From: Deal, Matthew
Sent: 2/22/2010 1:47:09 PM
To:
Cc:
Bcc:
Subject: FW: Independent Power Producers: (Transfering Lead Coverage) - Hopes Deferred as Power Dims

This is some interesting analysis regarding independent Power producers. The attachment appears to offer more detailed information about industry trends, factors leading to the individual ratings, and general musings on the industry in general. It's long, but might be worth a quick scan.

From: Julien.Dumoulin-Smith@ubs.com [mailto:Julien.Dumoulin-Smith@ubs.com]
Sent: Monday, February 22, 2010 1:10 PM
To: undisclosed-recipients
Subject: Independent Power Producers: (Transfering Lead Coverage) - Hopes Deferred as Power Dims

<<ELEC_022210_IPP.pdf>>

- **Concerns remain for merchant power; transitioning coverage**

We see several negative themes continuing to affect the Independent Power Producers (IPPs). Despite the modest gas price recovery projected in our natural gas commodity forecast ($6.25/MMBtu in '10 & $7.00/MMBtu in '11 & beyond), hedges priced in '07/'08 are not likely to be replicated, resulting in backwardated EBITDA profiles across much of the sector. Further negatives include a tempered "check-mark"-like recovery in electric sales (0.5-1.5% in '10), basis compression in gas spreads to Henry Hub due to Marcellus shale gas, and depressed capacity auctions results due to demand side mgmt and energy efficiency initiatives.

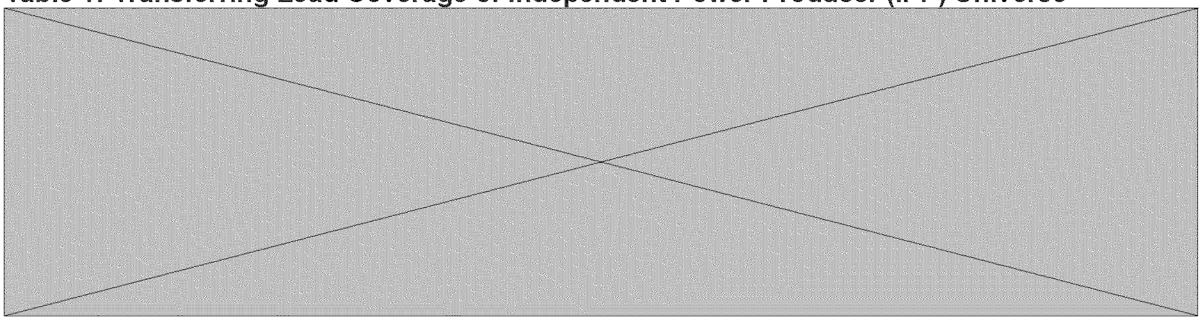
- **Anticipate little new generation in near term; new regulation looming**

We anticipate relatively little new merchant generation in restructured markets due to both the depressed and highly volatile nature of power prices, markedly higher construction costs, low fixed-capacity payments, siting issues, and uncertain environmental policy. We see emission standards as exacerbating these factors.

- **Downgrading MIR to Sell; Upgrading CPN to Buy; Reiterate DYN as Sell**

Following a complete re-evaluation of our models and valuations, we are downgrading MIR to Sell and lowering our PT to $11 from $15, and upgrading CPN to Buy and raising our PT to $14 from $11.50. We believe the near-year comps for MIR mask the roll-off of its deeply in-the-money hedges, as well as the LT impact of the TRAIL transmission project. We are raising our target on CPN in light of increased confidence in mgmt's ability to grow its EBITDA. However, we remain relatively underweight on the IPPs, and reiterate our Sell rating on DYN.

Table 1: Transferring Lead Coverage of Independent Power Producer (IPP) Universe



Source: FactSet (for AES data) and UBS estimates; averages include entire sectors

Struggling to Generate a Profit

We are transferring lead coverage of select companies within the merchant generation sector, reiterating our dour near term outlook on the sector

We are transferring lead coverage of the Independent Power Producers and reiterating our dour outlook on the sector as a whole. We believe weak power prices are likely to persist through 2010 due in large part to weak commodity underlying fundamentals and mild electric sales that have shown only stabilizing or minimally improving QoQ trends recently. A significant takeaway from the ongoing fourth quarter earnings season is the generally tepid outlook presented for 2010, with many utilities anticipating sales to remain flat to modestly up; we expect sales to recover a modest 0.5-1.0% in 2010. Finally, the mandated development of renewables by state renewable portfolio standards (RPS) threatens to continue to undercut power prices and heat rates in many regions, most notably the Midwest. A further headwind is our concern for compressed gas price basis to Henry Hub in the northeast due to Marcellus Shale gas production.

Power price fundamentals in the longer term remain robust with a lack of new generation capacity and the threat of tighter environmental controls to likely significantly affect power prices

Longer term, we anticipate a wave of retirements and a broader lack of new capacity to push power prices higher. Given both the exceptional volatility and low nominal value of natural gas and power in the last several years, we see cash flow uncertainty as an impediment for attracting new, large fixed capital investments in restructured markets. Further, the implementation of carbon regulation (along with other environmental control requirements) could result in widespread switching from coal to gas, pushing both power and gas prices upwards. However, should the EPA pursue carbon regulation prior to the passage of federal legislation, we see litigation and extreme uncertainty significantly limiting any new generation.

It's all downhill from here; EBITDA peaked in 2009

CPN offers at least *a flat profile*, while the balance offer sharply declining earnings profiles

Downgrading MIR to Sell with a $11 PT; we see the name as expensive to peers and likely to

disappoint with no further share repurchases

In this environment, we are upgrading our rating on Calpine to Buy (raising our price target to $14 from $11.50), as we believe those generators that have the greatest ability to weather the downturn in commodity cycle while maintaining exposure to longer term volumetric improvement deserve more than a marginal premium to peers. Even with a recovery in commodities to our long term $7/MMBtu gas, we see EBITDA at many of the IPPs as likely to drop sharply over the next five years.

We are also downgrading our rating on Mirant to Sell and lowering our price target to $11 from $15. We believe MIR is a clear example of investors looking at peak near year multiples without focus to the sharp declines in EBITDA in 2010 and beyond. With new transmission, a secularly lower power price environment in the Washington, DC area, significant exposure to higher priced NAPP coal, and earnings concentrated to just four units, we see a risk profile not worth a peer multiple. In the near term, we don't anticipate management to deploy its $2 Bn in cash on the balance sheet, likely saving it for rainy days and maturities. Longer term, we see MIR's coal fleet as particularly poorly positioned with respect to carbon legislation given its location in a gas-oriented power market. All of this leads us to ask, why pay so much for a stock with such low normalized EBITDA?

Reiterating Sell rating on DYN and $1.30 PT; why keep paying a premium multiple for eroded fundamentals?

We are also using the opportunity to reiterate our Sell rating and $1.30 price target on Dynegy given its exposure to Midwest power fundamentals, the build out of renewables across the plains states, and carbon legislation. The stock continues to trade at a significant premium to the sector, despite having some of the weakest fundamentals of its IPP peers.

In Summary, we remain underweight the sector relative to its regulated and Competitive Integrated (hybrid) peers. We highlight CPN as our top investment idea in the space, and MIR as our top Sell idea in the space.

Please see attachment for disclosures and disclaimers.

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