

US Electric Utilities & IPPs

Riding the MISO Roller Coaster

Equities

Americas
Electric Utilities

MISO capacity auction slumps ~50% YoY but still beats expectations

In the MISO 2016/2017 auction the key zones 2-7 (Illinois and Michigan are the primary investor focus) cleared at \$72/MW-day, down from \$150/MW-day in the prior year's auction but the result is modestly ahead of UBS's (\$50/MW-day) and meaningfully ahead of even lower Street expectations. The auction cleared in a highly-sensitive portion of the demand curve and a +/- ~185MW change in capacity was the difference between ~\$25/MW-day and \$110/MW-day. The MISO auction outcome is most relevant for Dynegy and Exelon but as we discuss next it is far less important with companies increasingly transacting with municipalities and retailers outside of the construct. A surprise beneficiary in the auction is CMS with Michigan Zone 7 prices jumping to \$72/MW-day from \$3.48/MW-day previously. CMS has 10-25% capacity available for 2016-2017 so the EPS benefit is de-minimus today but could be \$0.05/sh in 2018+. Full results [here](#).

How important is the auction? Not a material driver given the bilaterals

Going into the auction Dynegy had already contracted for 3,920MW versus 2,334MW in the prior year's auction as management continues to reduce its reliance on the unpredictable MISO auction. As of Thursday evening Dynegy had not disclosed the magnitude of capacity it cleared but we expect a low number (below 200MW) based upon our analysis of prior bidding behavior by market participants and commentary from management following our trip on Wednesday [\[details here\]](#).

Retirements still coming for both DYN and EXC: not high enough

Although the auction surpassed our estimates, the ~50% decline versus the prior year will significantly pressure merchant generators in the Illinois region, notably Dynegy and Exelon, and we anticipate both companies to announce asset retirements based on the auction outcome. For Exelon, management reported that Clinton was free cash flow negative following the \$150/MW-day print in the last auction and we expect a formal retirement announcement in September to take effect in Spring 2017. At Dynegy the IPH assets are at the most risk, specifically the higher-cost Newton unit (1.2GW).

How do we expect shares to react? Mixed in short-term but paves a path

Although investors were anticipated a low auction outcome (<\$75MW-day), a sharp decline YoY in a major capacity auction is rarely a positive development. Taking the bull thesis, the bad print will result in more retirements further increasing the probability of market reforms in MISO. If Exelon announces the retirement of Clinton this could also be a catalyst for legislative reform in Illinois. Dynegy addressing its non-recourse Illinois Power Holdings (IPH) subsidiary which we view as overlevered (debt trades in the 30-40s). We reiterate that following our management meeting we see addressing the IPH overhang as a top priority for the Dynegy, potentially as soon as its 2Q16 earnings call.

Results still suggest more exports to PJM possible?

We note that with auction results clearing lower YoY, DYN will be keen to export yet further MWs to PJM if possible. We note expectations into next month's auction have moderated substantially to \$120-140/MW-day range (we're at the higher end).

Call tomorrow with MISO to discuss takeaways

MISO will be hosting a call tomorrow at 10am ET; Participants dial-in: 888-572-7034

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Figure 1: MISO Capacity Auction Snapshot

MISO Local Resource Zone	Zone 1 MN, ND, Western WI	Zone 2 Eastern WI, Upper MI	Zone 3 IA	Zone 4 IL	Zone 5 MO	Zone 6 IN, KY	Zone 7 MI	Zone 8 AR	Zone 9 LA, TX	Zone 10 MS
2014-2015 ACP (\$/MW-d)	\$3.29	\$16.75	\$16.75	\$16.75	\$16.75	\$16.75	\$16.75	\$16.44	\$16.44	N/A
2015-2016 ACP (\$/MW-d)	\$3.48	\$3.48	\$3.48	\$150.00	\$3.48	\$3.48	\$3.48	\$3.29	\$3.29	N/A
2016-2017 ACP (\$/MW-d)	\$19.72	\$72.00	\$72.00	\$72.00	\$72.00	\$72.00	\$72.00	\$2.99	\$2.99	\$2.99
2016-2017 ZRC Offer Cleared	4,522	2,840	9,636	8,242	7,927	14,060	20,141	9,676	17,934	4,511
2016-2017 Total Committed	18,775	14,903	10,138	9,152	7,927	18,398	21,534	9,995	18,511	6,151
2016-2017 FRAP (Delta)	(14,253)	(12,063)	(502)	(910)	-	(4,338)	(1,393)	(319)	(577)	(1,640)
2016-2017 Conduct Threshold	\$25.80	\$26.06	\$25.52	\$25.93	\$26.42	\$25.85	\$25.98	\$24.76	\$25.12	\$24.61
2016-2017 CONE	\$258.00	\$260.58	\$255.15	\$259.26	\$264.19	\$258.47	\$259.81	\$247.56	\$251.21	\$246.05

Source: MISO | ACP = Auction Clearing Price; ZRC = Zonal Resource Credits; FRAP = Fixed Resource Adequacy Plan; CONE = Cost of New Entry

How Much of a Headwind is It? Not Much for Either

Below we show YoY sensitivities for Dynegy and Exelon which depend on the ultimate magnitude of capacity cleared. Even when considering the large change relative to last auction the valuation impact is immaterial for Exelon and still quite low for Dynegy. The most significant ramification relates to the potential regulatory/legislative ramifications that could follow.

Figure 2: MISO 2016/2017 Sensitivities: \$150/MW-day prior year → \$72/MW-day current year

MISO 2016/2017 Sensitivities: \$150/MW-day prior year → \$72/MW-day current year						
Dynegy			Exelon			
Net Cleared Cap.	EBITDA Δ	Value Δ	Net Cleared Cap.	EBITDA Δ	EPS Δ	Value Δ
1000	(28)	-\$1.99	1000	(28)	-\$0.02	-\$0.23
900	(26)	-\$1.79	900	(26)	-\$0.02	-\$0.21
800	(23)	-\$1.59	800	(23)	-\$0.02	-\$0.18
700	(20)	-\$1.40	700	(20)	-\$0.01	-\$0.16
600	(17)	-\$1.20	600	(17)	-\$0.01	-\$0.14
500	(14)	-\$1.00	500	(14)	-\$0.01	-\$0.11
400	(11)	-\$0.80	400	(11)	-\$0.01	-\$0.09
300	(9)	-\$0.60	300	(9)	-\$0.01	-\$0.07
200	(6)	-\$0.40	200	(6)	\$0.00	-\$0.05
100	(3)	-\$0.20	100	(3)	\$0.00	-\$0.02
0	-	\$0.00	0	-	\$0.00	\$0.00
DYN: Every 100MW cleared ≈\$5Mn EBITDA, or ~\$0.20/sh equity value @ 7x multiple						
EXC: Every 100MW cleared ≈\$5Mn EBITDA (~\$0.01 EPS), or ~\$0.02/sh equity value						

Source: MISO and UBS Estimates

In contrast, relative to our \$50/MW-day expectation for the auction the \$72/MW-day outcome is a relatively immaterial positive.

Figure 3: MISO 2016/2017 Sensitivities: \$50/MW-day forecast → \$72/MW-day actual

MISO 2016/2017 Sensitivities: \$50/MW-day forecast → \$72/MW-day actual						
Dynegy			Exelon			
Net Cleared Cap.	EBITDA Δ	Value Δ	Net Cleared Cap.	EBITDA Δ	EPS Δ	Value Δ
1000	8	\$0.56	1000	8	\$0.01	\$0.06
900	7	\$0.51	900	7	\$0.01	\$0.06
800	6	\$0.45	800	6	\$0.00	\$0.05
700	6	\$0.39	700	6	\$0.00	\$0.05
600	5	\$0.34	600	5	\$0.00	\$0.04
500	4	\$0.28	500	4	\$0.00	\$0.03
400	3	\$0.22	400	3	\$0.00	\$0.03
300	2	\$0.17	300	2	\$0.00	\$0.02
200	2	\$0.11	200	2	\$0.00	\$0.01
100	1	\$0.06	100	1	\$0.00	\$0.01
0	-	\$0.00	0	-	\$0.00	\$0.00
DYN: Every 100MW cleared ≈\$1Mn EBITDA, or ~\$0.05/sh equity value @ 7x multiple						
EXC: Every 100MW cleared ≈\$1Mn EBITDA (<\$0.01 EPS)						

Source: MISO and UBS Estimates

Distilling Last Year's Supply Curve for Clues

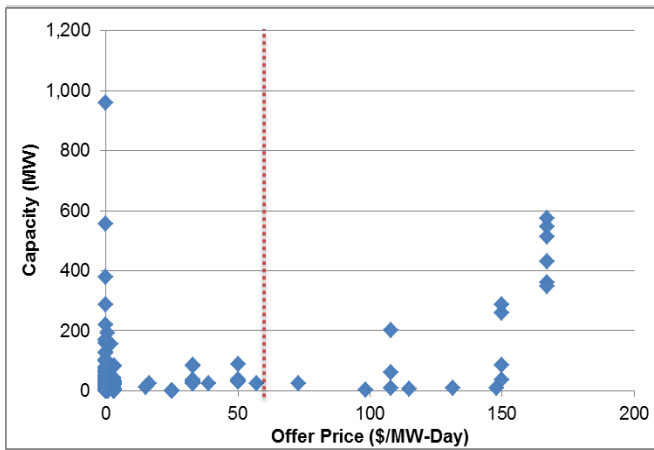
What can the 2015-2016 MISO auction teach us about the current 2016-2017 auction?

Below we show the offer price (\$/MW-day) relative to segment offer capacity (MW) for the 2015-2016 MISO auction showing where individual units bid in the previous auction. We have imposed the \$72/MW-day clearing price for both zones 4 and 7 over the data to show which units that cleared in the previous auction would not have cleared in the 2016-2017 auction assuming the same bidding behavior.

In the 2015-2016 auction for Zone 4 there were four market participants who bid over \$33/MW-day with average offer prices of \$144 (2,560MW), \$159 (1,151MW), \$87 (126MW), and \$40 (695MW). The market participant who bid 1,151MW at \$159/MW-day also interestingly bid \$0/MW-day for a separate 1,709MW which included one 958MW plant (the top left datapoint in the IL figure below).

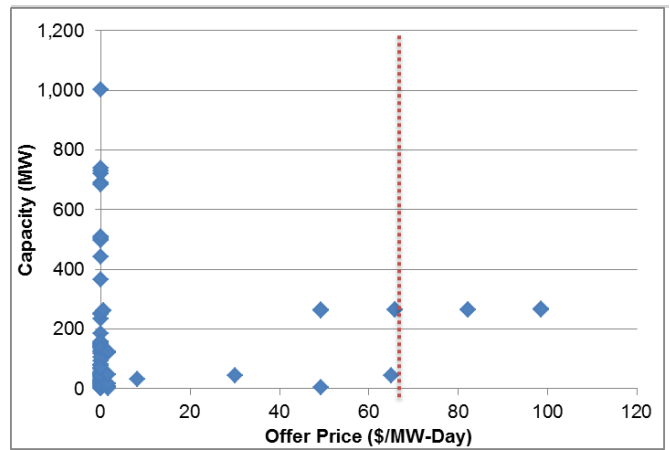
Exelon commented last auction that it has historically bid in its 1,069MW Clinton nuclear plant as a price taker and in the 2015-2016 auction it did execute bilateral contracts reducing the amount of capacity available to bid.

Figure 4: IL Zone 4 2015-2016 Bidding Data



Source: MISO

Figure 5: MI Zone 7 2015-2016 Bidding Data



Source: MISO

In Michigan there was one asset owner who bid in 2,644MW for 2015-2016 at prices ranging from \$1/MW-day to \$99/MW-day and only cleared 525MW at \$3.48/MW-day; this was one of the few market participants to not bid in \$0/MW-day. For example one market participant bid 10,953MW at \$0/MW-day, presumably a regulated entity.

For more supply curve information please see [here](#).

Valuation Method and Risk Statement

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.

DYN valuation based on sum-of-the-parts. CMS valuation based on average peer utility P/E sum-of-the-parts. EXC valuation based on sum-of-the-parts.

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Neutral	FSR is between -6% and 6% of the MRA.	38%	26%
Sell	FSR is > 6% below the MRA.	14%	19%
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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.	<1%	<1%
Sell	Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.	<1%	<1%

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Company Name	Reuters	12-month rating	Short-term rating	Price	Price date
CMS Energy Corporation ¹⁶	CMS.N	Neutral	N/A	US\$41.29	14 Apr 2016
Dynegy, Inc. ^{4, 6, 7, 16}	DYN.N	Buy	N/A	US\$14.84	14 Apr 2016
Exelon Corp. ^{4, 6, 7, 16}	EXC.N	Neutral	N/A	US\$34.94	14 Apr 2016

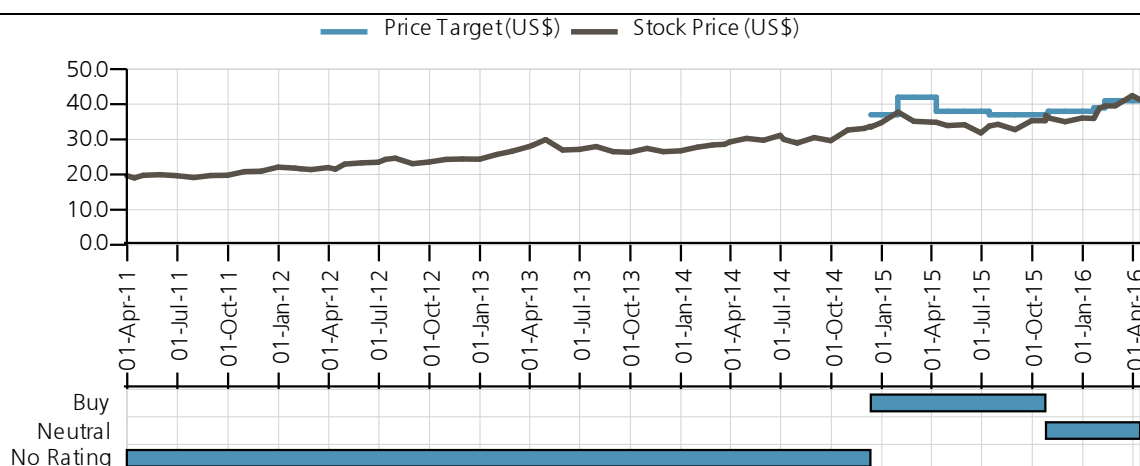
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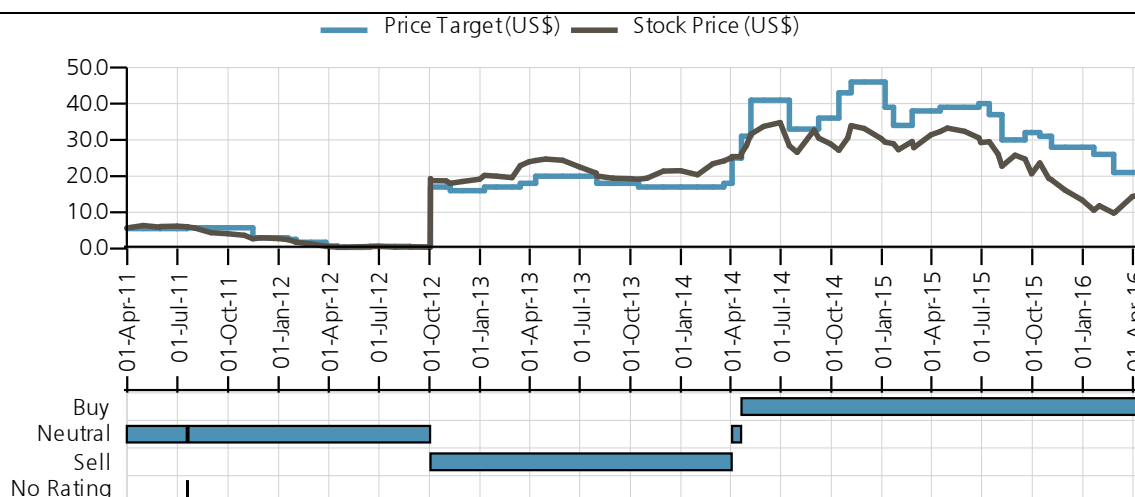
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CMS Energy Corporation (US\$)



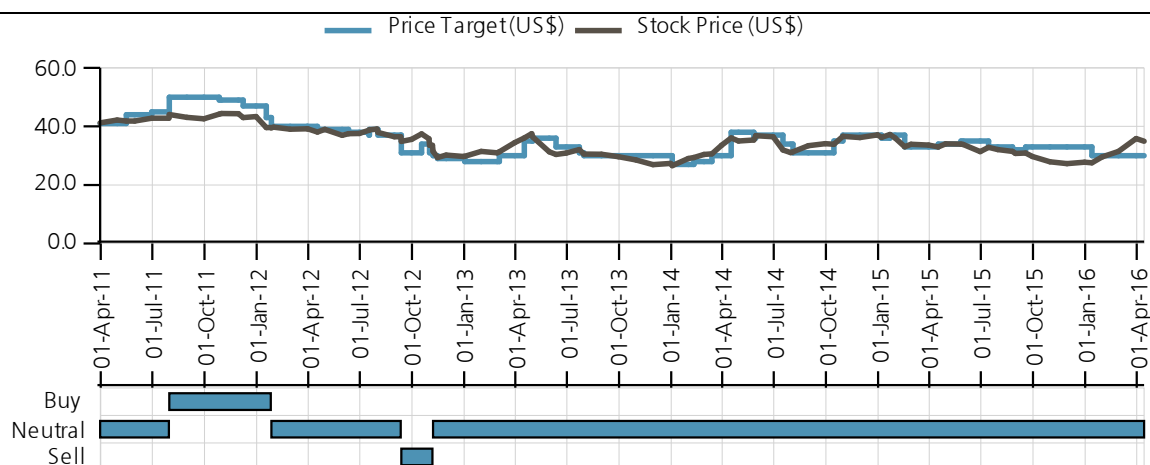
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Dynegy, Inc. (US\$)



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