First Read

US Electric Utilities & IPPs
CPP Gets Stayed Out in the Cold

Clean Power Plan stayed by Supreme Court in rare move
Earlier today the US Supreme Court moved yet again to act in the utility sector, this time subjecting the key Clean Power Plan (CPP) regulations to a stay pending a final decision from a DC Circuit Court of Appeals. The decision was along ideological lines on a 5:4 vote, and was unexpected among utility investors. With this among the key capex growth drivers for US utilities in recent memory and a critical 'next' juncture of spend amidst a weak sales growth environment, the stay puts in doubt the timeline for rule implementation. In the near term, we believe utilities will continue to develop plans with their state regulators amidst the risk of an eventual re-implementation. We expect shares across the regulated utility sector to be negatively impacted by the regulations, with the IPP industry conversely recovering for the likes of principally NRG (as well as DYN and TLN); all three of which have meaningful coal exposures within their portfolios (even if not generating any significant energy margins today). EXC is likely more negatively impacted given lower probability around carbon price expectations in IL. In contrast, we expect NY to continue to support upstate nuclear despite the CPP stay.

The stay highlights the contentious nature of rules
The move to grant a stay in implementation highlights how impactful the rules could be – despite only taking effect in 2022. The stay has been widely interpreted as a negative read on the eventual legality of the approach adopted by EPA to use Section 111(d) of the Clean Air Act (CAA) to regulate emissions like carbon. Opponents had argued that the CAA was designed to regulate conventional criteria pollutants (SO2 and NOx) and had never been designed to target carbon. Timing of an ultimate decision from the DC Court of Appeals remains unclear; oral arguments are set for June with a ruling possible by year-end. However, we expect further appeals up to the Supreme Ct, which could be granted given the latest stay.

How critical are they to renewables today? More limited
We emphasize the stay is likely to have a limited effect on total renewable demand today – and through the medium term given the bulk of procurement remains largely under the context of ‘economic’ decisions net of the recent extensions of wind and solar. In meetings with NEE management yesterday, they categorized almost all wind sales in recent periods as driven near solely by the relative economics of the resource rather than proscriptive to an RPS requirement. Ultimately, with the next boom slated for 2018 and 2019 for wind and solar, respectively, we see the procurement cycle as having been partially driven by CPP considerations, particularly for solar, attempting to time in-service to align with the initial period with which projects can qualify for Clean Energy Incentives (e.g., early action credits) under the CPP program. Net-net, we assume developers will still move forward given the clear incentives afforded from the ITC and PTC extensions. Had these extensions not happened, the sector would be meaningfully more exposed to the stay of CPP regulations.

Timeline of Coal-to-Gas shift is also at risk with CPP stay
While low gas prices continue to put substantial pressure on the existing incumbent coal portfolio we see the real impacts of the stay in the CPP regulations as extending the existing life of ‘economic’ coal plants (that would not otherwise close due to compressed natural gas curves). As such, we see the wider coal-to-gas trend at risk from the delay and the corresponding gas pipeline infrastructure may also be at risk. The ball is now back in the hands of both the states and companies to decide whether to continue to work a CPP framework – or continue to work on a carbon regime through the pendency of the stay given the complexity of rules involved.

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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 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. Valuation for IPPs and competitive integrated utilities is based on a sum-of-the-parts analysis.
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<table>
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<th>12-Month Rating</th>
<th>Definition</th>
<th>Coverage¹</th>
<th>IB Services²</th>
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<tbody>
<tr>
<td>Buy</td>
<td>FSR is &gt; 6% above the MRA.</td>
<td>48%</td>
<td>36%</td>
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<td>Neutral</td>
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<td>28%</td>
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<td>Sell</td>
<td>FSR is &gt; 6% below the MRA.</td>
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<th>Short-Term Rating</th>
<th>Definition</th>
<th>Coverage¹</th>
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<td>Buy</td>
<td>Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.</td>
<td>&lt;1%</td>
<td>&lt;1%</td>
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<tr>
<td>Sell</td>
<td>Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.</td>
<td>&lt;1%</td>
<td>&lt;1%</td>
</tr>
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</table>

Source: UBS. Rating allocations are as of 31 December 2015.
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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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<th>Company Name</th>
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<th>Short-term rating</th>
<th>Price</th>
<th>Price date</th>
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<td>09 Feb 2016</td>
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<td>Sell</td>
<td>N/A</td>
<td>US$39.62</td>
<td>09 Feb 2016</td>
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