Ontario reform: just where could the province go on renewable cuts & beyond

Bank of America Merrill Lynch

Industry Overview

Equity | 17 July 2018

Ontario to cancel 758 renewable contracts to reduce rates

We hosted our latest conference call on Monday with Jason Chee-Aloy, managing director at Power Advisory LLC, on the recent Ontario Power & Utilities, including the latest order (from late last Friday, 7/13) that aims to reduce overall utility bill rates by -12%, in part by cancelling 758 renewable energy contracts in development only. The lingering question after this initial batch of project cancellations remains just which other efforts could be pursued to achieve the full -12% reduction contemplated (a precise 'baseline' is still elusive in campaign promises). Specifically, Ontario Premier Doug Ford's campaign commitment has focused on terminating those in the pre-construction phase that have *not* fulfilled critical milestones for commercial operation to ensure maximum cost savings. As such, we see large interconnected wind projects and rooftop solar projects under development as the most at-risk, meanwhile operating contracted assets as relatively safe. This is part of a broader effort that began last week, with earlier in the week removal of the Hydro One board of directors and CEO, following campaign promises by the new administration to do so and ultimately concluding with the publication of contracts to be cancelled. Overall, we still see an overhang reconciling the -12% reduction in rates with the anticipated $790mn in savings from the project cuts (albeit still *net* of unclear costs for abrogating contracts), while waiting for Ontario to shed more light as to which projects exactly are slated for review.

What does this mean for renewable ProjectCo's?

Amidst the slate of renewable projects cancelled, neither Pattern Energy's (PEGI) in-service nor under-development projects were targeted, seemingly on account of their perceived local support. We continue to believe these contracts will not be renegotiated, but rather remain worried of a broader discount to be applied to the region given recent actions; we see this as particularly relevant amidst a backdrop of potential strategic review of PEGI's wider portfolio. Beyond renewable projects, we see lingering risk to both contemplated nuclear repowering in the province (despite a nominal commitment to the energy). Expensive energy has driven sizable inflation in recent years – and would expect limited further new commitments in renewables to materialize too under the leadership. For more context please see: Pattern Energy Group: What will come of the Ontario portfolio? Downgrade to Underperform, $17 PO 13 July 2018).

A push for cost savings – transmission in focus too

With the wide spectrum for the 758 terminated contracts, we see the transmission and distribution projects as potentially up for renegotiation and reconsideration in terms of their economic value. We highlight the 230kV East-West Tie Transmission project between NextEra Energy and Enbridge as having the potential. Additionally, we note that the Northwest line connecting to rural jurisdictions (Thunder Bay to Wawa) is lower in priority, given the lack of economic development in these areas. With the project still undergoing environmental assessment, and construction set to begin in late 2018, we see the East-West tie as on the chopping block, albeit with potential nuances related to rural mining efforts requiring interconnection. Finally, we see prospects for FTS/ITC's Lake Eerie connector as also specifically at risk; this project had already been delayed for a protracted period. Specifically, those that do not generate cost-savings for customers will be under fire, given the aggressive need to lower rates by 12%.

United States
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Financial compensation guaranteed but varied

We see the future amendment pending clarification, but sure to have financial compensation for terminated contracts. Depending on what stage of development they are in for notice to proceeds (NTP), they will receive a tiered level of reimbursement, with those further along receiving more. However, we note that this is not meant to stop all energy projects given that Ontario is expected to be energy deficient in mid-2020s going into 2030, with 3,000MW of nuclear set to retire by 2024 and 7,000MW refurbished in the late 2020's. Instead, we see the pro-nuclear legislation and cancellation of renewables as indicative that they are neutral on what's in the market, with cost-effectiveness taking priority. We note that the cap-and-trade program and the feed-in tariff programs (FIT) 1-5 will wind down, with all three types of contracts (FIT, large renewable procurements (LRP), and hydroelectric standards) fair game to be terminated with financial compensation. Again, we reiterate that those that have existing contracts are not in danger, while awaiting more clarity on future legislation for those under the pre-construction phase.

Market design evolution too for IESO

Additionally, with rising customer costs, lower demand, and an overhang of supply, we note that Ontario is expected to redesign their wholesale markets to more closely emulate ISO-NE's capacity markets and include locational marginal pricing. However, given the discontinuation of future projects, we still question how this translates to the decrease in hydro rates currently.

No more sunny skies - cloudy with high winds forecasted

In line with expectations, we saw solar projects as the primary victims of the renewable contract termination, accounting for approximately 95% of the 758. This includes rooftop, non-rooftop, and ground mounted solar. We note that wind projects remain broadly unaffected, but are not in the clear yet, with the White Pines Wind Project scheduled for termination (7/16) despite nearing completion of construction; this specific project is among the most surprising developments. The project had been under development for 10 years with over $100mn in costs, but has been cancelled due to strong opposition from local groups. *This local opposition element appears to be among the starkest dynamics to note in determining the fate of individual development projects.* As such, we see continued risk for projects in the later development stage not only for renegotiation, but potential cancellation. Should projects be cancelled we emphasize that compensation under existing arrangements is still to be expected as part of collateral deposits made with counterparty.

Table 1: Cancelled renewable contracts by type

Power Type	# Contracts	% Total
Solar	717	94.7%
Biogas	16	2.1%
Waterpower	11	1.5%
Wind	5	0.7%
Biomass	4	0.5%
Hydroelectric	4	0.5%

Source: BofA Merrill Lynch Global Research

Wind curtailments remain a risk exposure too

Despite initial relief, we still perceive contract risk across the province pertaining to curtailment payments given their uniquely high compensation levels; specifically provincial wind assets. Based on 2017 curtailment figures, we note that PEGI's four wind plants – South Kent, Grand Renewable, Armow, and K2 – received higher capacity payments based on contracted feed-in-tariffs (FITs) than market rates. On average, the plants received $132/MWh for 382MW of capacity, assuming a 40% capacity factor, for curtailment (not going online). This is higher than 2017 mid-peak time-of-use (TOE) electricity rates of $133/MWh, and even closer to on-peak prices of $156/MWh. Given the premium prices customers are paying on already high FIT prices, we remain concerned about wind contracts not only for PEGI (300MW Henvey Inlet under construction), but also the wider market construct.

More background on bill inflation: where did it start?

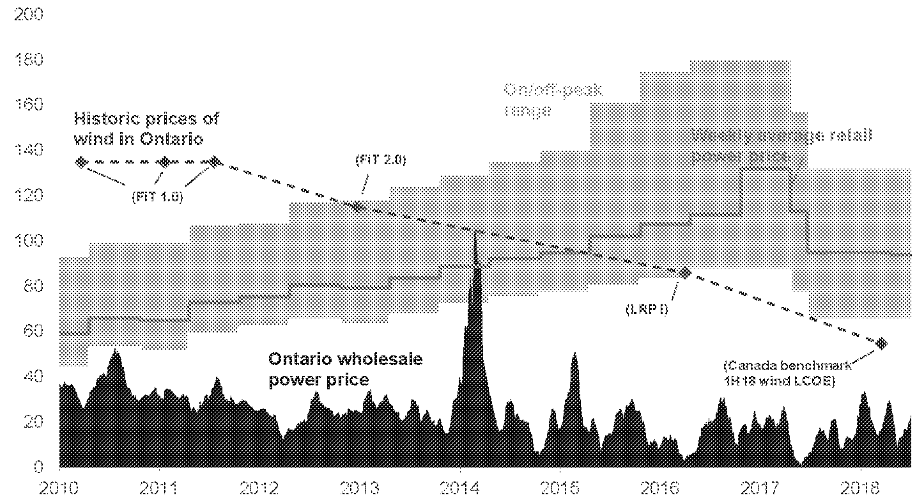
Ontario has supported renewables through a number of programs at a cost, including FiT 1.0 and LRP I. FiT 1.0 rewarded contracts of C$135/MWh in 2011 and before, while LRP I was a competitive process that rewarded wind assets contracts of C$85.94/MWh in 2016. Meanwhile, the onshore wind LCOE benchmark in Canada has dropped to around C$55/MWh. We highlight a large discrepancy between old contracts and the cost of new build (see green datapoints in figure below).

We also highlight that retail rates skyrocketed in 2010 through 2016. While they have come down somewhat, retail power prices are still far above wholesale power prices, which generally decreased through the same time. Expensive renewable contracts are not the only culprit to blame for high retail rates, but are one target the government is addressing in decreasing retail prices.

We see this as another step Premier Ford's administration is taking to reach its promise of lowering electricity bills and cutting the Hydro One bill specifically by 12%. Ontario's high retail rates have been a topic of debate, and we have seen the Ontario government take drastic measures already to decrease retails power prices, including:

- September 2016: The government-run competitive auction LRP II (Large Renewable Procurement) was cancelled.
- July 2017: The previous administration issued the Fair Hydro Plan to reduce retail rates by 25%.
- July 10, 2018: Under the new government, the small 18MW White Pines Wind Project was cancelled.
- July 11, 2018: Premier Ford's government announced Hydro One CEO Mayo Schmidt is retiring from the company, effective immediately. The Board of Directors is also out the door with Schmidt, which is scheduled - and expected - to be completed by August 15.

Exhibit 1: Ontario retail rates (orange), wholesale power prices (blue), and general trend in cost of wind (green) ($/MWh)



Source: BofA Merrill Lynch Global Research, Bloomberg, Ontario Energy Board

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	Primary Author	Date Published
US Electric Utilities & IPPs: Weekly Power Points: Deal maneuvering in full focus (D, ES, SRE)	Julien Dumoulin-Smith	16 July 2018
Pattern Energy Group: What will come of the Ontario portfolio? Downgrade to Underperform, $17 PO	Julien Dumoulin-Smith	13 July 2018
US Electric Utilities & IPPs: Midweek Power Points: Wind & Storage (AEP, VST)	Julien Dumoulin-Smith	13 July 2018

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The proposed transaction is subject to approval by shareholders of Spectra Energy Partners LP, Enbridge Energy Partners LP, Enbridge Energy Management LLC, and Enbridge Income Fund Holdings Inc.

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Price objective basis & risk

Pattern Energy Group (PEGI; B-3-8; $17.96)

Our $17/sh PO is based on a 50/50 weighting between a DCF valuation and a drop-down valuation.

Main assumptions in our DCF are:
- 7.28% cost of equity on a CAPM approach (using 2.85% risk free rate, 5.5% equity risk premium, 0.81 adjusted Beta)
- Cash SG&A expense of $52mn in 2017, increasing at 2.0% per year
- $5mn annual recurring O&M savings by 2018, $10mn by 2019, $18mn by 2020, and $26mn from 2020 onwards - assuming this includes recurring corporate savings

Main assumptions under our drop down approach include:
- 1,500 MW of assets are dropped down
- A DPS of $1.68, where it is today
- A 7.5% required yield based on the 2020E dividend yield for the YieldCo peer set plus a 100 bps discount to reflect the uncertainty around the devco business and ability to reduce dividend payout to target levels

Downside risks are: 1) the company may or may not be able to make accretive acquisitions to grow, 2) the co may not be able to access capital markets at favorable terms, 3) the co may or may not be able to successfully develop new projects, 4) the co may or may not be able to implement its full cost savings plan, 5) the co may or may not be able to grow DPS at the targeted growth rate, 6) the co may or may not be able to sustain its current dividend levels, and div yield could increase Upside risks are further cost reductions include cost allocations between parent sponsor and potential strategic actions including partial or full sale of company, in effort to extract synergies.

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US - Electric Utilities, Alternative Energy & LNG Coverage Cluster

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	NRG Yield	NYLD	NYLD US	Julien Dumoulin-Smith
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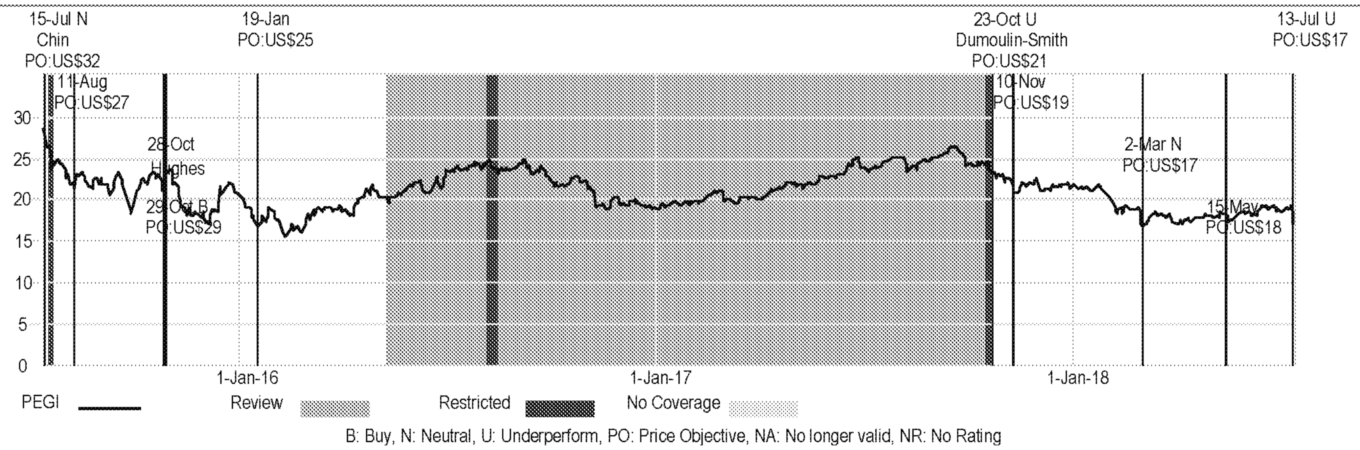
PEGI Price Chart



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Equity Investment Rating Distribution: Utilities Group (as of 30 Jun 2018)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	69	47.59%	Buy	49	71.01%
Hold	35	24.14%	Hold	27	77.14%
Sell	41	28.28%	Sell	25	60.98%

Equity Investment Rating Distribution: Global Group (as of 30 Jun 2018)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1639	55.35%	Buy	1044	63.70%
Hold	615	20.77%	Hold	390	63.41%
Sell	707	23.88%	Sell	340	48.09%

* Issuers that were investment banking clients of BofA Merrill Lynch or one of its affiliates within the past 12 months. For purposes of this Investment Rating Distribution, the coverage universe includes only stocks. A stock rated Neutral is included as a Hold, and a stock rated Underperform is included as a Sell.

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