

US Electric Utilities & IPPs

Carbon Cometh to the States

Equities

Americas
Electric Utilities

Awaiting the final carbon rule from EPA this morning

In a long-awaited development, we look for the EPA to finalize regulations on existing sources of carbon emissions as soon as this Monday, August 3rd according to the White House; this is a bit sooner than many speculators had thought and is consistent with EPA's thoughts on a mid-summer release. Initial reports suggest a delay to the first targets by two years to 2022 vs. 2020, however raising the target to -35% by 2030 off 2005 levels, vs. -30% initially contemplated. Most notably, it would appear final plans would be due to the EPA in mid-2018, placing this firmly in the next administration's camp on what state plans they will accept or reject (a draft would be required by June 2016).

CPP could feature prominently this Fall - likely positive for regulated utilities

Following rule finalization of EPA's Clean Power Plan (CPP), we expect not only litigation to begin, but also utility planning to evolve, with many likely keen to talk up longer-dated spending, seeing an inflection point potentially in what has otherwise been a declining prospective spending outlook for the sector. From our view, the 35% target translates to more ratebase \$ and the two year delay isn't likely to have much impact since most utilities thought 2020 was unreasonable anyway. We expect the rule to ultimately bolster shares later in the year as this inflection is realized in the sector, particularly with updated long-term views at the EEI conference. We suspect Infrastructure stories will be among those best positioned to benefit- with Dominion and NextEra emerging at the top of this list. We suspect this bid could even accrue to other large-cap regulated peers DUK and SO. Rather than the traditional nuclear power play on the read-through from Carbon, we recommend focusing on utilities with real renewable and midstream efforts underway.

What does this mean for power markets? Little today, but eventually it will.

The reality for power IPPs will have limited practical implementation today, particularly for those without cap-and-trade schemes. Rather, we expect modest carbon prices to become a reality as states gradually come around to the efficiency of pricing carbon in power prices as a way to reduce the risk over time. We see the rules as simply putting downward pressure on terminal FCF of many of the IPPs, beginning in ~2022. We would not expect any explicit retirement requirements of IPP units, rather, this will only exacerbate the 'war of attrition' between coal vs. gas, tipping the balance further in favor of gas dispatch. We would expect pressure on coal IPPs (NRG, DYN, TLN), and benefits accruing to nuclear and gas generators (CPN, EXC, and PEG) simply as a headline today/tomorrow.

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Incentives for efficiency and renewables? Details here are key.

While the program is ultimately more of a 'stick' for the environmental community, initial media reports suggest a new incentive program will prove forthcoming for both energy efficiency and renewables. While the nature of the support is unclear, coming from the EPA, we suspect the announcement could well be complemented by a White House initiative to extend subsidies. Existing Investment Tax Credits (ITCs) for the solar industry are due to step down to 10% from 30% by end of next year – and would clearly require legislative approval. Among the key potential efforts to be pursued by the administration could yet be an IRS extension on how much of a project needs to be completed by the time of expiration, providing an implicit extension to the utility-scale solar industry. Bottom line, it remains unclear what tools the White House and EPA can leverage to subsidize renewables and efficiency today, particularly given their longer-dated implementation. Other potential avenues that could see some attention in 2H include clarification of certain renewable assets as qualifying for REIT status.

How will utilities tangibly participate?

We see incremental capex planning as already beginning, with both southeast greenfield gas midstream capacity a key product of future planning for carbon as well as utility-proposed plans for large-scale solar. Alongside an 'uptick' in long-dated capex ~driving YoY increase in 2019 and 2020 as spending ticks up in anticipation of targets. To be clear, CPP is unlikely to drive meaningful incremental spend in the next ~3-years, seeing the pendency of state-specific plans and the need to hit 2022 targets as still largely too 'early'. That said, seeing a bottoming in the capex cycle is likely to be welcome by many investors after seeing spending boosted in recent years largely by the EPA's MATS targets. Ultimately, spending programs will look like a continuation of current spending plans to hit RPS targets and build out takeaway capacity from the Shale-gas oriented regions. At a high level, most states will comply by leveraging as much coal-to-gas switching as possible with existing assets (potentially complementing their portfolios with additional gas resources), adding to their efficiency goals, and back-solving for any further needs with wind and solar renewables depending on geography. The southeast is likely to be among the regions to see the greatest incremental switching to hit targets.

The renewable angle: coming just in time?

We see the CPP program as largely coinciding with the conclusion of many state renewable portfolio standards (RPS), which have target dates between 2020-2025. We suspect many of the states will simply leverage CPP procurement to continue annual incremental layering in of renewable generation into their portfolios. We suspect all renewable equities will respond well to rules despite their long-dated implementation timeframe. Ultimately, if states force utilities to meet carbon targets, subsidies will need to come in the form of above-market offtake contracts in lieu of tax credits. It remains unclear if formal RPS targets will be revised upwards to reflect CPP compliance, or if renewable procurement will simply arise out of wider carbon reduction strategies that could force renewables to compete with efficiency and other 'sources' of reduction on a more real-time economic basis. A further risk is that of program leakage to adjacent countries via implicit and explicit schemes.

New life for the Nuclear Industry?

We also tend to view the new rules as potentially the first bit of good news for the struggling nuclear industry since shale gas started becoming competitive with other forms of baseload fuels. However, we caution that the CPP itself is unlikely to flip the industry's "on" switch overnight, with continued fierce competition from solar, wind, and storage, distributed resources, and the like. That said, still don't expect new nuclear; *it's about getting credit for plants built today and keeping the existing portfolio intact.*

Expect significant litigation – rules will not be quietly implemented

With the EEI industry association already coming out saying that the EPA did not moderate sufficiently the rules from draft – and will result in 76GW of coal retrofits of retirements – we expect significant litigation across a wide range of constituents. While any administration's hands remain tied on whether to pursue regulations at all (seeing rules remain mandates as part of Supreme Court decision), the manner in which the rules will be put in place remain a challenge. We expect much of the near-term focus among companies and lawyers to focus around litigation strategies to challenge rules – and any potential for stay in rules pending petitions.

Significant political risk too: a lot still up to the next administration.

While the Obama administration will formally kick-start the EPA's efforts this year, with final acceptance of proposed states plans a 2018 due-date, this puts the onus on the next administration to ensure compliance. We suspect many states will push back significantly, with the EPA likely to be in a position to reject many of the plans put forth by Republican state administrations in 2018 (for instance, it appears Texas will not be submitting a plan given their belief the federal EPA does not have jurisdiction). Under a potential subsequent Republican administration for 2017-2021, we suspect the vigour of standards implemented will clearly be reduced. Bottoming line, we see any subsequent administration as meaningfully dictating the pace of whether 2022 will remain in place – and to what degree standards will have teeth.

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 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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Source: UBS. Rating allocations are as of 30 June 2015.

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Dominion Resources ^{2, 4, 5, 6a, 6b, 6c, 7, 16}	D.N	Buy	N/A	US\$71.70	31 Jul 2015
Duke Energy ^{4, 5, 6a, 6c, 7, 16}	DUK.N	Neutral	N/A	US\$74.22	31 Jul 2015
Dynegy, Inc. ^{2, 4, 5, 6a, 16}	DYN.N	Buy	N/A	US\$26.05	31 Jul 2015
Exelon Corp. ^{4, 6a, 6c, 7, 16}	EXC.N	Neutral	N/A	US\$32.09	31 Jul 2015
NextEra Energy ^{2, 4, 6a, 6c, 7, 16}	NEE.N	Buy	N/A	US\$105.20	31 Jul 2015
NRG Energy Inc. ¹⁶	NRG.N	Buy	N/A	US\$22.45	31 Jul 2015
Public Service Enterprise Group ¹⁶	PEG.N	Neutral	N/A	US\$41.67	31 Jul 2015
Southern Company ^{2, 4, 6a, 16}	SO.N	Sell	N/A	US\$44.73	31 Jul 2015
Talen Energy Corp ¹⁶	TLN.N	Sell	N/A	US\$15.73	31 Jul 2015

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