphosis started in 2016 when Dominion Energy came together with Utah-based natural-gas utility Questar. Three years later, Dominion Energy fused with South Carolina-grounded electricity and natural-gas utility SCANA. The sale of the company's merchant generation and gas transmission and storage assets has taken place over the past five years.

The result is that 88% of Dominion Energy's operating earnings now come from state and federally regulated utility subsidiaries compared with 40% in 2006. The remaining 12% of earnings flow from zero-carbon, long-term contracted power-generation assets; namely, from Dominion's nuclear power plant in Connecticut, its interest in a liquified natural-gas facility on the Virginia side of Chesapeake Bay, and a portfolio of solar generation assets.

To see why Dominion Energy's shift to being a regulated utility with a focus on sustainable energy is of interest to investors, it helps to understand how utilities are regulated.

The key feature of utilities is they are monopolies in their vicinities. To stop utilities using this power to overcharge their customers, governments and utilities have developed a 'regulatory compact'. Under this deal, monopoly utilities must invest the money required to provide the essential service in a safe and reliable manner. In return, utilities are allowed to recover their costs and earn a 'fair' return. The amount invested on which a utility can earn a fair return is driven by the capital invested and is known as its 'rate base'. As approved capital spending drives their long-term earnings, utilities seek to maximise the amount of regulator-approved investment as defined by the rate base, while also managing customer bill impacts.

Under this regulatory framework, Dominion Energy is a promising investment for two reasons. First, given the legacy of unregulated assets, the company's stock trades at a discount to other highly regulated peers. We expect this discount to close over time as investors come to appreciate the predictable income stream from its regulated assets that in rate-base terms are valued at about US$42 billion. (About 77% of rate base is attributable to the electricity utility and the rest to gas, while Virginia and South Carolina subsidiaries account for a significant majority of regulated operations – representing about 52% and 20% respectively.)

The other reason Dominion Energy is a promising investment is the long-term relatively low-risk earnings growth we expect from the company's assets. This is being supported by regulators and legislators who are pushing utilities to invest in renewable forms of power generation because they help governments meet their decarbonisation goals and lower bills for users. The total cost of electricity of the solar farms being installed by Dominion Energy, for example, is lower than the variable costs of the coal power plants they are replacing.

The company thus has the regulatory ok to boost its rate base by spending a lot of money on green energy, which provides the company with strong capital growth prospects. Over the next five years, Dominion Energy intends to spend US$26 billion in emissions-reducing capital. By 2035, the utility could spend as much as US$72 billion to achieve regulatory-approved environmental goals.

The company's capital investment plan is expected to drive long-term earnings growth of 6.5% per annum. The combination of such capital and earnings growth on top of the predictability of the company's income stream are why we hold Dominion Energy in the infrastructure fund.

Now to the risks. The biggest one for utilities is that regulators regularly reassess their allowed rates of returns. But Dominion Energy has largely settled its allowed return for its Virginia and South Carolina electricity subsidiaries for the medium term. Execution is another risk, especially given the magnitude of Dominion Energy's investment plan. Some plans might never happen. Dominion Energy, for example, was recently forced to abandon its joint-venture Atlantic Coast Pipeline project due to delays from never-ending legal challenges that nearly doubled the cost of the project in the six years since it was announced. But that venture was peripheral to the company's regulated utility business.

The risks thus appear contained. To the benefit of investors, Dominion Energy has changed much since it first invested in solar power in 2013. The utility promises to transform itself much more in coming years, most likely for the benefit of investors as well as society.

Sources: Company filings and website.

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