The great yield rush
A closer look at total shareholder return in the US power and utilities sector
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About this report
This report provides an analysis of the largest 50 US utilities (hereafter EY50) by market capitalization and includes detailed analysis by segment. Our segment analysis considers four segments: energy delivery, local distribution natural gas companies (LDC), integrated utilities and hybrids, including independent power producers (IPPs).

The total return calculation assumes that any dividends paid by the company are reinvested at the closing price of the security on the ex-date of the dividend. Total return is calculated as: (current price + US$ value of dividends in fractional shares - start price)/start price.

The price-to-earnings ratio is calculated as: market share price/trailing 12-month earnings per share.
The great yield rush

Introduction

Investors aggressively pursuing yield had pushed utility valuations to pre-financial crisis levels; however, with news that the Federal Reserve could begin a tapering regime on monetary policy, is this the beginning of the end for investors' love affair with utilities?

The current paradigm in the US power and utilities (P&U) sector is intriguing. As speculation continues on when the Federal Reserve will ease up on its activist monetary policy and begin tapering its aggressive bond buying program, it's worth considering what the impact may be on the P&U sector as well as reflecting on how the utilities delivered for shareholders in 2012.

In 2012, the US economy gathered momentum and investor sentiment improved, sending the total shareholder return (TSR) for the S&P 500 to 16%. However, the P&U sector lagged, with the EY50 (largest 50 US utilities by market capitalization) returning just 1.6% for the year. Between low natural gas prices, tightening environmental regulation and weak growth in electric demand, utilities struggled to keep pace with the broader market recovery.

The upturn in economic confidence resulted in capital rotating out of a sector viewed by many as a safe haven in times of uncertainty. So, with higher growth opportunities in other sectors, investors were leaving the safety of the P&U sector for more attractive returns offered by sectors such as financials, consumer discretionary and transportation. However, through 21 June 2013, utility stock returns, although off their recent highs in late April, have been admirable — the utilities have delivered 7.9% total return compared to the S&P’s 12.8% — even as demand for other traditional safe harbor investments (particularly gold) has fallen as the US regains its confidence.

Dividends, of course, are a major source of the EY50’s charm. Despite their general lack of a growth story relative to other sectors, utilities continue to offer attractive dividend yields, averaging 420 basis points (bps) or a spread of approximately 230 bps to the 10-year Treasury in 2012. But prices have climbed in 2013, and utilities are beginning to look expensive, trading significantly above their 10-year average price/earnings (P/E) multiple.

If interest rates remain low, utilities should continue to benefit from the yield play. However, interest rates are rising. Since May 21, the 10-year Treasury has gained an astounding 58 bps to end the week of June 21, 2013 at 252 bps. A continuation of this would have a devastating impact on both bonds and equities, with the downside significantly more pronounced for utilities. This, combined with earnings pressure brought on by fundamental changes in the industry, such as flattening growth and increasing environmental mandates, will challenge utilities’ ability to maintain current yields and place enormous pressure on their earnings multiples.

Key findings

• Current valuations are likely unsustainable in the long run. Utilities continue to trade significantly above long-term P/E multiples, propped up by investor appetite for yield amid an artificially low Treasury environment and investor uncertainty of the underlying strength of the US economy.

• 20x is not the new normal. We believe that the peak P/E valuations of 20x in early May 2013 do not represent a new normal, and the recent correction was imminent. However, despite this, valuations are unlikely to revert to historical averages of 15.4x P/E.

• Industry transition creates a new landscape for utilities. Forecasted anemic electric demand over the next two decades, combined with significant capital investment requirements (an aging infrastructure and unprecedented environmental mandates), will place pressure on utilities’ ability to continue to deliver attractive returns.

• Earnings under pressure. Higher interest rates, pressure on return on equity (ROE), depressed energy prices and rate pressure from the combination of lower demand and higher infrastructure costs discussed above will increase stress on earnings and cash flow.
Total shareholder return

Utilities struggle to deliver amid 2012 market recovery; 2013 a different story

In an uncertain economy, investors have turned historically towards the relatively safe harbor of rate-regulated utilities. Despite forming the foundations of portfolios, when optimism returns, investors typically venture farther up the risk curve in search of higher growth opportunities.

True to form, in 2011, amid a volatile market environment spurned by global economic concerns, the EY50 delivered a TSR of 18.4% versus 2.1% by the S&P 500. Then, in 2012, the tide turned. Increased confidence in the US economy, depressed natural gas and wholesale power prices, pressure on utility return on equity (ROE) rates, significant environmental capital expenditures and sluggish overall load growth all contributed to a tough equity market environment for utilities. Towards the end of 2012, election year campaign rhetoric also hurt total returns, as investors feared proposed tax structures and their impact on the value of utilities’ dividends. For most of the companies in the EY50, TSR fell to near zero as the S&P 500 took off.

However, despite the broader market dynamics that handicapped other utility segments, a few companies (e.g., Sempra Energy (SRE), NextEra Energy (NEE) and NRG Energy (NRG)) managed to outpace the market. These companies were able to deliver premium returns principally due to their diversified portfolios in attractive regions, (e.g., Electric Reliability Council of Texas (ERCOT)), investment in lucrative renewable energy projects supported by long-term power purchase agreements (PPAs) and strategic acquisitions that enhanced scale and delivered synergies. Two key merger announcements led the EY50 transaction news in 2012: NRG Energy acquired GenOn for US$1.7 billion and Fortis acquired CH Energy (CHG) for US$1.5 billion. The market supported these transactions, pushing NRG Energy and CH Energy into the top 10 of the EY50 in overall TSR performance. Figure 1 below summarizes the TSR for the EY50 and the S&P 500.

![Figure 1: 2012 total shareholder return](image)

- Signs of improvement in the US economy emboldens investors to seek higher growth opportunities in the broader equities market. Share prices of the S&P 500 outpace the risk-averse utilities.
- Spanish/Italian sovereign bonds plummet, reigniting Euro fears. Volatility within the market spikes and S&P 500 erodes earlier gains. Utilities rally, as investors flock to a safe haven.
- ECB President Draghi pledges to do “whatever it takes” to preserve the Euro. Broader market volatility settles, the S&P 500 rebounds and capital rotates out of utilities again in search of high growth opportunities.
- US elections, political rhetoric and fiscal cliff concerns create uncertainty around a proposed dividend tax. The high-yield utilities are impacted more acutely than the broader market, and the EY50 ends the year close to where it began.

Source: SNL Financial, EY analysis

\(^1\) As of market close, 21 June 2013.
On the back of strengthening underlying economic sentiment, the S&P 500 has returned a healthy 12.8% YTD 2013. Despite some mixed signals, signs of an improving US economy are there, including a 10.9% increase in year-over-year national home prices. All things being equal, we would expect utilities to be underperforming this strong market growth; however, nothing about the current situation is normal. The EY50 has returned a 7.9% TSR year-to-date that is less than the S&P 500’s return of 12.8% (although through 30 April 2013, the EY50 was outpacing the S&P 500). There are two key factors that drove this strong performance. Firstly, the continued dismal Treasury yield has sent investors searching out bond equivalent equities such as utilities. Secondly, investors skeptical of the surging market rally had banked on utilities as a safe haven – somewhere to shelter should the storm come. The influx of capital from these two investor demographics has driven utility stocks to flourish through April 2013.

A recent pullback may signal trouble ahead

Despite the strong performance year-to-date, utilities were the worst performing sector of the S&P in May, and June is proving equally dismal. Rising optimism on underlying economic growth and concern about the potential wind down of the ultra-easy monetary policies have sent a shiver through investor confidence in utilities. Suddenly, the technology and industrial sectors seem more attractive. The potential for higher returns from bonds (both corporate and Treasury) will reduce the need to seek out income from utility equities.

Utilities are still trading above 10-year P/E averages, despite late May correction

Yet, as investors have traded up utility stocks, searching for yield in a climate of artificially low interest rates driven by activist central bank policies, utility equities are looking increasingly expensive by historic standards. The EY50 has pushed through its historic 10-year average P/E ratios of 15.4x and closed 2012 trading at 17.2x. In the early part of 2013, they had been pricier still, peaking in early May at 10-year highs of 20.6x before receding to 18.4x at the end of June. Utilities also look expensive relative to other equities in the broader market, especially in light of a stronger US economy. The overall P&U sector finished 2012 with a price-to-earnings ratio of 17.1x, on par with that of the S&P 500. This is a jump over its 10-year medians, where the S&P 500 (19.1x) trades at a 1.3x premium to the utilities (15.3x).

Figure 2: Price-to-earnings ratio

Source: SNL Financial, EY analysis

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2 As of market close, 21 June 2013.
3 Ibid.
Valuations supported by attractive yield; 2013 sees a softening on the back of strong share price growth

A primary source of the utilities' high valuations is the dismal yield of US Treasuries and other debt securities. The Federal Reserve's stimulus policies helped drive interest rates to record lows, pushing investors to other steady income alternatives, such as high-yield equities. In 2012, utilities, especially integrated utility companies, represented a compelling option, with the EY50 finishing the year with yields at 420 bps, a 250 bps spread to 10-year Treasuries.

Taking a closer look at yields, the end of 2012 saw utility yields surpass investment grade corporate bonds on the spread to 10-year Treasuries. Dollar for dollar, utilities were offering a more attractive yield play for investors, despite the fact that equities bear more risk than bonds. With the upside potential in equity growth for utilities compared to bonds, this has historically been a relatively uncommon occurrence.

On the back of strong stock price performance so far in 2013, utility yields have come under pressure, with the EY50 at 395 bps, 145 bps above 10-year Treasuries. Corporate bond yields have actually appreciated a bit, with BBB bonds at 405 bps, 10 bps above the utilities.  

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**Figure 3: EY50 vs. BBB Corporate Bonds (difference in 10-year Treasury spread)**

![Graph showing comparison between EY50 and BBB Corporate Bonds](image)

Source: SNL Financial, Bank of America/Merrill Lynch U.S. Corporate BBB bonds, Federal Reserve, EY analysis

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4 As of market close, 21 June 2013.
5 Ibid.
Through 30 April 2013, valuations for utilities had escalated at an incredible rate. Investors seeking yield amid low Treasury rates and those wary of an imminent market correction kept utility valuations near all-time highs. However, the recent shift in market conditions and the Federal Reserve’s announcement that it could begin tapering its massive bond buying by year-end, could affect investor sentiment and send investors fleeing the sector en masse.

Viewpoint

The great yield rush

To drive broader economic growth, the Federal Reserve has kept interest rates low, sending investors scrambling for higher yields. The utilities have provided an alluring yield, including an average dividend of 4.2% in 2012, that has attracted investors and driven P/E multiples well above historic norms. However, with the economy and labor markets continuing to improve in 2013, the Federal Reserve is forecasting that it could reduce its unprecedented bond buying program by year-end if the economy and labor markets hit certain targets, including annualized GDP growth of between 2.3% to 2.6% and unemployment between 7.2% to 7.3%. If the economy does improve as forecasted, reducing the bond buying program should lead to higher long-term interest rates. Since early May when the Federal Reserve announced it could begin tapering its purchase, long-term interest rates have risen dramatically. Add in the impact of growing investor confidence and suddenly investors could consider utilities overvalued.
2012 segment highlights

2012 was a tough year for utility returns; however, 2013 has a different story with EY50 up 7.9% YTD 21 June 2013

Figure 4: TSR 2012.

Integrated utilities lead the industry in 2012

The integrated utility segment was the best performing segment in 2012, delivering a 3.6% TSR. Underpinning this solid, if not spectacular, result was the successful divestment of unregulated assets (PNM Resources (PNM)) and strong, steady returns (UNS Energy (UNS), NV Energy (NVE)) in supportive regulatory regions. UNS delivered a 20% return on the back of a supportive regulatory environment and was the only integrated utility to outperform the S&P 500.

Hybrids were among the big winners and losers for 2012

The hybrid segment, including independent power producers (IPPs) (e.g., NRG Energy, Calpine and Dynegy), featured the best and worst performers of 2012. The hybrids were well represented in the first quartile, with six utilities experiencing strong returns of 11.0% to 33.8%. However, this was offset by six hybrids in the last quartile that posted poor TSRs ranging from -2.4% to -27.4%. Overall, the polarizing performances led hybrids to end the year roughly where they began, with a segment TSR of -0.4%.

The top performing companies, Sempra, NRG Energy and NextEra, delivered strong returns on the back of fleet diversification (both fuel and location), acquisitions (e.g., NRG/GenOn) and projects that delivered predictable cash flows, such as long-term PPAs for new renewable projects.

On the flipside, downward pressure on natural gas prices amid abundant supply, and resultant low power prices, hurt coal and nuclear-heavy generation companies such as TECO (TE), Entergy (ETR) and Exelon (EXC).

Energy delivery companies were lukewarm performers in 2012

Performance for companies in the energy delivery segment (0.8% TSR for 2012) ranged evenly, with two companies in each quartile. CH Energy was the top performer on news of its acquisition by Fortis. The performance for the rest of the segment was largely a function of outage response in the aftermath of Superstorm Sandy, as investors closely watched regulators’ reactions and extrapolated their impact on rate case filings.

LDCs lost value in 2012

The LDC segment was the worst performing segment of 2012 with over half (six of 11) of the companies languishing in the bottom quartile with a TSR of -2.5%. This poor performance can be partially attributed to low natural gas prices, which hurt unregulated ventures, particularly those focused on exploration and production such as National Fuel Gas Company (NFG). However, in 2012, a larger trend emerged where all LDCs traded at a discount relative to historical valuations, indicating a possible step-change in how investors regard the segment amid low growth concerns.

Source: SNL Financial, EY analysis
Outlook

A new paradigm

The Federal Reserve will continue its activist monetary policy until it believes the economy can grow without substantial support. As the Federal Reserve looks to taper its bond-buying program, the P&U sector faces a number of challenges that we expect will surface in the later part of 2013 and 2014. Against a backdrop of sustained low natural gas prices, anemic electric load growth, continued environmental regulation and growth in distributed generation and demand response, the industry is poised for a new paradigm fraught with challenges. Capital rotation out of the sector will limit shareholder return and rising interest rates could impact balance sheet strength and the ability to drive growth. Utilities could turn to M&A as a means to drive shareholder return.

With a new paradigm comes an adjustment to valuations. We see the current P/E multiples to be likely unsustainable in the long run and expect a pullback. A revision to mean may not be the case though. We expect valuations to settle somewhere between the 10-year historical average of 15.4x (trailing P/E) and the early May peak of 20.6x. Despite continued pressure on earnings from tightening environmental regulation and anemic load growth, utilities remain well positioned to enter this challenging time. Most are in reasonable financial shape with healthy credit ratings. Protecting these ratings, de-risking earnings and sustaining dividends are set to be the focus. There will be continued pressure for growth in order to attract investor capital. Look for utilities to continue to invest in their regulated operations while selectively pursuing non-regulated opportunities. The Cove Point LNG project by Dominion Resources is an example.

The 2014 and 2015 forward curve is showing signs of a slight recovery in power prices. Coal-fired generation retirements in PJM and MISO and thin reserve margins in ERCOT are likely to provide some optimism for increasing wholesale energy prices. This alone is not enough to provide healthy returns for shareholders though.

Several strategies have developed among sector participants. Some utilities in this environment are focused on their business and are driving to improve operations to earn maximum allowable ROEs, while they are seeking growth through capital investments in their regulated businesses. Others are looking to de-risk their businesses by either disposing of competitive generation or acquiring additional regulated businesses. Still others, such as companies in the IPP sector, are seeking growth through developing contracted generation as well as other competitive businesses across a diverse geographic area while driving costs out of their existing businesses. Executives will need to focus on executing their strategy and communicating a clear vision to stakeholders of the path to sustained growth. The years of easy shareholder returns are over. In the years to come, investors will look for steady dividends and credible growth prospects in the face of industry transition.
In 2012, integrated utility companies posted the strongest TSR performance of all segments. Investors rewarded companies that “act like traditional utilities.” Companies that deliver predictable earnings and operate in a regulated environment with a regulator that fairly balances the competing interests produced the strongest TSR.

Figure 5 illustrates the TSR for the integrated utility segment for 2011 and 2012. PNM Resources, the segment’s top performer, drove value by securing a favorable rate case settlement and divesting its retail energy marketing and merchant generation entity in 2011.

In 2012, top performers added shareholder value chiefly by growing the rate base. Favorable rate case approvals for UNS Energy and NV Energy drove TSR in 2012, while NiSource (NI) delivered in 2011 on an approved project to transport shale gas. However, Xcel Energy (XEL) is an exception to this trend and stands as a cautionary tale. In 2012, supportive regulators approved a significant infrastructure plan with an ambitious timeline. Yet concerns about near-term cash flow alarmed investors and depressed share price performance.

Lengthy rate case proceedings (i.e., regulatory lag) and low allowed ROEs tied to low interest rates continue to challenge integrated utilities’ ability to translate capital expenditures into predictable earnings and shareholder value. However, companies are taking innovative measures to mitigate this risk. For example, many utilities are becoming more willing to accept a slightly lower ROE in exchange for a “formula rate” framework that carries a more automatic regulatory approval. These utilities consider the lesser returns on capital a cost-effective alternative to the risk of rate case rejection.

Utility companies that were involved in disasters such as PG&E’s (PCG) San Bruno explosion and the Joplin tornados (Empire District Electric Co. (EDE)) delivered the weakest TSR performances.
So far in 2013, integrated utility companies have been the slowest segment out of the gate, posting a 7.8% TSR. NV Energy has led the pack, up 31.6% after its acquisition by Berkshire Hathaway for US$5.6 billion. OGE Energy (OGE) comes in close with a 19.2% year-to-date TSR after forming an interstate pipeline partnership with CenterPoint Energy (CNP) and ArcLight Capital Partners. Other leaders such as Vectren (VVC - 14.3%) and ALLETE (ALE - 19.7%) provide value in a more conventional manner, beating consensus earnings estimates with increases to rates and an escalation in industrial demand.

Viewpoint

**Regulatory engagement crucial**

Favorable rate case decisions, rate base growth, dividend increases and uncertainty about the health of the US economy continue to drive the most value for shareholders of integrated utilities. However, integrated utilities are increasingly challenged to deliver strong TSR as anemic load growth and large capital expenditure requirements could dampen earnings growth by increasing the need for rate increases.
LDC segment
A new era for LDC valuations?

The LDC segment was the worst-performing segment of the P&U sector in 2012, posting a TSR of -2.5%. The performance is indicative of an emerging trend in market valuations for LDCs versus the broader P&U sector. Since the 2009 S&P 500 market lows, LDCs have traded at an average P/E of 16.7x, a 2.2x premium to the EY50’s 14.5x over the same time frame. However, in 2012, LDCs closed at 17.7x, just above the 17.3x of the EY50 and marking a possible step change in how investors view LDCs.

With volumetric decoupling provisions and purchase pass-throughs, LDCs represent one of the safer investment opportunities in the P&U sector and, as a result, have historically commanded a premium multiple. The realignment of valuations reflects stagnant market growth, fuel price exposure on retail operations and exploration and production (E&P), as well as investors leaving the safety of the sector for more attractive returns in other sectors.

While the LDC segment produced poor TSR results in 2011 and 2012, there is a clear trend for the segment’s top companies to outperform the rest. The strongest performing LDCs (Piedmont Natural Gas (PNY), Atmos Energy (ATO) and WGL Holdings (WGL)) feature large regulated businesses, favorable or diversified regulatory environments, expanding market potential and extensive use of weather-hedged supply contracts.

The segment’s poorest performing companies were companies with exposure to declining natural gas prices that impacted both retail energy marketing profit margins and E&P portfolios. National Fuel Gas was the worst performer of the segment, with revenue from its E&P business dropping dramatically. South Jersey Industries (SJI) and New Jersey Resources (NJR) also fell, as poor retail and wholesale gas marketing revenues dragged them into the bottom quartile.

AGL Resources (GAS) was the top performer for 2011-2012, despite its gas price exposure on the retail side, in part because its 2011 acquisition of Nicor reduced its exposure to unregulated revenue. While the US$2.5 billion price tag was initially perceived as expensive, investors approved of the expansion of the regulated business into an area with strong growth potential.

Figure 6: LDC performance

![Figure 6: LDC performance](image)

Source: SNL Financial
LDCs began 2013 with a rebound from the 2012 doldrums, producing a segment TSR of 11.6%, leading the sector. Questar (STR) is the frontrunner, with strong earnings and a dividend increase leading to 20.0% TSR. Companies with exposure to commodity prices, such as National Fuel Gas (15.5%) and South Jersey Industries (13.6%), have also thrived as natural gas prices rally to 18-month highs.

**Viewpoint**

**A step change in valuations?**

The convergence of LDC trading multiples with those of the broader P&U sector represents a possible step change and a new era for the segment. This devaluation will result in companies having to find new avenues to generate higher earnings and increase growth. Given the weak long-term natural gas price outlook, expansion of unregulated businesses will remain unappealing, hampered by tight profit margins. The same goes for retail. Expanding the rate base and ensuring that individual LDCs earn up to their maximum ROE will be the way forward. Merger activity may be the quickest way to deliver growth.
The energy delivery segment earned just 0.8% TSR in 2012, but that was still enough to make it the second-best performing segment of the EY50 for the year. This was a sharp decline from the 26.1% TSR posted in 2011, when investors were more attracted to its regulated returns and insulation from low commodity prices.

Unlike other segments, energy delivery leaders (e.g., CH Energy) and followers (Pepco Holdings Inc (POM)) had nearly the same performance, which is a reflection of the segment’s low-risk nature. With the exceptions of CenterPoint Energy’s favorable settlement with regulators regarding previously disallowed stranded costs (US$1.7 billion in 2011) and Unitil’s (UTL) constructive regulatory environment, companies have been unable to create shareholder value through large capital expenditure programs, regulatory victories or increases in ROE.

The slight differences in TSR performance among EY50 energy delivery companies correlate closely with their outage response record. In 2011, Pepco Holdings’ response to a severe winter snowstorm drew criticism from Maryland’s governor. Investors, fearing implications on an upcoming rate case, retreated from the stock. Likewise, Consolidated Edison (ED) stock plummeted as investors were concerned that Superstorm Sandy’s prolonged outages might have an impact on the regulator’s perspective prior to a key rate case filing. On the other hand, UIL Holdings’ (UIL) response to Sandy was lauded by Connecticut regulators and led to investor optimism about regulatory goodwill in future cases.

The need to upgrade aging infrastructure suggests a potential upside for the energy delivery segment in the relative near future. In recent years, the US has underinvested in its aging power grid, leaving investors concerned about efficiency, reliability and the ability to handle the influx of renewable resources. There are also concerns about the aging US gas infrastructure, with the 2010 San Bruno explosion standing as a stark lesson of potential consequences of neglecting asset integrity. Investments in grid modernizations and pipeline integrity technologies such as smart meters, distribution automation, outage management provisions, condition-based maintenance sensors, micro-grids and others will be increasingly necessary. These and other large capital expenditure projects should drive revenue and stock performance for energy delivery companies for some time into the future.

**Figure 7: Energy delivery segment 2011–12 comparison**

<table>
<thead>
<tr>
<th>Company</th>
<th>2011</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>CHG</td>
<td>24.5</td>
<td>15.7</td>
</tr>
<tr>
<td>CNP</td>
<td>30.5</td>
<td>11.6</td>
</tr>
<tr>
<td>UIL</td>
<td>24.6</td>
<td>6.3</td>
</tr>
<tr>
<td>NU</td>
<td>16.8</td>
<td>12.3</td>
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<tr>
<td>ITC</td>
<td>34.8</td>
<td>3.4</td>
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<tr>
<td>UTL</td>
<td>31.9</td>
<td>-3.9</td>
</tr>
<tr>
<td>ED</td>
<td>30.8</td>
<td>6.7</td>
</tr>
<tr>
<td>POM</td>
<td>17.7</td>
<td>2.1</td>
</tr>
</tbody>
</table>

Source: SNL Financial, EY analysis
Large infrastructure transactions have driven shareholder value for the energy delivery segment (8.1%) in 2013. CenterPoint Energy leads the pack, as the pipeline partnership with OGE and ArcLight drives 20.4% TSR. ITC Holdings (14.8%) comes in second as optimism swells about regulatory approval for the purchase of Entergy transmission assets.

Viewpoint

Steady as she goes

Prolonged outages amid recent major storms have raised concerns of rate regulators about the age of the current infrastructure. Energy delivery companies that can attain approval for grid modernization and other large capital projects will separate themselves from the pack in producing shareholder value. The need for incremental infrastructure will create growth opportunities for transmission and distribution companies.
Hybrid utilities, which are companies that hold a combination of regulated and unregulated portfolios, continued to divest competitive power generation assets in 2012: FirstEnergy (FE), Dominion Resources (D) and Ameren Energy (AEE) all recently announced asset sales. FirstEnergy announced its intention to sell off a number of assets it defined as non-strategic, including up to 1,181 MW of its merchant hydro asset portfolio. Dominion Resources struck a deal to sell three fossil-fuel-fired merchant power plants to private equity firm Energy Capital Partners LLC for US$650 million. Dynegy’s acquisition of Ameren’s competitive business for US$599 million was welcomed by investors.

The difference between the best and worst performers was more pronounced in the hybrid segment than all of the other segments – from Sempra Energy on the high side to Exelon on the low. Merchant heavy power generators struggled over the last two years as natural gas prices depressed power prices across much of the US. Exelon, Entergy and FirstEnergy all underperformed as low commodity prices translated to tighter profit margins and depressed earnings.

Despite a general trend of hybrids divesting merchant assets, pure play IPPs performed strongly. Calpine (CPN) was rewarded for its large efficient gas fleet in key markets of ERCOT, while NRG succeeded on the back of its growing retail book and attractive renewable portfolio, underpinned by long-term attractive PPAs. Despite this, hedge roll-off remains a concern for merchant players.

The fuel source of the merchant power portfolio drove overall returns for hybrid segment companies in 2012. Natural gas generation fleets such as Calpine benefitted from its ERCOT exposure and efficient generation fleet. Utility companies, such as TECO, with significant coal-generation fleets suffered lower returns because of lower power prices and the fear of EPA regulations. Renewable-heavy companies such as NextEra fared better.

Figure 8: Hybrid utilities comparison for 2011–2012

Source: SNL Financial
Hybrids roll into 2013 with a solid segment performance of 7.8% TSR; however, they continue to have a large divergence between the top and bottom companies’ performances. Black Hills Corp. (BKH) produces a TSR of 29.1%, as rate adjustments and increases in demand drive earnings above consensus. FirstEnergy has the lowest TSR of the segment at -10.3%, as low power prices continue to be a headwind. The most recent PJM capacity auction attracted a record amount of new generation. Capacity prices were pressured by competition from new gas-fired generation, low growth in demand and an increase in imports of capacity outside of PJM.

**Viewpoint**

**Climbing prices power optimism**

There is a growing sense that power prices may be on the rise, at least from the very low levels seen today. Upcoming coal retirements in markets such as PJM and declining reserve margins in ERCOT provide optimism. Despite this, recent capacity auctions in PJM suggest a recovery in power prices may be pushed out as new supply comes online and the role of demand response continues to grow. Prices don’t need to rise much for returns to increase. Analysts have estimated that a US$1/mmBtu rise in gas prices could deliver Dynegy about US$330 million in EBITDA, following its acquisition of Ameren’s competitive fleet.
## Definitions

<table>
<thead>
<tr>
<th>Segment</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Integrated utility</td>
<td>The integrated utility owns and operates generation power plants, transmission systems and distribution lines to provide all aspects of electric service. The integrated utility may also feature a gas LDC component.</td>
</tr>
<tr>
<td>Local distribution companies (LDCs)</td>
<td>The core business of the LDCs is the regulated local distribution of natural gas. These companies feature commission-regulated rate structures that may or may not include decoupling provisions. LDCs may contain unregulated ventures, such as retail and upstream gas businesses, however, the regulated distribution of gas is their predominant revenue stream.</td>
</tr>
<tr>
<td>Energy delivery</td>
<td>The core business of the energy delivery company is to provide the transmission and distribution of electricity or electricity and gas. These companies feature rates regulated by a governing body such as a public utilities commission, are insulated from commodity volatility and exhibit a relatively low risk profile.</td>
</tr>
<tr>
<td>Hybrid</td>
<td>Companies in the hybrid segment feature a diverse portfolio of power services, including regulated and unregulated components. Unregulated businesses might include merchant power, international businesses and non-utility ventures such as mining or construction as part of their portfolio. Independent power producers (IPPs) are a sub-segment of hybrids whose primary business is the sale of wholesale power. These companies may feature other businesses, such as retail and marketing services; however, they possess no regulated assets.</td>
</tr>
</tbody>
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EYG no. DX0198
BSC no. 1305-1077505
ED 0114

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