

Risky business

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 top 50 US utilities (hereafter EY50) by market capitalization and includes detailed analysis by segment. Our segment analysis considers four segments: energy delivery, local distribution companies (LDCs), 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: $((\text{current price} + \text{US\$ value of dividends in fractional shares}) - \text{start price}) / \text{start price}$.

The price-to-earnings ratio is calculated as: $\text{market share price} / \text{trailing 12-month earnings per share}$.

Risky business

Introduction

In the past, low Treasury rates triggered a yield rush that sent investor capital pouring into US utility equities. However, that bubble burst in May 2013 as skyrocketing interest rates sent utility stocks tumbling. Amid Fed tapering and a host of industry challenges, how will utilities be able to attract investment capital going forward?

2013 was a turbulent and transformative time for US investor-owned power and utilities companies. Speculation surrounding the Federal Reserve's activist policies, including the much-anticipated tapering of its aggressive bond-buying program, impacted the utilities and the broader economy. However, a host of challenges unique to the industry, ranging from weak demand to increased competition, further complicated the situation. This paper analyzes how the utilities delivered value to shareholders in 2013 and how that might impact future performance in the years to come.

In 2013, the US economy continued its rise from the ashes of the Great Recession. Equity markets were especially robust as the S&P 500 produced a total shareholder return (TSR) of 32.4%, shattering all-time highs along the way. But the utilities missed out on the party: the largest 50 US utilities by market capitalization (EY50) registered a TSR of only 14.3%, marking the second year in a row the utilities underperformed the broader market.

The recent escalation of Treasury rates was the largest contributor to the utilities' lackluster performance. Utilities' high dividends have historically been a key driver in attracting capital as investors are

drawn to low-risk utility yields that have averaged almost twice those of the S&P 500. Yet as Treasury rates doubled over an 18-month period (from mid-2012), compelling low-risk high-yield alternatives dampened the relative appeal of the utilities and sent investors shopping elsewhere. The year ended on a sour note with the EY50's yield spread to 10-year T-note at 0.8%, well below January's starting point of 2.3% and the tightest spread since May 2011.

Another factor contributing to the EY50's 2013 underperformance was that the US and global economic recoveries have had a muted impact on the utilities compared with that on the S&P 500. While US manufacturing has increased, that growth has not translated into a spike in electricity usage; demand remains tepid at 0.9% growth. In fact, the bullish equity markets have actually hurt the EY50, driving investors out of relatively stable utilities into equities with greater upside potential. 2013 saw capital drifting out of the utilities into sectors such as financials, technology and consumer products, with higher risk and greater gains.

These trends are problematic for a sector already experiencing serious challenges. Stagnant consumer demand and rising interest rates will pinch the cash flow of any industry. Add in regulators clamoring for higher quality at lower cost, an aging infrastructure in dire need of significant capital investment and an investor demographic that demands consistently high dividends, and the situation worsens. And now, with the recent emergence of new market entrants – from solar start-ups to technology powerhouses – there is greater impetus for reliable, cost-competitive service than ever. In these unstable conditions, investor-owned utilities find themselves forced to walk a tightrope without a safety net, harsh winds from every direction, and a long way to fall.

Key findings

- **Utilities pop, then fizzle.** Propelled by record-low Treasury rates, the EY50 surged past the broader market through May 2013, topping out at 20.1% TSR to the S&P 500's 12.7%. However, utilities fumbled the rest of the year, finally settling at 14.3% TSR.
- **We're not out of it yet.** EY50's P/E valuations remained high (22.4x), but valuations were no longer supported by yields that were attractive relative to other investment options. If economic growth continues, utilities have further to drop.
- **Industry challenges continue to mount.** Utilities continue to feel pressure amid low energy-commodity prices, stagnant demand, significant investment requirements and environmental mandates. Increasingly stronger regulatory regimes and competition from upstart distributed generation ventures create additional headaches.

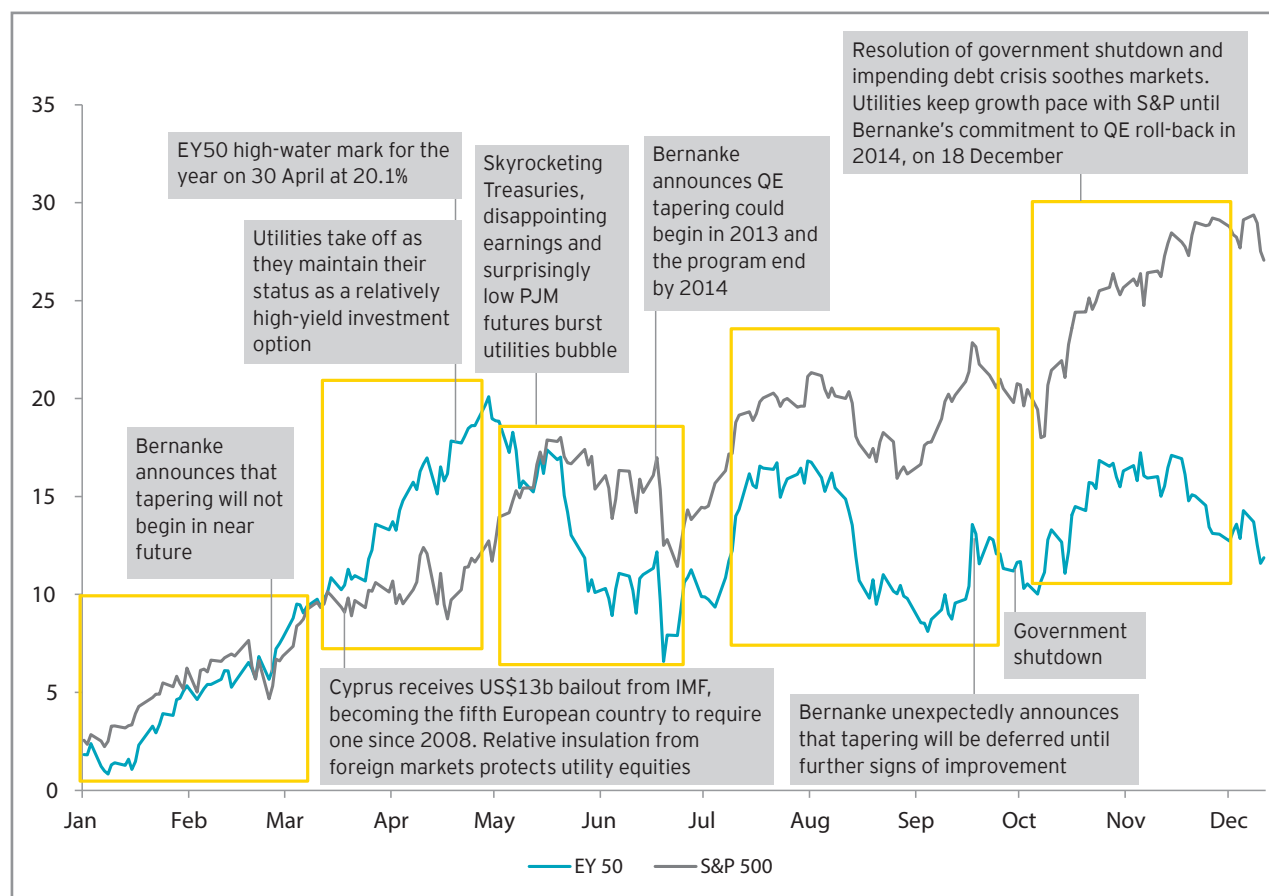
Total shareholder return

Utility performance in 2013: a topsy-turvy year

2013 was a stellar year for investors as the bulls ran rampant in the equity markets, pushing TSR for the S&P 500 to 32.4%, the highest since 2007. The Federal Reserve's activist policy – the US\$85 billion bond-purchasing program known as quantitative easing (QE) – continued to provide a strong tailwind as investors enjoyed another year of uninterrupted cheap borrowing. Additionally, positive economic indicators, including a 32.7% increase in the Consumer Confidence Index and a 13.4% spike in home prices, the largest leap in seven years, suggested that the US economy was continuing to gain steam.

Unfortunately for utility equities, this rising tide did not lift all boats. The EY50 started the year strong, with a TSR of 20.1% by 30 April, well above the S&P 500's laudable 12.7% run. However, this was to be the high-water mark for utilities. Beginning in May, utilities faced a series of challenges that included rising natural gas prices, consistently low electricity prices and stagnant demand. The most concerning development, however, was the rise of the US Treasuries. On 30 April, Treasuries offered a 1.7% yield – just above the 1.66% low for the year – but they closed out the year at 3.04%. The result was the EY50 giving back much of its gain and settling at 14.3% TSR on the year.

Figure 1: 2013 total shareholder return



Source: SNL Financial, EY analysis

Early into 2014, this trend has shown signs of reversing. Year to date, the EY50 has returned an impressive TSR of 12.9% compared with the S&P 500's moderate TSR of 6.5%.¹ After spending most of January in the red, the EY50 has since skyrocketed while S&P returns have remained stagnant. Concerns regarding the situation

in Russia/Ukraine and stalled growth in China have stymied the S&P 500 thus far, causing investors to focus their attention on safer investments, such as utilities. In addition, the colder than normal winter no doubt helped the EY50.

¹ As of market close, 10 June 2014.

Utilities lose premium yield status, hurt by juiced valuations and higher Treasury yields

A strong dividend yield averaging around 4% was a primary reason investors have historically flocked to utility equities. Accordingly, a good indicator of utility equities' value is to compare yield relative to other stable investment options, such as US Treasuries. In January 2013, the EY50 peaked at 4.2%, a robust 2.4% spread to US Treasuries at the time. This spread attracted investors through May, pumping up utility equity prices and narrowing the margin between the EY50 yield and the 10-year note. As long as Treasury yields remained low, the utilities maintained their appeal against alternative yield plays: the EY50's 2013 ceiling of 20.1% TSR coincided with the T-note's 2013 floor of 1.7% on 30 April.

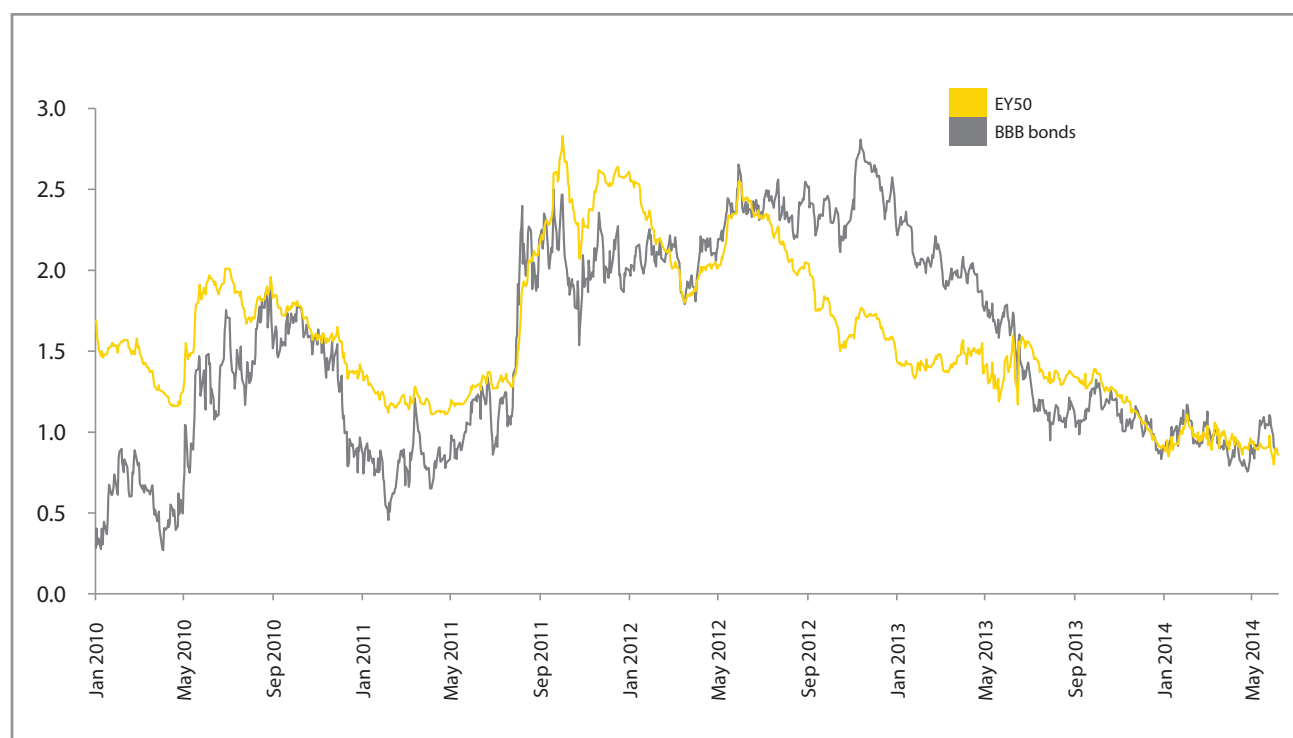
In May, however, this delicate balance was disturbed as Treasury rates lurched into high gear. Suggestions by then-Federal Reserve Chairman Ben Bernanke that the tapering of the QE program could begin before the end of the year sent investors clamoring and Treasury yields skyrocketing. By the end of June, rates on the 10-year T-note had ratcheted up 47.1% – from 1.7% to 2.5% – in less than two months' time. As rates continued to rise throughout

the year, they chipped away at the EY50's relative yield value; when 10-year Treasuries ended the year at 3.0%, the EY50 maintained a mere 0.8% spread.

To fully comprehend the magnitude of this drop within the context of 2014 and beyond, it is useful to examine the 2013 performance of US BBB corporate bonds. US corporate bonds are a good benchmark for utility equities as both feature comparable returns with a similarly stable risk profile. Bond markets were active in 2013 with more than US\$1 trillion in bonds issued for only the third time on record.

Historically, BBB bonds have produced a slightly higher yield than utilities, but 2013 started with a deviation from this trend as the EY50 sported a 0.9% yield advantage against corporate bonds. Unlike utility equities, however, bond yields kept pace with Treasuries; as the EY50 yield plummeted, corporate bonds ended the year asserting themselves as the preferred fixed-income investment with a 3.9% yield, just above the EY50. The resounding message: in 2013, utility equities lost their status as a premier source of yield.

Figure 2: EY50 vs. BBB corporate bonds (difference in 10-year Treasury spread)



Source: SNL Financial, S&P ASX Corp Bond Index, Fed, EY analysis²

In 2014, as the broader equity market has stagnated, investors have been pouring more money into Treasuries and corporate bonds. Treasuries, which started the year with 3.0% yield, have dropped toward yields of 2.6%. Likewise, BBB bond yields have slipped from

3.9% to 3.5% so far this year. While utility stocks have surged in 2014, dividend yields for the EY50 have dropped slightly from 3.9% to 3.5%. As a result, the EY50 yield has been equal to the yield of BBB corporate bonds during 2014.³

² As of market close, 10 June 2014.

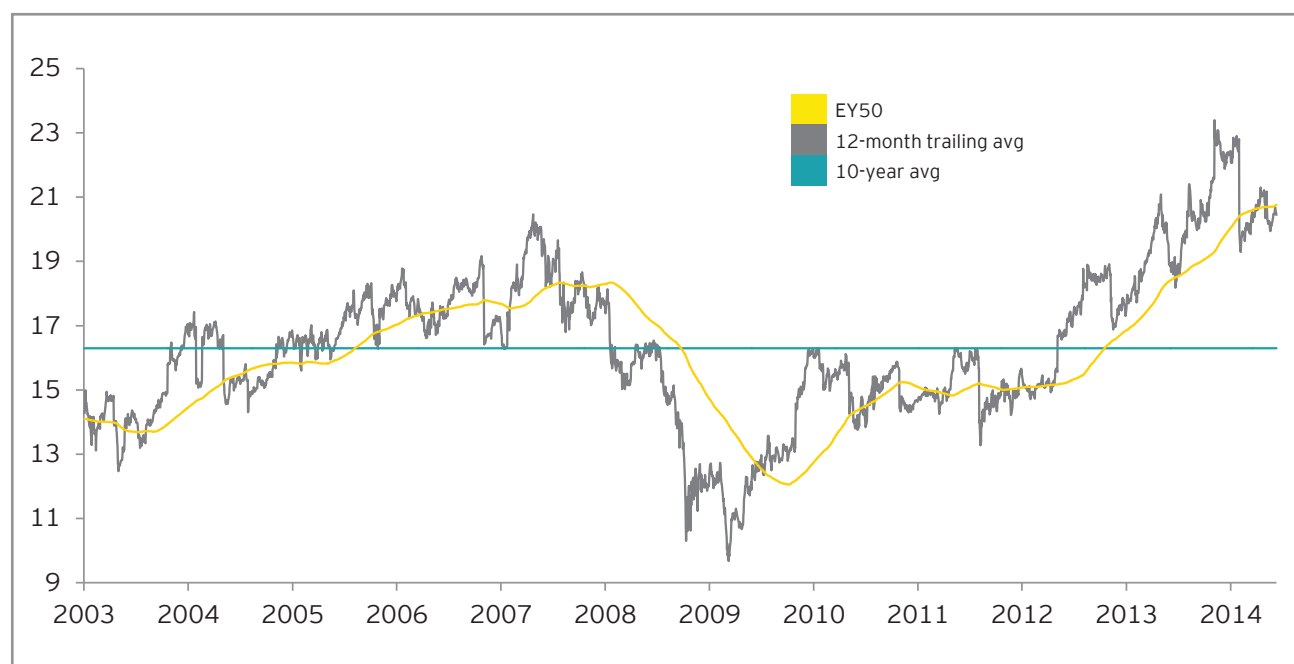
³ Ibid.

10-year P/E peak with lofty value oscillations causes concern

Examining the EY50's price-to-earnings (P/E) ratio provided another way to assess the value of utility equities in 2013. The year started off with the EY50 at a multiple of 17.4x, slightly above the S&P 500's 17.0x. As low Treasury yields attracted an influx of investor dollars chasing utility yields, prices and P/Es of the EY50 pumped up, peaking on 1 May with a then 10-year high of 20.6x. This represented the apex of the bubble, just before Treasury yields escalated dramatically.

As expected, rising Treasury yields led to a pullback in utility equities, with prices plummeting and the EY50 dropping two P/E multiples in less than a month. But what followed is intriguing: shortly after the drop, utilities rallied, with P/Es hitting 20x again in July and peaking all the way to 23.4x in early November. For the rest of the year, utility P/Es continued this pattern of spiking and sinking, oscillating around an average P/E of 22.5, still well above historic norms. As utilities fluctuated at all-time highs, the broader market lagged; 2013 ended with S&P 500 valuations at 19.2x, far less than the EY50's 22.4x.

Figure 3: Price-to-earnings ratio



Source: SNL Financial, EY analysis⁴

Thus far in 2014, there has been a pullback in the EY50 P/E even as prices are broadly increasing. The EY50 P/E dropped down to 19.3x in early February before climbing back up to 20.4x by early June.

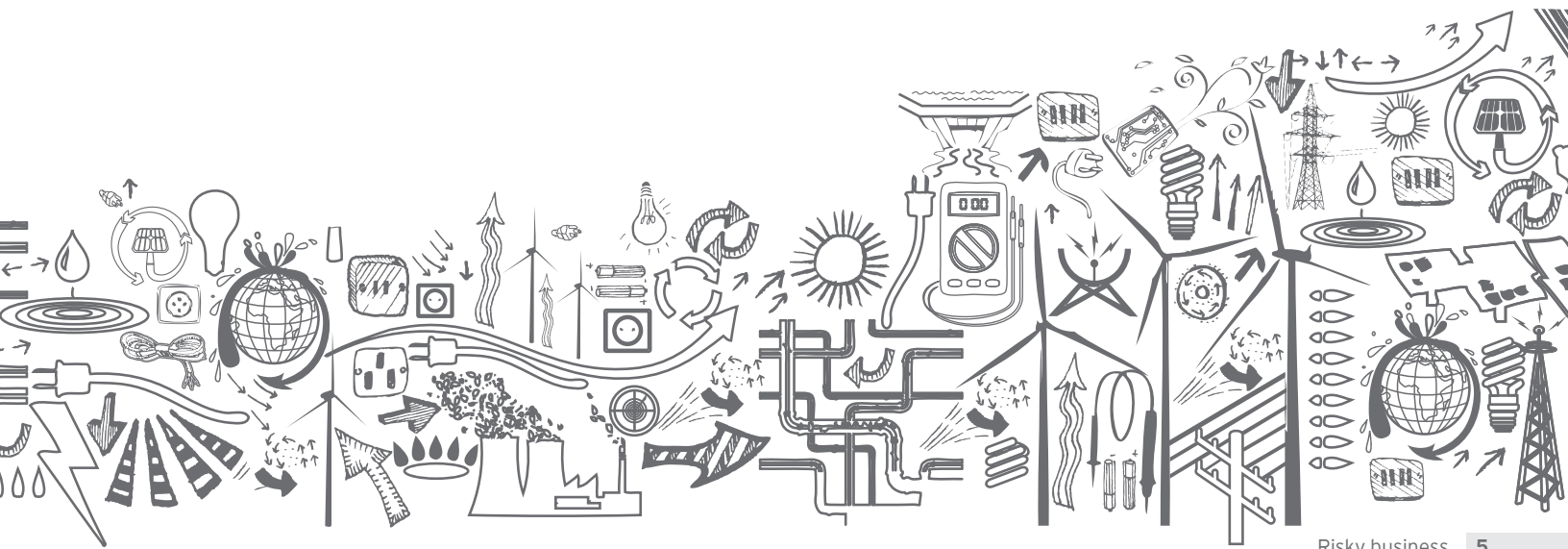
⁴ As of market close, 10 June 2014.

Viewpoint

Risky business

Current valuation indicators for utility equities are unsettling. In 2013, the EY50 lost considerable value as some investors swapped utility dividends for the improved yields on lower-risk Treasuries and corporate bonds. Concurrently, absolute P/E valuations remained lofty at near all-time highs. The high valuation is puzzling and can't be driven by prospective positive upsides – indeed, with the host of industry challenges and modest growth outlook, the future does not look particularly bright. What is going on?

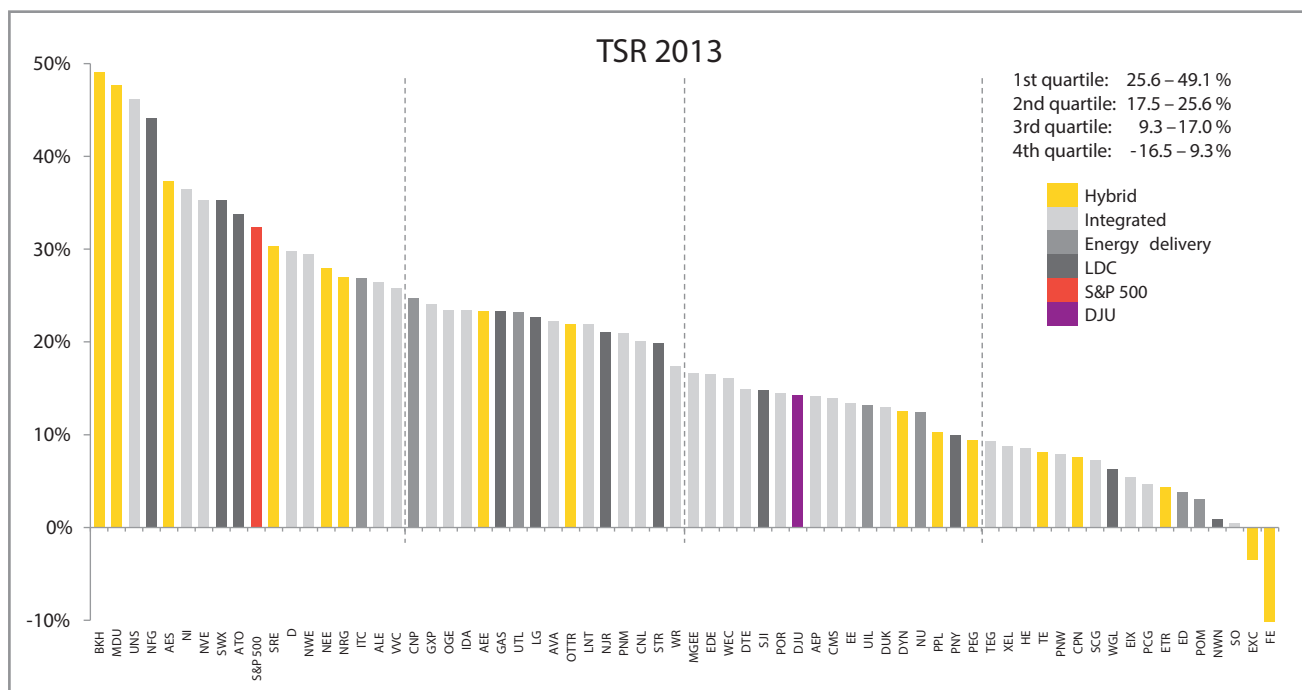
Perhaps investors are asking the same questions. The wild fluctuations in P/E could be indicative of an investor base that can't determine the value of utilities because it is uncertain of the value of all equities. With the US economy posting only anemic economic growth during the past five years, utility P/E valuations may be at near-highs because investors remain uncertain about the prospects for the US economy and want to hold onto defensive stocks like utilities. In the current environment of tapering and low GDP growth, what is the equilibrium value for utilities, and how does their risk profile affect value?



2013 sector observations

2013 proved to be a year of transition for several utilities. Below are some of the observed trends.

Figure 4: TSR 2013



Source: SNL Financial, EY analysis

Low prices push merchants out

Lackluster earnings associated with depressed commodity prices have weighed on the industry since the onset of the shale gas revolution. In 2013, we saw the straw that broke the camel's back in the form of abysmal May 2016-17 capacity auction results in PJM. An unprecedented 90.4% increase in imports, including 4.7 GW from MISO, sent capacity prices – and shareholder expectations – tumbling. Add disruptive renewables, including increasingly prevalent wind resources that sell at low to almost zero marginal prices, and the outlook for unregulated power appeared grim. Ameren (AEE) responded by exiting the business altogether, selling over 4,100 MW of merchant generation to Dynegy (DYN). Other big players, including Exelon (EXC) and FirstEnergy (FE), are responding by diverting capital dollars toward other expenditures, such as transmission, signaling a change in their growth strategies.

Active merger market for regulated assets

2013 was a notable year for mergers and acquisitions as utilities executed several transactions geared toward restructuring their asset portfolios. Regulated assets were particularly coveted, as highlighted by the multibillion-dollar acquisitions of NV Energy (Berkshire Hathaway – US\$5.6 billion) and UNS Energy (Fortis – US\$4.3 billion). Smaller transactions, such as NorthWestern's (NWE) US\$900 million acquisition of hydro assets from PPL (PPL) and TECO Energy's (TE) US\$950 million purchase of New Mexico Gas Company (from PNM Resources [PNM]), were further examples of utilities bolstering regulated assets. However, not all companies are playing conservative: NRG Energy's (NRG) US\$2.6 billion acquisition of Edison Mission assets and Dynegy's above-cited acquisition of Ameren's unregulated generation show that the independent power producers (IPPs) aren't sitting idle either.

MLPs and YieldCos deliver greater shareholder value

2013 marked an expansion in the way utilities seek to attract capital and provide shareholder value through the emergence of innovative financing structures. Establishing Master Limited Partnerships (MLPs) became a growth tactic for companies that provide energy transportation services, such as oil and gas pipeline businesses. The high-payout structures are a rewarding mechanism for capital-heavy companies, and TSR skyrocketed for the company that established them (CenterPoint Energy [CNP]), as well as the one that declared intent (Dominion Resources [D]). In another creative transaction, NRG spun its renewable and gas-fired power plant assets into a yield company (YieldCo) that launched in June. By placing contracted gas and wind assets into a YieldCo, NRG could appeal to investors seeking some risk to boost yields well above current Treasury yields.

Gas as good as gold

The impact of the low-cost gas supply from shale basins continued to be the disruptor of the industry, squashing power-commodity prices and, as a result, earnings for those with commodity exposure. However, those with a strong exploration and production (E&P) portfolio, such as top performers Black Hills (BKH) and National Fuel Gas (NFG), enjoyed increases in output and a 31% rise in gas price in 2013. Companies with gas infrastructure and pipeline construction plays also thrived; these included MDU Resources Group (MDU), Vectren (VVC) and Southwest Gas (SWX). And the newest growth opportunity has been the export of LNG, with Dominion Resources and Sempra Energy (SRE) taking the most advantage.

Outlook

The new Fed Chair, Janet Yellen, has signaled that the interest rate concern of 2013 may not be repeated soon. In fact, Yellen has indicated that the Fed will keep interest rates low even if and when the economy recovers. However, while that concern may now be lessened, other major challenges remain for the sector.

The first challenge relates to the decrease in electricity consumption. Electricity usage appears to be increasingly decoupled from economic growth as homes and businesses tap into energy efficiency measures provided by third-party experts, big box appliance stores and even the local hardware store. As policy-makers largely support increasing energy efficiency, there is little reason to expect this trend to change any time soon. With the stagnation in consumption, utilities must find other areas for growth, whether through increased use of gas (e.g., pipeline expansion linked to shale play) or through new technologies, such as distributed energy.

The emergence of distributed energy, however, also represents the second challenge for utilities. Every time a homeowner installs solar panels on the roof, traditional utility “sales” decrease. The real problem with the growing adoption of distributed energy is that it unravels the traditional regulated utility business model. All but the most diehard traditionalists acknowledge that the only question is when, not if, distributed energy will become a significant force in the utility world. Some, like NRG’s CEO David Crane, have roped LDCs into the distributed energy space by linking solar PV to local gas-fired distributed generation as a backup supply. Big dollars are going into disruptive technologies like solar PV, storage and fuel cells – and they aren’t going away. In the near future, utilities can increasingly expect such questions from investors as: “What’s your distributed energy strategy?”

The third key challenge is the massive capital investment requirement facing both electric and gas utilities in the coming years. This capital investment regards environmental compliance, gas distribution and pipeline expansion and upgrades, modernization of the electric grid, power transmission build-out, and the overhaul of aging IT systems. For utilities, stepping up capital investment is normally beneficial as it leads to increasing the rate base and, through the rate case process, yields a growth in earnings. But with

stagnant consumption compounded by the proliferation of distributed energy, this earnings growth is realized at the expense of energy consumers in the form of rate increases.

Increased rates mean distributed energy options look even more attractive, driving consumers away from the traditional electricity delivery of utilities. With fewer consumers, the utility is forced to recover operating and capital costs from a smaller pool, leading to even higher rates. This, in turn, sends more consumers away, and on it goes. This self-destructive cycle has been dubbed the “death spiral,” and the implications are potentially devastating. While utilities are still trying to understand the full impact to their businesses, the early experience of utilities in Germany and Australia indicates that the message is not encouraging.

Conventional wisdom would dictate that the utilities invest in the new, growth-oriented opportunities. However, that is exactly the strategic action the major credit rating agencies have discouraged. Their position is that investment in such growth industries as distributed generation changes the utilities’ typically conservative risk profile, and that any major shift in business model will require improved credit metrics – or else result in a downgrade. Until there is a utility that serves as a poster child for such operating models by successfully integrating distributed resources into its business, this stance is unlikely to change.

Amid these challenges, utility executives are required to chart a path for their companies. Vision statements developed by many utilities increasingly contain the phrase “industry leader” or similar leadership language. However, lessons learned from other industries that have undergone such a wholesale transformation, like telecommunications, suggest that incumbent players face significant odds in successfully transitioning their companies to compete in the new world. First movers are not always rewarded.

The future of utilities is very much in flux. Developing a sound strategy and a clear focus on how to allocate capital spending is a huge challenge going forward. Are utilities willing to change their models despite the potential threat of credit downgrades? Or will they stick to the current model despite the risk of the “death spiral”? Our bet is that utilities will shift their models. The key question is which will be the first to move and when.

LDC segment

LDCs bounce back on unregulated gas opportunities

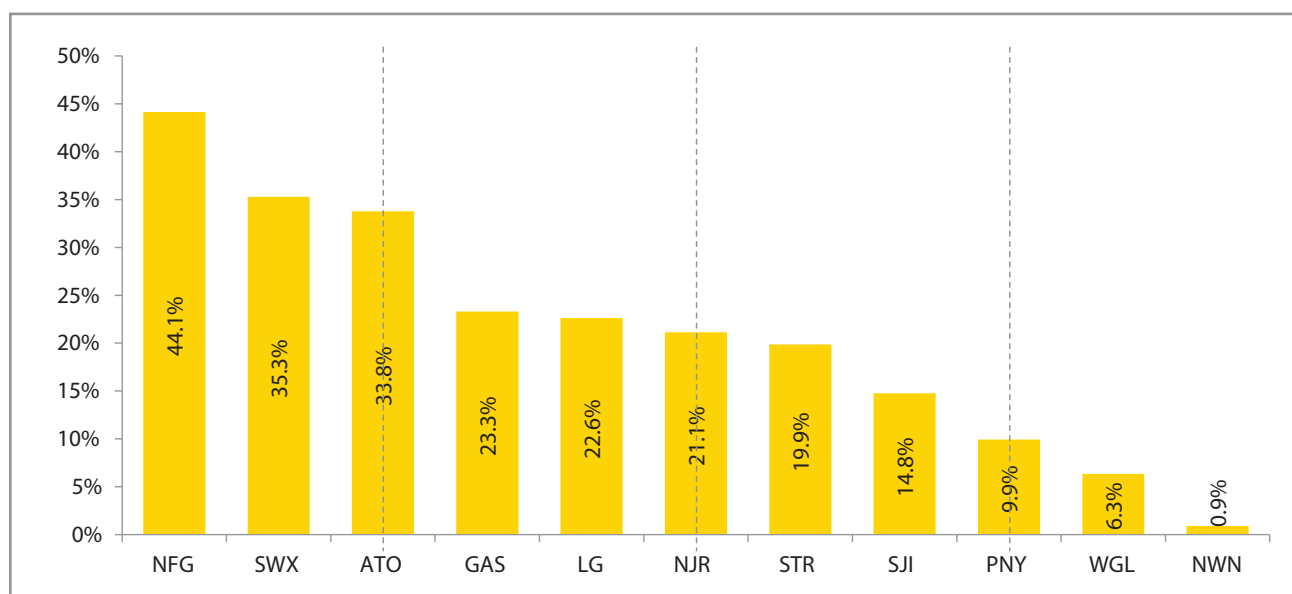
The local distribution company (LDC) segment was the strongest performer in the sector in 2013, posting a robust 24.2% segment TSR and featuring three companies in the top quartile of all utility equities. After logging a dismal -5.6% in 2012, the segment was due for bounce-back or a reversion-to-the-mean, depending on one's perspective. However, for some companies, an additional tailwind was provided by strong E&P revenues, as well as production services associated with shale gas production.

In their purest form, LDCs are one of the least risky equity investments. Governed by regulators that provide a fixed rate of return on infrastructure investment, and with most having decoupled commodity costs and earnings, these companies typically produce predictable earnings quarter to quarter. In this case, the differentiating factors between the best- and worst-performing equities are the hospitality of their regulatory environments and their customer-growth prospects.

Among LDCs, Atmos Energy (ATO) produced the strongest TSR, with 33.8%. Atmos operates in eight states that are diverse from both a geographic and regulatory standpoint; this diversity shelters it from the adverse impact of any one operating area. Additionally, Atmos conducts operations in strong growth areas, such as Texas and Louisiana. On 8 August, the company sold its distribution assets in Georgia to Algonquin Power for US\$155 million. Although this accounted for 64,000 customers, ~2% of the total customer base, the consensus that this capital would be invested into further Texas operations made investors cheer.

On the other end of the spectrum is Northwest Natural Gas Co. (NWN) with its 0.9% TSR. In October 2012, Northwest received a crippling settlement in connection with its first rate case in a decade. In Q1 2013, Northwest reduced its guidance more than anticipated, catching investors by surprise and sending its price plummeting. With the outcome of this rate case and regulated operations based solely in Oregon, Northwest looks to be facing performance challenges for the foreseeable future.

Figure 5: LDC segment



Source: SNL Financial, EY analysis

However, the upward movement of the segment relied on LDCs whose business models expand beyond regulated operations. National Fuel Gas Co. produced the strongest TSR, 44.1%, as ramped-up E&P operations in Marcellus and speculation about gas opportunities in its Utica and Seneca regions rallied investors. National Fuel was further bolstered by speculation it would spin its midstream operations into an MLP – although management has reiterated that this is not imminent.

Southwest Gas Corporation also thrived due to its unregulated distribution arm (pipeline construction), with a TSR of 35.3%.

Southwest's pipeline construction business exceeded expectations as low interest rates and customers' need to replace aging infrastructure fueled strong revenues.

Still, buyers need to be alert to the downside of unregulated businesses. WGL Holdings Inc. (WGL) posted a TSR of just 6.3%. WGL's regulated business provides regulated returns in a high-growth area, yet its unregulated retail electric arm dragged down earnings in 2013. While revenue has remained consistent year-to-year, WGL was exposed to low PJM prices, reducing earnings and lowering TSR.

After leading the pack in 2013, LDCs have started as the slowest segment in 2014, posting an 8.3% TSR. Atmos Energy continues its momentum from 2013, posting a TSR of 13.6% and trailing only New Jersey Resources (NJR) and AGL Resources (GAS). NJR (20.2% TSR) and AGL (14.3%) have been propelled by higher than expected revenues caused by the cold winter. Southwest Gas is last in the segment, posting a TSR of -5.4%, which reflects lower than expected earnings in its construction segment.

Viewpoint

LDCs will stick to what they know

With ever-increasing earnings pressures, many utilities are seeking out growth opportunities outside of their core utility operations. Of all the segments, few are as well prepared for this expansion as the LDCs. The shale gas revolution has created tight price margins; however, ample prospects remain throughout the gas value chain, including midstream, pipeline construction and LNG export opportunities. LDCs need to pursue investment opportunities related to base steel/cast iron replacement and gas distribution modernization. LDCs have historically enjoyed a premium P/E ratio compared with other utility segments precisely because of their risk-averse nature. But if they deviate too far from their roots – investment in natural gas delivery infrastructure – investors will be hesitant to award LDCs that premium and TSR will suffer.

Integrated utility segment

Top integrated performers take advantage of ripe merger market

The integrated utility segment was the second-strongest performer in 2013, with a 14.3% TSR. The largest of the segments, comprising 32 utilities and more than US\$300 billion in market cap, the integrated utility group features a diverse set of companies with a variety of opportunities and challenges that drive TSR performance. However, in 2013, the two dominant factors in determining shareholder value were growth through acquisition and the ability to curb exorbitant costs.

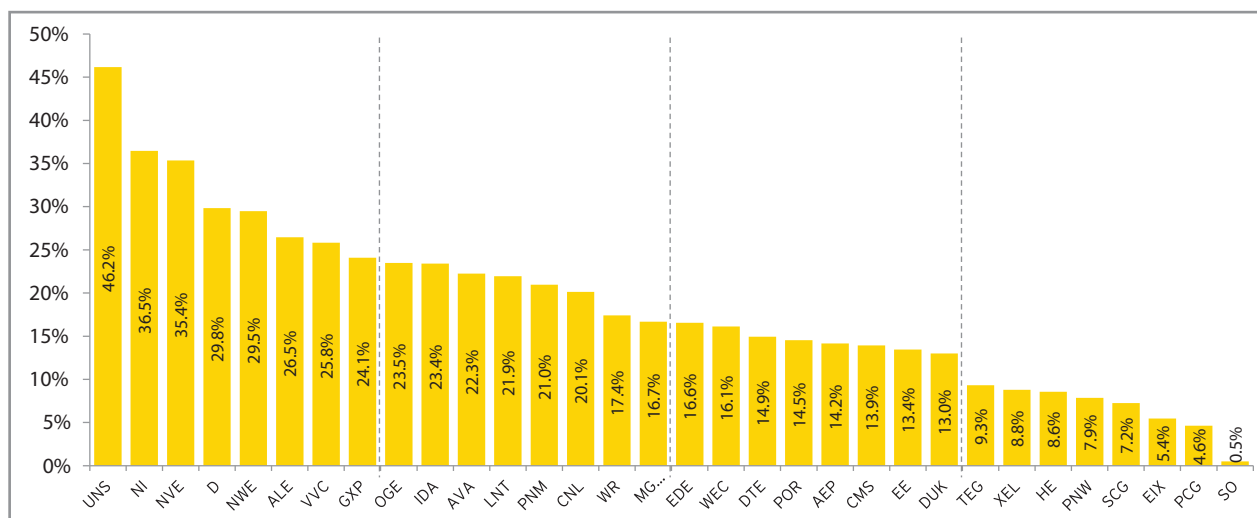
Acquisitions headlined the segment's top success stories. Berkshire Hathaway's MidAmerican kicked things off in May with the acquisition of NV Energy (NVE) for US\$5.6 billion, a 23% premium, which secured the company a 35.4% TSR. MidAmerican cited the growth potential of NV Energy's operating territory as a key driver for the transaction. But it was the Canadian company Fortis's acquisition of UNS Energy for US\$4.3 billion, a 31% premium, that propelled UNS's 46.2% TSR to the top of the segment. Its second large US acquisition in as many years (after purchasing CH Group), Fortis cited higher growth opportunities in the US and the desire to diversify geographically as the motivation. Northwestern Energy also made a significant transaction, purchasing 663 MW of hydroelectric assets in Montana from PPL for US\$900 million, which effectively doubled its nameplate capacity and pushed TSR to 29.5%. Interestingly, these were the same

assets Northwest had sold in 1999 to PPL as it rapidly expanded its unregulated opportunities. PPL's strategy has since shifted, with its competitive business contracting in favor of regulated opportunities.

At the end of 2013, rumors swirled around NiSource (NI) as a potential acquisition target; however, this was merely a bonus on top of a strong year. NiSource's 36.5% performance in 2013 hinged more on the favorable regulatory environment associated with planned infrastructure investment in Indiana and in connection with its pipeline systems. NiSource is taking advantage of a recent regulatory shift toward an automatic rate-tracking mechanism that limits regulatory lag and increases capital investment.

Meanwhile, Dominion provided shareholder value by making dramatic moves into the unregulated shale gas space. The strategy was launched in 2012 with the US\$1.5 billion joint venture agreement with Caiman Energy to build the Blue Racer pipeline to transport shale oil from the Utica shale region. But the big leap occurred on 16 September 2013, when the Department of Energy approved the exportation of LNG from Dominion's Cove Point facility to non-signatories of the Free Trade Agreement (non-FTA), including the ultimate goldmine, energy-starved Japan. The day after the ruling, Dominion packaged Cove Point and Blue Racer into an MLP, elating shareholders and sending the year-end TSR to 29.8%.

Figure 6: Integrated utility segment



Source: SNL Financial, EY analysis

Nonetheless, 2013 was not great for everyone. Southern Company (SO) had the most meager returns in the integrated utility segment, with a mere 0.5% TSR. Its underperformance can be expressed in two words: Vogtle and Kemper. Vogtle, Southern's much-maligned nuclear plant, finally started to control costs after years of project delays and budget overruns; expectations are for completion by 2018. Clean-coal technology plant Kemper, on the other hand, remains a source of dismay. Cost overruns have become the norm for Kemper, with the US\$1.1 billion through Q3 2013 representing a little over 3% of Southern's total market capitalization.

Along with Southern, two California utilities – Edison International and PG&E (PCG) – occupied the basement in 2013, with 5.4% and 4.6%, respectively. Despite the sale of 8,000+ MW of bankrupt EDE assets to NRG for US\$2.4 billion, the tale of Edison International is that of a plant failing expectations. In June 2013, Edison decided to

close the San Onofre Nuclear Generation Station (SONGS) due to high costs and minimal upside. The plant had been shut down in January 2012 because of mechanical failure, but it was undetermined when – or if – it would be repaired and restarted. After the decision to close it, the question that now goes to regulators is who picks up the remaining US\$2.1 billion in net plant invested. If the answer is “shareholders,” expect a further drop.

PG&E, meanwhile, was still impacted by the continuing fallout from the San Bruno gas explosion. Three years after the incident that cost eight people their lives, the California Public Utilities Commission recommended that PG&E pay an additional US\$2 billion in unrecoverable gas infrastructure and an unprecedented additional US\$300 million fine to the state of California. This brought the total up to more than US\$4 billion in damages. Drama ensued, with PG&E's CEO declaring that such punitive measures would bankrupt the company.

So far in 2014, integrated utility companies have been the second-fastest segment out of the gate, posting a 10.4% TSR. PNM Resources (PNM – 20.9%), Edison International (EIX – 20.7%), and American Electric Power (AEP – 16.7%) have led the pack. Edison International has performed admirably due to Q4 2013 earnings results and 2014 guidance reflecting the cost savings associated with the recent shutdown of SONGS. Bringing up the rear was Hawaiian Electric (HE) with a TSR of -3.6%, due primarily to rumors of a dividend cut and increased use of solar panels on the island.

Viewpoint

Managing growth

The regulatory compact among utilities, regulators and shareholders is well defined: as long as the company provides a high level of service to customers at a reasonable price point, it should earn its allowed return on investment. This compact forms a strong basis for the value of any utility stock. But that is only part of a utility's valuation because embedded in the value of every utility stock is the expectation of earnings growth. The greater the growth expectation, the greater the stock price. Managing that growth is important to the health of the utility and its stock price. Investing in the right project can lead to earnings growth and increased dividends. But investing in the wrong project can lead to write-offs, lower earnings, reduced credit ratings and lower dividend yields. The impact could be felt in a utility's stock for years to come. In our estimation, managing growth should be as important to the utility executive as reliability and safety.

Hybrid segment

The shale revolution continues to draw lines between leaders and laggards in the hybrid segment

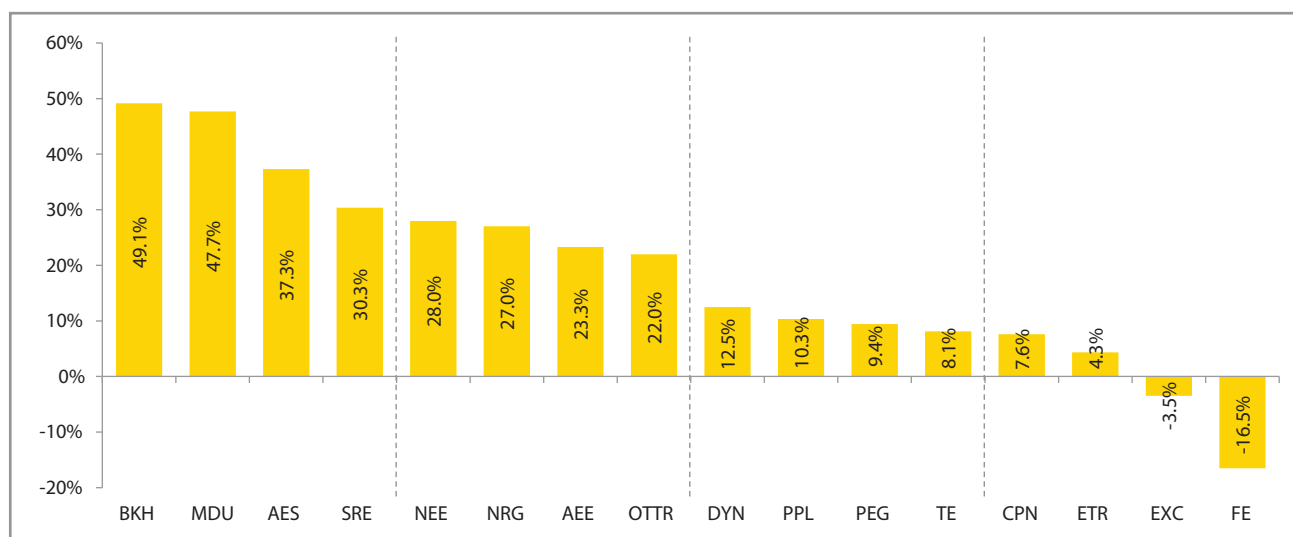
The hybrid segment provided 13.8% TSR in 2013, the second lowest in the sector. Continuing the trend of 2012, individual company performance varied wildly, with hybrids occupying mostly the highest and lowest quartiles of the utilities analyzed – including the two best and worst performers on the year. TSR performance in this group was largely determined on the basis of the side of the shale revolution a company was on as cheap natural gas continues to be the single most disruptive force in the segment.

Black Hills Corp. delivered a sector-leading 49.1% TSR associated with increased natural gas production and bullish speculation on its Mancos shale assets. MDU Resources Group was second in line, its 47.7% fueled by an uptick in gas output at its Bakken and Paradox E&P businesses, as well as robust returns from its construction segment

operating in the Bakken basin. These E&P plays were further propelled by natural gas prices that rose 30% – with Henry Hub prices ending the year at US\$4.31/MMBtu – as well as investor speculation about potential MLP opportunities.

Sempra enjoyed its second year of 30%+ TSR as optimism peaked at the prospect of exporting liquefied natural gas. Sempra's Cameron facility in Hackberry, LA, hoped to receive permission from the DOE to export natural gas to countries not included in the FTA, as occurred with Dominion's Cove Point. This would open alluring markets, such as energy-deprived Japan, and provide additional customers for the estimated 12 million tons of gas per year that will be exported from the terminal.

Figure 7: Hybrid segment



Source: SNL Financial, EY analysis

And then there is the ugly side of gas. A flood of cheap natural gas has depressed electricity prices for the last few years, pinching margins for merchant-heavy hybrids. In early 2013, there was optimism about a slight recovery in wholesale power markets as several older coal plants scheduled for decommissioning raised the possibility of tighter supply dynamics and ensuing price spikes. However, that hope was shattered in early May, when auction prices for PJM's 2016-17 capacity market came in well under expectations, and prices dropped as much as 56% in some zones. An unprecedented 90.4% climb in power imported into PJM was the primary culprit, with almost 5,000 MW coming from MISO. Matters got worse as NRG acquired Edison Mission Energy assets and opted to retrofit rather than retire them, thereby increasing the forecasted supply base.

Exelon and FirstEnergy got hit the hardest, logging the lowest TSRs in the sector with -3.5% and -16.5%, respectively. Exelon was acutely impacted by NRG's revised strategy regarding the EME assets. FirstEnergy was hammered as investors feared the impact of sustained low prices on cash flow and the ability to maintain the dividend. FirstEnergy shocked investors at the EEL conference when it announced a shift in strategy away from merchant power and toward regulated business, including substation transmission investment. Pitched as an effort to reduce risk associated with power markets and increase earnings stability, it was rejected by Wall Street, and FirstEnergy's stock price plummeted.

Indeed, reducing risk has garnered surprisingly varied results across the sector. AES Corporation (AES), which has one of the most complicated profiles in the sector, secured 37.3% TSR as it took strides to restructure to look more like a typical utility. AES has a broad international presence, including operations in several emerging markets. While emerging markets provide the upside of a 5%+ growth in demand – as opposed to the near-zero growth rate in the US – exposure to currency fluctuations and political instability jeopardizes predictable earnings. Historically, this has driven investors to levy a discounted multiple on AES. However, in the last few years, AES has narrowed its geographic exposure from 28 to 20 countries, selling more than US\$1 billion in assets in China, France, Spain and several Eastern European countries. This, in conjunction with the instantiation of a dividend (albeit a meager 1.5% yield) in Q4 2012, had shareholders applauding.

Yet risk reduction didn't benefit all companies. TECO produced a TSR of 8.1% after acquiring New Mexico Gas Company from PNM Resources in May for US\$950 million. TECO has suffered in recent years as environmental mandates translated into investors' negative perceptions of the company's coal mining business. TECO declared the New Mexico move a shift in strategy to regulated business in order to reduce commodity exposure and earnings volatility, but investors rejected the price tag for the LDC because of the regulatory climate and its geographical remoteness from TECO's base of operations.

Hybrids are off to a strong start in 2014, producing a segment-leading TSR of 18.1%. The colder than normal winter and the announcement of PJM's 2017-18 capacity market auction price in May (at double last year's prices) have excited investors. Dynegy (66.8%) has led the EY50, buoyed by better than expected Q4 2013 and Q1 2014 earnings while also exploiting Illinois and Indiana hub energy prices. Exelon (38.3%) has also performed admirably despite the market's initial lukewarm reception to its recently announced plan to purchase Pepco Holdings for US\$6.8 billion. On the other hand, AES was the segment's poorest performer, with a TSR of -0.8%, after it announced a Q4 2013 loss driven by missed revenue expectations as its Brazil business suffered. In other news, NextEra (NEE – 13.6%) made headlines in late April when it announced its plans to spin off its renewable plants into a YieldCo.

Viewpoint

Continued low power prices trigger revision of growth strategies

2013 marked a dramatic shift in how the industry values merchant generation. After years of depressed energy prices, hybrids such as Exelon and FirstEnergy have expressed interest in reducing their exposure, while others, such as Ameren, have exited the business altogether.

As shareholders get fed up with underwhelming generation profits, expect more hybrids to de-emphasize their merchant generation businesses. Not everyone is bearish, though; amid these unsettling conditions, IPPs have gone shopping, and NRG and Dynegy have both added significantly to their generation portfolios. Whether these transactions are viewed as bargains or boneheaded blunders will hinge largely on whether energy prices bust out of their prolonged slump.

Energy delivery segment

The delivery segment struggled to retain investor interest

The energy delivery segment produced the sector's most meager returns, with 12.1% TSR in 2013. In conjunction with 2012's 0.8%, this led to the worst segment performance over a two-year stretch. Battles with regulators over allowable ROEs headline the list of woes although disappointing rate cases, lagging recovery mechanisms and poor load growth also weighed down the segment.

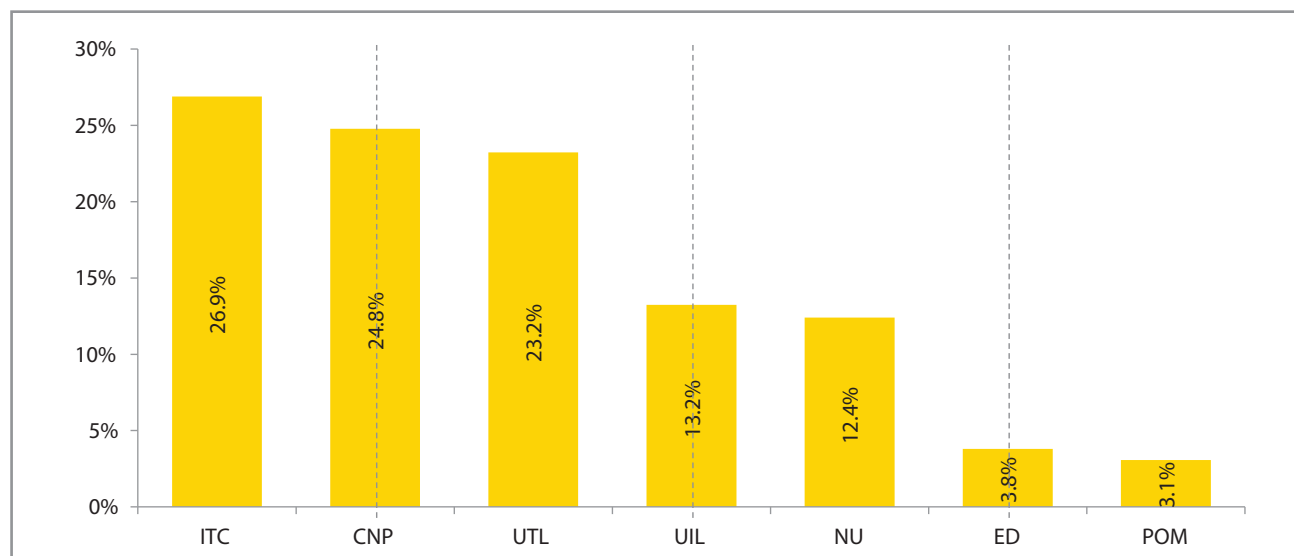
Similar to LDCs, the energy delivery segment is heavily regulated and largely insulated from fluctuations in commodity prices; thus, it is considered a low-risk investment for yield-hungry investors. Similarly, the performance of its stock correlates to the hospitality of the regulatory environment and any growth potential.

Consolidated Edison (ED) was on the wrong side of a regulatory ruling, which limited its TSR to 3.8%. In January 2013, Con Edison filed a US\$460 million rate case for its electric, gas and steam

delivery. Pushback came from all corners, including from Governor Andrew Cuomo, who said the increases were "not warranted," and Mayor Michael Bloomberg, who stated in sworn testimony that, in light of Hurricane Sandy, the utility was not doing enough to protect itself from the impacts of future storms. In December, Con Edison relented, withdrawing its proposed rate increase, accepting a lower than expected ROE and committing to locking in rates for at least two years.

Pepco Holdings (POM) also suffered the wrath of the regulators as a disappointing rate case settlement for subsidiary Atlantic City Electric dragged TSR down to 3.0%. Additionally, Pepco has been unable to convince regulators to adopt recovery mechanisms that track closely to capital expenditures, leading to commission gridlock and continued regulatory lag.

Figure 8: Energy delivery segment



Source: SNL Financial, EY analysis

ITC Holdings (ITC) was the belle of the ball in 2013, with high ROE FERC-regulated transmission rates fueling a segment-leading 26.9% TSR. ITC's share price performance was undeterred by discussions among regulators and consumer advocacy groups in New England and the Midwest clamoring for lower transmission rates. Gains were also unimpeded by the ultimate ruling to forgo the much-scrutinized transaction with Entergy. Although Mississippi regulators unanimously voted to strike down the merger, shareholders had long assumed the worst, and the share price retained value when the bid was finally abandoned in December.

Meanwhile, CenterPoint was buoyed by a successful transaction with OG&E and ArcLight to form a midstream MLP, sending TSR to 24.8%. The deal included 20,000 miles of pipeline and 11 major natural gas processing plants valued at US\$1.1 billion and resulted in the creation of Enable Midstream Partners. This was the first utility MLP of the year, and investors were thrilled at CenterPoint's creativity in optimizing the value of shareholder capital. The jubilation was tempered slightly in November, however, as Enable filed with the SEC to raise US\$500 million at IPO, well below consensus estimates.

The energy delivery segment has continued its sluggish performance relative to the EY50 with a TSR of 9.7% in 2014. The segment was lifted in part, due to the surge of Pepco Holdings (45.8%) as the market reacted very well to the company's announcement of a potential sale to Exelon for US\$6.8 billion. ITC continues to be one of the few bright spots, with its forecasted 15%-17% EPS CAGR through 2016 exciting shareholders and yielding a 18.2% TSR. Meanwhile, UIL Holdings (UIL) has the lowest TSR of the segment in 2014 at -4.2% as the market has reacted negatively to its announcement of a US\$1.9 billion acquisition of Philadelphia Gas Works in early March.

Viewpoint

It's all about where you work

For energy delivery companies, which enjoy complete protection from commodity price fluctuations, earnings performance is most acutely impacted by the regulators' actions. CenterPoint has led the segment in TSR over an aggregate three-year span due in part to the favorable regulatory landscape in which it operates. On the flip side, utilities operating in the Atlantic states – such as Con Edison, Northeast Utilities (NU) and Pepco Holdings – are saddled with an environment that suffers from low ROEs, active consumer advocacy groups and clunky cost-recovery mechanisms. Adding in the recent pressures to lower transmission ROEs in New England, the near-term outlook in the East is grim. Barring vast changes in public utility commissions or their sentiments, shareholders should anticipate further resistance in these poor regulatory environments and temper their TSR expectations.

Appendix

Definitions of utility segments

Segment	Description
Local distribution companies (LDCs)	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.
Integrated utility	The integrated utility owns and operates power generation plants, transmission systems and distribution lines to provide all aspects of electric service. The integrated utility may also include a gas LDC component.
Hybrid	<p>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 the portfolio.</p> <p>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.</p>
Energy delivery	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.

