

Financial Performance of Owners of Unregulated Generation in PJM

2010 Update

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**1875 Connecticut Avenue, NW, Suite 1200
Washington, D.C. 20009-5715
202/467-2900**

www.publicpower.org

I Introduction

This paper summarizes several key indicators of the 2010 financial performance of companies that sell significant quantities of unregulated generation in the wholesale electricity market operated by the PJM Interconnection, as well as other RTO-operated markets. These companies are: Exelon Corporation, Constellation Energy, Public Service Enterprise Group (PSEG), PPL Corporation, FirstEnergy and Allegheny Energy. (FirstEnergy and Allegheny Energy merged on February 25, 2010.) The three key indicators of financial performance are net income, return on equity and gross margin. A more detailed explanation of each, along with the sources of the data used and calculations made, is provided in the final section.

Overall, this updated financial review confirms the conclusions of prior analyses.¹ Companies owning incumbent merchant generation continue to earn revenues from the RTO-operated wholesale electricity markets that greatly exceed their costs of producing electricity. Because the presence of such high profits in a truly competitive market would bring additional entrants into the market, thereby driving down prices, such continued high profitability is a direct indicator of insufficient competition and higher costs for consumers.

The absence of competition in these markets, and the resulting protection of high profits, is once again confirmed by statements of risks in the companies' 10-K reports to the Securities and Exchange Commission. In a typical statement, FirstEnergy cautions that: "Although we expect wholesale electricity markets to continue to be competitive, proposals to re-regulate our industry may be made, and legislative or other action affecting the electric power restructuring process may cause the process to be delayed, discontinued or reversed in the states in which we currently, or may in the future, operate. Such delays, discontinuations or reversals of electricity market restructuring in the markets in which we operate could have an adverse impact on our results of operations and financial condition."²

Exelon similarly states that: "Exelon's and Generation's [Exelon Generation Company LLC] operating results and cash flows are heavily dependent upon the ability of Generation to sell power at market-based rates, as opposed to cost-based or other similarly regulated rates ... Generation [Exelon Generation Company LLC] may be negatively affected by possible Federal or state legislative or regulatory actions that could affect the scope and functioning of the wholesale markets..."³

These same generators making such statements label these restructured markets as "competitive." But it is difficult to find any truly competitive market where sellers view competition as protective of their earnings.

¹ 2009 *Financial Performance of Owners of Unregulated Generation, High Profits Earned in Restructured Wholesale Electricity Markets During the Recession*, May 2010, <http://appanet.cms-plus.com/files/PDFs/2009FinancialPerformanceMay2010.pdf>

² Form 10-K, FirstEnergy Corporation, February 16, 2011 "Risks Associated With Regulation," P. 31, <http://www.sec.gov/Archives/edgar/data/20947/000095012311014700/c11256e10vk.htm>

³ Form 10-K, Exelon Corporation, February 10, 2011, "Regulatory and Legislative Risks," p. 39-40, <http://www.sec.gov/Archives/edgar/data/22606/000119312511030543/d10k.htm>

II Overview of 2010 Financial Indicators

Although three companies as a whole, and all but one of the generation-owning segments experienced a decline in earnings between 2009 and 2010, their returns on equity continued to be high and much greater than typical regulated utility earnings. Moreover, gross margins on generation remained close to those of the prior year, showing that revenues earned from the sale of generation continue to greatly exceed the costs of producing or purchasing such power.

General reasons for the drop in earnings for the unregulated power plants were declines in power prices, frequently reflecting a time lag between the fall in energy prices in 2009 and the signing of contracts for the sale of power, and reduced volumes of sales.

Constellation's financial performance is complicated, making direct year-to-year comparisons difficult. In November, 2009, Constellation sold 49.99 percent of the ownership of Constellation Energy Nuclear Group, the subsidiary owning the company's five nuclear reactors, to EDF Group. As a result, Constellation Energy Nuclear Group reported a \$690 million decrease in generation revenue between 2009 and 2010.⁴

PPL was one dramatic exception to the earnings decline, with an 84 percent increase in overall earnings, and a nearly 200 percent growth in its generation subsidiary profits between 2009 and 2010. A central reason for this increase was the ending of rate caps in PPL's service territory, resulting in higher payments from the regulated utility to the generation subsidiary.

Power prices and earnings began to pick up for two other companies toward the end of the year. Exelon reports that its generation segment saw an increase in the gross margin from \$38.36 to \$41.45 per megawatt-hour and a \$97 million increase in net income between the fourth quarters of 2009 and 2010 largely due to "higher energy prices under the power purchase agreement with PECO, favorable capacity pricing related to RPM and increased nuclear output largely reflecting fewer outage days."⁵ PSEG also noted an increase in wholesale prices in the fourth quarter of 2010, and an increase in the gross margin of wholesale power sales from \$51 to \$53 per megawatt-hour compared to the fourth quarter of 2009.⁶

Three of the merchant generation segments had returns on equity exceeding 20 percent (Exelon, PPL and PSEG.) In contrast, the returns on equity for the regulated affiliates of the companies in this study were generally between 5 and 10 percent. Because these regulated subsidiaries do not own generation, a comparison is also made with vertically-integrated utilities that own

⁴ Form 10-K, Constellation Energy, Revenue Table, p.43, March 1, 2011, <http://www.sec.gov/Archives/edgar/data/9466/000104746911001579/a2202089z10-k.htm>

⁵ *Exelon Announces Fourth Quarter and Full Year 2010 Results; Introduces Guidance Range for Full Year 2011 Earnings*, January 26, 2011, p. 5-6, <http://phx.corporate-ir.net/External.File?item=UGFyZW50SUQ9MzY0MzIwOXx0aGlsZElEPTQxMTA0OXxUeXBIPtI=&t=1>

⁶ *PSEG Earnings Conference Call, 4th Quarter and Year-end 2010*, February 22, 2011, p. 20, <http://phx.corporate-ir.net/External.File?item=UGFyZW50SUQ9NDE0Nzg5fENoaWxkSUQ9NDI2NTA5fFR5cGU9MQ==&t=1>

generation. Two large owners of vertically-integrated electric utilities -- American Electric Power and Southern Company -- reported returns on equity for their regulated utilities of between 10 and 12 percent, much lower than the merchant generation segments in this study.⁷

The relevance of the return on equity for determining just and reasonable rates is demonstrated by a November 2009 launch of three investigations into the rates for interstate transmission of natural gas by the Federal Energy Regulatory Commission (FERC). The impetus for these investigations was the finding by FERC staff that those three companies were over-recovering revenues based on calculated returns on equity of 20.83, 24.36, and 24.5 percent.⁸

This past April, FERC Chairman Wellinghoff informed a group of reporters that FERC would consider new investigations of company earnings, including the electricity industry. As promising as sounds on its face, Wellinghoff then provided very vague criteria for the determination of excess earnings when he stated:

We look at the level of earnings...and then based on that level of earnings, we sit down with staff and say, you know, are these people way, way over where they need and should be?...[W]e only go after those people who we think are earning far in excess of what is a reasonable rate of return...⁹

According to this and prior financial analyses, in our opinion, it does appear that these merchant generation owners are earning profits that are actually “way, way over” a just and reasonable level.

The next section provides a summary of these key financial indicators, and the last section provides a more detailed explanation of these measures.

⁷ Form 10-K, American Electric Power, February 25, 2011, p. 21 shows that the regulated returns approved for all but one of AEP’s thirteen regulated electric utilities were between 10 and 11 percent, with one at 12 percent, <http://www.sec.gov/Archives/edgar/data/4904/000000490411000023/ye10aep10k.htm>. Southern Company reported a weighted average 12 percent return for its four investor-owned utilities in 2009 and 2010, 2011 Analyst Meeting, Financial Overview, Southern Company, March 9, 2011, <http://files.shareholder.com/downloads/SO/1220844162x0x448880/cb03ce2d-bb3b-463a-bb63-ee3b9718ec04/Financial%20Overview.pdf>

⁸ For additional discussion of these investigations, see *Supplemental Comments of the American Public Power Association, RTO Performance Metrics*, Docket AD10-5-000, Federal Energy Regulatory Commission, June 15, 2010, <http://elibrary.ferc.gov/idmws/common/OpenNat.asp?fileID=12367632>

⁹ Quoted in *FERC to initiate more rate investigations, chairman says; ‘earnings way, way too high?’*, Platts Electric Utility Week, April 11, 2011, p. 1, www.platts.com, Subscription required.

III Summary of Key Indicators

Table 1. 2009 and 2010 Net Income from Ongoing Operations (non-GAAP)

(millions of \$)						
	Exelon	Constellation	PPL	PSEG	FirstEnergy	Allegheny
Total Company						
2010	\$2,689	\$496	\$1,358	1,584	\$1,104	411.7
2009	\$2,723	\$673	\$738	1,567	\$1,149	392.8
Change	(\$34)	(\$177)	\$620	\$17	(\$46)	\$19
	-1.2%	-26.3%	84.0%	1.1%	-4.0%	4.8%
Generation Subsidiary						
2010	\$1,928	\$250	\$990	\$1,091	\$493	\$163
2009	\$2,092	\$429	\$333	\$1,193	\$517	\$248
Change	(\$164)	(\$179)	\$657	(\$102)	(\$24)	(\$85)
	-7.8%	-41.7%	197.3%	-8.5%	-4.7%	-34.2%

Table 2. 2010 Returns on Equity

Exelon	Constellation	PPL	PSEG	FirstEnergy	Allegheny
Total Company					
19.8%	6.3%	18.1%	17.1%	13.0%	12.0%
Generation Subsidiary					
26.9%	4.3%	22.0%	21.7%	13.0%	N/A

Table 2a. 2010 Regulated Subsidiary Returns on Equity

Exelon		FirstEnergy	
ComEd	5%	Ohio Edison	17%
PECO	14%	Cleveland Electric	6%
Constellation		Toledo Edison	8%
Baltimore Gas & Electric	6%	Jersey Central Power & Light	7%
PPL		Metropolitan Edison	5%
PPL Electric Utilities	6%	Pennsylvania Electric	7%
PSEG			
PSEG	10%		

Table 3. 2009 and 2010 Gross Margins on Wholesale Generation

2010					
Exelon		Constellation	PPL		PSEG
Total	\$37.62	\$58.62	Total	\$36.52	\$54.00
Mid-Atlantic	\$42.67		Eastern U.S.	\$37.76	
Midwest	\$40.98		Western U.S.	\$29.57	
South and West	(\$9.83)				
2009					
Total	\$38.02	\$68.00	Total	\$43.96	\$60.00
Mid-Atlantic	\$44.03		Eastern U.S.	\$50.54	
Midwest	\$41.67		Western U.S.	\$28.17	
South and West	\$(7.82)				

Appendix

Explanation and Sources of Data for Financial Indicators

Net Income

The net income reported in this document and in prior financial analyses is what is termed a non-GAAP (Generally Accepted Accounting Principles) measure, which excludes the cumulative effects of changes in accounting principles, discontinued operations and special items (defined as significant items that are not related to ongoing, underlying business or which distort comparability of results) included in operations.¹⁰ Most companies report non-GAAP net income and/or non-GAAP earnings per share in their reports to the financial community, and report GAAP measures in their 10-K forms filed with the Securities and Exchange Commission.¹¹

Return on Equity

Return on equity is calculated by dividing the non-GAAP net income (after preferred dividends) by the average common equity. Net income is the profit of the company and the common equity is the amount under shareholder ownership.

Two of the total company returns on equity were directly reported by companies in their financial statements: PPL and PSEG¹². The remaining full company ROEs and all generation subsidiary ROEs were calculated using the non-GAAP net income from the presentations to financial analysts and common equity obtained from the Form 10-Ks.

Gross Margins

The gross margin is the total revenue from the sale of electricity, less the cost of fuel and purchased power. While margins are necessary, for example, to provide for a return on capital and other costs, too high a margin indicates that decreases in power costs are not being passed on to consumers.

¹⁰ Definition is from Constellation Energy's 2010 Financial Statements, *Constellation Energy Reports Full Year 2010 Results, February 4, 2011*, <http://ir.constellation.com/releasedetail.cfm?ReleaseID=547730>

¹¹ One exception is Allegheny Energy which no longer has any reports to the financial community posted following its merger with First Energy. Net income data were obtained only from the 10-K form, http://www.sec.gov/Archives/edgar/data/3673/000119312511043729/d10k.htm#rom126096_21. Two companies' non-GAAP net income was calculated from data provided. Constellation's non-GAAP net income was determined by adding the individual non-GAAP net income for each segment of the company. First Energy's was calculated by adding back the special items used to calculate non-GAAP earnings per share from the table on p. 16 of the earnings report to the net income on pages 9 and 10. First Energy Consolidated Report to the Financial Community, Fourth Quarter 2010, February 16, 2011, <http://phx.corporate-ir.net/External.File?item=UGFyZW50SUQ9ODE3NjR8Q2hpbGRJRjRD0tMXxUeXBIPtM=&t=1>

¹² *PPL Reports 2010 Earnings*, February 4, 2010, Key Indicators, <http://pplweb.mediaroom.com/index.php?s=12270&item=25374>; *PSEG Announces 2010 Results*, February 22, 2011, Attachment 11, <http://phx.corporate-ir.net/External.File?item=UGFyZW50SUQ9ODI2Nzh8Q2hpbGRJRjRD0tMXxUeXBIPtM=&t=1>

Sources of Data

Non-GAAP Net Income:

- Exelon Announces Fourth Quarter and Full Year 2010 Results; Introduces Guidance Range for Full Year 2011 Earnings, January 26, 2011, p. 20 <http://phx.corporate-ir.net/External.File?item=UGFyZW50SUQ9MzY0MzIwOXx0DaGlsZEIEPTQxMTA0OXxUeXBIPtI=&t=1>
- Constellation Energy 2010 Year-End Earnings Presentation, February 4, 2011, p. 49, 53, and 57, <http://files.shareholder.com/downloads/CEG/1147753753x0x439125/6a8484c5-8fd6-4f4d-b0df-cd19a99f6d36/2010%20Year-End%20Earnings%20Presentation%20-%20SUPPORTING%20MATERIALS.pdf>
- PPL Reports 2010 Earnings, February 4, 2010, <http://pplweb.mediaroom.com/index.php?s=12270&item=25374>
- PSEG Announces 2010 Results, February 22, 2011, <http://phx.corporate-ir.net/External.File?item=UGFyZW50SUQ9ODI2Nzh8Q2hpbGRJRd0tMXxUeXBIPtM=&t=1>
- First Energy Consolidated Report to the Financial Community, Fourth Quarter 2010, February 16, 2011, <http://phx.corporate-ir.net/External.File?item=UGFyZW50SUQ9ODE3NjR8Q2hpbGRJRd0tMXxUeXBIPtM=&t=1>

Common Equity was obtained from the 10-K forms for each company.

Returns on Equity for the regulated utilities were calculated using the net-income from the above financial reports, or in the case of FirstEnergy, from the 10-K form.

Gross Margins:

- Exelon: Form 10-K, p. 9
- Constellation: Form 10-K p. 8, total gross margin divided by generation
- PPL: Total gross margin from 10-K, divided by wholesale generation sales from the 2010 earnings report.
- PSEG Earnings Conference Call, 4th Quarter and Year-end, 2010, February 22, 2011, p. 20, <http://phx.corporate-ir.net/External.File?item=UGFyZW50SUQ9NDE0Nzg5fENoaWxkSUQ9NDI2NTA5fFR5cGU9MQ==&t=1>