

US Electric Utilities & IPPs

PJM: Ramping up Compensation, Sooner

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Latest white paper on 'Capacity Performance' looks to transition up revenues

PJM released an updated white paper on its performance scheme, designed to improve the 'quality' of its capacity during peak seasonal periods following its particularly poor performance this past winter. At the heart of PJM's updated proposal is a move to enable a 'transitional' auction design, to effectively compensate generators for meeting tougher thresholds, sooner. While details are still pending, compensation through this **interim** period (specifically 2016/17 and 2017/18 auction years) could be quite substantial for generators qualifying as 'Capacity Performance', (CP) with price and offer caps both at \$165 and \$211/MW-day. Importantly generators already committed into the auction can opt to shift their commitment to this product (we suspect many will). For winter 2015/16 PJM proposes to procure an additional 10GW of capacity – seemingly beneficial to those assets having not cleared, with FirstEnergy (FE) benefitting in particular in our view, giving assets which didn't clear the auction on the first go around, another shot. On its 2Q14 call FE disclosed that its 2.5GW Bruce Mansfield Plant did not clear in the 2017/2018 and "only partially cleared" in 2016/2017.

What does this mean? Could add some real upside through 1H15 for IPPs

Transitional auctions could lead to positive earnings revisions across the sector, emphasizing 2016/17 and 2017/18 auctions could see meaningful upside, with up to ~\$100/MW-day for qualifying assets should prices approach the transition price cap. We suspect price caps will likely be triggered, particularly in more constrained zones during those periods (emphasis on PSEG, ATSI, etc). Notably, we do not see new build resources as truly eligible to participate during this transition, enabling a meaningfully higher compensation value. Although, the offset is that this could yet squeeze retailers with existing commitments priced off these historic results (mitigating this impact on retailers was not addressed in the proposal). As such, we reiterate our view that DYN remains the most levered company to this theme, with NRG, PEG, PPL, and CPN benefitting. We suspect retailers such as EXC and FE could well face some offsets – but will both still materially benefit.

Stiffening up the penalties too. The real stick is here to incentivize change

The latest proposal appears to increase the penalties for non-performance during peak hours, with a maximum liable rate of \$2,700/MWh. This increase, more than any other formal 'requirement' on delivery will likely prove the true limiting factor on portfolios. While we do not expect PJM to necessarily 'police' whether units have adequate fuel deliverability (for both gas, coal plants), this meaningfully higher penalty cap is likely to incentivize this behavior regardless. We emphasize during non-scarcity hours, penalties will be assessed at Net CONE prices, rather than just LMP price during that period; the prior proposal was generally viewed as too weak to incentivize adequate change (despite the protests of some generators). Addressing generator input, the latest proposal would also allow IPPs to make up deficiencies with capacity from other units (allowing 'portfolio compliance'). We emphasize it appears generators will be subject to meaningfully less stringent mitigation, given the ability to add risk premiums to bids, with the exact methodology for the transition auctions further unclear. We suspect bid caps can largely be viewed as the clearing price for these transitions on first blush, particularly with the default price equal to the caps should there be insufficient capacity committed. Different from New England, generators would not be responsible if transmission line outages occurred – and units were undeliverable.

[Link to PJM Whitepaper on Capacity Performance](#)

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The Power Line on PJM:

Putting it all back together: PJM datapoints remain quite robust

While reform has been an inalienable fact to the PJM market in recent years, we emphasize the exceptional impact of the latest slew of changes (capacity performance, shift in demand curve, and demand response participation). The latest white paper only reiterates our confidence in PJM's capacity construct ability to structurally see higher prices, even at higher levels of reserve margins. The primary risk to our thesis around higher prices remains the threat of continued new supply given the combination of low interest rates and hyper-cheap gas available atop the Marcellus and Utica shales to gas developers. The pace of development could push many of these projects out beyond next year's auction (suggesting next year's capacity prices represent a 'peak' in compensation – and the power cycle overall in PJM). We maintain our expectation for a net \$50/MW-day improvement in the 2018/19 auction clearing price for 'performance' capacity (which is still the bulk of existing capacity), emphasizing PJM equities upside on the back of the latest white paper, particularly with the potential for transitional market payments under the program as under-appreciated by the market. Ultimately, we emphasize the rules remain simply a proposal, with key hurdles including PJM board approval leading to a subsequent FERC vote early next year. While rules could yet be diluted in terms of upside impact, we suspect key elements of upside will remain intact.

All signs continue to point towards significant improvement in the next PJM capacity auction for the 'Capacity Performance' product.

For further details on PJM, please refer to our recent notes:

[10/6/14 PJM: Another Year of Weak Gas \(Basis\)](#)

[9/29/14 Turning the Heat Up on PJM to Perform](#)

[9/18/14 In a Tight Spot: The Power Constraints Thesis](#)

[9/16/14 PJM's Potential Triple Whammy Uplift](#)

Transition mechanisms in detail:

At the heart of the proposal is a transition plan that could drive up compensation for generators during the transition period. We see this as the most impactful update within the relatively technical documentation on how the program would be implemented.

Taking steps to improve reliability, and compensate generators along the way.

- **For December 2015 – March 2016**, PJM proposes to seek up to 10GW of additional capacity for this winter season, potentially benefitting seemingly coal generators (like FE, etc).
- **For 2016/2017**, PJM proposes to hold a transitional auction, which resources would be allowed to replace their existing commitments with a ceiling and offer cap at $0.5 * \text{RTO Net CONE}$ (\$165/MW-day). Penalties would be limited at $0.33 * \text{the proposed cap under the new reforms}$, with a maximum penalty equal to just $0.5 * \text{Net CONE}$ (effectively capping penalties at loss of all capacity revenues). Importantly, this transition would allow generators to offer in up to $0.5 * \text{Net CONE}$
- **For 2017/18**, PJM proposes to increase the 67% of the proposed penalty cap, with max penalty at $0.75 * \text{Net CONE}$. The new offer cap for this auction would be $0.6 * \text{Net CONE}$, with a ceiling price set at an equal price (\$211/MW-day).

And don't forget about agreement on removing demand hold back

Lastly, if the proposal did not appear favorable enough – we see PJM's proposal (and agreement with market monitor) to remove the 2.5% holdback as particularly constructive, and effectively adding 4.1GW of demand to the market. While this had previously been used to 'set' prices for the incremental auctions – and effectively reserved to be filled with demand response – this would likely drive results up by ~\$30/MW-day further if ultimately approved (using \$8/MW-day sensitivity for 1GW change for the RTO market released recently from 2017/18 auction).

Not holding back prices any longer.

Oh... and RTO market could improve further with even self-serve entities meeting new targets

PJM also proposed to extend the new capacity performance requirements to FRR (Fixed Resource Requirement) entities, otherwise known as self-serving entities (largely vertically integrated, regulated utilities) within PJM. To the extent that their portfolio is unable or does not desire to meet the new CP, they can either pay penalties or commit to procure additional capacity (from the broader capacity market). We suspect this too will help provide support to this market.

And how about fixing Demand Response (DR) while we're at it? PJM 'works around' Order 745

As an initial response to the uncertainty injected in the sector on the back of the DC Courts' over-turn of FERC Order 745, transitioning Demand Response (DR) to state (vs. federal) jurisdiction, PJM's latest white paper also includes an initial 'fix' to continue to embed demand response into the market place. Notably, the latest scheme would place demand response commitments onto load serving entities to effectively bid in reductions in demand into the auction. It is unclear to us how this would jive with existing Demand Response obligations from aggregators – and suspect this added layer of complexity will yet drive down DR participation (which cleared ~11GW this year). PJM released a simultaneous DR white paper alongside the capacity performance paper today, ahead of a workshop to be held later today. We suspect other RTOs are likely to pursue such compromise schemes to enable continued participation of demand resources in spite of the latest order. PJM further emphasizes the dynamic state of affairs, with both the appellate court petition and FERC interpretation both superseding the latest update.

Compromising on DR but additional complexity could reduce participation.

Expect more details here – from PJM and FERC

Other RTOs likely to follow the lead here too on a 'middle way'

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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Sell	FSR is > 6% below the MRA.	11%	21%
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Source: UBS. Rating allocations are as of 30 September 2014.

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Dynegy, Inc. ^{1, 2, 4, 5, 16}	DYN.N	Buy	N/A	US\$31.20	07 Oct 2014
Exelon Corp. ^{4, 6a, 6c, 7, 16}	EXC.N	Neutral	N/A	US\$34.76	07 Oct 2014
FirstEnergy Corp. ¹⁶	FE.N	Sell	N/A	US\$33.63	07 Oct 2014
NRG Energy Inc. ¹⁶	NRG.N	Buy	N/A	US\$31.35	07 Oct 2014
PPL Corporation ^{2, 3, 4, 6a, 6c, 7, 16}	PPL.N	Neutral	N/A	US\$33.58	07 Oct 2014
Public Service Enterprise Group ^{6b, 7, 16}	PEG.N	Neutral	N/A	US\$37.33	07 Oct 2014

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