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TRENDS & IDEAS

NUCLEAR CRISIS IN JAPAN HURTS U.S. UTILITES

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TAKEAWAY: S&P sees license renewal of U.S. nuclear plants and approval for new ones getting much more difficult.

NEGATIVE IMPLICATIONS:

American Century Utilities Fund;Investor	★★★★	[BULIX]
Edison Intl	★★★	[EIX]
Entergy Corp	★★★★	[ETR]
Exelon Corp	★★★★	[EXC]
Franklin Utilities Fund;A	★★★★	[FKUTX]
PG&E Corp	★★★	[PCG]
Public Svc Enterprises	★★★★	[PEG]

In the wake of the ongoing crisis at the Fukushima Daiichi nuclear plant, the immediate impact on electric utility stocks in the U.S. was understandably negative. Since their close at the end of Friday, March 11, the day of the Japanese earthquake and tsunami, through the close on Friday, March 18, the shares of Entergy (ETR 66 ****) dropped 10.9%, Exelon (EXC 40 ****) 7.3%, Public Service Enterprise Group (PEG 30 ****) 6.0%, PG&E Corp. (PCG 43 ***) 5.8%, and Edison International (EIX 36 ***) 5.4%. For the same time period, the S&P Electric Utilities index fell 4.9%, versus a 1.9% decline for the S&P 500.

We think the sharp decline at Entergy, the second largest nuclear generator in the U.S., largely reflects investor expectations that the already strong opposition to the renewal of its operating licenses for its plants in New York and Vermont would become even more intensified, and be extremely difficult and/or costly to obtain. The current license for its Indian Point Unit 2 plant in New York (which accounts for 21% of Entergy's non-utility nuclear generating capacity) expires in September 2013, and in December 2015 for the Unit 3 plant (20%), (which, according to 2008 seismic data compiled by the U.S. Geological Survey, lays directly above a fault line). Also, last week, New York Governor Andrew Cuomo said Unit 3 was considered the most likely of the nation's 104 nuclear reactors to suffer core damage from an earthquake, citing an MSNBC analysis of an August 2010 report by the Nuclear Regulatory Commission (NRC). He reiterated his long-held belief that the plant, which is located within 35 miles of New York City and accounts for roughly 25% of its power, should be closed. He also ordered a new safety review. (The NRC later disavowed the MSNBC study, stating that its report had not ranked each plant for seismic risk.)

The current operating license for Entergy's Vermont Yankee plant (which accounts for 11% of the company's non-utility generating capacity) expires in March 2012. However, the opposition to renewal has become so strong as the plant had been leaking tritium (a radioactive isotope of hydrogen - which state officials have said was not a threat to public health). Also, state officials claimed they were misled by senior plant personnel on matters related to the leak. Given the intensity of the opposition, Entergy announced last November that it was exploring the sale of the plant. On March 10, 2011, the NRC approved a 20-year license extension for the plant. However, we would not expect a sale of the plant to take place unless a potential buyer were assured by the governor, Peter Shumlin, and the state's legislature agreeing to the extension. While we believe the concerns and uncertainties surrounding Entergy are very real, we think the shares, which are expected to remain volatile, have been oversold and may recover once all of the possibilities and probabilities of plant safety are reexamined and public and political perceptions evolve.

We believe the decline at Exelon, which is the largest nuclear generator in the U.S. with about 20% of the country's nuclear power capacity, was primarily due to the controversial MSNBC analysis, which cited the company's Limerick Generating Station as the third most likely reactor to suffer core damage from an earthquake. The probability according to the analysis was considered to be 1 in 18,868, compared to the 1 in 10,000 cited for the Unit 3 plant at Indian Point, and the cited national average of 1 in 74,176. The two units at the Limerick plant, which is located about 20 miles northwest of Philadelphia, produce 2,345 net megawatts of electricity (nearly 14% of Exelon's total nuclear generating capacity), which is enough to power more than two million average size homes. Following the crisis in Japan, Exelon has called for a complete review of its nuclear activities, including its $3.65 billion "Power Uprate" program, which is designed to increase power production from its existing fleet. We note, however, that while the Limerick plant is subject to a potential earthquake, it is not considered susceptible to a tsunami, which is currently believed to be the primary cause of the crisis at the Fukushima plant.

Public Service Enterprise Group shares with Exelon a 50% interest in the Peach Bottom nuclear plant, which is not considered to be in serious risk of seismic activity, and a 57%/43% interest in the Salem generating station, which, together with its 100%-owned Hope Creek plant, is considered to be more prone to hurricanes and floods than earthquakes. The last two plants (both at the mouth of the Delaware River) are 89 feet above sea level and were designed to withstand a flood or tsunami of 107 feet above sea level. In California, however, where there is considered to be a more than 90% chance of an earthquake in the magnitude of 6.5 in the next 30 years, there has long been strong opposition to the Diablo Canyon plant owned by Pacific Gas & Electric, the subsidiary of PG&E Corp., and the San Onofre plant, owned by Southern California Edison, the subsidiary of Edison International, which together produce nearly 15% of the state's power. PG&E says the Diablo plant was built to withstand a 7.5 earthquake and, at 85 feet above sea level, would be protected from a tsunami, while Edison International says the San Onofre plant, protected by a 30-foot seawall, was designed to withstand a 7.0 earthquake.

While President Obama has ordered the NRC to do a comprehensive safety review of the nation's nuclear plants, he has stated his confidence, as has the NRC, that they have been designed to withstand any number of extreme contingencies. However, given public and political pressure, we think utilities will face far more thorough and costly scrutiny, as they seek to renew the license permits for existing plants or approvals of new plants.

The following mutual funds had exposure to two or more of the stock mentioned above and can be reviewed by looking under the Mutual Funds Tab of MarketScope Advisor: American Century Utilities Fund (BULIX 15 ****) and Franklin Utilities Fund (FKUTX 12 ****).

Note: The fund rankings in this article - from five star (highest) to one star (lowest) - are quantitatively derived from performance, holdings, risk, and exposure analysis. S&P Equity Research's stock rankings or STARS - using a scale of 5-STARS (Strong Buy) to 1-STAR (Strong Sell) - are based on S&P equity analysts' qualitative and fundamentally driven outlooks for stocks over the next 12 months.

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