

MARYLAND POWER PLANTS

Re-Regulation Outline

Maryland Tax Education Foundation

February 20, 2009

Executive Summary

- BG&E and PEPCO can buy their respective MD generating plants, place them under regulation and cut electricity rates by 10% to 18%.
- The savings may be greater, depending on factors that must be researched further.
- The purchase of the assets will not damage the respective financial conditions of Constellation Energy and Mirant, the current owners.
- The purchase and re-regulation of the plants involves neither state investment nor debt guarantees.

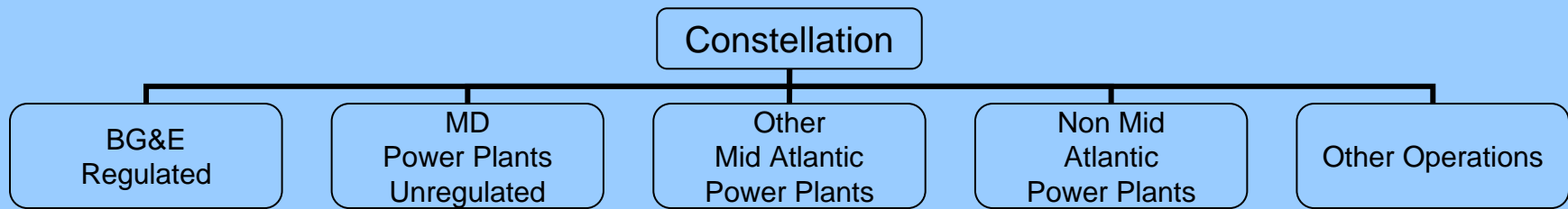
The objective of this presentation is four fold

- Part 1: Show how Constellation is organized and show how one division sells electricity to another division.
- Part 2: Show (i) how a transfer of unregulated assets is accomplished, in order to lower rates; and (ii) how it involves neither state money nor state guarantees.
- Part 3: Show that the PSC can effect the transfer without an adverse impact to Constellation's financial condition.
- Part 4: Show that the process is essentially the same for PEPCO and the Mirant plants.

Part 1

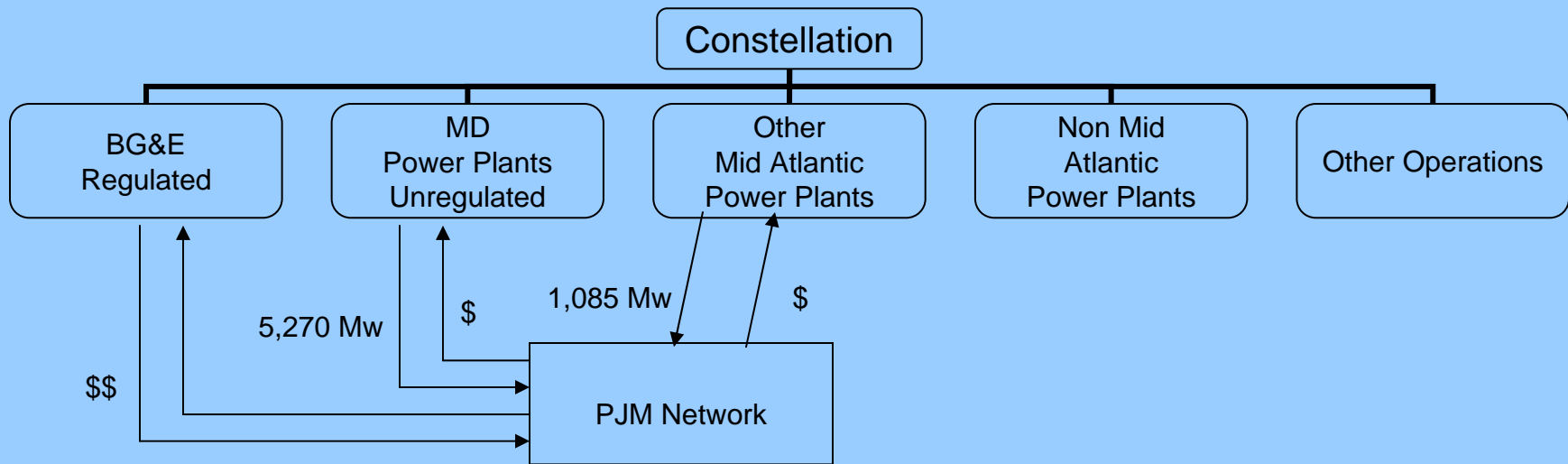
- The organization of Constellation
- How it sells electricity to itself

Present Situation



Present Situation

Constellation Sells Power to Itself Through the Pennsylvania-Jersey-MD (PJM) Interchange Network



\$ = Dollar flows

Mw = Megawatts, a measure of power production

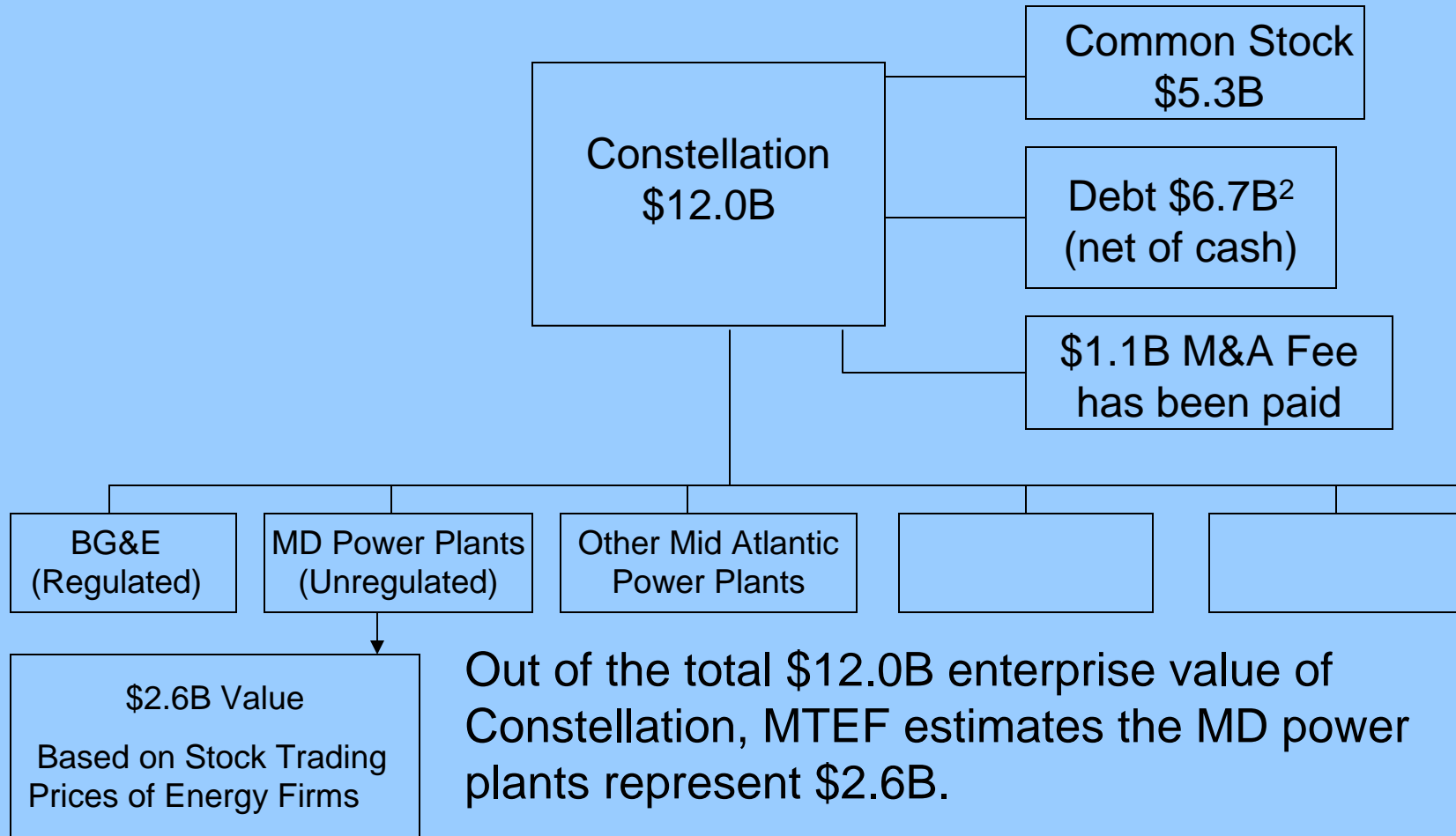
Explanation of Previous Slide

- Constellation sold \$1.1B of its MD and Mid Atlantic power generation to BG&E in 2007, running this unregulated power through PJM.(2008 data is available shortly).¹
- Essentially, Constellation sold its MD power to itself (i.e., BG&E) at PJM marginal cost, typically a large mark-up from actual plant production cost. The mark-up provides extra profit for the MD power plants.
- BG&E ratepayers pay the mark-up through the PSC's rate structure in MD.

Part 2: How to transfer the unregulated assets to BG&E without being unfair to Constellation

- Establish a fair price for the MD power assets.
- BG&E buys the assets from Constellation (its parent company) at that price.
- BG&E raises new equity and debt funding to pay for the assets.

Market Value of Constellation's Unregulated MD Power Plants



Market Value of Constellation's MD Power Plants

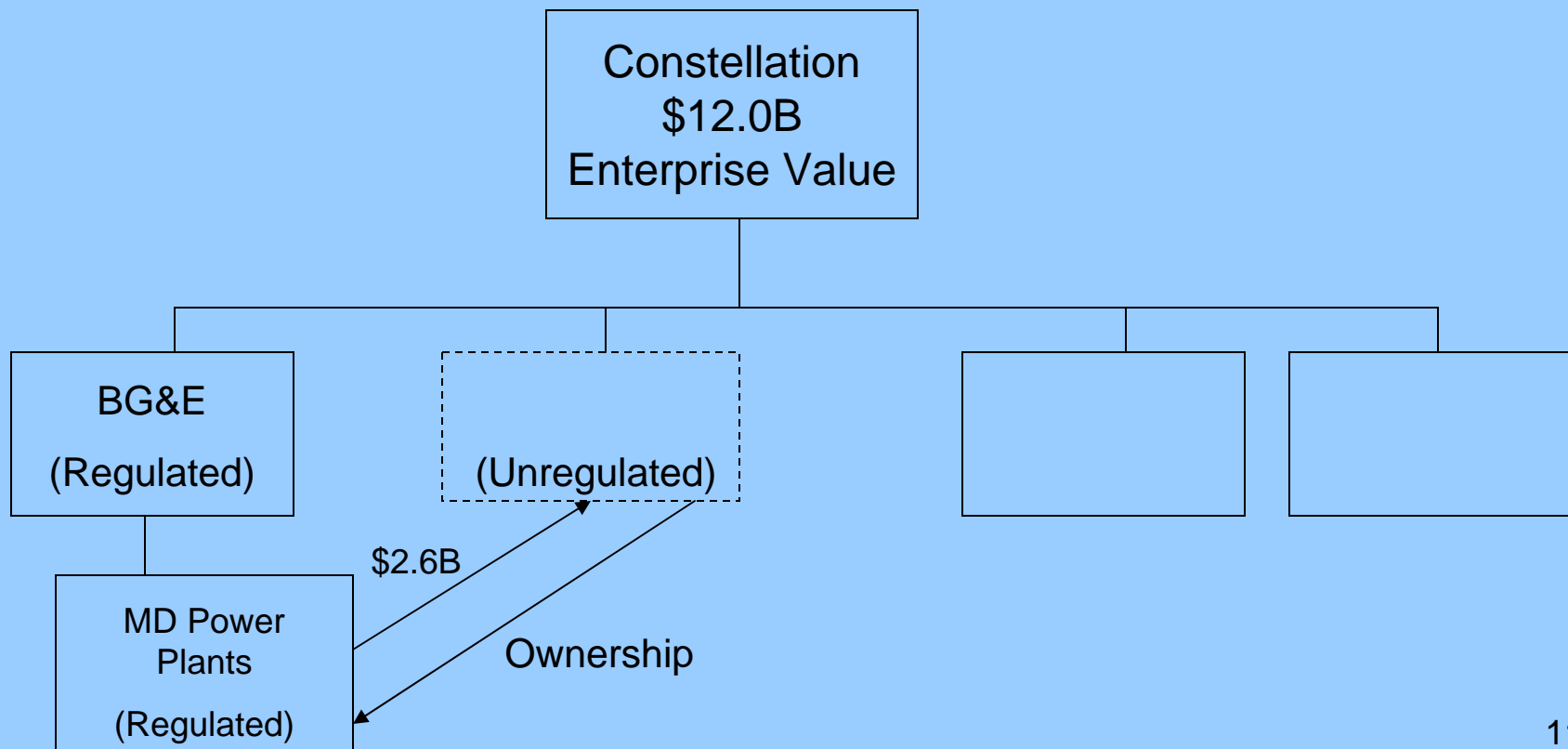
- Calvert Cliffs Power Plants' estimated earnings before interest, taxes on income, depreciation and amortization (EBITDA) of \$370 million.
- EBITDA of coal fired and other non-nuclear MD plants is \$200 million. The total is \$570 million.
- Public price multiples of merchant power generators range from 3x to 8x EBITDA.
- We assign a 4.5x multiple to set a \$2.6B value, which equals 4.5 x \$570 million.

Public Market Values of Prominent Merchant Power Companies

<u>Company</u>	<u>EV/EBITDA³</u>
Mirant	3.6
AES	4.6
NRG	5.0
Constellation	6.2
Dynergy	7.1
Calpine	8.0
Reliant	8.3

Re-Regulation of MD Power Plants

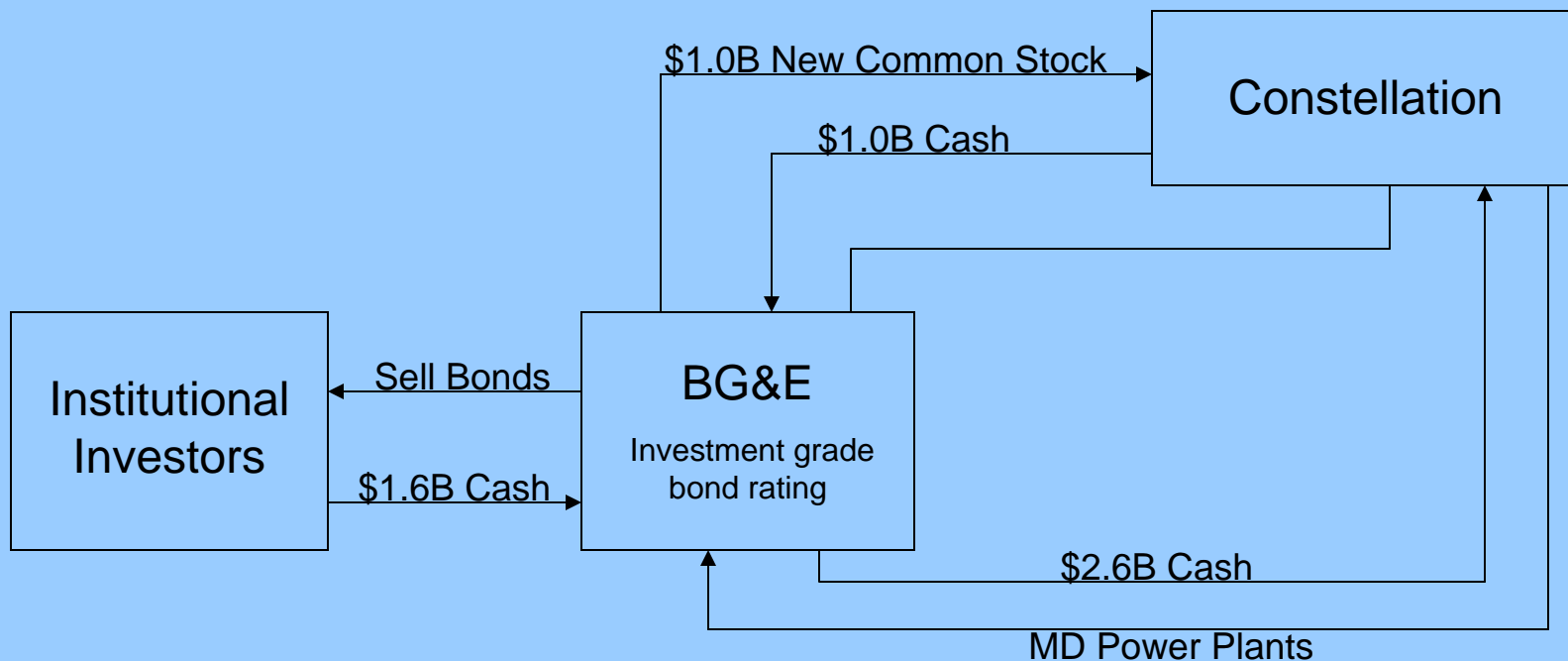
BG&E Buys the Plants from Constellation
at a \$2.6 Billion Price, Designed to Lower Ratepayer Bills



\$2.6 Billion Purchase Price Easily Raised by BG&E- No Funding from State of MD

\$1.0 Billion of New Common Stock Issued to Constellation

\$1.6 Billion of New Debt Sold to Bond Investors, with Cash Proceeds Provided to Constellation



PSC Provides BG&E With Adequate Rate of Return on Newly Regulated \$2.6B in BG&E Assets

- The PSC allows BG&E to earn a reasonable return on its new \$2.6B in MD Power Plant assets.
- The PSC mandates a 60-40 debt/equity ratio to moderate returns (6% pre-tax debt is cheaper than 11% after-tax equity). The pre-tax return on equity is 17%.⁴
- The “regulated” return, however, is \$230 million less per year than the previous “unregulated” return.⁵
- With the MD power plants now earning less, BG&E pays less for power. BG&E can charge lower rates to its customers (10% lower), rather than asking for higher rates.
- The 10% savings may rise, depending on factors such as the price paid or lower overhead charges under regulation.⁶

Alternate Scenario Including EDF

- Instead of BG&E buying 100% of the Calvert Cliff's plants, it could acquire a 51% interest, with EDF purchasing a 49% interest.
- The BG&E/EDF joint venture would sign a long-term contract with BG&E under regulated returns similar to those presented earlier.
- EDF has experience with plants in a regulated environment. Constellation and EDF could reprice their transaction under either scenario.
- BG&E would still buy 100% of the MD non-nuclear generating plants.

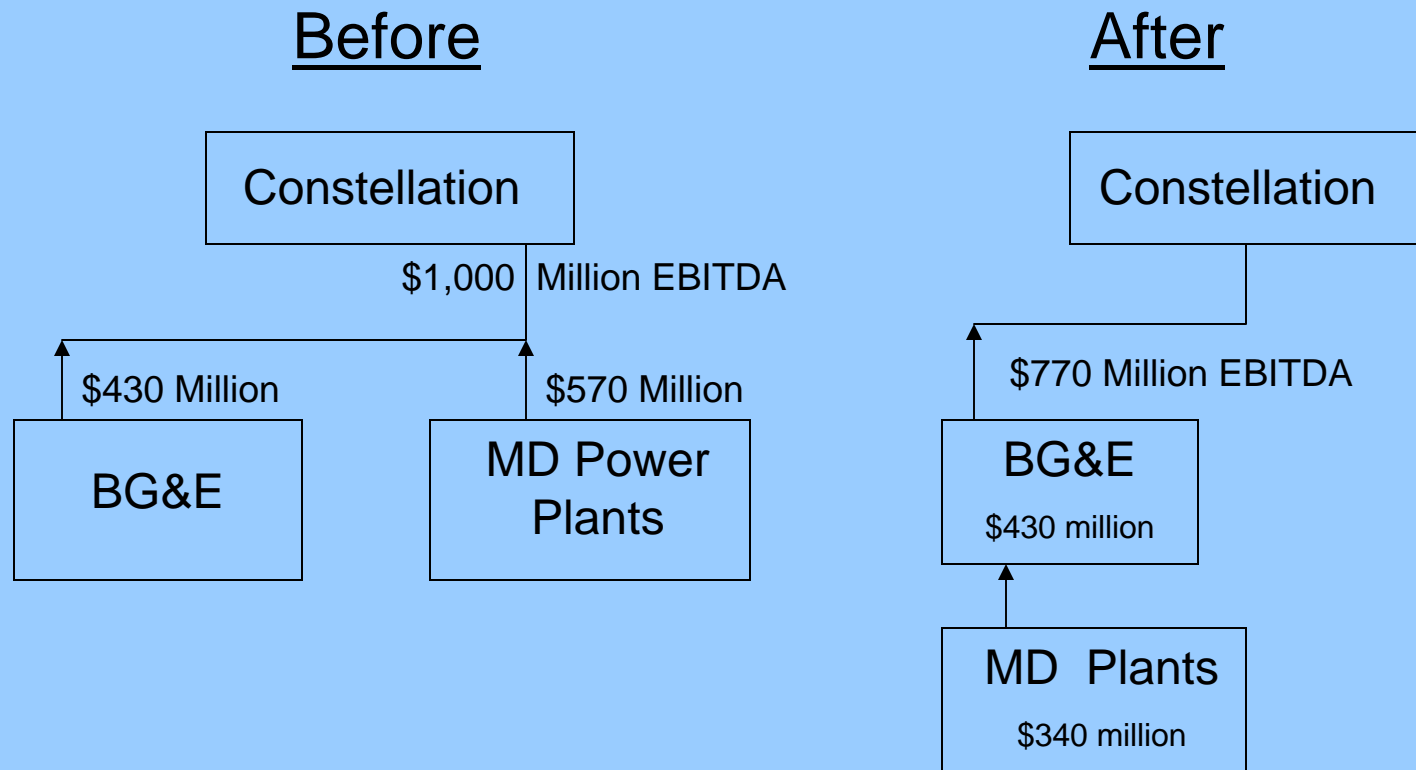
Risks?

- The transfer of assets from “unregulated” to “regulated is neither complex nor fraught with risk, contrary to the December PSC report.
- The principal risk of re-regulation seems remote: i.e., a scenario where there is much over-capacity.
 - Scenario 1: Sharp decline in demand from long term recession or widespread conservation.
 - Scenario 2: A large jump in capacity from new speculative merchant power plants in the region.
- In either remote case, BG&E customers pay the fixed costs of unused regulated capacity.

Part 3

Re-regulation has minimal impact on
Constellation's financials

Constellation Income (EBITDA) Falls After Re-Regulation



Constellation receives \$230 million less EBITDA per year

[\$1000 (before) minus \$770 (after)]

Constellation Remains Strong After Re-Regulation

- Constellation EBITDA drops by \$230 million, or just 15% based on total EBITDA of \$1.8B.
- The \$1.6B in debt raised by BG&E is offset by \$1.6B in cash paid to Constellation.
- The newly regulated assets earn less; however, a regulated earnings stream is safer than an unregulated one. Many investors and bond rating agencies may favor this change.
- The changes will not place Constellation in danger of bankruptcy.

How Does the PSC Effect Re-regulation And Help Constellation's Financials?

- \$4 per share might be the net effect of (i) a decline in EBITDA plus (ii) less risky earnings through regulation.⁷
- The PSC could reverse all, or a part of, the unreasonable \$1.1 B Mid American termination fee (\$6 per Constellation share).⁸
- The PSC assists with the closing of the EDF transaction. This removes much uncertainty from Constellation. The PSC thus boosts the stock price, perhaps by \$8 or more (much like a zoning change enhances land value).
- Thus, PSC's re-regulation effort, combined with an EDF transaction, should be a "win" for Constellation and its stockholders.
- The next slide illustrates one such scenario.

Constellation's Stock Price Can Improve Through PSC Actions

Current Stock Price	\$26
<u>PSC Actions</u>	
Re-regulating MD Power Plants	-4
Reducing M&A Termination Fees to Normal Levels	+5
Decreasing Constellation Risk Perception by EDF Closing	<u>+8</u>
Stock Price After Implementing this Outline	\$ 35

PART 4

PEPCO ACQUIRES MIRANT PLANTS

PEPCO Situation

- Mirant's EBITDA from its former PEPCO plants is \$875 million, according to the Levitan report and SEC filings.
- Mirant trades at 3.6x EBITDA. If PEPCO buys the plants for \$3.5B (4x EBITDA), the rate decline could be 18%.
- Why? The newly regulated assets have a lower return than the unregulated assets.
- PEPCO raises the money (\$3.5B) in the institutional market, without state guarantees.
- Note that the Levitan report suggested an 8x purchase price, when Mirant trades at 3.6x. At 4x, the re-regulation saves money immediately. At 8x, the savings begin in year six and have a \$1.6B NPV.

MTEF and the Calculations in this Outline

- Maryland Tax Education Foundation is a non-profit, non-partisan research institute that studies budget and tax issues in the State of Maryland.
- MTEF's Chairman, Jeff Hooke, has extensive expertise in corporate finance, M&A and valuation matters regarding electric utilities, both in the US and abroad.
- The estimates in this presentation were made using public information and assuming PSC rate of return processes. Additional data would refine the analysis, but this data is confidential to Constellation, Mirant and the PSC.
- The PSC may request the requisite data from Constellation and Mirant if the PSC explores re-regulation.

Endnotes

1. Data for fiscal 2008 for CEG will be available shortly.
2. Estimated from CEG's SEC filings.
3. EV/EBITDA is a popular valuation ratio. Enterprise Value is the sum of equity market value plus net debt.
4. BG&E debt rate is forecast at 2% over US Treasuries. 11% after tax return is consistent with prior PSC rulings.
5. See Exhibit A.
6. If CEG bills its merchant power division for corporate overhead, this cost might be reduced under re-regulation.
7. The EBITDA drop results in an EV decline of \$1.2B, which is then partially reversed due to regulated earnings safety.
8. MTEF's legal research indicates that the \$1.1B M&A termination fee may be excessive by \$900 million.

MD Generating Plants: Before and After

Exhibit A

<u>Before – 2007</u>	<u>Constellation</u>	<u>Mirant</u>
EBIT	\$500	\$800
D&A	<u>70</u>	<u>75</u>
EBITDA*	\$570(A)	\$875(A)
	<u>\$2.6 Billion</u>	<u>\$3.5 Billion</u>
60% Debt x 6% Interest	\$100	\$130
40% Equity x 17% Return	<u>170</u>	<u>240</u>
EBIT	270	370
D&A	<u>70</u>	<u>75</u>
EBITDA*	\$ <u>340</u> (B)	\$ <u>445</u> (B)
Difference (A-B)	\$230	\$430
Difference as % of Revenues	10%	18%

*EBITDA is a statistic that already reflects deduction for fuel costs and other operating expenses, which we assume are the same under the “before and after” scenarios.