

Industry Analysis

Utilities

Q4 2013

Industry Overview

Utilities firms play integral roles in creating wealth in both the developed and developing worlds as investments made by this industry create a network of infrastructure that allows for the delivery of energy needed to fuel economic growth. Affordable and reliable energy, for example, is made possible by utilities companies through the construction of integrated cable networks and pipelines. These infrastructures are important to household productivity and the development of most industries, from agriculture to finance to health care to communications. While the utilities industry, construed broadly, includes engineering, infrastructure, telecommunications, and water services, this report focuses only on firms engaged in the distribution and transmission of electricity and gas, as well as utility companies with significantly diversified activities in addition to core electric, gas, and water utility operations.

Energy derived from electricity and gas is crucial in modern society, with links to everything from a human's subconscious fear of the dark, the necessity to keep warm during cold weather, the practical need for illumination, up to production of both basic and high-value goods used every day. The entire world practically runs on electricity and gas, making these resources an important component of every economy regardless of its level of development. And without the utilities responsible for distributing and transmitting electricity and gas, many of today's industries will be crippled halting every aspect of daily living.

Market Structure. Energy produced by utilities for residential use is, for the most part, a necessity that is little affected by economic conditions. People will generally pay what it costs to heat or air-condition their homes, regardless of the strain on their incomes. In this aspect, utilities are considered a noncyclical industry, since the industry's fortunes are not correlated with the overall economy. On the commercial side, however, businesses may cut back on industrial plant and office space usage in tough economic times, making this segment of the industry dependent on business profits and expansion.

The use of a network of infrastructure creates special issues for utilities. The network often exhibits economies of scale and involves substantial sunk costs, so the issue of natural monopoly has played an important role in utilities literature. The network may require the use of public streets or other rights of way, so government involvement is of particular concern. Given the crucial role of government in this industry, utilities are often heavily regulated by the government or state-controlled.

The activities of utilities can be broken down into three components: production, transmission, and distribution. In some regulated utilities, a firm can be vertically integrated into all three functions. In others, firms may leave the production activity to suppliers to ensure competitive rates and focus on transmission and distribution functions. Their activities can also be broken down by type of utility: electrical, natural gas, and multi-utilities that are involved in both. Energy is sourced from multiple sources: coal, natural gas, oil, nuclear, dams, among others, as well as renewable sources like solar and wind. Although there are small niche companies in this industry, the large utility corporations with the resources and economies of scale needed to thrive

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