UBS

Global Equity Research

Americas

Electric Utilities

Sector Comment

UBS Investment Research

US Electric Utilities & IPPs

Highlights from Inaugural Regulator Survey

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www.ubs.com/investmentresearch

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■ Survey offers a few surprises

We surveyed utility regulators for insights on expectations, including returns, capital structure, demand outlook, as well as key issues affecting the sector. We believe industry ROEs may decline modestly but equity structures will remain largely intact. Regulators continue to await an above-average number of utility rate case filings, driven in large part by above-normal capital investment. By and large, regulators believe load growth will be limited in the near term, with the three-year outlook only modestly better at ~1%. Those States pursuing more aggressive energy efficiency programs indicated generally negative near-term demand growth projections. The key issue among respondents remains the impact of EPA regulations, with many both formally and implicitly citing its challenges. Lastly, regulators appear to be content with electric restructuring and the latest acceleration in customer shopping.

■ Survey confirms our reserved view on fundamental outlook for utilities

The survey results confirmed our more modest-to-cautious outlook on regulated utilities. We expect more frequent rate case filings – driven from EPA-related capital investments – coupled with a weak economic backdrop and record low Treasury yields may put downward pressure on regulated earnings beginning in earnest in 2013. Earnings could be further pressured as we see an increasing need for external equity, exacerbated with the expiration of bonus depreciation tax benefits. We highlight Key Call Wisconsin Energy (WEC) as our top regulated pick given its constructive regulation, above average dividend growth and positive free cash flow. Among hybrid utilities, we prefer Exelon (EXC), given its leverage to improving power prices resulting from CSAPR implementation.

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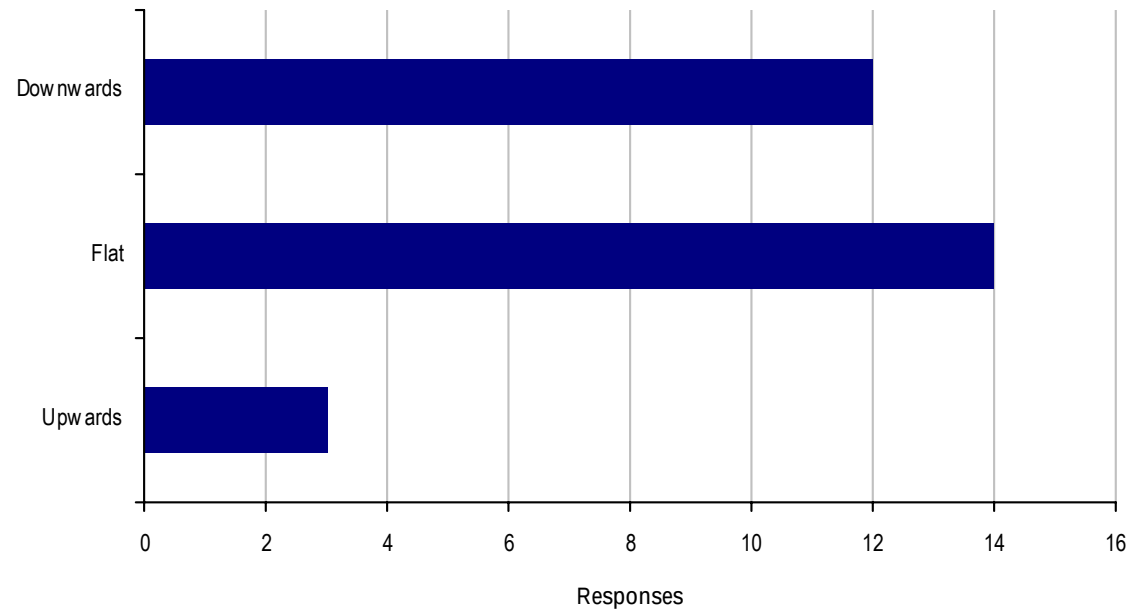
Background – Inaugural Survey Overview

We conducted a survey wherein we asked 16 questions of each regulator in all 50 states. (A copy of our survey questions are shown in Appendix A at the end of this note.) In all, we heard from 30 regulators. Their identities remain confidential. The purpose of the survey was to ask general "industry assessment/trend" type questions and to avoid any state- or company-specific questions. Importantly, the views of the regulators were those of their own, and not necessarily how their respective commissions view the world. The respondents were not required to answer every question, and in most cases, they did not. We recognize that this survey is not statistically significant and we draw no conclusions that way. In the sections shown below, we provide the responses to our questionnaire.

Return on Equity: Trending Flat to Downwards

Respondents indicated either a flat or declining cost of equity; generally only states with ongoing regulatory changes indicated upward returns. We appreciate the trend towards lower ROEs given that the economic spreads between allowed returns and the 10-Year and 30-Year Treasuries are at historic highs, but we caution using this as an underlying benchmark. The average utility cost of debt has not been on a downward trajectory despite the lower Treasury levels. Simply put, it is too expensive given "make whole" provisions and the consumer does not see a material benefit. Keep in mind the cost of equity for utilities will certainly rise the moment the market begins to chase beta in earnest.

Chart 1: Directionally, how has the cost of equity trended over the last 12 months?

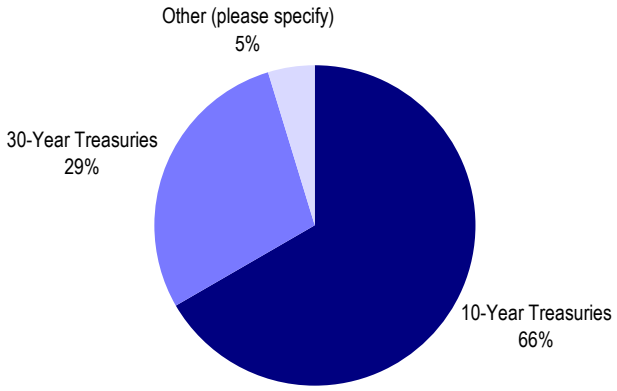


Source: UBS survey

What is the Most Appropriate Measure to Track Risk?

Survey respondents significantly preferred the 10-year US Treasury Note over the 30-Year Treasury Bond as the most appropriate measure to track the risk free rates. Given the prolonged period of depressed 10-Year rates resulting from government bond purchasing programs, we've noted an increasing tendency to use 30-year rates as meaningful measure of risk. In particular, we highlight the latest formulaic bill proposed in Illinois (passed both chambers, but vetoed) ties authorized ROEs to 600 basis points above 30-year Treasuries.

Chart 2: Which do you see as the most appropriate measure to track the risk free rate?

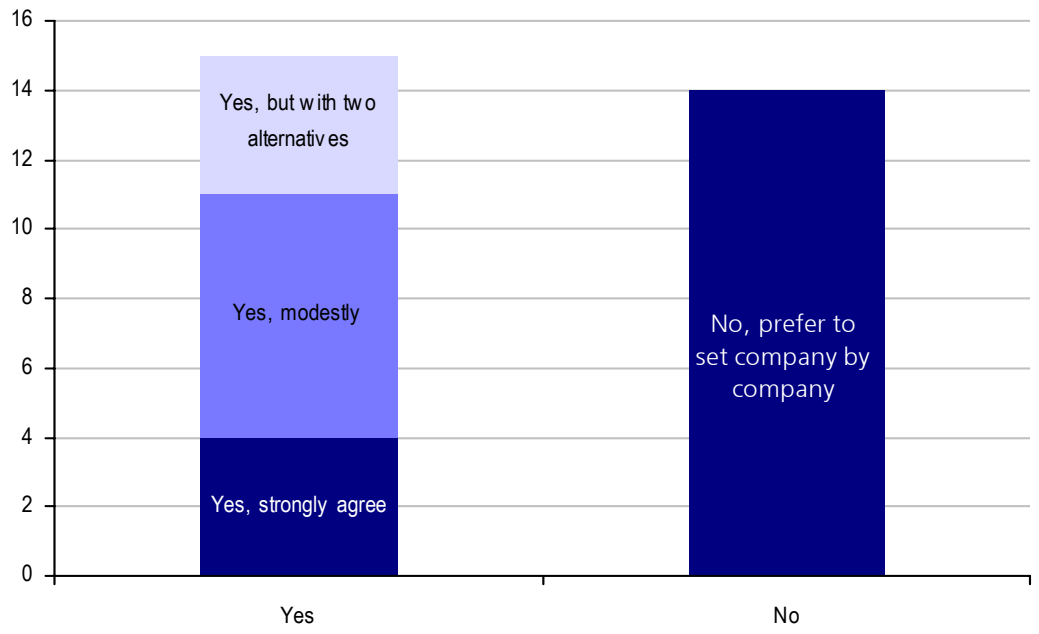


Source: UBS survey

Should there be a Formulaic Approach to ROEs?

The results regarding the method of setting the allowed ROEs were split almost evenly between those who think it's best to use a well-defined formulaic approach and those who prefer it to be set company by company. Although the results are split, the majority who agree with the use of a formulaic approach would like alternatives or a modest approach indicating that a middle ground may be considered to be the most appropriate method.

Chart 3: Should allowed ROEs be set through a well-defined formulaic approach?

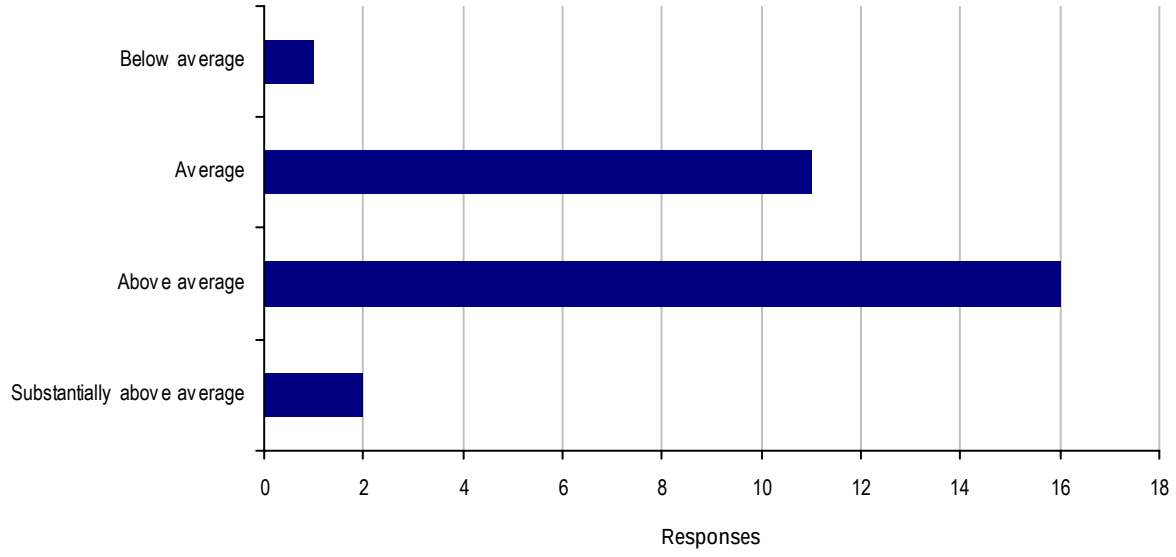


Source: UBS survey

Rate Case Filings

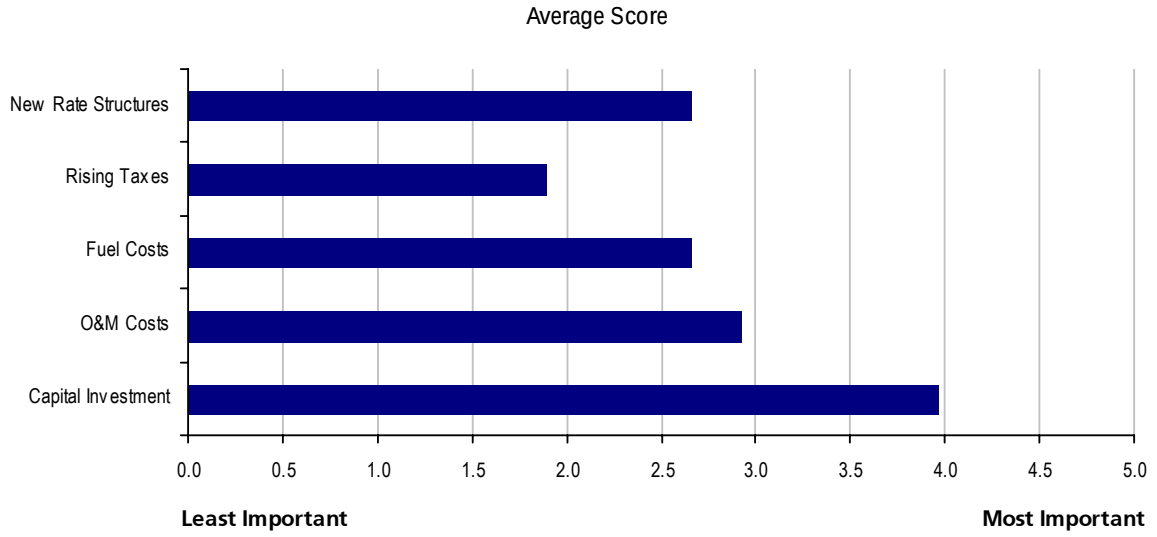
Our survey indicates that the regulators expect a greater-than-usual number of rate cases to be filed, with capital investment among the most significant drivers for the acceleration in the number of filings. O&M costs, fuel costs, and new rate structures appear to have an average influence on the need to file. We believe the preponderance of capital invested can be tied to retrofits on coal fired plants and transmission investments.

Chart 4: Are utilities poised to file more or less rate cases in the coming 12 months versus the historical average?



Source: UBS survey

Chart 5: On a scale of 1 to 5, 1 driving the least and 5 driving the most, please rate how much each factor drives the need for rate cases.

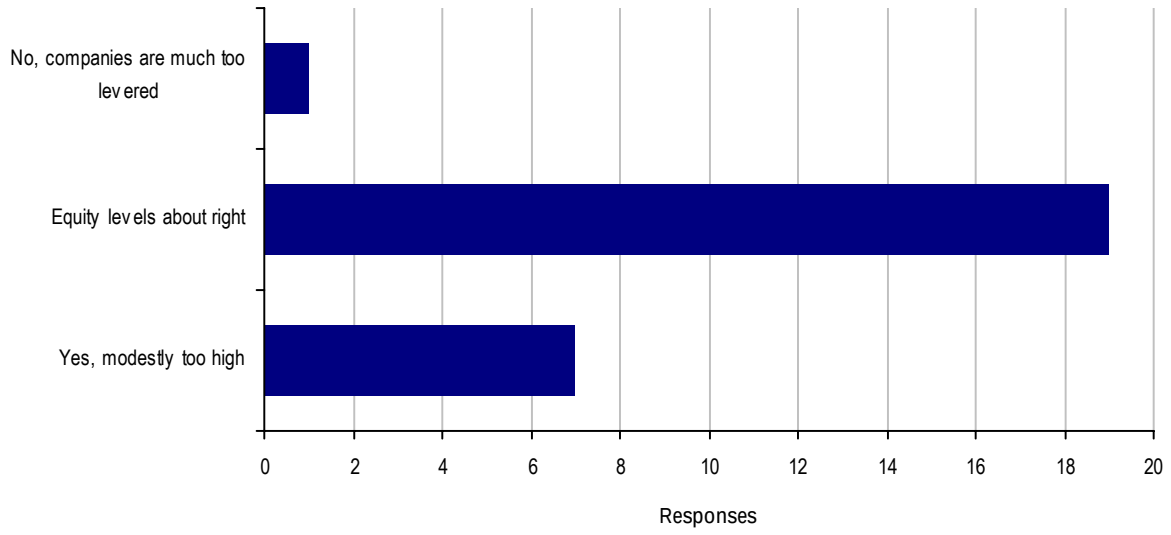


Source: UBS survey

Capital Structure: Equity Component Sufficient?

The survey indicates that people believe current equity levels are appropriate with several considering levels too high. This shows that regulators would prefer to see utilities companies employing more leverage rather than deleveraging.

Chart 6: What is your view on the present capital structures in the electric utility industry?

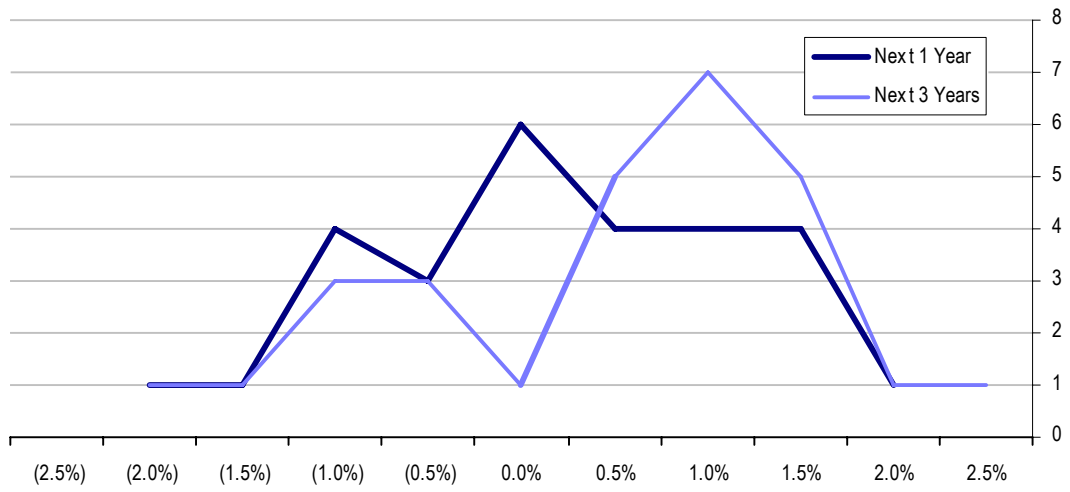


Source: UBS survey

Demand Growth Expectations

Overall, demand growth appears to be near zero in the next year with the distribution skewing slightly positive. Over the coming three year period, regulators largely agreed on near ~1% growth. Regions with meaningful energy efficiency targets all indicated either flat to declining load.

Chart 7: Where do you see overall demand trending over the next year and over the next three years (per annum basis)?



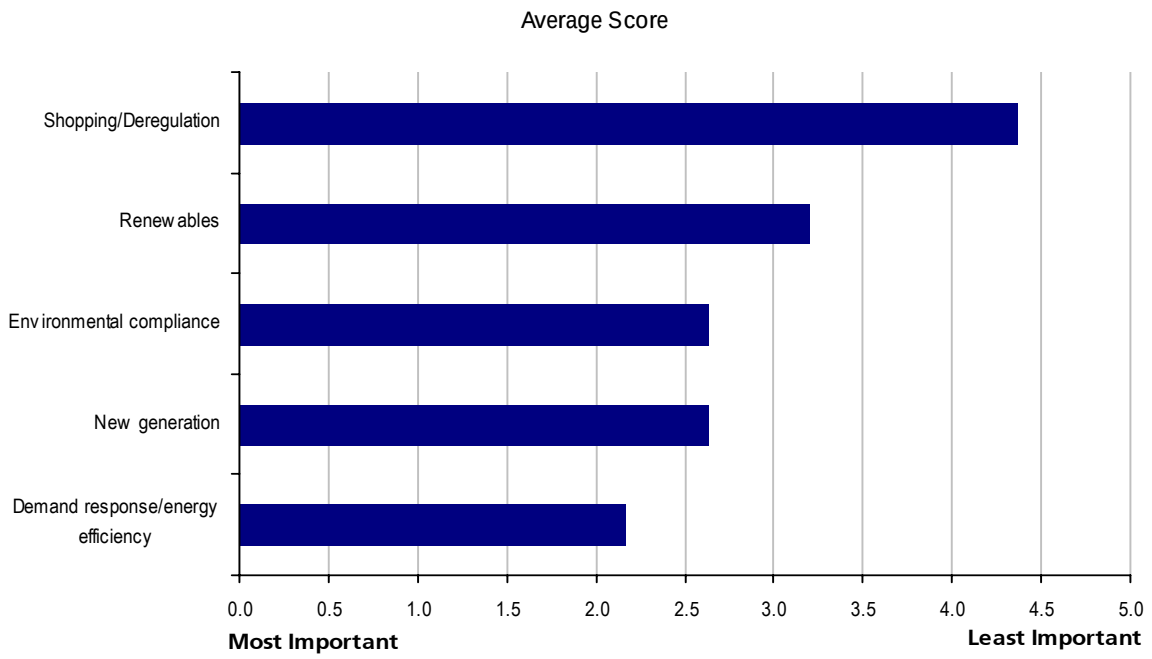
Note: 2.5% data point for next three years is the result of a response of "other" indicating an expectation of 2.5%-3.5%

Source: UBS survey

Regulator Priorities

The survey clearly indicates that shopping/deregulation is of least importance while demand response and energy efficiency is of greatest importance. In large part, we view the relatively lower degree of concern on shopping as illustrative of the successful transition to restructuring for the time being and the overall trend of declining retail rates. New generation and environmental compliance are considered modestly important while renewables are less important.

Chart 8: Please prioritize each factor in order of importance (1= most important; 5= least important)

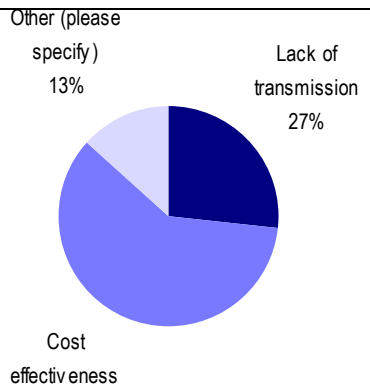


Source: UBS survey

What is the Great Impediment to Renewables?

The vast majority of the regulators believe cost is the biggest impediment to the development of renewables.

Chart 9: What is the greatest impediment to renewables?

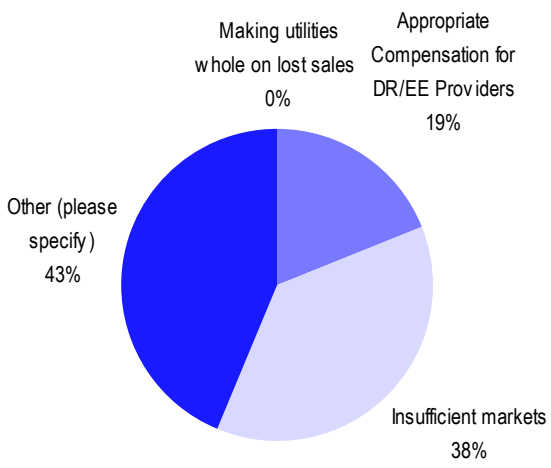


Source: UBS survey

What is the Great Impediment to Demand Response?

The majority of responses indicate that the greatest impediment to enhanced Demand Response and Energy Efficiency development is making utilities whole on lost sales. Please note that a little over one quarter of responses were marked "Other" to include a different reason, indicating a wide array of perceived issues. Furthermore, when asked if they were comfortable with the ability of DR products to respond to peak load reductions, respondents indicated a high degree of confidence in responses.

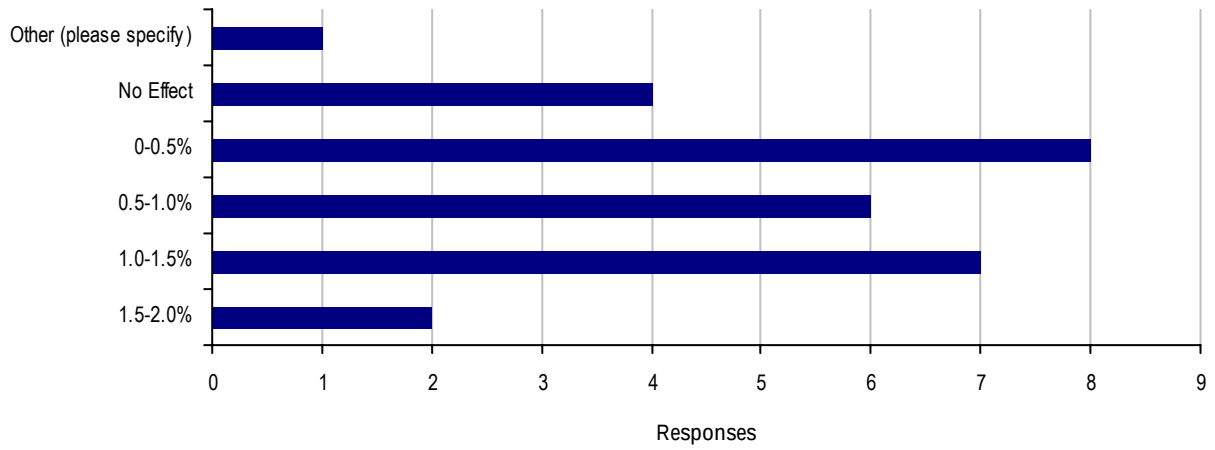
Chart 10: What is the greatest impediment to enhanced Demand Response and Energy Efficiency deployment?



Source: UBS survey

Demand Response and Energy Efficiency are expected to reduce demand between 0.0% and 1.5%. The results were fairly evenly distributed across the metrics, indicating that regulators may be unsure of their effects on demand.

Chart 11: What effect do you anticipate Demand Response/Energy Efficiency will have on reducing demand in the next three years (per annum)?

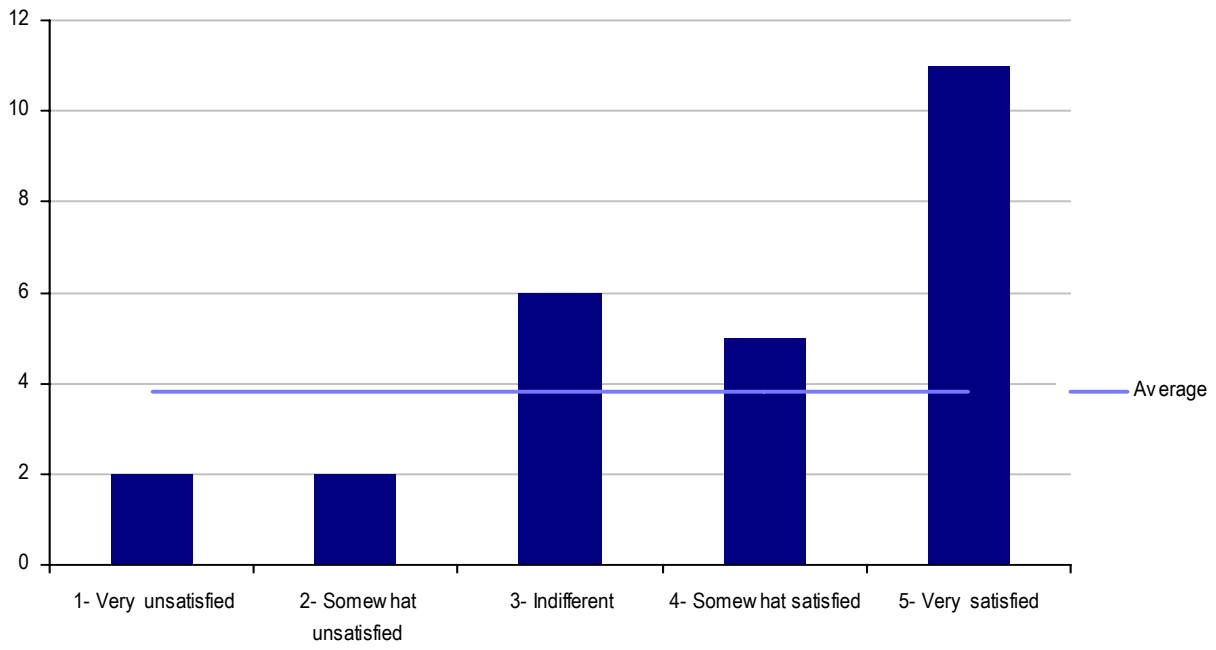


Source: UBS survey

Satisfaction with Electric Restructuring

The majority of those surveyed are very satisfied with electric restructuring in their state, with the average score being 3.8 out of 5. Generally unfavorable views were exhibited by states that had previously explored but never fully pursued deregulation. We believe the fortunate timing regarding the transition to full competition during a period of declining commodity prices has much to do with the vocal support for competition in several states.

Chart 12: On a scale of 1 to 5, how satisfied are you with electric restructuring in your state?



Source: UBS survey

Appendix A: Survey Questions

1. Directionally, how has the cost of equity trended over the last 12-months?

   ☐ Significantly Downwards ☐ Downwards ☐ Flat ☐ Upwards ☐ Significantly upwards

2. Are utilities poised to file more or less rate cases in coming 12-months versus historical average?

   ☐ Substantially above average ☐ Above average ☐ Average ☐ Below average ☐ Substantially below average

3. On a scale of 1 to 5, 1 driving the least and 5 driving the most, please rate how much each factor drives the need for rate cases

   ___ Capital Investment ___ O&M Costs ___ Fuel Costs ___ Rising Taxes ___ New Rate Structures
   Other (please specify_____)

4. Which do you see as the most appropriate measure to track risk free rates?

   ☐ 10-year Treasuries ☐ 30-year Treasuries ☐ Other (please specify_____)

5. Should allowed ROEs be set through a well-defined formulaic approach?

   ☐ Yes, strongly agree ☐ Yes, modestly ☐ Yes, but with two alternatives ☐ No, prefer to set company by company

6. What is your view of the present capital structures in the electric utility industry?

   ☐ Significantly too much equity ☐ Yes, modestly too high ☐ Equity levels about right ☐ No, too little equity
   ☐ No, companies are much too levered

7. Is there an appropriate payout ratio?

   ☐ ≥ 80% payout ☐ 70% to 80% ☐ 60% to 70% ☐ 50% to 60% ☐ ≤ 50 to 40% ☐ ≤ 40%

   Note: Insufficient responses to this question to include in our survey results

8. Where do you see overall demand trending over the next year?

   ☐ -2% ☐ -1.5% ☐ -0.5% ☐ -1% ☐ 0% ☐ +0.5% ☐ +1% ☐ +1.5% ☐ +2%
   ☐ Other (please specify_____)

9. Where do you see overall demand trending over the next three years (per annum basis)?

   ☐ -2% ☐ -1.5% ☐ -0.5% ☐ -1% ☐ 0% ☐ +0.5% ☐ +1% ☐ +1.5% ☐ +2%

   ☐ Other (please specify_____)

10. How much will each customer class grow volume-wise, over the next year on a percent basis?

    ___ Residential customers ___ Commercial ___ Industrial

11. Please prioritize in order of importance (1 = most important; 5 = least):

    ___ New generation ___ Demand response / energy efficiency ___ Renewables ___ Environmental compliance
    ___ Shopping/Deregulation

12. What is greatest impediment to renewables?

    ☐Lack of transmission ☐ Cost effectiveness ☐Lack of political support ☐ Other (please specify_____)

13. What is the greatest impediment to enhanced Demand Response and Energy Efficiency deployment?

☐ Making utilities whole on lost sales ☐ Appropriate Compensation for DR/EE Providers ☐ Insufficient markets
☐ Other (please specify_____)

14. What is your perceived comfort with the reliability of Demand Response to meet peak periods of demand?

☐ Very confident ☐ Confident ☐ Average ☐ Unsure ☐ Very unsure ☐ Other (please specify_____)

15. What effect do you anticipate Demand Response/Energy Efficiency will have on reducing demand in the next three years (per annum)?

☐ No Effect ☐ 0-0.5% ☐ 0.5-1.0% ☐ 1.0-1.5% ☐ 1.5-2.0% ☐ 2.0-2.5% ☐ Other (please specify_____)

16. On a scale of 1 to 5, 1 being not satisfied at all and 5 being very satisfied, how satisfied are you with the electric restructuring in your state? If you have answered 1 or 2, please explain why you are dissatisfied. _____ (Includes Box: N/A)

Are there any trends/issues that are currently impacting the industry that we should know about? _____
_____
_____

Other question topics to consider:

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.

Risks for regulated utilities include the uncertainty around the composition of state regulatory Commissions, adverse regulatory changes, unfavorable weather conditions, variance from normal population growth, and changes in customer mix. Changes in macroeconomic factors will affect customer additions/subtractions and usage patterns

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UBS 12-Month Rating	Rating Category	Coverage[1]	IB Services[2]
Buy	**Buy**	59%	35%
Neutral	**Hold/Neutral**	35%	33%
Sell	**Sell**	6%	14%
UBS Short-Term Rating	**Rating Category**	**Coverage[3]**	**IB Services[4]**
Buy	**Buy**	less than 1%	0%
Sell	**Sell**	less than 1%	20%

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.
3:Percentage of companies under coverage globally within the Short-Term rating category.
4:Percentage of companies within the Short-Term rating category for which investment banking (IB) services were provided within the past 12 months.

Source: UBS. Rating allocations are as of 30 September 2011.

UBS Investment Research: Global Equity Rating Definitions

UBS 12-Month Rating	Definition
Buy	FSR is > 6% above the MRA.
Neutral	FSR is between -6% and 6% of the MRA.
Sell	FSR is > 6% below the MRA.
UBS Short-Term Rating	**Definition**
Buy	Buy: Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.
Sell	Sell: Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.

KEY DEFINITIONS

Forecast Stock Return (FSR) is defined as expected percentage price appreciation plus gross dividend yield over the next 12 months.

Market Return Assumption (MRA) is defined as the one-year local market interest rate plus 5% (a proxy for, and not a forecast of, the equity risk premium).

Under Review (UR) Stocks may be flagged as UR by the analyst, indicating that the stock's price target and/or rating are subject to possible change in the near term, usually in response to an event that may affect the investment case or valuation.

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Equity Price Targets have an investment horizon of 12 months.

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UBS Securities LLC: Julien Dumoulin-Smith; Jim von Riesemann.

Company Disclosures

Company Name	Reuters	12-mo rating	Short-term rating	Price	Price date
Exelon Corp.[4, 5, 6a, 6b, 7, 16]	EXC.N	Buy	N/A	US$41.93	07 Oct 2011
Wisconsin Energy Corp.[4, 6a, 16]	WEC.N	Buy	N/A	US$31.49	07 Oct 2011

Source: UBS. All prices as of local market close.
Ratings in this table are the most current published ratings prior to this report. They may be more recent than the stock pricing date

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6a. This company/entity is, or within the past 12 months has been, a client of UBS Securities LLC, and investment banking services are being, or have been, provided.
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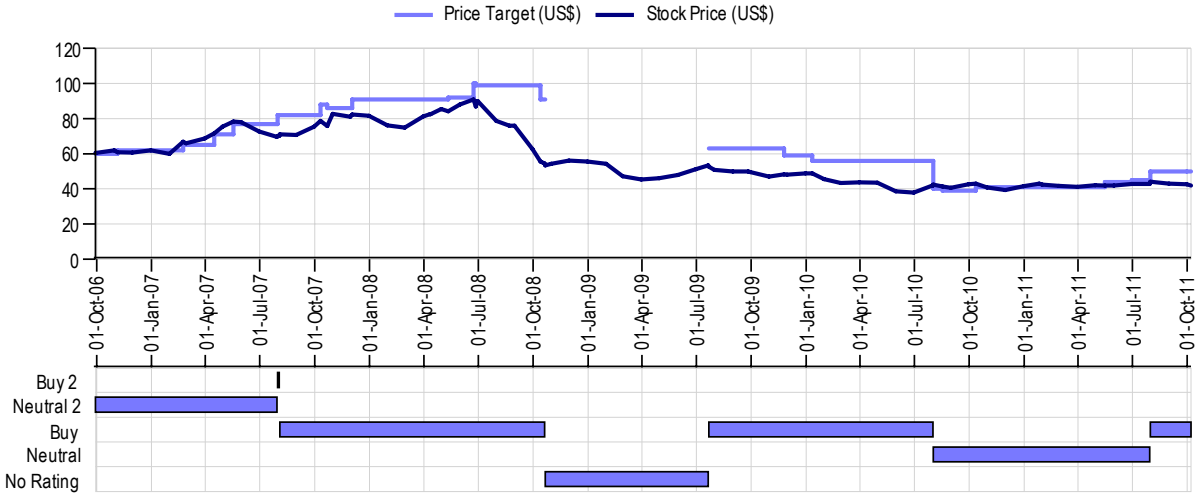
16. UBS Securities LLC makes a market in the securities and/or ADRs of this company.

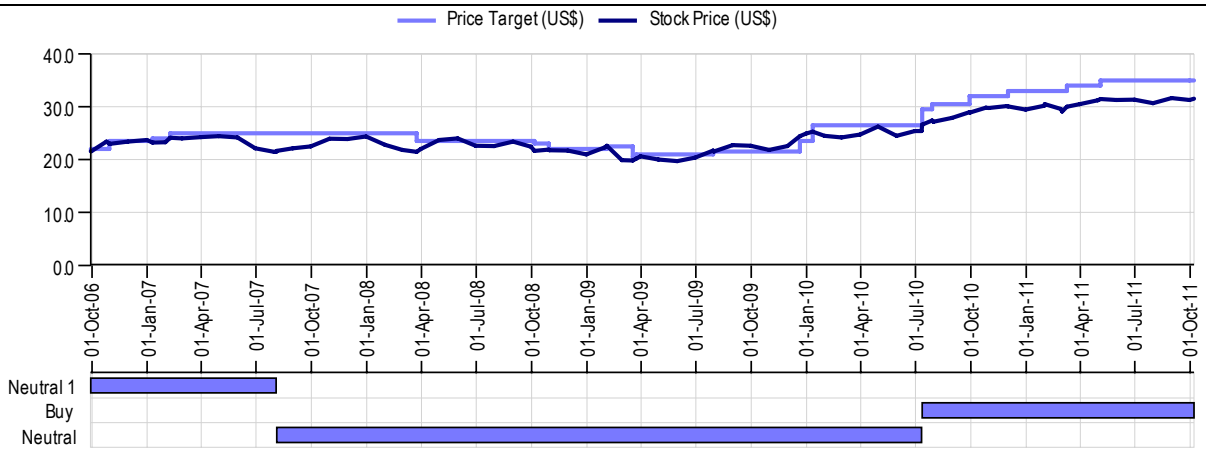
Unless otherwise indicated, please refer to the Valuation and Risk sections within the body of this report.

Exelon Corp. (US$)



Source: UBS; as of 07 Oct 2011

Wisconsin Energy Corp. (US$)



Source: UBS; as of 07 Oct 2011

Note: On August 4, 2007 UBS revised its rating system. (See 'UBS Investment Research: Global Equity Rating Definitions' table for details). From September 9, 2006 through August 3, 2007 the UBS ratings and their definitions were: Buy 1 = FSR is > 6% above the MRA, higher degree of predictability; Buy 2 = FSR is > 6% above the MRA, lower degree of predictability; Neutral 1 = FSR is between -6% and 6% of the MRA, higher degree of predictability; Neutral 2 = FSR is between -6% and 6% of the MRA, lower degree of predictability; Reduce 1 = FSR is > 6% below the MRA, higher degree of predictability; Reduce 2 = FSR is > 6% below the MRA, lower degree of predictability. The predictability level indicates an analyst's conviction in the FSR. A predictability level of '1' means that the analyst's estimate of FSR is in the middle of a narrower, or smaller, range of possibilities. A predictability level of '2' means that the analyst's estimate of FSR is in the middle of a broader, or larger, range of possibilities. From October 13, 2003 through September 8, 2006 the percentage band criteria used in the rating system was 10%.

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