US Electric Utilities & IPPs

No Fracking, No Way

Equities

Americas
Electric Utilities

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New York State midstream policies at odds with nuclear ambitions

We increasingly view delays around new pipeline efforts out of the Marcellus into New York State as gradually more at odds with the state's desire to decommission the Indian Point nuclear facility near NYC, as well as hampering efforts to improve gas deliverability into New England. We note growing opposition to WMB's proposed Constitution pipeline, through Southern New York as efforts to ban fracking in the state expand to limit new pipeline capacity of fracked gas. While efforts to further expand DTE's Millennium pipeline appear nascent, it remains to be seen to what extent this expansion (up to 0.5 bcf/d) will face similar opposition (although adding additional compression capacity is clearly less controversial). We read this as not only positive to ETR's prospects for a modestly longer life of its Indian Point asset, but also more broadly for the portfolios of incumbent New England and New York generators, who stand to benefit from a protracted period of higher gas prices; as a reminder, NRG is the largest IPP in both of these markets, with its 1Q results firmly illustrating its leverage to this thesis- the latest adds to our confidence scarcity will persist two more seasons.

Pick your poison: oil, gas, nuclear or none of the above?

While New York itself directly appears poised to depend increasingly on oil (in lieu of natural gas) to meet its peak winter needs (although logistics/deliverability of even these products are a problem themselves), we see the inability to cross NY into New England as a greater risk where this region appears increasingly opposed to oil-fired capacity (the latest proposed gas plant to replace the Salem Harbor coal station settled that it would not seek dual fuel capability). We suspect this project will face significant challenges in raising funds given the substantial volatility exhibited in energy markets, with few market participants willing to offer long-term hedges at a reasonable price, against which to raise debt capital. With the latest pushback in New York, we see some risk to destabilizing ongoing efforts by the New England Governors (through NESCOE) to contract for expanded gas capacity (although here too we ultimately suspect the bulk of any expansion will be driven by added compressor capacity along the Algonquin line to feed generation).

So what will New York do about Indian Point? Time will tell.

With the state seemingly poised to convert not just the Danskammer coal facility to gas, as well as contract for additional gas CCGT capacity (likely Cricket Valley among other potential site, we suspect the structure could very well involve either the regional utility (CHE&G) or NYPA as responsible for procuring the gas to feed the sites, with these entities likely responsible to procure the necessary gas to operate these assets. Meanwhile, our latest discussions suggest Canadian imports of gas will continue to add pressure to the regional supply/demand (particularly with the potential conversion to oil from gas of certain pipelines in Canada).

How about bill inflation? New York faces heat here too.

Bills heading north in New York.

In a terrible twist of irony, NY's Gov Cuomo has been adamant to insist upon limited energy price inflation as among his chief energy policy agenda heading into this November's election in the state. Following this winter's run up in prices coupled with the implementation of the Lower Hudson Valley (LHV) capacity zone for the first time this summer, we see price inflation as among the most significant for consumers in recent memory. At this week's AGA Financial Conference Con Ed management commented that the formation of the LHV zone was responsible for ~10% rate inflation.

It's a matter of when, not if… but that when could be quite a while

We reiterate our belief that the structural uplift in gas basis will persist for some time (through ~2017), particularly during peak winter periods.

Among the greatest debates between investors of late remains how long bottlenecks will persist to adequately deliver natural gas to the Northeast from the Marcellus region in order to avoid repeats from last winter when gas prices spiked above $120/MMBtu. We flag comments from PSEG among others reflect a more bearish view on the timeline with which new pipeline construction will drive down premium pricing seen in NJ and NY (reflected by the meaningful premium of TETCO M3 and Transco Zn 6 pricing vs. Leidy Hub and Dominion-South). We reiterate our belief that the structural uplift in gas basis will persist for some time (through ~2017), particularly during peak winter periods.

How did we get such gas scarcity despite the glut: something about restructured markets?

Balancing reliability (oil-burning) against air standards.

Restructured generation markets are in part to blame for lack of takeaway capacity.

We increasingly attribute the issues around lack of gas deliverability encountered in the Northeast despite the proximity of Marcellus to the restructured nature of the generation market (and even to the lack of takeaway more broadly away from Marcellus), which is largely unable to contract for firm capacity to serve its incremental needs. The clearest near-term solution remains a focus on an expanded and more methodological use of oil-related products for limited peak-demand periods; however, a more widespread adoption could yet run afoul of state air quality permitting. While gas utilities have continued to serve as anchor tenants on key new pipelines (and sell their unused capacity when un-needed) and the balance have been funded by producers pushing their commodity to market, there remains a notable gap as generators have been entirely unable to fund any commitments for new capacity (with many new sites situated alongside existing pipelines). We believe had Marcellus and Utica not been located in restructured states, there would clearly have been a more expansive willingness for electric utilities to sign up for this capacity.

And what is the future of natural gas procurement? FERC precedent could be a thorny one

A slippery slope of 'out-of-market' solutions.

Getting more involved in gas procurement in ISO-NE could have precedent impacts elsewhere

We see New England's latest proposal to have the electric utilities serve as the financial intermediary to effectively fund the expansion of new gas pipeline as testing a new form of 'out-of-market' solution. With the scheme designed to socialize the cost and benefits of this added gas pipeline capacity across all generators, we see this as favoring gas over other competing fuels, and would suspect this to face meaningful challenge, likely before FERC seeing the initiative as effectively a new tariff for ISO-New England. We see any decision from the agency as prickly, given the potential to set precedent nationally on utilities' ability to procure gas; additionally, we suspect the issue to be fervently challenged, driving a

potential lengthy approval process (and likely delaying any solution further beyond the contemplated 2017 time period).

Statement of Risk

Risks for Utilities and Independent Power Producers (IPPs) primarily relate to volatile commodity prices for power, natural gas, and coal. Risks to IPPs also stem from load variability, and operational risk in running these facilities. Rising coal and, to a certain extent, uranium prices could pressure margins as the fuel hedges roll off Competitive Integrateds. Further, IPPs face declining revenues as in the money power and gas hedges roll off. Other non-regulated risks include weather and for some, foreign currency risk, which again must be diligently accounted in the company's risk management operations. Major external factors, which affect our valuation, are environmental risks. Environmental capex. could escalate if stricter emission standards are implemented. We believe a nuclear accident or a change in the Nuclear Regulatory Commission/Environment Protection Agency regulations could have a negative impact on our estimates.

Risks for regulated utilities include the uncertainty around the composition of state regulatory Commissions, adverse regulatory changes, unfavorable weather conditions, variance from normal population growth, and changes in customer mix. Changes in macroeconomic factors will affect customer additions/subtractions and usage patterns

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Buy	Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.	less than 1%	less than 1%
Sell	Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.	less than 1%	less than 1%

Source: UBS. Rating allocations are as of 31 March 2014.
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UBS Securities LLC: Julien Dumoulin-Smith; Michael Weinstein; Paul Zimbardo.

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Company Name	Reuters	12-month rating	Short-term rating	Price	Price date
Dominion Resources[2, 4, 5, 6a, 6b, 6c, 7, 16]	D.N	Buy	N/A	US$68.92	20 May 2014
Entergy Corp.[16]	ETR.N	Sell	N/A	US$73.49	20 May 2014
NRG Energy Inc.[16]	NRG.N	Buy	N/A	US$33.56	20 May 2014

Source: UBS. All prices as of local market close.
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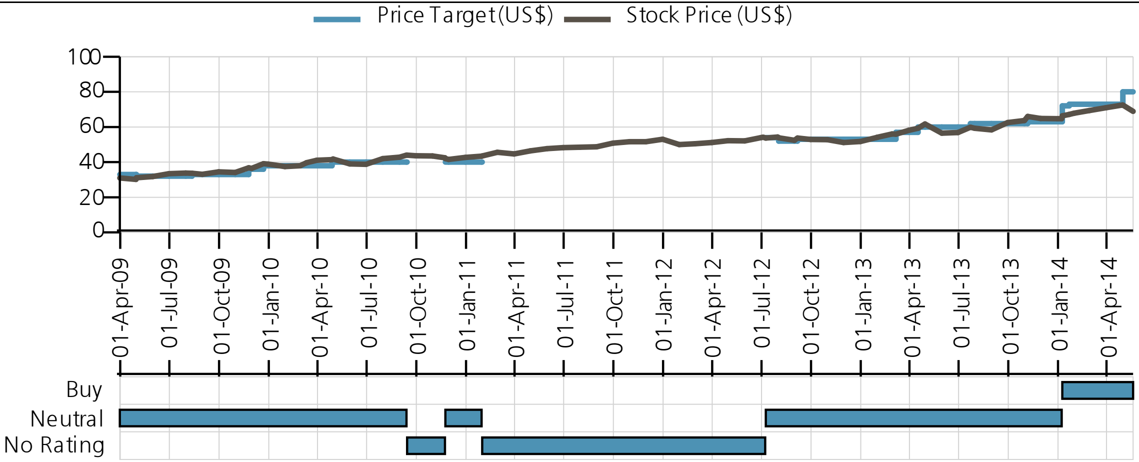
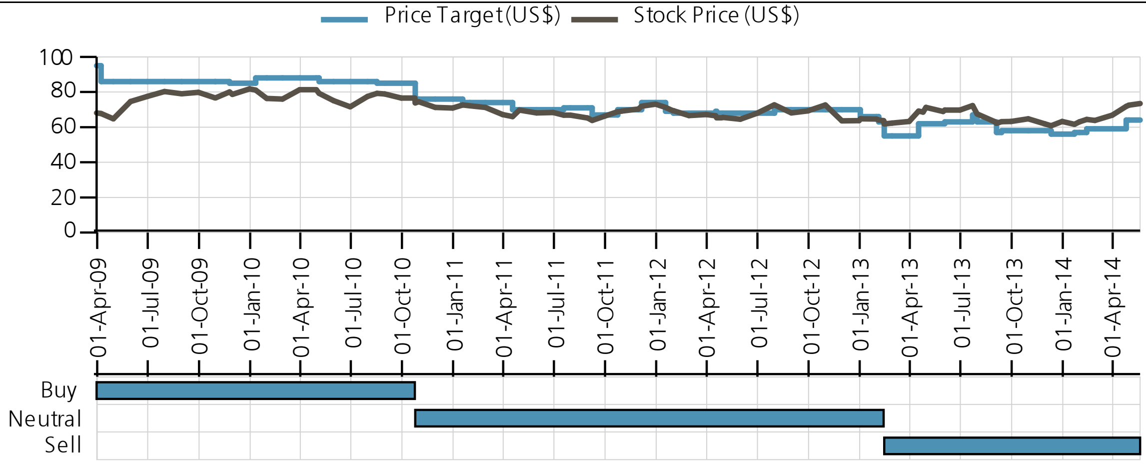


Source: UBS; as of 20 May 2014

Entergy Corp. (US$)



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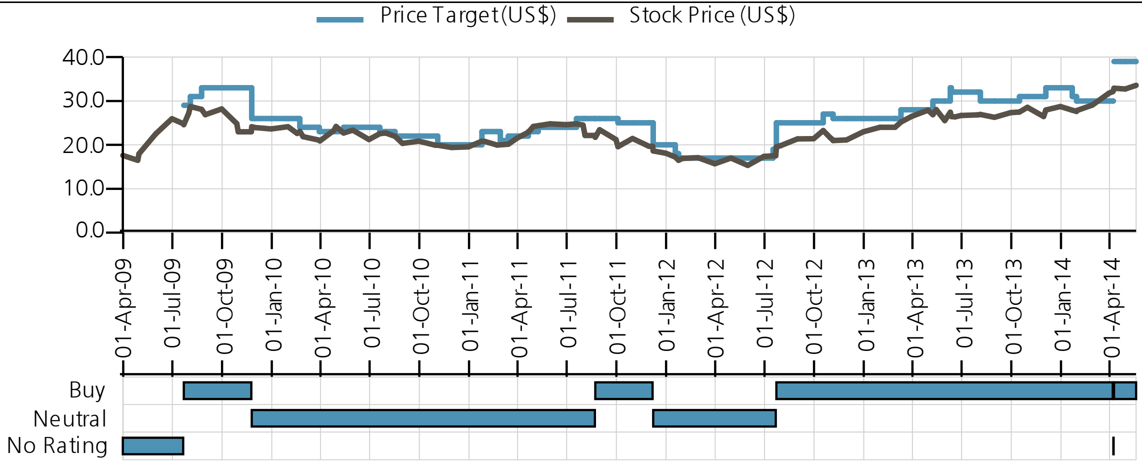
NRG Energy Inc. (US$)



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