Assessing the Transmission Outlook

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www.ubs.com/investmentresearch

Julien Dumoulin-Smith
Analyst
julien.dumoulin-smith@ubs.com
+1-212-713 9848

Jim von Riesemann
Analyst
jim.vonriesemann@ubs.com
+1-212-713-4260

Andrew Gay
Associate Analyst
andrew.gay@ubs.com
+1-212-713 3182

Despite the regulatory overhangs, transmission remains solid

In tandem with our launch of ITC Corp today, we are publishing a review of outstanding transmission issues at FERC. Despite a litany of potential near term overhangs as outstanding complaints are resolved in the transmission subsector, we remain positively biased in the long term. FERC continues to afford transmission utilities minimal rate lag, impressive transparency, and robust cash flow generation off of which to fund growth; the sector continues to see disproportionate growth opportunities afforded through regional reliability initiatives and renewable policy interconnectivity directives.

ROEs continues to receive focus, but backleverage escapes scrutiny

With at least three separate pending complaints at FERC on whether authorized returns on equity (ROEs) remain in the zone of reasonableness—including the Mass AG petition—we see some downside risk to authorized returns, albeit we see the burden to justify their reduction as particularly high. Moreover, we observe generally smaller 'adders' authorized, with some projects no longer receiving the same premiums, such as the rejection of PPL's latest petition for a 'nexus'-adder. However, we see broader concerns over regulation of holding company leverage as muted without any meaningful scrutiny of any party as to OpCo capitalization. We remind investors while base ROEs could be reduced modestly (although unlikely given the higher burden of proof involved), overall cash flows would be minimally impacted by ROE adjustments, suggesting credit metrics remain intact to fund growth—and would only modestly impact ITC's current EPS growth CAGR.

Generator interconnections: Who pays for the upgrade costs?

Following the latest petition by IPL over ITC's MISO Attachment FF tariff, the subject of who pays for generator interconnections has gained increasing relevance. Under ITC's current structure, 100% of upgrade costs are 'ratebased' by the utility, akin to policies in place across SPP and ERCOT. However, most of MISO and PJM have adopted alternate practices, focused on having generators partially (or substantially) contribute to requisite system upgrades. While we see the latest petition as resolved favorably for ITC, we believe the latest focus could actually spur latent interest among some parties in PJM and MISO to favor more ratebased expenses (utility as opposed to merchant generator funded) in order to encourage merchant development. Interconnection costs in PJM have frequently ranged in the tens of millions to upwards of hundreds of millions for cascading system reinforcements required.

Reviewing the regulatory construct: MISO 206 complaint explores process

A further focus of late in the sector has been on the transparency of the annual formula ratemaking process under RTO constructs. The MISO 206 complaint primarily focuses on the limited ability for interveners to be involved in rate-setting. While expanded scrutiny of the formulaic process is a likely outcome, rate lag impact should be minimal as the rate-setting process is likely adjusted accordingly for any greater length. Moreover, with ROE/capital structure not set in the annual formula ratemaking process and projects mostly elected through prior planning processes, the financial impact of any expanded review is likely minimal.

We include write-ups on perceived key issues in the Transmission subsector:

1) Potential ROE Reductions: The Mass AG Intervention

In September 2011, Massachusetts's AG office filed a 206 complaint at FERC asking for a rehearing on the authorized generic ROE for New England transmission utilities. The request suggests a mean of 9.2% and a median of 9.4% within its zone of reasonableness, driven off a reduction in 10-year treasuries from 2006 to 2011. The order specifically flags the last update to the rates upon rehearing in 2006, which increased ROEs from their 2004 level to reflect higher 10-year treasuries at the time (10.4% baseline ROE increased by 74 basis points to 11.14%).

We ultimately believe ITC's ROEs will not be successfully challenged.

We see the burden of proof regarding the ROE bands as challenging for interveners

Since the September 2011 filing (seemingly timed to coincide with approvals around the merger of NU and NST—two New England utilities), parties have failed to reach a negotiated agreement. In July 2012, the FERC set the matter for hearing given no successful resolution with interveners.

ROE reductions would still be piecemeal

As a reminder, the Massachusetts's AG case filing (FERC Docket: EL11-66) impacts *only* the generic New England rates—and further 206 filings would be necessary to change the generic ROEs utilized in MISO; and tariff specific rates received by individual utilities in PJM—suggesting a long-term, staggered adjustment would take place if the MA AG petition is successful. We see lower authorized ROEs as a broader trend for regulated utilities in light of the lower 10-year yield environment.

Other FERC 206 ROE Complaints

We flag that Niagara Mohawk's 11.5% transmission ROE was also recently challenged by the New York Association of Public Power (NYAPP), a coalition of nine munis and four rural electric co-ops that serve approximately 500 MW of load. NYAPP's testimony argues for a reduction to a 9.49% ROE with a 8.99% median, based on the zone of reasonableness of 6.38% - 10.75% plus a 50 basis points independence adder. Complainants argue that lowering the ROE to 9.49% would save customers $19 Mn annually. No schedule has been set yet; FERC has no timeline to respond. Docket: EL12-101.

The uptick in 206 filings is somewhat concerning however the New England ROE case will likely see a FERC ruling the earliest (Sept '13)

In a similar 206 complaint, a Maine customer group has filed a 206 challenge to Maine Public Service's transmission ROE, arguing for a cut in allowed return to 8.83% from the current 10.5%. Complainants argue for a zone of reasonableness of 7.27% – 10.97%. Docket: EL12-76.

Niagara Mohawk and Maine Public Service have had their ROEs challenged via 206 filings at FERC

2) ROE Adders: An Ebbing Trend at FERC?

Along with scrutiny of the premium ROEs awarded by the FERC is a growing trend in recent decisions to mitigate or outright remove ROE adders for unique projects. Notably FERC Commissioner Moeller dissented in the latest PPL Transmission filing, stating it was the first time of late (1st of ~100 incentive applications processed since 2006) the commission had *not* adopted any adders despite the fact that the project was not 'routine', which typically has garnered a 100 basis point premium (as part of 679 incentives). Many projects receive their status as being non-routine through their incorporation into regional planning processes (in this case, PJM's annual RTEP review). Other 'adders' garnered by some transmission companies are a 50 b.p. RTO membership benefit and a 100

ROEs 'adders' of any fashion have received greater scrutiny

Types of ROE Adders:

1. 'Unique Project' Adder (ranges)
2. RTO Membership (+50 bp)
3. Independent (+100 bp)

b.p. benefit for system independence. Notably ITC has did not file for *any* premiums for its proposed MidSouth acquisition from Entergy or previous ITC Midwest deal in 2007.

Non-ROE benefits are a growing palatable alternative?

Historically, the commission has offered both ROE benefits and non-ROE benefits for projects that were non-routine (met the commission's "Nexus test", otherwise referred to as 679 incentives). Risk-reducing non-ROE benefits include CWIP in ratebase, reimbursement of plant abandonment on higher risk projects (occasionally reducing the adder otherwise awarded), and a hypothetical capital structure.

3) Holding Company Leverage: Not in FERC's Target

We do not see a scenario under which FERC targets holding company leverage

Despite continued concerns among the investor community that HoldCo leverage will face scrutiny at the FERC, we continue to sense the commission is both paying limited attention to the issue—and more importantly is unlikely to act against the utilities. Rather, we see international precedents such as Ofgem in the UK, as illustrative of other regulatory paradigms where holding company leverage is similarly permissible. Ultimately, we see FERC potentially enacting tighter ringfencing provisions around operating companies as a much more likely resolution to greater concerns around holding company leverage.

Could see reform eventually of authorized capital structure at transmission OpCos

As a reminder, the issue of back-leverage is notable due to heavy equity-capitalizations pursued at FERC-regulated operating companies, with many opting for as much as a 60% equity layer. In turn, the holding company structure will issue incremental debt such that the consolidated entity is capitalized at ~30% equity. The ability to issue debt at the parent and receive equity treatment at the operating subsidiary results in substantial cash benefits. We ultimately see the ability to employ added leverage at holding companies as *more* important to the financial returns garnered by the company than its authorized ROE. *The only real manner in which we see capital structure as being at risk is if FERC should decide it would like to authorize greater leverage at the operating company level.*

4) The MISO 206 Complaint: Adding transparency to formula ratemaking with the RTOs

FERC is exploring process oriented reforms to improve transparency

The FERC recently initiated a 206 investigation into MISO's formulaic transmission tariffs in May, driving three key considerations: 1) scope of the formulaic proceedings, including who is included in their review; 2) transparency and disclosure requirements of formulaic rates; and 3) ability to intervene in formulaic proceedings, including provision of a discovery period for interveners. FERC has stated it would like to resolve the outstanding investigation by February 28th, 2013, suggesting the new procedures could take effect for the 2013 review cycle (for 2014 rates). While not targeting authorized ROEs or adders for transmission projects, the current investigation does seek to allow interveners greater transparency into the formula ratemaking process—potentially creating an extended period for rate reviews, and certainly resulting in greater scrutiny of projected costs and ratebase. We also note the current case is not questioning the use of forward formula rates either. Coupled with the risk of a lower ROE (eventually) from the Mass AG 206 complaint, we do see some risk to the favorable regulatory status of FERC-regulated transmission ratebase.

The investigation is derived from two prior cases in which the IURC (Indiana Utility Regulatory Commission) and ICC (Illinois Commerce Commission), among other parties, petitioned for greater transparency in transmission cases. Notably, parties petitioned for greater disclosure and involvement regarding the derivation of projected rates, particularly for adjustments made to FERC Form 1 inputs as well as non-form elements in the filings. In both of these cases, the FERC ultimately opted to avoid addressing the merits of the transparency complaints—opting to take up the current investigation instead. Ultimately, pressure for the contemplated reforms is primarily from state-regulators and broader regional quasi-regulatory bodies such as OMS (Organization of MISO States) rather than competing individual utilities or customers—and as such we see disproportionate political pressure for FERC to act.

Added involvement in a MISO Attachment O filing

While MISO transmission owners are required to engage their customers in an annual meeting and informally address outstanding questions, the current rate cycle does not formally allow for a "discovery" period to address customer concerns in the projected rates. Current annual Attachment O transmission rate reviews (in MISO) primarily involve a review by MISO staff in terms of translation and adjustment of FERC forms into rates—providing only transmission owners an opportunity to review rates prior to publishing new revenue requirements. We believe it is likely the FERC requires at least improved disclosure, if not the formal ability for interveners to get involved ahead of initial rates sent to transmission owners prior to final publishing (this is typically sent out on June 15th, ahead of October 1st formal publishing to OASIS transmission tariff system).

Annual trueup filings: Public informational filings on rate changes

Several interveners have also asked for the public disclosure of trueup filings, revealing under and over-earning in a given year, and subsequent rate adjustments. We believe these too will face acrimonious filings by interveners, with the FERC ultimately requiring some form of enhanced disclosure. As far as enhanced intervention policies, it would seem any added intervener discovery testimony would likely result in a corresponding extension in the annual rate case cycle timeline, limiting negative impact on rate lag.

5) Generator Interconnection Costs: IP&L's Complaint

The complaint is over $129 Mn in capital costs spent thus far, however, could limit ratebase growth at ITCM and ITC Transmission going forward

On September 14th, IP&L filed a 206 complaint against ITC with respect to attachment FF which provides for 100% reimbursement of the costs of eligible network upgrades for generation interconnects in the ITC Midwest system, allowing ITC to rate base the costs. FERC approved attachment FF in 2008 with an eye towards non-discriminatory operation of the transmission system; IP&L is arguing a return to the traditional cost allocation, where generators pay for ~90% of the interconnection costs, leaving only 10% of the investment for ITC, whereas MISO operates primarily under a 50/50 cost sharing scenario.

The issue raises broader questions as well, with contrasting policies on how generator interconnection transmission upgrades are handled in different RTOs. Notably, in SPP and ERCOT where utilities are responsible for 100% of the transmission costs (akin to ITC's current treatment in the outstanding case), the cost of building new generation is sizably reduced relative to markets where merchant generators in PJM and portions of MISO are responsible for the bulk of the transmission interconnection costs incurred. These costs can be meaningful for generators as system upgrade costs can trigger cascading required system retrofits, costing hundreds of millions on occasion (and effectively further disincentivizing large scale generation in merchant markets.) Moreover, given policies design to encourage renewable development, we believe regulators are likely to maintain status quo in an effort to limit impediments to intermittent renewable resources. Ultimately, the issue arises as most regions within the MISO footprint subscribe to the PJM-approach of ratebasing in just 10% of associated generator investments, with ITC Midwest an exception to this policy in MISO.

This issue raises broader questions of contrasting policies in different RTOs

ERCOT and PJM have contrasting policies on who pays for generator upgrades

Given the issues associated in PJM, we see the ratebase model as 'better'

The commission established MISO's latest Attachment FF rates premised on 50/50 sharing of interconnection upgrade costs in 2006, however, ITCM and ITC Transmission proposed the 100% ratebasing of costs in their 2007 tariffs, which the FERC eventually accepted. ATC similarly filed a comparable filing in 2008 for such treatment, which it subsequently received. IP&L did not object in either of these tariff modifications.

6) Order 1000 and ROFR Floodgates: the Upcoming Battle for Transmission Projects

We believe a key element to the ITC story in the long term remains tied to its ability to compete for and construct projects *outside* its native transmission service territories in SPP and MISO. With FERC Order 1000 *removing* the Right-of-First-Refusal (ROFR) for incumbent generators to build transmission projects, we believe ITC could be well positioned to compete and win projects outside of its service territory. Both MISO and SPP (among other RTOs) recently filed their FERC Order 1000 compliance filings on October 11th; a further compliance filing on inter-region FERC 1000 collaboration is due on April 11th, 2013. In turn, the first planning process in MISO under these new rules will begin in June of 2013, with resolution of the MTEP process driving new investment opportunities in 2015.

7) Where to Find Transmission Filings?

Modeling transmission assets is particularly aided through a multitude of filings at the respective RTOs. We include generic links below to transmission utilities in the following service territories:

MISO Projections:

Filings, including annual Attachment O filings can be found at this website. These include authorized returns, ratebase, and revenue requirement on an annualized basis. These are typically updated annually in late August. http://oasis.midwestiso.org/oasis/

These can also be found at the site below on a realized basis in XLS format:

https://www.midwestiso.org/Library/Pages/ManagedFileSet.aspx?SetId=259

SPP Projections

SPP also produces annual updates to its tariffs to reflect updated transmission expenditures under Attachment H that include projected ratebase, revenue requirement, and authorized capital structure. These can be found at the link below:

http://sppoasis.spp.org/documents/SWPP/MemberRelatedPostings/MemberRelatedPostings.asp.

PJM Projections

PJM also produces annual formulaic rate projections for each of its respective member transmission utilities under its Attachment H filings. PDF documents including ratebase, revenue requirement, etc are included below.

http://www.pjm.com/markets-and-operations/transmission-service/formula-rates.aspx

■ Statement of Risk

Risks for Utilities and Independent Power Producers (IPPs) primarily relate to volatile commodity prices for power, natural gas, and coal. Risks to IPPs also stem from load variability, and operational risk in running these facilities. Rising coal and, to a certain extent, uranium prices could pressure margins as the fuel hedges roll off Competitive Integrateds. Further, IPPs face declining revenues as in the money power and gas hedges roll off. Other non-regulated risks include weather and for some, foreign currency risk, which again must be diligently accounted 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.

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Neutral	**Hold/Neutral**	41%	31%
Sell	**Sell**	9%	20%
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Sell	**Sell**	less than 1%	0%

1:Percentage of companies under coverage globally within the 12-month rating category.
2:Percentage of companies within the 12-month rating category for which investment banking (IB) services were provided within the past 12 months.
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Source: UBS. Rating allocations are as of 30 September 2012.

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Company Disclosures

Company Name	Reuters	12-mo rating	Short-term rating	Price	Price date
Entergy Corp.[16]	ETR.N	Neutral	N/A	US$72.10	26 Oct 2012
ITC Holdings Corp[16]	ITC.N	Not Rated	N/A	US$79.20	26 Oct 2012

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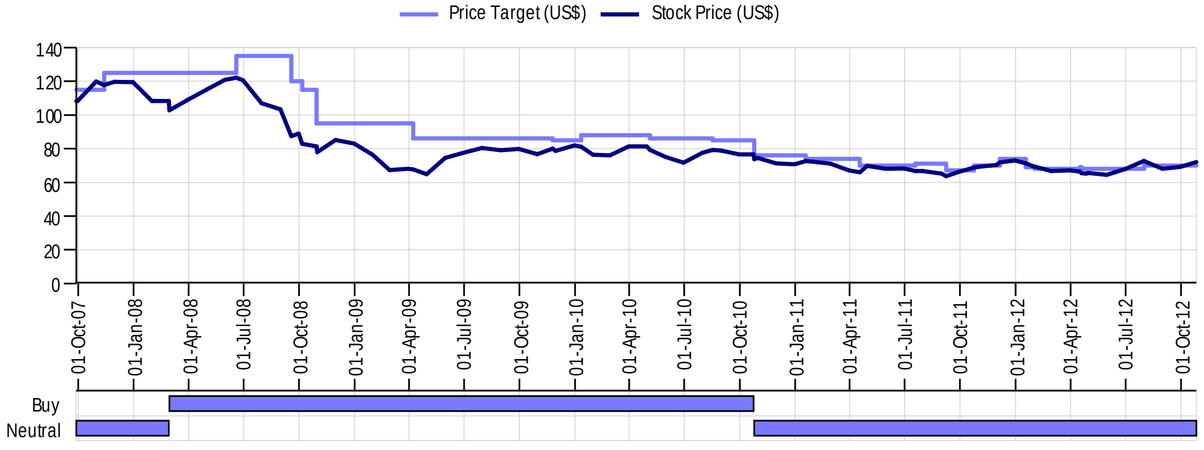

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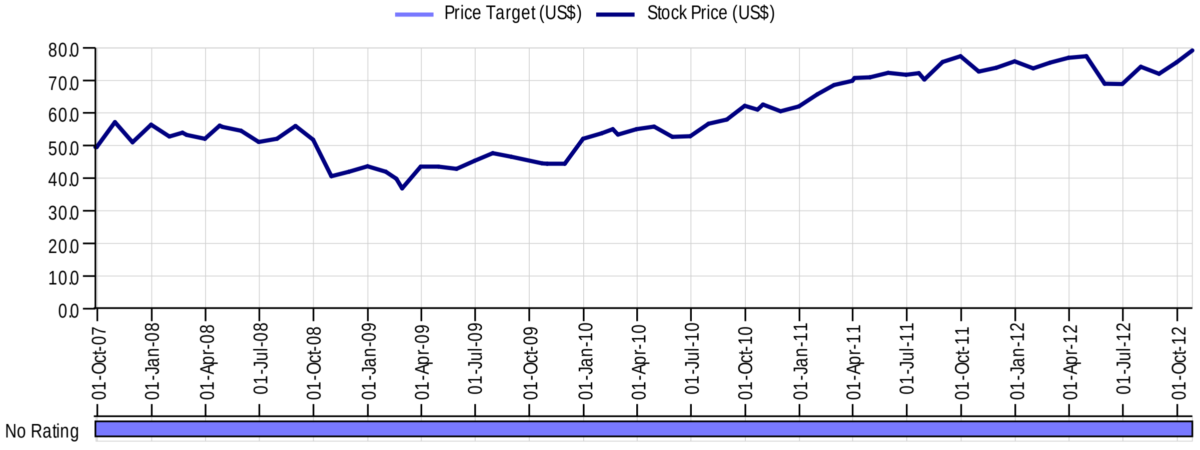

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