

US Electric Utilities & IPPs

In Transmission Risk is at the Top

Equities

Americas
Electric Utilities

Julien Dumoulin-Smith

Analyst

julien.dumoulin-smith@ubs.com

+1-212-713 9848

Michael Weinstein

Associate Analyst

michael.weinstein@ubs.com

+1-212-713 3182

Paul Zimbardo

Associate Analyst

paul.zimbardo@ubs.com

+1-212-713 1033

Latest FERC MtM analysis highlights 10.9% ROE as an outlier

Following the [initial decision](#) (ID) in the pending FERC regulated transmission base ROE complaints released on 3/22 we have prepared our latest mark-to-market using the consistent New England case methodology (midpoint of the upper half i.e. 75th percentile). Our analysis indicates a ~9.5% 75th percentile ROE, largely consistent with the outcome in the EL13-33-002 case (9.59% FERC base ROE). In our analysis we exclude ITC and TE (pending M&A) and adjust for GXP's "illogically-derived" IBES growth rate (9.1% vs 4-5% guidance 2016-2020), which has a ~105bp negative impact. The latest New England ROE FERC case (EL 14-86-000) for the Nov'14-April '15 period still *includes* both ITC and TE (both pending acquisition targets), which causes what we consider an outlier outcome versus what we perceive as a longer-term declining trend in utility ROEs.

How significant is the impact of "anomalous conditions"?

We estimate an 8.6% ROE at the midpoint, 88bp below the 75th percentile, and representing a level that is likely at a discount to state-level authorized returns in many jurisdictions. The wider question continues to be how FERC will continue its objective of incentivizing transmission as the spread declines. We wouldn't doubt a new approach emerges in subsequent ROE revisions to address this desire to keep FERC above states.

Who is exposed? ITC still at the top of the list

Companies with material transmission ratebase include ITC (100%), PEG (50% 2018E), ES (42% 2019E), AEP (48% of 2016-2018E capex), and AEE (27% of 2016-2020E capex). When asked about the potential for ROE challenges at its recent Analyst Day PEG stated that it has not observed anything that would make it question its current 11.68% ROE. Despite the exposure for these companies, we still see value in PEG and AEP in particular. For PEG we believe the market is undervaluing its premium utility with consistently beats expectations [\[here\]](#) while we believe AEP will benefit from its continued transition into more of a pure-play regulated utility [\[here\]](#).

Figure 1: Updated FERC ROE Mark-to-Market Analysis – The Latest Revision Down

ROE Analysis Summary	Low	Midpoint	High	FERC "Upper Midpt" 75th %	Ranked 75th %
Zone of Reasonableness (Original)	7.03	9.39	11.74	10.57	9.77
Zone of Reasonableness (1/4 GDP Weight)	6.97	9.51	12.05	10.79	9.84
Zone of Reasonableness (UBSe MTM 8/19/14)	7.14	10.25	13.35	11.80	9.65
Zone of Reasonableness (UBSe MTM 10/22/14)	6.77	9.28	11.80	10.54	10.25
Zone of Reasonableness (UBSe MTM 1/26/15)	5.96	8.81	11.65	10.23	10.11
Zone of Reasonableness (UBSe MTM 3/10/15)	6.30	8.68	11.07	9.87	9.32
Zone of Reasonableness (UBSe MTM 4/22/15)	6.22	8.64	11.05	9.84	9.36
Zone of Reasonableness (UBSe MTM 11/12/15)	6.31	8.60	10.89	9.74	9.41
Zone of Reasonableness (UBSe MTM 3/23/16)	6.87	8.63	10.39	9.51	9.45
Westar Settlement	July 2015			9.80	
FirstEnergy 2016 Settlement (Pre-Adder)	July 2015			9.88	
Transco NY Settlement	Nov 2015			9.0-9.5	
EL13-33-002 ALJ Initial Decision	Jan 2013-Mar 2014		10.42	9.59	
EL14-86-000 ALJ Initial Decision	Aug 2014-Sept 2015		12.19	10.90	
Increase/(Decrease) latest MTM from Orig	(0.16)	(0.75)	(1.35)	(1.05)	(0.32)

Source: FERC, Company filings, FactSet, Yahoo! Finance, and UBS estimates

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Breaking down the proxy group: In the table below we show the entire peer group used for calculating the FERC formula ROE. At the bottom of the table, we highlight the low-end ROE, high-end, midpoint (average of low and high), the upper midpoint (average of the midpoint and the high), and our calculation of the true "75th percentile" as determined by ranking all results (excluding companies involved in M&A, etc.). We emphasize that the ROEs listed are purely based on the formulas and do not represent the specific company's authorized ROE.

Figure 2: Updated FERC Mark-to-Market ROE Calculation (UBSe Prepared Mar 23)

Company	Tickers	LT GDP		Composite	6 Mo. Avg Adj. Div.		ROE	ROE Rank	Excluded (UBSe)	S&P Rating	Moody's Rating
		I/B/E/S 5Yr	Growth		Yield						
ITC Holdings	ITC	12.14	4.39	9.55	2.27		11.82		M&A	A-	Baa2
PEPCO Holdings	POM	8.00	4.39	6.80	4.34		11.13		M&A	BBB+	Baa3
Sempra	SRE	8.58	4.39	7.18	3.21		10.39	100%		BBB+	Baa1
PNM Resources	PNM	8.76	4.39	7.30	3.08		10.38		Credit	BBB+	Baa3
Otter Tail	OTTR	6.00	4.39	5.46	4.78		10.24	96%		BBB	Baa2
Wisconsin Energy	WEC	6.77	4.39	5.97	3.85		9.82	92%		A-	A3
TECO Energy	TE	7.20	4.39	6.26	3.54		9.80		M&A	BBB+	WR
Alliant Energy	LNT	6.65	4.39	5.90	3.89		9.79	88%		A-	A3
CMS Energy	CMS	7.24	4.39	6.29	3.49		9.78	85%		BBB+	Baa2
CenterPoint Energy	CNP	3.65	4.39	3.89	5.84		9.73	81%		A-	Baa1
ALLETE	ALE	6.00	4.39	5.46	4.17		9.63	77%		BBB+	A3
Dominion Resouces	D	6.00	4.39	5.46	4.10		9.57		M&A	A-	Baa2
NextEra Energy	NEE	6.75	4.39	5.96	3.41		9.37		M&A	A-	Baa1
El Paso Electric	EE	7.00	4.39	6.13	3.13		9.26	73%		BBB	Baa1
Ameren	AEE	5.60	4.39	5.20	4.04		9.24	69%		BBB+	Baa1
Eversource	ES	5.98	4.39	5.45	3.54		8.99	65%		A	NA
Empire District Elec.	EDE	5.00	4.39	4.80	4.17		8.97		M&A	BBB	Baa1
SCANA	SCG	5.40	4.39	5.06	3.90		8.96		Credit	BBB+	Baa3
Avista	AVA	5.00	4.39	4.80	4.02		8.82	62%		BBB	Baa1
PPL Corp	PPL	4.16	4.39	4.24	4.57		8.81	58%		A-	Baa2
Duke Energy	DUK	3.79	4.39	3.99	4.82		8.81		M&A	A-	Baa1
PG&E	PCG	5.50	4.39	5.13	3.68		8.81	54%		BBB	Baa1
Portland General Ele.	POR	5.73	4.39	5.28	3.48		8.76	50%		BBB	A3
Westar Energy	WR	5.27	4.39	4.97	3.71		8.68	46%		BBB+	Baa1
Southern Company	SO	3.48	4.39	3.78	4.89		8.67		M&A	A-	Baa1
Vectren	VVC	5.00	4.39	4.80	3.87		8.66	42%		A-	NA
Xcel Energy	XEL	5.10	4.39	4.86	3.77		8.64	38%		A-	A3
American Electric Po.	AEP	4.83	4.39	4.68	3.95		8.63	35%		BBB	Baa1
NorthWestern	NWE	5.00	4.39	4.80	3.71		8.51	31%		BBB	WR
Great Plains Energy	GXP	4.50	4.39	4.46	4.03		8.49	27%		BBB+	Baa2
Black Hills Corp	BKH	5.00	4.39	4.80	3.67		8.46		M&A	BBB	Baa1
DTE Energy	DTE	4.90	4.39	4.73	3.73		8.46	23%		BBB+	A3
Exelon	EXC	3.45	4.39	3.76	4.37		8.13		M&A	BBB	Baa2
Hawaiian Electric	HE	3.20	4.39	3.60	4.40		8.00		M&A	BBB-	WR
Pinnacle West Capital	PNW	3.60	4.39	3.86	3.96		7.82	19%		A-	A3
Cleco	CNL	3.00	4.39	3.46	3.95		7.42		M&A	BBB+	WR
IDACORP	IDA	4.00	4.39	4.13	3.13		7.26	15%		BBB	Baa1
Consolidated Edison	ED	2.43	4.39	3.08	4.04		7.12	12%		A-	A3
OGE Energy	OGE	1.75	4.39	2.63	4.30		6.93	8%		A-	A3
PSE&G	PEG	1.99	4.39	2.79	4.08		6.87	4%		BBB+	WR
MGE Energy	MGEE	4.00	4.39	4.13	2.68		6.80		Credit	N/A	NA
Edison International	EIX	1.33	4.39	2.35	3.16		5.51		ROE	BBB+	A3
Entergy	ETR	(2.31)	4.39	-0.08	5.00		4.93		ROE; Credit	BBB	Baa3
FirstEnergy	FE	(2.53)	4.39	-0.23	4.50		4.28		ROE; Credit	BBB-	Baa3
Avangrid	AGR	N/A	4.39	N/A	N/A		N/A		M&A	N/A	Baa1

Zone of Reasonableness (MTM)	Low	Midpoint	75th Percentile	Midpt of Upper	High
23-Mar-15	6.87	8.63	9.45	9.51	10.39
Prior calc (Nov 12, 2015)	6.31	8.60	9.41	9.74	10.89

Source: FERC, Company filings, FactSet, Yahoo! Finance, and UBS estimates

[For information from our previous November mark-to-market analysis please click here for the full report.](#)

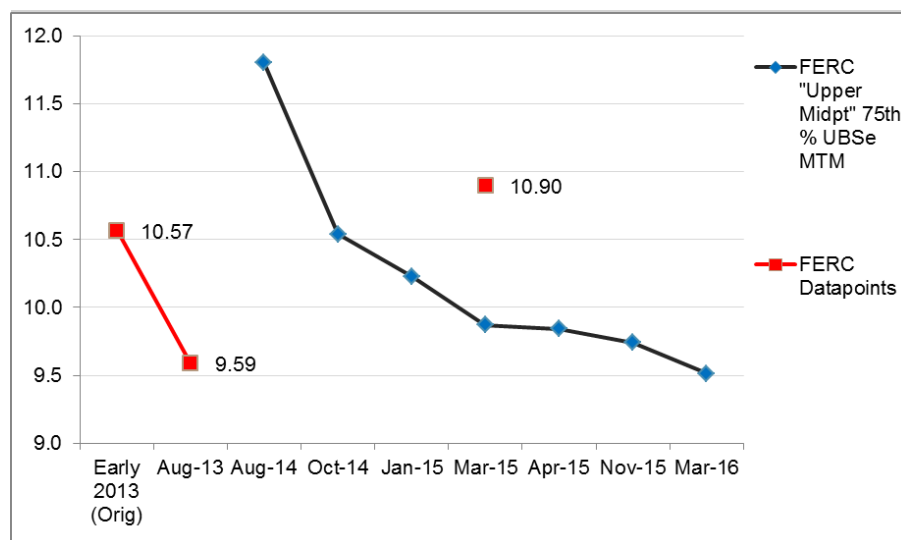
Redefining How to Address Anomalous Conditions?

With the FERC *already* employing an adjustment away from the midpoint of the proxy group in deriving its ROE (towards the "upper midpoint" to adjust for the anomalous market conditions), the question what *other* adjustment can be achieved to keep ROEs above that of state levels. We see this as more of an issue of *how* the ROEs of each of the constituents is calculated rather than a question of where the figures lie in the proxy group seeing the top end of the current range is only 9.7% for GXP (and even that appears higher than the guidance delineated by management.) We note Staff here appears keen to move away from IBES growth metrics as well, which would actually put further downward pressure on the stats.

Is this an indication the ROE trend could shift back downward?

With ROEs on transmission clearly at risk to the downside, the question remains whether state-level rates will see any meaningful recovery. We had seen a nascent trend towards improvement in states like AR earlier this year. We suspect the latest improvement in the equity markets and downtick in interest rates could yet put further (modesty) downward pressure on state-level ROEs.

Figure 3: FERC ROE Mark-to-Market Analysis vs FERC Datapoints



Source: FERC, Company filings, FactSet, Yahoo! Finance, and UBS estimates

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

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Buy	FSR is > 6% above the MRA.	48%	36%
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Sell	FSR is > 6% below the MRA.	12%	22%
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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%

Source: UBS. Rating allocations are as of 31 December 2015.

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UBS Securities LLC: Julien Dumoulin-Smith; Michael Weinstein; Paul Zimbardo.

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Company Name	Reuters	12-month rating	Short-term rating	Price	Price date
Ameren Corp. ¹⁶	AEE.N	Neutral	N/A	US\$48.99	23 Mar 2016
American Electric Power, Inc. ^{2, 4, 6, 7, 16}	AEP.N	Buy	N/A	US\$65.08	23 Mar 2016
Eversource Energy ¹⁶	ES.N	Neutral	N/A	US\$57.93	23 Mar 2016
ITC Holdings Corp ^{16, 19}	ITC.N	Neutral (CBE)	N/A	US\$42.59	23 Mar 2016
Public Service Enterprise Group ¹⁶	PEG.N	Buy	N/A	US\$46.21	23 Mar 2016

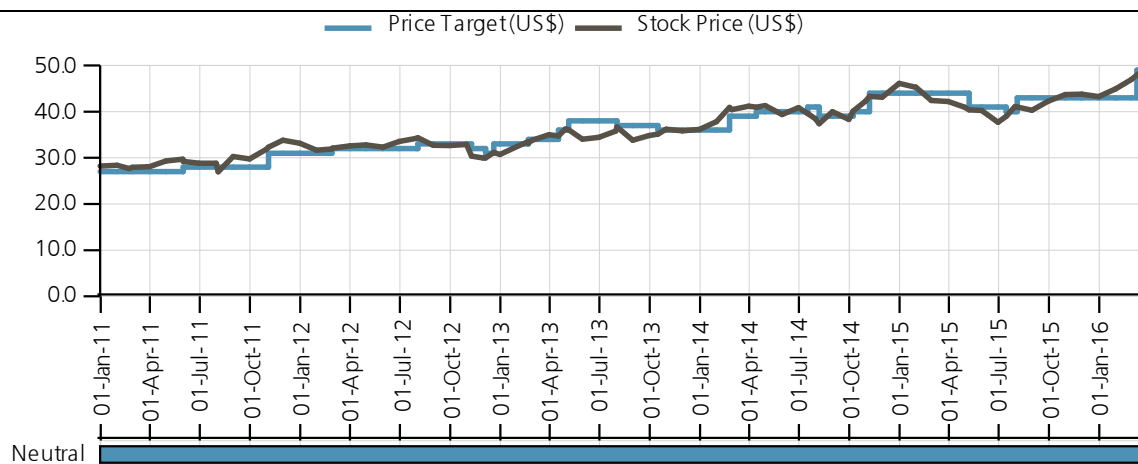
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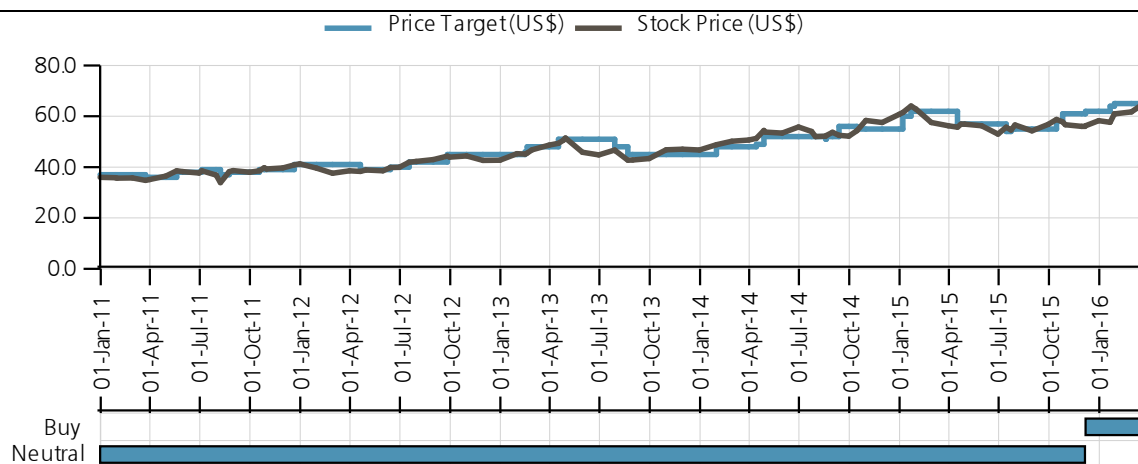
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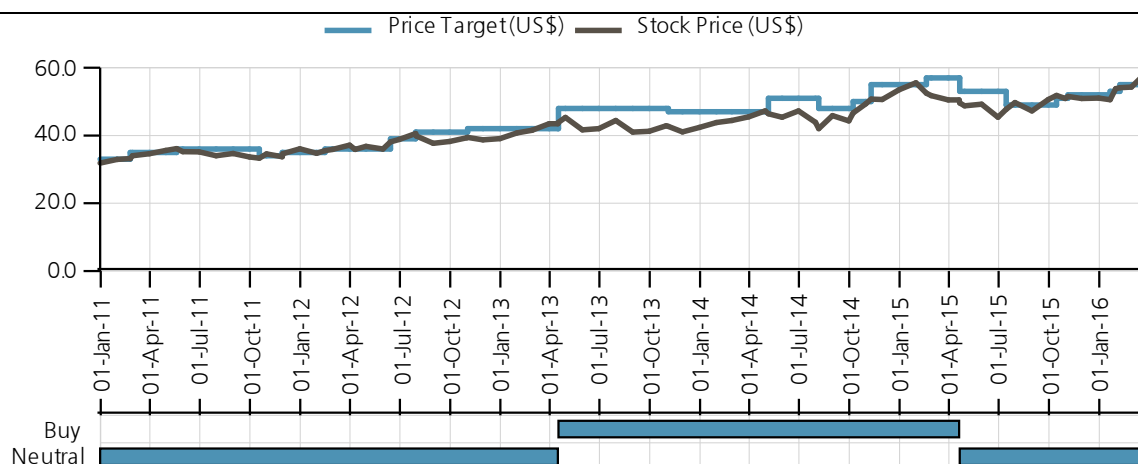
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American Electric Power, Inc. (US\$)



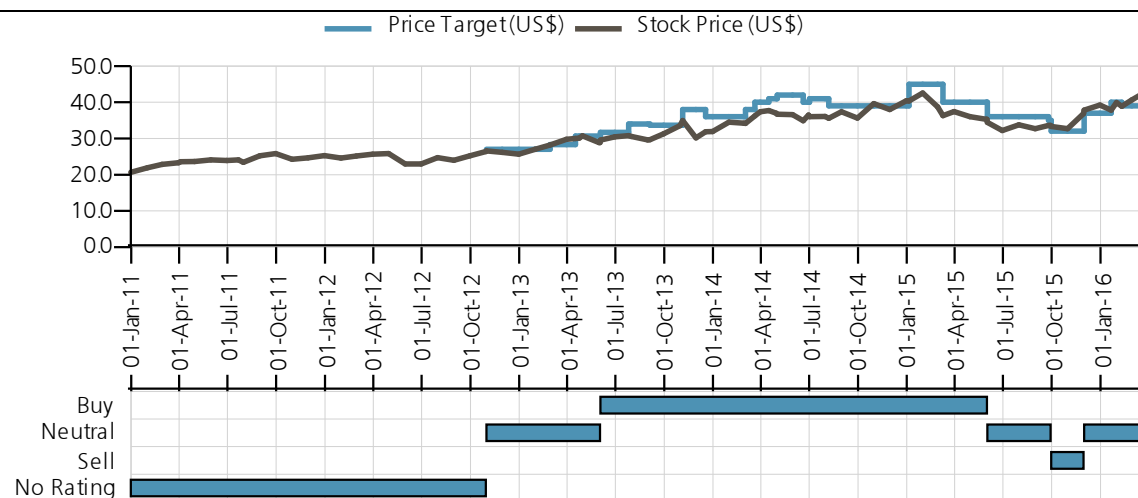
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Eversource Energy (US\$)



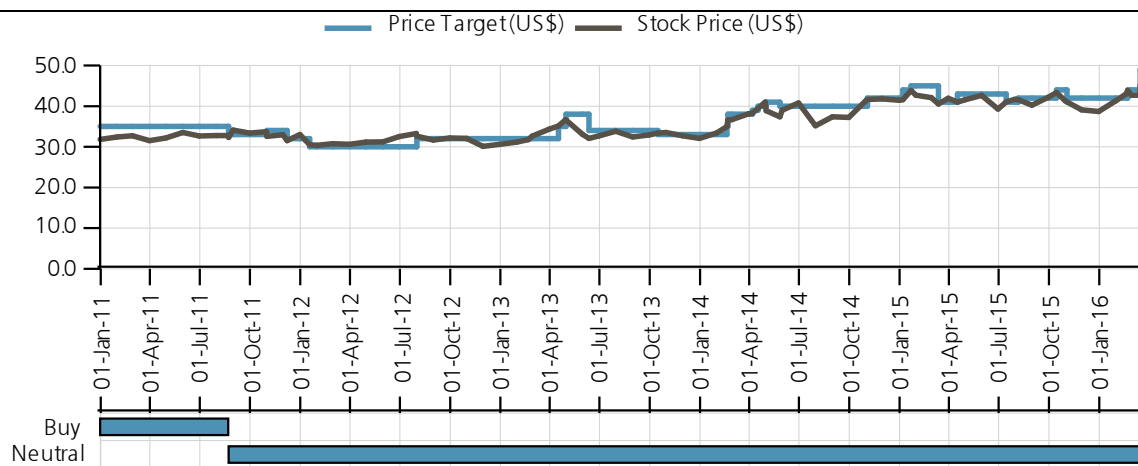
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ITC Holdings Corp (US\$)



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Public Service Enterprise Group (US\$)



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