US Electric Utilities & IPPs
More March Madness in Columbus

Equities

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Playing out the bracket scenarios, we see a PPA as still unlikely
We took our latest tour in March of Ohio State in an effort to figure out which of the 'final four' generators would win a PPA. Contrary to wider investor belief, we see a PPA in the state as still an uphill battle for AEP and FE. While the latest order in Ohio in AEP's ESP decision was clearly a partial win, the critical piece remains whether the forthcoming new Chair Andre Porter will move forward to put a full PPA in place.

Meeting the criteria will be the tough hurdle on the path to a PPA
Looking beyond the 'zero-based' rider approved in the AEP ESP order, the Public Utilities Commission of Ohio (PUCO) laid out several criteria which utilities must demonstrate in subsequent filings. Notably, this includes the financial necessity (it is unclear whether FE's assets generate cash losses, in contrast to EXC's nuclear units), as well as a plan forward under future environmental compliance (read 111d regulations). While we agree there is merit to concerns around the future of Ohio's coal fleet under implementation of EPA's 111(d), the priority for the PUCO could yet emerge around saving the nuclear units (like Davis Besse) given their important role in achieving overall carbon targets. Bottom line, the PUCO may have approved a rider, but creating a construct that is both financially palatable, sufficiently flexible in disclosure and review, and still legal on an interstate-basis could prove challenging. We see the move towards a zero-based rider as effectively punting the decision to the new chair.

What about the timeline? More of a 2H15 event – could be PJM buzzer-beater?
The PUCO is likely to push for additional time to decide, delaying filings in FE's pending case, allowing newly re-joined Commissioner Andre Porter the opportunity to fully vet the case. With the time-sensitive issue of setting new rates for AEP under its ESP for mid-2015, the Commission has wide latitude to review the PPA-specific proposals. Additionally, the initial PUCO order cites the desire to await clarity on pending PJM reforms and EPA regulation, also due mid-year.

Maintain Sell rating on FE – PPAs sideshow to focus on regulated story
Ultimately, we maintain our view that the PPAs should drive only modest initial value back to FE. Investors are gravitating to this story as a function of its regulated story rather than value in the merchant business – even adjusted for the uplift from any PPA. Management will likely continue to target an FCF breakeven outlook for FES, particularly amidst the latest pullback in regional gas prices, likely driving substantial increases in coal-to-gas switching in the PJM footprint YoY (and comparable to 2012). We sense many investors have already gravitated towards a valuation framework around the utilities & parent rather than continuing to include the negligible EPS from the GenCo.

AEP has more leverage to PPAs; rejection would be negative to both companies
We see the PPAs as having greater value to AEP, which has clear equity value remaining in its generation business – particularly with overall P/E valuation still including the modest contribution from its generation business. We reiterate downside to sentiment in both shares around a shifting in PUCO attitudes away from PPAs under a new chair. Investor expectations appear to clearly poised for approval, with a delay and ultimate rejection a modest negative to shares of both. We see the probability of an 'upset' ruling as higher than most investors we speak to.

Buckeye PPAs are Not a Slam Dunk

Why is the PPA a bigger deal than just a simple contract? We see the proposal from FirstEnergy and American Electric Power (AEP to enter into 10-year Purchase Power Agreements (PPAs) with the Public Utilities Commission of Ohio (PUCO)) as the most meaningful question around restructuring in the industry this year. Following on efforts to fully overturn retail competition in Michigan, we see the PPA effort as a first step towards re-regulation of Ohio, and industry via an attempt to pursue a quasi-ratebase treatment of existing plants in the state.

PUCO dynamics will drive approval process – balance of power will tip

While the state may not be enthralled with the uncertainty in rates ensuing from the electric restructuring, we emphasize the new pending Chair's (Andre Porter) historic proclivity towards competitive markets. Moreover, the Commission is seemingly more divided than commonly perceived in the unanimous recent 5-0 vote on AEP's Electric Security Plan (ESP). The new chair could yet tip the balance of power. This dynamic could yet become clearer upon the new chair's arrival. Assuming any PPA construct would necessarily result in rate increase for industrial customers, it appears clear they will remain adamant in their loud opposition.

What does this mean for the stocks? Approval of the PPAs would be a positive for both AEP and FE – seeing not just the incremental earnings accruing to the company, but also an important precedent established in Ohio, for other generation assets in the state to pursue (expect more petitions for PPAs for the balance of their respective fleets to follow), as well as even other states.

Who else does it impact?

AES: We see a positive read through as they continue to own the DP&L generation assets under an ESP tariff, making them eligible to follow suite

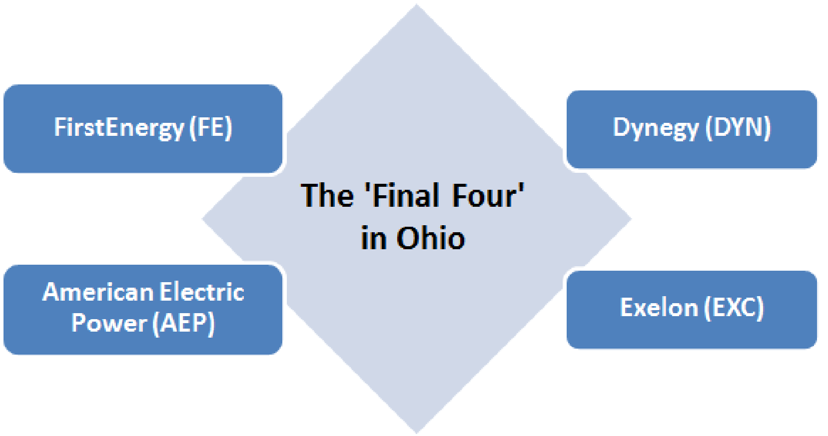
PPL: Seemingly negatively, seeing its pending spin of Talen as the most likely acquirer of any future generation divestments in Ohio. Missing out on the opportunity for consolidation would be disappointing for a company substantially exposed to Eastern PJM.

DYN: Success for AEP and FE would appear negative to DYN, as the company is prevented from following their example. Moreover, success in Ohio could yet push states like Illinois to provide comparable out of market contracts in their respective states.

EXC: Mixed, with a positive read through to their similar efforts in Illinois to save their nukes, while negative to their efforts to maintain 'market' constructs across the PJM footprint.

Other PJM generators: like CPN, NRG, and PEG are less impacted, but more negative. We don't perceive any palatability for a state like NJ to follow suite, seeing high bills as a concern as is; higher generation rates to ensure stable rates does not seem like a priority.

Figure 1: Four Generators Highly Interested in Ohio Outcome



Source: Company Filings

For additional background, please refer to our notes below:

2/25/15 Purchase Power Placeholder
1/13/15 Gauging The Outcome in Ohio State
1/8/15 Spinning the Wheel of Fortune in Illinois

AEP Divestment is unlikely if and until a decision is made on PPA

We reiterate that neither AEP nor FE are expected to make a decision on the fate of their generation portfolios until firm resolution is achieved from the PUCO around the fate of their respective pending PPA petitions.

Success on the PPA maintains optionality for the fleet as the free cash flow profile would solidify.

If they are successful in their petitions, we do not see divestment as obvious either. Even subsequent to a *successful petition* (to which we remain somewhat doubtful), AEP and FE would still unlikely pursue divestment seeing risk to the legal sanctity of their PPA portfolios.

Similarly, we attribute hesitant commentary from FE around any divestment of their corresponding FES (GenCo) business to a similar dynamic. Newly appointed CEO Chuck Jones has said he would not put further funds into this business, but has yet to commit to any future actions around the business; rather the implicit message suggests continued cost cutting will maintain this business at this contemplated breakeven level. However, with many individual units still FCF positive, albeit the overall portfolio negative once layered on with the full overhead costs, it is unclear what levers the company has aside continued delay in capex. The additional operational compliance requirements with the proposed PJM Capacity Performance (CP) penalty structure could force the investment decision.

First round of PPA approvals will lead to more

What is increasingly clear is the intention for both AEP and FE to pursue further rounds of PPAs in an effort to begin to re-regulate the bulk of the generation in Ohio (or at least that regulated under ESP with AEP, FE, and even DPL). *Can adjacent states like Pennsylvania under the leadership of a Democrat chair contemplate a similar move?* We suspect not, but FE could try.

Could certain plants be approved versus others? The Davis Besse question

Paying for carbon compliance could be a theme in future years as nuclear economics deteriorate.

We suspect there could be a growing focus on Davis Besse, the only nuclear plant in the state seeking to be contracted under the proposed PPA. In light of forthcoming 111(d) regulations from EPA on carbon, we see this as the growing priority to maintain in the state's generation portfolio (despite likely poor public reception given previous safety concerns). In contrast to other states like New York and Illinois, which have framed programs to save generators in part on carbon requirements, the PPA construct in Ohio has largely revolved around price security.

Price sanctity, but at what price?

There is value in reducing energy/capacity volatility for consumers but the premium needs to be palatable.

We flag the PPA proposal comes on the heels of wider industrial concerns with the PJM footprint that prices – between energy and capacity – have proven remarkably volatile and unpredictable in recent years. The PPA offers to attempt to hedge their price volatility through a 'rate-base' like construct to provide price security for at least a decade.

Is a ratebase construct the right approach?

Our concern around approval centers around whether a ratebase construct is unpalatably expensive, at a seemingly ~$20/MWh premium to merchant prices. Particularly under the context in which FE and AEP attempt to pursue a wider re-regulation of their portfolio, we suspect need for a compromise around the compensation scheme involved.

A further deal could be in the works – but expect just industrials

Following previous support from industrial participants in the state, we would not doubt that FE (and AEP) could yet find support from further industrial groups in the state following a stipulation in support filed earlier in the year. Notable in this deal – and likely subsequent deals – would be a condition for industrial constituencies to be largely excluded from any corresponding rate increases involved in the subsequent rate design involved with implementation.

What are Limitations to the PPA Approach: Details are Key!

Clarity in the filing on prudency and review

Clash between PPA and ratebase constructs make approach a bit clumsy

The Commission appears clear in its AEP order that it desires the ability to conduct an initial *and* ongoing prudency review of any assets under the PPA. The question remains to what extent the PPA construct would enable ongoing rate adjustments to reflect prudency, cost adjustments, and other review adjustments. Additionally, it would appear the contracts are also perceived to lack long-term credibility without a long-term firm commitment on price (rather than just the ten-years committed to). While AEP's appears to have lacked much of the initial cost detail sought by the PUCO, we look for a reaction from the PUCO around FE's proposal.

Losing out to FERC jurisdiction in the process?

A further consideration in the approval process remains the extent to which the PUCO is hamstrung by FERC jurisdiction in any modifications to the PPA and oversight of the contract. We suspect any ultimate construct will minimize FERC's involvement in the process, particularly in order to limit forthcoming litigation.

The Burden of Proof

The PUCO conditions for a PPA appear to bode most favorably for a FCF-negative nuclear plan.

The Commission explicitly spells out a series of conditions under which petitioners for the PPA would need to meet in order to qualify. These include:

- Financial Need of the generating plant (*Is it actually struggling financially?)*
- Necessity of the generating facility, in light of future reliability concerns (*we think EPA's 111d is contemplated here).*
- Compliance plan for the generation plant with relevant rules – and its plan for future compliance (*again, here read: EPA 111d compliance plan)*.
- The impact of its closure on prices regionally.
- The Commission reserves the right to require a third party study. (*It appears clear this avenue will be elected – evaluating the merits of the financial and reliability impacts)*.
- Provide for controls around 'rigorous' Commission oversight of the rider, including the process for a 'periodic' review. (*The issue at hand here is a PPA typically does not have re-openers and prudency reviews as conventional rate base investments do).*

Two key issues arise in the criteria—

Clearing or not clearing the capacity auction is the largest driver here.

1. **Explaining the financials**: We are not convinced many of the said assets are losing FCF. It is not clear the PUCO will see that the plants meet the 'Financial Need' threshold. An important nuance around whether the plants cleared the capacity auction will become increasingly relevant– will the PUCO see the lack of a given plant clearing in the auction as part of a wider bidding strategy in the ATSI region, or will see it as an indication of wider distress? We emphasize that this appears to be the primary driver as to whether or not a plant is FCF positive or negative.
2. **Compliance plan and illustrating reliability needs**: We read the implicit focus on EPA's 111(d) rules in two ways – first, we see the threshold here as written with sufficient latitude to explain *why* the plants (coal or nuclear) would be needed under the more dramatic PJM scenarios of carbon implementation. We expect FE and AEP to leverage statistics illustrating the potentially meaningful impacts on pricing as a reason for the PPAs- and need for greater price certainty.

We read the implicit focus on carbon as also continuing to stress the need for a compliance plan around the way forward, lending to supporting the nuclear units over the coal units.

How will new generation change the picture?

Could the proposed of a PPA and re-regulation scare the new build away?

Amidst the debate over the merits of PPAs to support AEP and FE's coal portfolio is the question over whether the market can deliver on new generation. We expect several new assets to clear in the upcoming PJM capacity auction in May in Ohio. With the PPA docket still likely undecided – and the outcome of the PJM auction seemingly a consideration in approval - **the question remains whether new plants in Ohio will continue to participate and how that could shift the PUCO's thought process around execution of the plan**.

These include:

1. Rolling Hills CCGT Conversion: We look for Tenaska to add +550 MWs, by converting this existing peaker to a CCGT.
2. Carroll County CCGT: We see the proposed 700MW CCGT in Eastern Ohio to bid into the next BRA auction, as indicated by filings before the Ohio Power Citing Board recently.

As a reminder, the new Oregon Clean Energy Project CCGT cleared in ATSI in the last auction already, kick-starting a nascent trend in the state. We suspect additional resources could yet enter in subsequent years – albeit partially dependent on the outcome of the pending PPA petition. We also flag that the Oregon CCGT could yet be upsized, albeit depending on a number of factors including transmission interconnection cost as well.

Commission still retains authority to procure *new* generation too

As a final note on the subject, we remind investors that SB221 in Ohio permits the Commission to pursue new generation under a backstop process under a competitive process. While this remains entirely off the table, the related authority is relevant in our mind as to the commission's ability to engage in resource adequacy and supply procurement.

M&A in Ohio: Dynegy unlikely to be candidate for AEP either

Despite recent talk of Dynegy's interest in the AEP Generation assets we reaffirm our belief that market power considerations would likely be a limiting factor on any such proposed transaction. We emphasize the pushback on its latest transaction in the state for DUK has produced a surprising amount of consternation and suspect a deal in which Ohio (PJM overall) would see greater concentration in the state would likely be troubled (albeit we would not close the door entirely pending behavioral mitigation agreements with the Independent Market Monitor).

AES decided last Summer that it would retain its DP&L generation assets but the right bid could change its decision.

The *real* question is whether Dynegy could ultimately pursue the AES DP&L generation portfolio as part of any potential interest from AES to divest the generation business and its volatile corresponding earnings. This would appear more likely, albeit this too would not be a 'slam dunk' either.

RPS Back on the Table in Ohio?

With the two-year anniversary of the 'freezing' of the states' renewable and energy efficiency goals, we suspect a program is revised, albeit scaled back from its initial intentions particularly as it relates to the energy efficiency element. This could garner some greater attention in coming months.

Compliance with EPA Carbon 111d rules the backdrop

Among the greatest implicit threats contained within the rules – and perhaps the driving factor for 'why now?' is the consideration of wider planning around Ohio's plans to comply with 111(d) regulations. There is an underlying concern Ohio's coal portfolio (FE/AEP) will *not* survive any future regulations – and need PPA price support to maintain regional reliability statistics. While this is an implicit element of the PPA efforts, we see the narrow definition of which plants are eligible (excluding DUK/DYN's plants) as illustrating this as a secondary factor. Saving the nuclear plants over coal could yet emerge as a key element.

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 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 for 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.	47%	37%
Neutral	FSR is between -6% and 6% of the MRA.	42%	32%
Sell	FSR is > 6% below the MRA.	11%	21%
Short-Term Rating	**Definition**	**Coverage[3]**	**IB Services[4]**
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 December 2014.
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Company Disclosures

Company Name	Reuters	12-month rating	Short-term rating	Price	Price date
American Electric Power, Inc.[6, 7, 16]	AEP.N	Neutral	N/A	US$57.55	18 Mar 2015
FirstEnergy Corp.[16]	FE.N	Sell	N/A	US$36.11	18 Mar 2015

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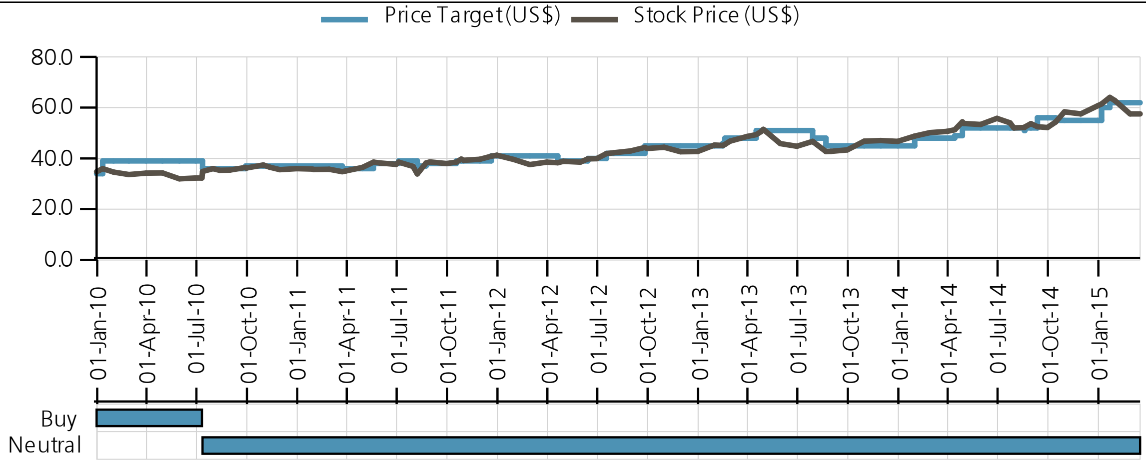
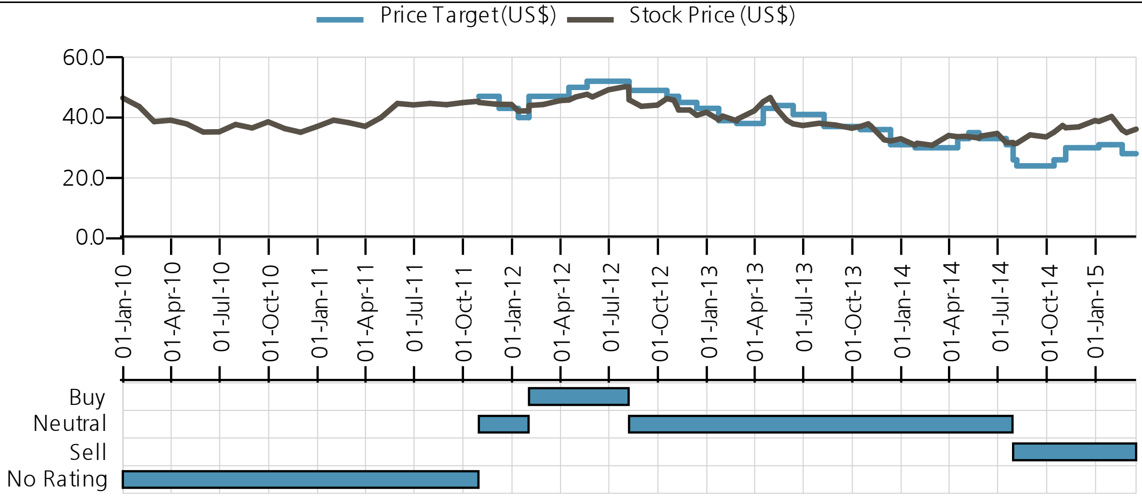


Source: UBS; as of 18 Mar 2015

FirstEnergy Corp. (US$)



Source: UBS; as of 18 Mar 2015

Additional Prices: Dynegy, Inc., US$28.84 (18 Mar 2015); Exelon Corp., US$33.72 (18 Mar 2015); AES Corporation, US$12.64 (18 Mar 2015); Source: UBS. All prices as of local market close.

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