

# US Electric Utilities & IPPs

## Reading the Tea Leaves in Texas Transmission

### [Updated]

#### Equities

Americas  
Electric Utilities

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#### What will the Oncor bankruptcy auction yield? We don't think NEE is a winner

With the second round of bidding set for this month in the auction process for the Dallas T&D utility, Oncor, as part of the wider EFH restructuring process, we reiterate our expectations for a home-grown Texas solution to the sales process of the 80% interest in the utility. Hunt Consolidation (parent sponsor to InfraREIT, NYSE: HIFR, and one of the largest private US companies) alongside peer Texas funds have indicated their interest in the media. Given HIFR's higher implied trading multiple (~15x 2016E EV/EBITDA), tax shield from its REIT status, and Texas domicile, we see it as a more obvious solution to any bid by NextEra Energy (NEE). Hunt family has indicated it has interest in an ownership interest; HIFR mgmt has not commented. Last year NextEra initially approached the creditors in an effort to buy the assets outside of a formal process but management has talked-down expectations in recent months. EFH has commented publicly that NEE's bid was worth ~\$18Bn. Having said that, while NEE is not based in Texas; they do already own a 330-mile portion of the CREZ transmission lines in Texas as part of its Lone Star project. This project could inevitably be collapsed into Oncor. That said, we do not necessarily see the business as a clear drop into its NEP YieldCo vehicle. Finally, understand the creditor group to Oncor is actually participating in the process itself – and keen to win (or dismiss the auction) and keep the assets. Second round bids are due next Monday (4/13), with a final decision expected by mid-June with bankruptcy court filings in August. We include the latest accretion estimates for Oncor to NEE below.

#### Who will push the FERC test case on the subject of transmission REITs?

While HIFR is structured as a REIT, its assets today sit strictly under PUCT jurisdiction in Texas. Even the two lines contemplated for development in NM (South Line and Verde) would be built under bilateral tariffs, bypassing the issue of FERC regulated returns for a REIT asset. While a precedent has already been established for REIT ownership structures for FERC assets through HIFR's previous Caprock acquisition this did not address returns, folding the assets into its ERCOT jurisdictional footprint and corresponding 9.7% authorized ROE. While HIFR mgmt intends to eventually expand into FERC jurisdictional assets via M&A and/or organic development, near-term development remains squarely focused on TX, with even these two FERC projects longer-dated (~2018-19).

#### How about transmission M&A: pushing the boundaries on returns

Meanwhile, HIFR has commented that they are open to pursuing third-party acquisitions as a source of future growth and noted that they will primarily be looking at potential M&A in Texas and the Southwest. While HIFR mgmt acknowledges the difficulty in finding and executing M&A in the transmission space with utilities coveting these higher-growth assets, mgmt would be disappointed if it did not succeed with any successful deal. Specifically, we see ITC as a potential acquisition target (particularly post the ROE uncertainty) for Hunt/HIFR. Benefitting from a 50bp independence adder, we see logic for any deal with ITC to remain separate from a traditionally vertically integrated utility lest they risk losing their incentive returns from FERC. Moreover, we see a reduced ROE as driving a higher likelihood that ITC management will ultimately pursue a REIT structure – or be acquired by a comparable structure, hence our projection that ITC could be a potential target for HIFR.

Update on page 1 corrects to reflect that HIFR management has not commented on the components of a potential bid for Oncor.

### So how much of a barrier are ROEs to expansion outside of Texas?

Currently HIFR holds no FERC jurisdictional assets, with an authorized ROE of ~9.7% at the PUCT in TX. *In contrast to potential reductions to ITC's rate of return, HIFR mgmt highlighted potential upside to its authorized ROE under a range of potential scenarios with FERC rates.* We flag the company is likely to benefit from both the independence 50bp as well as the 50bp RTO ROE incentives. We remain biased to believe all-in ROEs will remain buoyed by state levels at a ~10% threshold for the 'base' rate, providing some comfort that we are truly approaching a 'low' on possible awarded outcomes in expectations, particularly given the bitterly divided nature of the Commission. This is illustrated by the joint dissenting opinion from Clark and Moeller in the ITC Midwest case; it appears Chairwomen LaFleur was the deciding vote in the present case, with both Bay and Honorable seemingly exhibiting a more pro-consumer bend in their short tenures on the Commission. The question remains whether utilities will want to push the subject on ROEs or REITs under new FERC leadership with Chairman Bay, effective mid-April. We include our latest summary of authorized ROEs under our latest MtM in the table below.

State ROEs should ultimately provide an effective floor for FERC transmission ROEs.

For additional background, please refer to our recent ITC notes below:

[4/1/15 Is The Glass Half Empty?](#)

[3/10/15 Rewards Offset the Risks](#)

FERC Docket ER15-945.

**Figure 1: FERC Base ROE Analysis Summary – Comparison of Scenarios Through Recent MtM Calculations**

ROE Analysis Summary	Low	Midpoint	High	FERC "Upper Midpt" 75th %	Ranked 75th %
Zone of Reasonableness (Original)	7.03	9.39	11.74	10.57	9.77
Zone of Reasonableness (1/4 GDP Weight)	6.97	9.51	12.05	10.79	9.84
Zone of Reasonableness (UBSe MTM 8/19)	7.14	10.25	13.35	11.80	9.65
Zone of Reasonableness (UBSe MTM 10/22)	6.77	9.28	11.80	10.54	10.25
Zone of Reasonableness (UBSe MTM 1/26)	5.96	8.81	11.65	10.23	10.11
Zone of Reasonableness (UBSe MTM 3/10)	6.30	8.68	11.07	9.87	9.32
Increase/(Decrease) latest MTM from Orig	(0.73)	(0.70)	(0.67)	(0.69)	(0.45)

Source: Company Filings, FactSet, Yahoo! Finance (I/B/E/S), UBS Estimates

### Expanding the eligible REIT bucket... with solar?

We expect other REIT structures to join HIFR in the energy infrastructure space, with expected improved guidance from the IRS later this year potentially opening up the door to leased solar projects (both rooftop and potentially utility-scale). We flag the IRS already pro-actively provided updated guidance in Spring 2014; we see this as a palatable alternative to future Investment Tax Credit (ITC) extensions. Given the legal structure of REITs, most renewable energy assets don't qualify, but opening the tax code to a broader suite of renewable assets could be perceived as a palatable long-term 'solution' to the transition off of ITCs and PTCs. This could expand the opportunity set of transmission opportunities for the likes of ITC Holdings to interconnect more renewables as well as facilitate ownership of renewables outright in their vehicle.

**Figure 2: Updated FERC Methodology Replica ROE Analysis (Sept 1 – Mar 1;  
Prepared 3/10)**

Company	Tickers	I/B/E/S 5Yr	LT GDP Growth	Composite	6 Mo. Avg Adj. Div. Yield	ROE	ROE Rank	Excluded (UBSe)	Excluded Previously	S&P Rating	Moody's Rating
ITC Holdings	ITC	11.59	4.39	9.19	1.87	11.07	100%		M&A	A-	Baa2
TECO Energy	TE	7.08	4.39	6.18	4.81	10.99		M&A		BBB+	Baa3
PNM Resources	PNM	9.86	4.39	8.04	2.93	10.96	97%		Credit	BBB	Baa3
PEPCO Holdings	POM	7.80	4.39	6.66	4.11	10.77		M&A		BBB+	Baa3
NorthWestern	NWE	7.60	4.39	6.53	3.77	10.30	94%			BBB	Baa1
UIL Holdings	UIL	6.72	4.39	5.94	4.33	10.27		M&A	Credit	BBB	Baa2
Ameren	AEE	6.85	4.39	6.03	4.06	10.09	90%		Low ROE	BBB+	Baa3
Exelon	EXC	7.00	4.39	6.13	3.61	9.73		M&A	Div Cut	BBB	Baa2
Otter Tail	OTTR	6.00	4.39	5.46	4.23	9.69	87%			BBB	Baa2
CMS Energy	CMS	6.73	4.39	5.95	3.59	9.54	84%			BBB+	Baa2
ALLETE	ALE	6.00	4.39	5.46	4.04	9.50	81%			BBB+	Baa1
Black Hills Corp	BKH	7.00	4.39	6.13	3.23	9.36	77%			BBB	Baa1
El Paso Electric	EE	7.00	4.39	6.13	3.18	9.31	74%			BBB	Baa1
Sempra	SRE	7.60	4.39	6.53	2.64	9.17	71%			BBB+	Baa1
Eversource	ES	6.25	4.39	5.63	3.43	9.06	68%			A-	N/A
Dominion Resources	D	5.83	4.39	5.35	3.61	8.96		M&A		A-	Baa2
NextEra Energy	NEE	6.44	4.39	5.76	3.11	8.87		M&A		A-	Baa1
Wisconsin Energy	WEC	5.84	4.39	5.35	3.48	8.84		M&A		A-	A2
Avista	AVA	5.00	4.39	4.80	4.04	8.84	65%			BBB	Baa3
American Electric Po.	AEP	5.21	4.39	4.93	3.78	8.71	61%			BBB	Baa1
Vectren	VVC	5.50	4.39	5.13	3.54	8.67	58%			A-	N/A
Alliant Energy	LNT	5.40	4.39	5.06	3.60	8.66	55%			A-	Baa1
Duke Energy	DUK	4.52	4.39	4.47	4.14	8.61		M&A		BBB+	A3
Integrus Energy Group	TEG	5.00	4.39	4.80	3.79	8.59		M&A		A-	A3
Great Plains Energy	GXP	4.60	4.39	4.53	3.83	8.36	52%			BBB+	Baa2
Portland General Ele.	POR	5.26	4.39	4.97	3.33	8.30	52%			BBB	Baa2
SCANA	SCG	4.30	4.39	4.33	3.92	8.25		M&A		BBB+	Baa3
DTE Energy	DTE	4.86	4.39	4.70	3.54	8.24	45%			BBB+	A3
Xcel Energy	XEL	4.51	4.39	4.47	3.76	8.23	42%			A-	A3
Pinnacle West Capital	PNW	4.20	4.39	4.26	3.93	8.19	39%			A-	Baa3
Hawaiian Electric	HE	3.35	4.39	3.70	4.21	7.91		M&A		BBB-	Baa2
PG&E	PCG	3.95	4.39	4.09	3.69	7.79	35%			BBB	Baa1
Southern Company	SO	2.28	4.39	2.98	4.62	7.60	35%			A	Baa1
Cleco	CNL	4.00	4.39	4.13	3.45	7.58		M&A		BBB+	Baa1
Westar Energy	WR	3.37	4.39	3.71	3.80	7.51	29%			BBB+	Baa3
Consolidated Edison	ED	2.77	4.39	3.31	4.14	7.45	26%			A-	WR
Empire District Elec.	EDE	3.00	4.39	3.46	3.94	7.40	23%			BBB	Baa1
OGE Energy	OGE	4.00	4.39	4.13	2.95	7.08	19%			A-	A3
PSE&G	PEG	2.23	4.39	2.95	3.89	6.84	16%		Low ROE	BBB+	Baa2
CenterPoint Energy	CNP	1.58	4.39	2.51	4.32	6.83	13%			A-	Baa1
MGE Energy	MGEE	4.00	4.39	4.13	2.67	6.80	10%		Credit	AA-	N/A
Edison International	EIX	3.53	4.39	3.81	2.70	6.51	6%		Low ROE	BBB+	A2
IDACORP	IDA	3.00	4.39	3.46	2.84	6.30	3%			BBB	Baa2
Entergy	ETR	-1.17	4.39	0.68	4.05	4.73		ROE	M&A	BBB	Baa3
FirstEnergy	FE	-1.03	4.39	0.78	3.92	4.69		ROE		BBB-	Baa3
PPL Corp	PPL	-2.20	4.39	0.00	4.33	4.32		M&A, ROE		BBB	Baa3
UNS Energy Group	UNS	#N/A	4.39	N/A	N/A	N/A		M&A	Credit	N/A	Baa1
CH Energy Group	N/A	#N/A	4.39	N/A	N/A	N/A		M&A	No Est.	N/A	N/A
NV Energy	N/A	#N/A	4.39	N/A	N/A	N/A		M&A	Credit	N/A	N/A

Source: Company Filings, FactSet, Yahoo! Finance (I/B/E/S), UBS

### More competition entering the fray?

We also flag competition continues to grow in the space, with Blackstone recently announcing it was expanding its transmission efforts to the US in MISO and SPP with its GridLiance effort. We suspect these efforts could yet expand into ERCOT as well. This comes amidst a slowdown in projects given planning uncertainty around 111(d) carbon rule implementation.

### How accretive is the Oncor deal for NEE?

We also include our latest accretion math for NEE in the case the company pursues this deal. Recall that Oncor depreciates its assets over a ~20-year life leading to disproportionate FCF profile vs. peer utilities with longer depreciable lives.

Figure 3: Potential Accretion from NextEra Energy Acquiring Oncor (UBSe)

<b>EFIH</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>	<b>2016</b>	<b>2017</b>	<b>2018</b>
<b>EBITDA Projections (excluding)</b>	1,744	1,838	1,870	1,904	1,929	1,952
Securitization	146	111	11	-	-	-
<b>EBITDA Projections (including)</b>	1,890	1,949	1,881	1,904	1,929	1,952
<b>TXU Portion of EBITDA @ 80%</b>	1,512	1,559	1,505	1,523	1,543	1,562
Oncor Debt (as of 12/31/14)	6,347					
TXU Portion @ 80% Ownership	5,171					
1st Lien DIP @ 4% (From Loop / Williams Capital)	5,400	<i>DIP = L+325, with 1% Floor -&gt; Will Need to be Refi'd</i>				
DIP Financing Proposal from NEE (Cash pays down 2nd Lien bonds)	2,400					
Implied Total EFH Equity @ DIP for 68% Implied Equity of 98% Interest	3,601					
<b>Total Enterprise Value for 80% Stake in Oncor</b>	<b>14,173</b>					
<b>Total Implied Enterprise for 100% of Oncor</b>	<b>17,716</b>					
<b>Implied EV/EBITDA</b>	9.4x	9.1x	9.4x	9.3x	9.2x	9.1x
<b>Leverage (Debt/EBITDA)</b>	7.0x	6.8x	7.0x	6.9x	6.9x	6.8x
<b>Net Income Projections (from EFH 8k)</b>	<b>395</b>	<b>437</b>	<b>459</b>	<b>469</b>	<b>476</b>	<b>478</b>
Net Income @ 80% Ownership for TXU	316	350	367	375	381	382
Interest Expense on 1st Liens @ 4.25% (Tax-effected), L+325	(149)	(149)	(149)	(149)	(149)	(149)
Net Income to Equity	167	200	218	226	232	233
<b>Implied P/E Multiple on Equity</b>	<b>21.6x</b>	<b>18.0x</b>	<b>16.5x</b>	<b>15.9x</b>	<b>15.5x</b>	<b>15.4x</b>
Distributions to Owners (80%)	(310)	(282)	(344)	(340)	(404)	(344)
Distributions to Owners @ 80% Ownership	(248)	(226)	(275)	(272)	(323)	(275)
<b>Implied Yield on \$3.6 Valuation</b>	<b>6.9%</b>	<b>6.3%</b>	<b>7.6%</b>	<b>7.6%</b>	<b>9.0%</b>	<b>7.6%</b>
<b>NEE's Stake \$1 Bn is in DIP</b>						
NEE's Ownership of Net Income	46.3	55.7	60.5	62.8	64.3	64.8
50% Parent Leverage @ 5% (\$500 Mn Issuance)	(16.3)	(16.3)	(16.3)	(16.3)	(16.3)	(16.3)
Net Income Accretion to NEE	30.1	39.4	44.3	46.5	48.1	48.5
50% Equity NEE @ \$100/sh						
<b>New Shares Issued (Mn)</b>	<b>5</b>					
Stand-Alone NEE Net Income	2,121.5	2,370.0	2,703.0	2,982.7	3,234.1	3,356.7
Stand-Alone NEE Shares Outstanding	427.0	440.8	454.9	467.4	465.8	450.2
Stand-Alone NEE EPS	\$4.97	\$5.38	\$5.94	\$6.38	\$6.94	\$7.46
<b>EPS Accretion to NEE Calculation (2013 Illustrative) for Partial Stake</b>						
Combo NEE Net Income	2,151.6	2,409.4	2,747.3	3,029.2	3,282.1	3,405.2
Combo NEE Shares Outstanding	432.0	445.8	459.9	472.4	470.8	455.2
Combo NEE EPS	\$4.98	\$5.41	\$5.97	\$6.41	\$6.97	\$7.48
<b>EPS Accretion to NEE (Pre-Synergies) on Partial Stake</b>	<b>\$0.01</b>	<b>\$0.03</b>	<b>\$0.03</b>	<b>\$0.03</b>	<b>\$0.03</b>	<b>\$0.02</b>
<b>EPS Accretion to NEE Calculation (2013 Illustrative) for Full Acquisition (15% Premium to Other Equity Holders)</b>						
New Shares (Mn): 50% Equity NEE @ \$100/sh on ~50% of \$3.5 Bn	20					
Parent Leverage: 50% @ 5% (\$500 Mn Issuance)	(64)					
Combo NEE Net Income	2,224.8	2,506.9	2,857.5	3,145.2	3,402.2	3,526.4
Combo NEE Shares Outstanding	446.5	460.3	474.5	487.0	485.3	469.7
Combo NEE EPS	\$4.98	\$5.45	\$6.02	\$6.46	\$7.01	\$7.51
<b>EPS Accretion to NEE (Pre-Synergies) on Full Stake</b>	<b>\$0.01</b>	<b>\$0.07</b>	<b>\$0.08</b>	<b>\$0.08</b>	<b>\$0.07</b>	<b>\$0.05</b>

Source: Company Filings and UBS Estimates

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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 Integrations. 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	FSR is > 6% above the MRA.	45%	37%
Neutral	FSR is between -6% and 6% of the MRA.	43%	33%
Sell	FSR is > 6% below the MRA.	12%	20%
Short-Term Rating	Definition	Coverage <sup>3</sup>	IB Services <sup>4</sup>
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 2015.

1:Percentage of companies under coverage globally within the 12-month rating category. 2:Percentage of companies within the 12-month rating category for which investment banking (IB) services were provided within the past 12 months.

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**UBS Securities LLC:** Julien Dumoulin-Smith; Michael Weinstein; Paul Zimbardo.

## Company Disclosures

Company Name	Reuters	12-month rating	Short-term rating	Price	Price date
<b>InfraREIT Inc</b> <sup>2, 4, 5, 6, 16</sup>	HIFR.N	Not Rated	N/A	US\$30.85	07 Apr 2015
<b>ITC Holdings Corp</b> <sup>13, 16</sup>	ITC.N	Buy	N/A	US\$35.94	07 Apr 2015
<b>NextEra Energy</b> <sup>2, 4, 6, 16</sup>	NEE.N	Buy	N/A	US\$104.29	07 Apr 2015

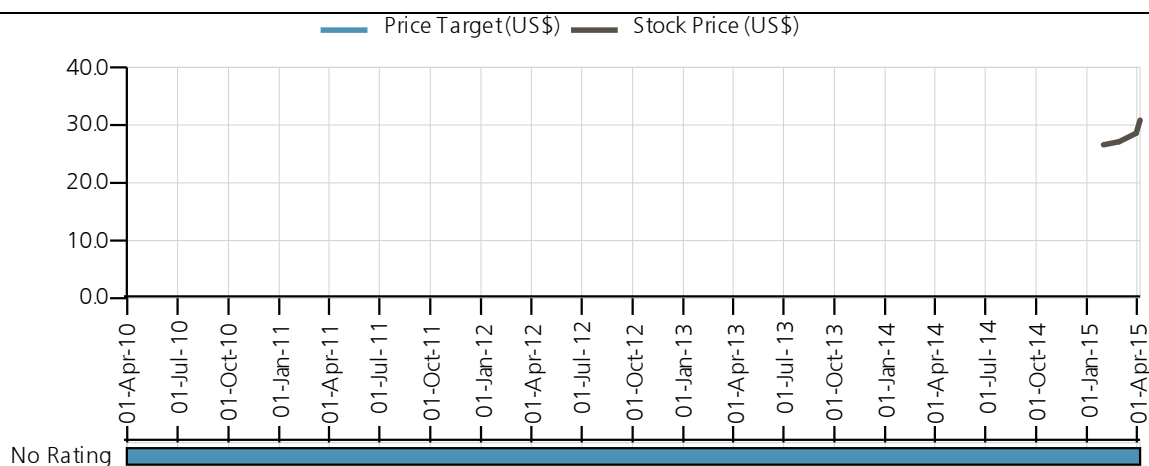
Source: UBS. All prices as of local market close.

Ratings in this table are the most current published ratings prior to this report. They may be more recent than the stock pricing date

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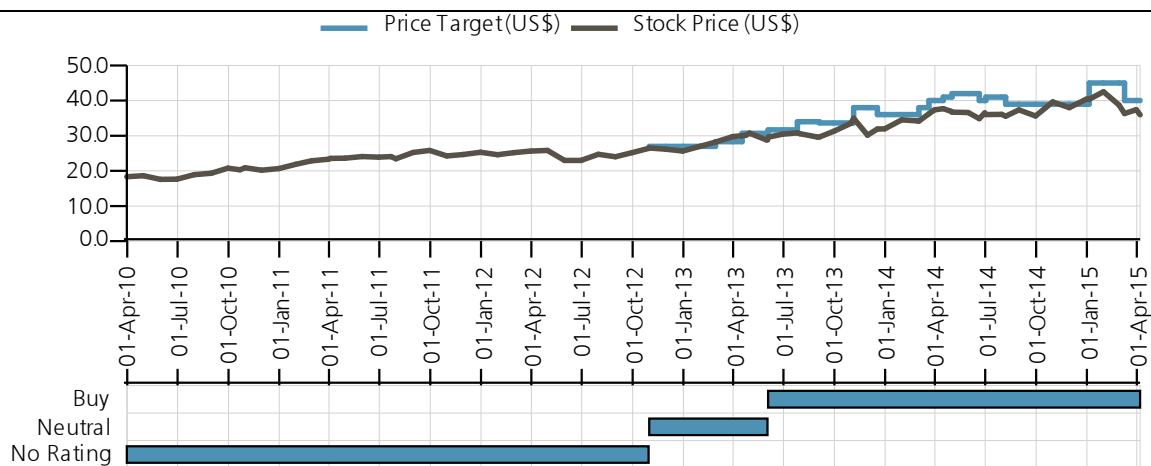
Unless otherwise indicated, please refer to the Valuation and Risk sections within the body of this report.

### InfraREIT Inc (US\$)



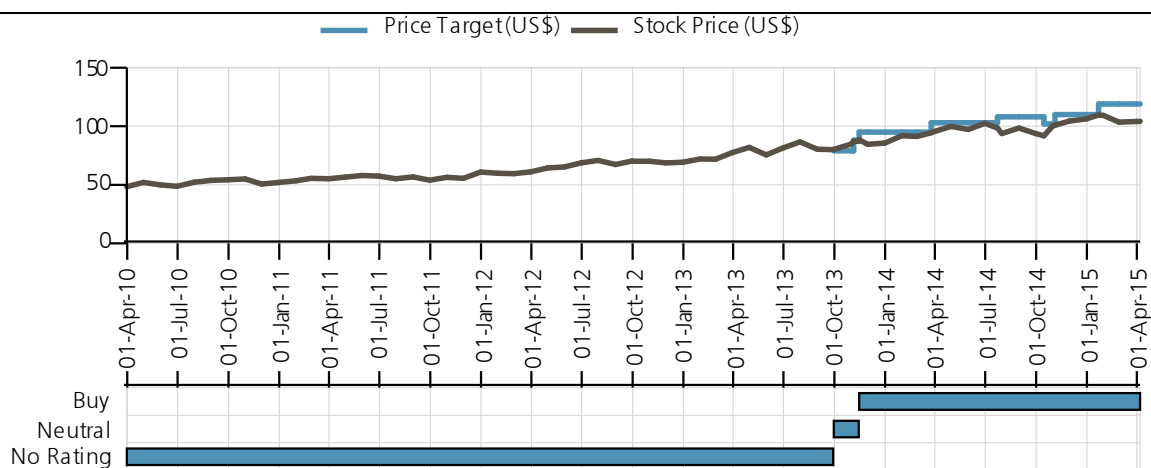
Source: UBS; as of 07 Apr 2015

## ITC Holdings Corp (US\$)



Source: UBS; as of 07 Apr 2015

## NextEra Energy (US\$)



Source: UBS; as of 07 Apr 2015



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