

31-Jul-2014

# Exelon Corp. (EXC)

Q2 2014 Earnings Call

## CORPORATE PARTICIPANTS

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Christopher M. Crane

*President, Chief Executive Officer & Director, Exelon Corp.*

Joseph Nigro

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## OTHER PARTICIPANTS

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## MANAGEMENT DISCUSSION SECTION

**Operator:** Good morning. My name is Amy, and I'll be your conference operator today. At this time, I would like to welcome everyone to the Second Quarter 2014 Earnings Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be question-and-answer session. [Operator Instructions] Thank you.

Mr. Ravi Ganti, you may begin your conference.

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Ravi Ganti

*Vice President-Investor Relations, Exelon Corp.*

Thank you, Amy. Good morning everyone and thanks for joining our second quarter 2014 earnings conference call. Leading the call today are Chris Crane, Exelon's President and CEO; Jack Thayer, Exelon's Executive Vice President and CFO; and Joe Nigro, CEO Constellation.

We are joined by other members of Exelon's senior management team, who will be available to answer your questions following our prepared remarks. We issued our earnings release this morning along with the presentation, each of which can be found in the Investor Relations section of Exelon's website.

The press release and other matters that we discuss during today's call contain forward-looking statements and estimates that are subject to various risks and uncertainties. The actual results could differ from our forward-

looking statements based on factors and assumptions discussed in today's earnings release, comments made during this call and in the risk factors section of the earnings release.

Please refer to today's 8-K and Exelon's other filings for a discussion of factors that may cause the results to differ from management's projections, forecasts and expectations. This presentation also includes references to adjusted operating earnings, which is a non-GAAP measure. Please refer to the information contained in the appendix of our presentation, and the earnings release for reconciliation between the non-GAAP measures to the GAAP earnings.

We have scheduled 60 minutes for this call. I now turn the call over to Chris Crane, Exelon's CEO.

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## Christopher M. Crane

*President, Chief Executive Officer & Director, Exelon Corp.*

Thanks, Ravi. Good morning to everybody and thank you for joining. We had a good quarter overall, but before I get into those details, I wanted to start today's call by reemphasizing Exelon's long-term strategy. Our strategy is to continue to leverage our integrated business model to create value, invest for growth and explore ways to diversify our business into other areas of the energy value chain.

The utilities provide stable earnings and dividend support, and allow us to reinvest in projects to strengthen the infrastructure. Our competitive business provides commodity upside and the platform to diversify into adjacent markets. On the regulated side, the Pepco Holdings transaction provides an opportunity to accelerate our regulated growth and provide stable cash flows, earnings accretion and dividend stability.

The geographic fit and the operational synergies provide us the opportunity to deliver better customer service. On the GenCo side, we continue to look for ways to grow in the existing markets we serve and diversify into other related areas. Our partnership with Bloom Energy Fuel Cells is aligned with our goals of keeping up with our customer needs and the growth demand for distributed generation.

Our acquisition of the Integrys Energy Services business allows us to expand our regulated – our retail footprint further in an industry that continues to mature, consolidate and provide hedging diversification benefits for our existing portfolio.

Similarly, our interest in the Annova LNG is another example. We are significant participants in natural gas market, managing approximately 1.4 trillion cubic feet of gas on an annual basis. This project fits nicely in this business and aims to develop midscale LNG facility near Port of Brownsville, Texas. And it's in early stages, screening for development with very little financial commitment for us at this moment, but has significant potential upside. So you can expect that we will continue to look for and find diversification opportunities that leverage our expertise and strengths.

Moving on to the quarterly results. We posted a solid quarter with operating earnings of \$0.51 per share, which is just over the upper end of our guidance range. For the full year, we are reaffirming our guidance range of \$2.25 to \$2.55 a share, which we provided to you at the beginning of the year. Jack is going to go into more details about the earnings and our financial performance in his remarks.

On the operational front, we've had a solid operational performance at our nuclear fleet this quarter. We achieved 91.8% capacity factor while completing five refueling outages during the second quarter. After completing our spring refueling outages, we ran at 98.8% for the month of June. These capacity factors include our ownership share of the CENG plants, which became integrated into the Exelon operations platform on April 1.

Our Gas renewable fleets had a strong quarter as well, with fossil-hydro dispatch match at 99.2%, and our solar and wind energy capture at 94.7%. ComEd and PECO had significant storms around the end the quarter, and on the last day of the quarter, we had severe weather, including multiple tornadoes in Illinois that caused service interruptions to over 420,000 customers in the ComEd service territory. PECO faced two storms on July 3 and 8 that left more than 400,000 customers without power. In the matter of three days or a little less, the power was restored to over 99.9% of those affected, demonstrating the storm response capability of our organization. I'd like to thank those personnel that were involved for their quick and rapid response.

On the regulatory side, ComEd filed its most recent annual distribution and transmission formula rate update in April. BGE filed its electric and gas distribution rate in early July. In early June, the EPA came out with its much anticipated draft rule for greenhouse gas regulations for existing power plants that set limits on emission by 2030. We see this as a potential positive for Exelon and we are pleased that the rule recognizes the critical importance of the nation's nuclear generation as vital to achieving the proposed standard.

While it's too early to draw sweeping conclusions about state-by-state impact, given the complexity of the rule and the time reported to the states to respond, we think that our clean baseload nuclear fleet is well positioned to take advantage of the potential changes in the stack composition and the generation mix that this rule will achieve.

Let me give you a quick update on the Pepco holdings transaction. So far, we have submitted filings with FERC, Virginia, D.C., New Jersey and Delaware. We continue to expect this transaction will close in the second to third quarter of 2015. We've made progress on the funding acquisition as well – funding the acquisition as well. We had a successful equity issuance in June and assets sales are proceeding, including our sale of our ownership in Safe Harbor that is expected to close in the third quarter. Jack is going to go into more of the specifics around this area.

Touching upon the state of the power markets, despite the recent pullback due to mild weather across the U.S. and the higher gas production and injection rates, the forward power prices are still higher year-to-date. 14 gigawatts of coal assets that are set to retire in the PJM footprint by next year are still operating. Current weather and expected gas storage levels are going to dictate the forward power prices in the near term.

We saw high spot volatility in the markets during the first six months of the year and have seen higher risk premiums and margins for wholesale and retail load products. We aggressively hedged during the quarter and move close to our ratable hedging strategy, capturing the upside prices we saw during the quarter. Joe Nigro is going to go into more details in his comments.

On the PJM auction results, as you know, the auction cleared at \$120 a megawatt day. It was higher than most anticipated, due to primarily the rule changes around lower imports, lower demand response and participants' bidding behavior. We think the results are encouraging for our plants to clear. But there is an opportunity for further improvements in the market rules in the future, such as firm fuel commitments, anti-speculation rules and with the recent court ruling looking for clarity on the role of demand response energy efficiency in the capacity markets.

Our nuclear units, Oyster Creek, Quad Cities and Byron, five in total, did not clear the auction. For Quad Cities and Byron, these units are important for grid reliability, environmental and from an economic standpoint, are especially critical in helping Illinois meet its environmental goals in light of the recent EPA rules. To that extent, Illinois House passed the House Resolution 1146 in May, recognizing the value of nuclear energy for its reliability and its carbon-free benefits and urged the exploration of opportunities to avoid closing nuclear plants.

We have agreed not to make any decisions about retiring these units until June of next year to allow for the Illinois legislature time to enact market-based reforms at the state level. This could be items such as joining REGI [Renewable Energy Group, Inc.] or Clean Energy Standard. However, as we've said in the past, if we're unsuccessful and we do not see a path to sustained profitability for these units in question, we will be forced to retire them to avoid long-term losses.

I do want to be clear again about one thing. We are not looking and do not want contracts for subsidies from Illinois, only contracts that recognize the environmental benefit and the reliability of the assets. To wrap up, we're confident in our fleet operations and our portfolio management to deliver our earnings expectations for the full year. A key area focus for us during the second half of this year is to continue working through regulatory approvals to close the PEPCO transaction.

We will continue to look for opportunities to invest in assets that add value to Exelon and to its shareholders and ways to diversify our portfolio.

With that, now I'll turn it over to Joe Nigro to share his views on the commodity markets.

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### Joseph Nigro

*Executive Vice President, Exelon; Chief Executive Officer, Constellation, Exelon Corp.*

Thank you, Chris. Good morning, everyone. I wanted to take some time to talk about power market developments this quarter, as well as year-to-date. I will also touch on our generation hedging strategy, discuss the results of this 2017-2018 PJM capacity auction, provide an update on load margins, and finally tell you how this translates to our gross margin forecast.

Moving to slide 3, the spot power markets in the first half of the year have been defined by volatility. We have had six months of very constructive spot market signals, followed by July weakness, due to weather conditions. In the first quarter of this year, the polar vortex led to higher spot prices in PJM, as we observed the growing reliance on resources such as natural gas units, demand response and oil peakers.

Throughout the second quarter, we saw spot power prices clear higher than what saw during the same period in 2012 and 2013. Expanding heat rates have been observed under most load conditions. These higher delivered heat rates can be attributed to the change in generation stack.

During July, we've experienced unusually mild weather, leading to lower spot power and delivered natural gas prices across the board. Cooling degree days are trending approximately 10% below normal at a national level, and 35% below normal in the NiHub area. Due to lack of weather-related demand in July, spot prices in PJM have been clearing lower than the previous two years.

Moving to slide 4, I'll discuss the forward market and its impact on our hedging profile. It has been a volatile year for forward power prices. The second quarter of 2014 was a continuation of the trend we saw in the first quarter in terms of an increase in both power prices and heat rates at the NiHub and West Hub markets. During the second quarter, forward NiHub around the clock prices for 2015 and 2016 increased approximately \$2 to \$3 per megawatt hour, while West Hub prices increased by close to \$2.

A lot of the increase was in line with our long-held belief that power prices should increase, given the ongoing changes to the generation stack associated with coal plant retirements and an increased reliance on natural gas supply and other high-priced non-baseload resources.

During the second quarter we were able to take advantage of the rising power prices and move our behind ratable strategy as well as our cross commodity hedge position closer towards ratable. We have been operating behind our ratable hedging strategy for some time, as we felt the upside in the market at both NiHub and West Hub warranted a more open position.

During the quarter we captured the running forward prices, increasing our hedge generation by approximately 11% in 2015 and 9% in 2016. We also took advantage of market conditions by reducing the amount of our portfolio that was hedged with natural gas from near 10% to below 5% in both 2015 and 2016. In total, we reduced our power price exposure in 2015 and 2016 by 17% and 12% respectively. Our generation suite is now hedged between 92% and 95% in 2014, 75% and 78% in 2015, and 46% and 49% in 2016.

Since the end of the second quarter we have seen forward markets soften due to the weather-related weakness in the spot market. Forward prices for natural gas, natural gas basis and power are down during the month of July. The move down is largely driven by a decline in the prices for the winter delivery months.

Specifically, Tetco M3's natural gas basis has declined heavily in the winter months, which has led to a corresponding decrease in both West Hub and NiHub power prices. Spot natural gas basis prices were strong in Q1, driven by weather conditions, but were lower in Q2 as weather-driven demand backed off. The forwards responded accordingly with 2015 gas basis prices increasing through the first part of the year, only to decline during May and June.

Our gas basis view is split into a short-term and long-term view. Over the next two years, we expect volatility to continue, while longer term we expect stability in the Mid-Atlantic basis, driven by the development of the infrastructure to transport gas away from the Marcellus Shale area, expanding LNG exports to Mexico, industrial expansion and gas demand for power generation.

With respect to the forward power market, we still see upside price opportunity in certain non-winter months in seasons where we believe the markets are undervalued. While we have moved our hedging strategy closer to ratable, and more neutral across the calendar years in 2015 and 2016, we think there's an opportunity to benefit from power price upside in those delivery periods.

We will continue to set our hedging strategy according to this view.

Fundamentally, our view of power price upside has not changed. We understand that there are very short-term factors that can impact spot and forward prices. As we saw in the winter and then again in July of this year: weather by itself can have a significant short-term impact on the market. However, our view is grounded in the fundamental changes that are taking place in the market.

Specifically, we expect about 30 gigawatts of coal generation to retire across the eastern interconnect by next year, of which approximately 14 gigawatts will be in PJM. Changes in the supply stack and more disciplined load pricing are just a few of the fundamental market changes we have witnessed this year.

Before moving on to our gross margin update, I want to touch on the PJM capacity auction and then an update on our retail margins. The PJM auction cleared at \$120 per megawatt day in both the RTO and MAAC regions. The RTO clearing price doubled from the previous year's auction, indicative of tighter supply/demand fundamentals following coal retirement announcements. The clearing prices were primarily driven by 3,000 megawatts of lower imports, 1,400 megawatts of lower demand response and participant bidding behavior. These drivers were partially offset by nearly 6,000 megawatts of new generation that cleared.

There are further potential market design changes that we will continue to monitor, which will impact future capacity prices as well. Some examples of this include uncertainty regarding the impact on capacity and energy markets of the D.C. Circuit Court vacating FERC Order 745, as well as FERC and PJM working to curb speculation about potential changes to the shape of the demand curve and potential changes due to cold weather reform.

This was the first auction that we bid in some of our nuclear units after ACRs, and as a result, Quad Cities' Units 1 and 2, Byron Units 1 and 2 and Oyster Creek did not clear. As Chris mentioned, the failure of these units to clear will be a key factor in our decision on whether or not to shut down the plants. Our nuclear plants rely on the capacity market for revenues and without those revenues their economics will be stressed even more. We have committed that no decision will be made on any of our Illinois units before June of 2015.

Moving on to our load margins. So far this year, we began to see increases in both our wholesale and retail load margins as providers become more disciplined in their pricing assumptions. We have and will remain disciplined in our risk premiums and will not chase volume for the sake of volume. We continue to see an improving retail market developing through longer-term contracts from competitor consolidation.

As many of you may have heard, yesterday we announced an agreement to acquire Integrys Energy Services, a leading retail power and natural gas provider serving 1.2 million customers across 22 states and the District of Columbia. The Integrys portfolio adds further scale to our retail power and natural gas business and provides generation and load matching benefits to our portfolio. We expect the transaction to close in the fourth quarter of this year or the first quarter of 2015.

Turning to slide 5, I will review our updated hedge disclosure and some of the significant changes given the events of the second quarter. Focusing on 2014, we have a net \$50 million increase to gross margin since the end of the first quarter, driven primarily by the elimination of the DOE nuclear waste fee, partially offset by an extended outage at Salem.

As I mentioned before, our portfolio management teams performed very well in managing our portfolio generation and load, given the volatile market. This contributed to us executing on \$100 million of our power new business targets, and \$50 million of our non-power new business targets during the second quarter.

For 2015, we saw prices increase across most regions, increasing around \$2 per megawatt hour in the Mid-Atlantic and the Midwest. This along with the DOE fee resulted in an increase in our open gross margin of \$450 million. Given our hedge position and our execution of \$100 million of power new business, our total change in gross margin was an increase of \$300 million.

For 2016, prices increased by \$2 to \$3 per megawatt hour. This resulted in an increase of \$600 million in our open gross margin with a hedge position of between 40% to 50% for the quarter and an execution of \$100 million in power new business, our total change in gross margin was an increase of \$450 million.

Overall, the first half of 2014 has resulted in higher prices from where we began the year, while mild weather, increased gas production and following natural gas basis prices have challenged power prices during July. While the volatility in the market is likely to persist, we are also confident that gas and power markets are fundamentally stronger than where they were just a year ago at this time.

Now I'll turn it over to Jack to review the full financial information for the quarter.

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## Jonathan W. Thayer

*Executive Vice President and Chief Financial Officer, Exelon Corp.*

Thank you, Joe, and good morning, everyone. I'll cover Exelon's financial results for the quarter, our third quarter guidance range and update our cash outlook for 2014, including a discussion of the financing for the Pepco Holdings acquisition. I'll start on slide 6.

As Chris mentioned earlier, Exelon delivered second quarter earnings of \$0.51 per share, exceeding our guidance range of \$0.40 to \$0.50 per share. This compares to earnings of \$0.53 per share in the second quarter of 2013. The key drivers of the reduction in earnings quarter-over-quarter were lower realized energy prices at Exelon Generation, offset by increased distribution revenue at the utilities.

The cost of the expanded outage at Salem during the second quarter is offset by the elimination of the DOE nuclear waste fee. I'll go into greater detail on the quarter drivers at each of the utilities in a few moments. For the third quarter, we are providing guidance of \$0.60 to \$0.70 per share.

In April, Exelon received the operating licenses for the CENG nuclear fleet and began operating those plants. Prior to closing, Exelon and Generation each accounted for its investment in CENG under the equity method of accounting. After the close, we moved to a consolidated method of accounting and recorded all assets, liabilities and EDF's non-controlling interest in CENG at fair value on Exelon and Generation's balance sheet as of April 1. Ongoing operations will be included in the consolidated Exelon and Generation financial statements. However, these accounting changes do not materially change the earnings and cash flow for Generation and Exelon.

For the full year, we are reaffirming our guidance range of \$2.25 to \$2.55 per share. This guidance includes the impact of the elimination of the DOE nuclear waste fee, and is partially offset by increased outages, primarily in the nuclear fleet at Calvert Cliffs and Salem. These outages and their impacts are expected to be a \$0.12 per share drag for the year. As we stated before, the full year benefit of the fee expiration is around \$150 million per year, or approximately \$0.11 per share. We do not expect Congress to act to reinstate this fee in the immediate future, and therefore have removed it from all years of our gross margin disclosures.

Turning to utilities on slide 7, they delivered combined earnings of \$0.25 for the quarter. Before explaining the drivers of each utility, let me provide a brief update on our latest load forecast.

In general, we are seeing load growth year-over-year at ComEd and PECO, while BGE growth is flat to 2013. ComEd is seeing positive load growth of 0.8% across all three customer classes, led by 1.2% in the residential sector. PECO's overall load growth of 0.7% is led by 1.2% growth in the large commercial and industrial sector, and offset by a decline in load in the small commercial and industrial sector. You can find our latest full-year load estimates in the appendix on slide 18.

For the second quarter, ComEd earned \$0.13 per share compared to \$0.11 per share in the same quarter last year. The increase is primarily related to higher distribution revenue, due to rate base growth from higher capital investment. PECO's earnings were \$0.10 per share for the quarter. This is up \$0.01 per share from the second quarter of 2013, due to decreased income tax expense primarily due to additional tax repair benefits from February and July storms, and redemption of preferred securities, which resulted in a reduction of preferred dividends.

As Chris mentioned earlier, PECO had two significant storm events in early July. Combined, these storms had a total incremental O&M cost of \$10 million to \$20 million, and incremental capital cost of \$10 million to \$20

million. Despite these storms and the ice storm in February, we are comfortable that PECO can still meet its full year guidance range.

BGE delivered earnings of \$0.02 per share in the first quarter, a decrease of \$0.01 from the same period in 2013, due to increased O&M costs primarily due to bad debt expense and labor, contracting and materials, partially offset by increased distribution revenue.

Earlier this month, BGE filed a rate case with the Maryland PSC, asking for increases of \$117.6 million for electric, and \$67.5 million for gas. We expect the final order in late January 2015, with new rates going into effect shortly thereafter. As you know, ComEd filed its annual formula rate case in April, and we expect a decision from the ICC by December 12, and the new rates will go into effect in January of 2015. More information about the filings can be found in the appendix on slides 19 and 20 for ComEd and BGE respectively.

Slide 8 provides an update of our cash flow expectations for this year. We project cash from operations of \$6.975 billion. This compares to \$6.2 billion last quarter. The variance is primarily driven by proceeds from divestitures and a decrease in OPEB contributions. As you know, we had a busy quarter working on financings for the Pepco Holdings acquisition. On May 30, 2014, we announced that we had entered into a \$7.221 billion bridge loan facility to support the transaction and provide flexibility for timing of permanent financing.

We executed the first portion of the permanent financing with a successful equity issuance via a forward sale, which priced on June 11. We issued \$1.2 billion of mandatory convertible units and \$2 billion in equity forward contracts. Each of these transactions included green shoots, the proceeds of which may be utilized for accretive growth opportunities. As a result of the equity issuances, we reduced the bridge loan facility to \$4.2 billion.

We're well down the road with our asset sale program. In May we sold our Safe Harbor hydro facility to Brookfield Capital for \$613 million, or \$375 million after tax, with an expected close in the third quarter. We're also proceeding with efforts to divest Fore River, Quail Run, Hillabee and Keystone/Conemaugh. We anticipated raising greater than \$1 billion in after-tax proceeds from the divestitures, with the excess proceeds funding future investment and growth.

As a reminder, I'd like to point out a few changes made to the presentation of the projected sources and uses of cash in the first quarter, due to the consolidation of CENG into Exelon. For the fourth quarter of 2013 we showed 100% of CENG cash flows net of distributions reflected in the cash from operations line and the CENG distribution to EDF in the other line. Starting in the first quarter, we have kept the CENG distribution to EDF in the other line. However, we now include 50% of CENG's CapEx in investing, while leaving all other CENG cash flows net of distributions in cash from operations. As a reminder, the appendix includes several schedules that will help you in your modeling efforts.

Now, before I open the call for Q&A, I want to acknowledge that this is Ravi Ganti's last call as VP of IR. Ravi is moving back east to become the Senior Vice President and Chief Commercial Risk Officer. I want to thank him for representing Exelon through the past two years. I also want to welcome Francis Idehen as the new VP of IR. Many of you on the phone have met Francis and we at Exelon are excited to have him in this new role.

That concludes my remarks. Operator, we'd like to turn it over to Q&A.

## QUESTION AND ANSWER SECTION

**Operator:** Yes, sir. [Operator Instructions] Your first question comes from the line of Dan Eggers with Credit Suisse.

Christopher M. Crane

*President, Chief Executive Officer & Director, Exelon Corp.*

Hey, Dan.

A

Dan L. Eggers

*Analyst, Credit Suisse Securities (USA) LLC (Broker)*

Q

Can we talk a little bit more about what's going on in the retail markets, A, as far as what kind of margins and profitability you guys saw in the quarter? And then with the Integrys acquisition, how you think about the scale of selling power through retail channels relative to other ways of hedging your exposure?

Christopher M. Crane

*President, Chief Executive Officer & Director, Exelon Corp.*

Joe will take that.

A

Joseph Nigro

*Executive Vice President, Exelon; Chief Executive Officer, Constellation, Exelon Corp.*

A

Good morning, Dan. The retail market remains very competitive. As you know, there's a number of participants in all the areas that we're in. I would say, however, since January, we have seen improvement in all of the retail markets. And it's really happened on two fronts, from our perspective.

The first is just the premiums, the risk premiums charged to serve load, and I'm talking both in the retail markets as well as on the polar side, have gone up with the increased volatility we've seen in the market. And then in addition to that, we have seen our margins on the C&I origination on the power side expand as well. And I think both of those things are positive. We had been saying for some time that we expected to see this happen because we couldn't get our hands around where the market was trading at effectively.

I think from the Integrys perspective, it's a really good fit for our portfolio from the standpoint of: their core products are power and gas, which dovetail nicely into our existing retail business. The 22 states that they're in also fit nicely with the geographies that we're in. And it is just a natural opportunity for us to grow the business as you see some of the competitors scale back.

Dan L. Eggers

*Analyst, Credit Suisse Securities (USA) LLC (Broker)*

So, Joe [indiscernible] (32:38) -

Q


Christopher M. Crane

*President, Chief Executive Officer & Director, Exelon Corp.*

The only thing I'd add to that, Dan, is the nature of the business is still very competitive, as Joe said. There's dozens and dozens of participants that are still in markets like Northern Illinois. We expect upon closure that our

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combined footprint would be about 29%. I think it's been over-reported in a few outlets. And so 28% to 29%. But there, again, as the contracts come up, they'll be processed in a very competitive way. So we feel strong about the acquisition and we still think it supports a very competitive market.

**Dan L. Eggers**

*Analyst, Credit Suisse Securities (USA) LLC (Broker)*

Q

You guys have historically talked about \$2 to \$4 margins for the retail business. Where are you seeing new business fall within that continuum?

**Joseph Nigro**

*Executive Vice President, Exelon; Chief Executive Officer, Constellation, Exelon Corp.*

A

Dan, we've mentioned previously in the last six months that at one point we were slightly below that \$2 to \$4 threshold for C&I originations. We're now back over that \$2 threshold at, call it, low to mid-\$2 and we've seen improvement. And then, as I mentioned, in addition to that, on top of that, we've seen the actual risk premiums increase. So the increase has been really on two fronts, but our margins alone are above that \$2 threshold.

**Dan L. Eggers**

*Analyst, Credit Suisse Securities (USA) LLC (Broker)*

Q

Yeah. And I guess just one other question. After the Pepco deal there was talk about looking to buy more generation assets prospectively as well, and maybe the asset sale is freeing up even more balance sheet room. Can you just walk through the criteria you guys expect as you look at buying assets in this market and then with the volatility in power markets we've seen in the last few months, how is that maybe affecting decisions or where you might want geographic exposure?

**Christopher M. Crane**

*President, Chief Executive Officer & Director, Exelon Corp.*

A

We continue to look at growing both sides of the business, either through on the generation side, either through acquisitions or potential development projects. But they have to pass the test of accretion and over the period, in a value proposition, a positive NPV contribution to earnings and free cash flow or EPS. We participate as assets come. More recently, assets have been going at higher valuations than we would put them in the portfolio for. But we'll continue to watch as things come to market and run them through our models.

They need to be generally in the markets that we're serving and trying to grow into. Some of the asset optimization that we're going through now is carried back on a few of the assets that don't have the good well-run assets, good employee base, highly reliable, but they don't have the value creation in our portfolio. So continuing to optimize the assets as we go forward.

As we've said previously, really interested in the Texas market. We see the economy there strengthening. We see the demand, although not as fast as previously reported, presenting opportunities for further growth in wholesale and retail opportunities which would, with our business model we try to match as much as we can the generation to the load in the portfolio.

**Dan L. Eggers**


*Analyst, Credit Suisse Securities (USA) LLC (Broker)*

Q

Okay. Thank you, guys.

**Operator:** Your next question comes from the line of Steven Fleishman with Wolfe Research.

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**Steven I. Fleishman**

*Analyst, Wolfe Research LLC*

Q

Yes, hi. Good morning. Just first on the guidance for this year, have you incorporated any of this bad July weather or August forecast in the range or not?

**Jonathan W. Thayer**

*Executive Vice President and Chief Financial Officer, Exelon Corp.*

A

Yes.

**Steven I. Fleishman**

*Analyst, Wolfe Research LLC*

Q

Okay, good. And that's in your Q3 forecast as well?

**Jonathan W. Thayer**

*Executive Vice President and Chief Financial Officer, Exelon Corp.*

A

I think four of us said yes at once there, so we're pretty firm on making sure there's clarity.

**Christopher M. Crane**

*President, Chief Executive Officer & Director, Exelon Corp.*

A

Yes on the second one, as well.

**Joseph Nigro**

*Executive Vice President, Exelon; Chief Executive Officer, Constellation, Exelon Corp.*

A

Yes on the second one.

**Jonathan W. Thayer**

*Executive Vice President and Chief Financial Officer, Exelon Corp.*

A

Yes on the second one.

**Steven I. Fleishman**

*Analyst, Wolfe Research LLC*

Q

Okay. Good. And then just going back to the TEG transaction, retail. Can you give us maybe any sense of a metric of what kind of valuation you might have paid for that business?

**Joseph Nigro**

*Executive Vice President, Exelon; Chief Executive Officer, Constellation, Exelon Corp.*

A

Well, as we mentioned in the press release, Steve, we paid \$60 million for Integrys and then assumed the working capital of approximately \$180 million or so. I would say on an EBITDA multiple basis, it's close to or less than 2 times on an EBITDA multiple basis.

**Steven I. Fleishman**

*Analyst, Wolfe Research LLC*

Q

Okay. And then this might be a bit of farfetched question, but just curious because you've been growing your renewables business at a decent amount and contracted generation. What's your kind of take on this yieldco trend

and is this something you'd want to kind to sell your assets to, given that you can probably sell them for a lot now, or you want to keep trying to grow the business? Just how are you thinking about it?

**Christopher M. Crane**

*President, Chief Executive Officer & Director, Exelon Corp.*

A

We like the business on the projects that you can get for the right value. It is on the renewables a free cash flow play and with the current tax rules that are there, it's a tax play. We've leaned more towards project financing and we think that fits our needs better than a yieldco in the long term, what we see for the tax environment for these assets going forward. So we're not heading towards yieldco or pushing assets into the yieldcos. We're more continued development in project finance the assets.

**Steven I. Fleishman**

*Analyst, Wolfe Research LLC*

Q

Okay, thank you.

**Operator:** Your next question comes from the line of Greg Gordon with ISI Group.

**Greg Gordon**

*Analyst, International Strategy & Investment Group LLC*

Q

Thanks. A couple questions. First, I know you had a good update on cash flow, in part from tax. Were those tax inflows contemplated as possible at the beginning of the year and you just excluded them from your guidance because of you were uncertain on timing, or were they something new that developed over the quarter? And then should we assume a normal effective tax rate in the subsequent quarters and in the next couple years?

**Christopher M. Crane**

*President, Chief Executive Officer & Director, Exelon Corp.*

A

Greg, I'd say some elements were, I would say, on the opportunity side. So we had some visibility. We had about \$100 million improvement based on tax reimbursement for our decommissioning trust funds. The safe harbor sale allowed us to accelerate some tax credits. So that pulled forward about \$175 million.

So we have had some elements that we had some visibility might come to fruition and with some successful settlements with the IRS as well as some very successful sale of safe harbor, have created an incremental opportunity there.

On the effective tax rate side, we would anticipate about a 31% to 32% consolidated effective tax rate on operating earnings for the year. On the GAAP side, mark-to-market earnings kind of causes that to have some variability around it. But for modeling purposes, I think you can safely assume the 31% to 32%.

**Greg Gordon**

*Analyst, International Strategy & Investment Group LLC*

Q

And in subsequent years, is that a reasonable bogey or is it, should we assume something higher in lieu of any one time tax monetizations?

**Christopher M. Crane**

*President, Chief Executive Officer & Director, Exelon Corp.*

A

I think that's a fairly reasonable level.

Greg Gordon

*Analyst, International Strategy & Investment Group LLC*

Okay. So consistent at that level?

Q

Christopher M. Crane

*President, Chief Executive Officer & Director, Exelon Corp.*

Yes.

A

Greg Gordon

*Analyst, International Strategy & Investment Group LLC*

Okay. And then can we talk a little bit about gas and gas basis? Working here with Jon Cohen, we watch not just the strip, but the monthlies and you've still got a pretty positive winter basis and a pretty negative summer basis at Tetco M3, but then at the Chicago City Gate, basis hasn't been nearly as volatile. What is going on in the real-time market, and what is your point of view – Exelon's point of view on how we ought to think about gas basis?

Q

Joseph Nigro

*Executive Vice President, Exelon; Chief Executive Officer, Constellation, Exelon Corp.*

Yes, morning, Greg. It's Joe. I think from a gas basis perspective, your point is right on. We've seen the Nov-March strip for next year and the M3 basis drops since the end of June, about \$0.50. And versus its high in early May, it's dropped almost \$1. And to your point, really the summer period since the end of June for that M3 basis hasn't fallen at all. We've dropped some since the high at the end of May. Chicago has been much more stable.

A

From our perspective, there's a couple of things. Obviously, the strong Q1 spot prices had a big impact on driving the forward prices higher, both in the winter and summer periods. We're seeing an impact that dragged through to the forward curve on what's going on in the spot market. I mentioned in my prepared remarks how we're 35% down on cooling degree days in Chicago and 10% nationally. That's having an impact in the gas market, both at Henry Hub and the drag through the basis.

I think specifically, the M3 basis, we're going to continue to see some of this volatility in the next two years or so as we continue to produce more gas at the Marcellus Shale. We're producing about 15 bcf a day in Marcellus, and we just don't have the takeaway capacity to move that gas efficiently.

As you get out to towards 2017, we really expect that gas demand, the supply/demand balance at Marcellus to come into much better equilibrium, when you think about some of the pipeline reversals with Transco and Texas Eastern and the Rockies Express, which will provide an uptick and more stability to that gas basis.

Greg Gordon

*Analyst, International Strategy & Investment Group LLC*

So, when you guys roll out, when will you guys roll out how you've positioned yourselves for 2017 vis-à-vis hedging and would we expect that to be reflect – that perspective to be reflected in your positioning when you do so?

Q

Joseph Nigro

*Executive Vice President, Exelon; Chief Executive Officer, Constellation, Exelon Corp.*

Yeah. I think the way I would answer that is first is, we'll roll out 2017 like we do every year at EEI. And we do have – our ratable program for 2017 began this year. We are impacted by gas basis just like everyone else on our open position. But I would also say as we convert to power sales obviously, we don't have as big an impact on – the

A

gas basis doesn't have as big an impact on us, and once we sell the power, because we have so much long baseload nuclear generation that it's not impacted once the power is sold.

Christopher M. Crane

*President, Chief Executive Officer & Director, Exelon Corp.*

A

But 2017 will come out at EEI.

Greg Gordon

*Analyst, International Strategy & Investment Group LLC*

Q

Thank you, gentlemen.

**Operator:** Your next question comes from the line of Jonathan Arnold with Deutsche Bank.

Jonathan P. Arnold

*Analyst, Deutsche Bank Securities, Inc.*

Q

Good morning, guys.

Christopher M. Crane

*President, Chief Executive Officer & Director, Exelon Corp.*

A

Good morning.

Jonathan P. Arnold

*Analyst, Deutsche Bank Securities, Inc.*

Q

Could I just ask you to give us an update on how you see the whole kind of discussion in Illinois around these market-based solutions playing out? I guess you said you won't take any action on plants until middle of 2015. The legislature is going to come in for a veto session in November, and then be back in the early part of next year. What's going on currently, if anything, and how is this actually going to move forward?

Christopher M. Crane

*President, Chief Executive Officer & Director, Exelon Corp.*

A

Get Joe Dominguez to cover his actions there.

Joseph Dominguez

*SVP-Public Policy, Government & Regulatory Affairs, Exelon Corp.*

A

Sure. What's going on currently is that the Illinois stakeholders are taking a look at the 111, the proposed rule, which obviously provides a strong signal to the states to preserve nuclear as part of their compliance plan. The other thing that is happening is as part of the resolution that Chris mentioned at the outset, state agencies are drafting a number of reports that'll look at the economic value of the units to the local communities, jobs, the value of the energy produced, the value of the low carbon resources. And so we expect those reports to be completed sometime around November or December, positioning us for a discussion of solutions in the spring session.

So I think the first time we'll see the actual legislation in different proposals will be in the spring. As Chris mentioned, we're looking for a market solution. To the extent that low carbon resources and [ph] hamster (46:09) liability are attributes that society needs, we'll expect to be compensated for those attributes, and we'll expect that compensation really at all of the plants, and not just the plants that are in jeopardy.

So that's our go-forward plan and I think that's the timing.

Jonathan P. Arnold

*Analyst, Deutsche Bank Securities, Inc.*

Q

So the next thing we will probably see will be these reports coming out towards the end of the year?

Joseph Dominguez

*SVP-Public Policy, Government & Regulatory Affairs, Exelon Corp.*

A

That's right.

Jonathan P. Arnold

*Analyst, Deutsche Bank Securities, Inc.*

Q

And then would you say that the stakeholders' interest in this is entirely dependent on 111(d) or does it kind of run – is there a chance we move on this regardless of what happens with the EPA and carbon?

Christopher M. Crane

*President, Chief Executive Officer & Director, Exelon Corp.*

A

The state has long positioned itself as focused on environmental issues and they have individually, as a state taken, actions in advance in 111(d), and looking at different programs that they may be able to participate in. We see this as helping them with a roadmap on going forward. So there is an interest within the state for that. There's also an interest within the stakeholder body to secure the long-term viability of these assets. They're greatly, highly critical to the economy, local economy in which they're located in, serving as tax bases, job bases, economic support for the community. So it's a multifaceted view, but the environmental support has been a long-term focus for the state.

Jonathan P. Arnold

*Analyst, Deutsche Bank Securities, Inc.*

Q

Okay. Thanks, Chris. And can I just ask, a similar idea but different topic, on the various avenues you're pushing for in terms of PJM market structure reform? Could you give us an update on which of those is getting the most traction and what your expectations are around timing and process there as well?

Christopher M. Crane

*President, Chief Executive Officer & Director, Exelon Corp.*

A

Joe, you want to comment?

Joseph Dominguez


*SVP-Public Policy, Government & Regulatory Affairs, Exelon Corp.*

A

Sure. So, there's some unfinished business around the speculation reforms that had been proposed in advance of the last auction and FERC has set up some sessions to deal with that. We think that will ultimately revive some of those speculation reforms for FERC approval in advance of the next auction. The other issue that is gaining a lot of attention, is an examination of the winter reliability situation, I think has revealed some gaps in the capacity product that we have purchased thus far on behalf of consumers.

So I think PJM is going to be looking at something that procures some additional commitments around high-availability resources. I think that's going to look a lot like resources that have firm fuel, like our nuclear plants.

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And I think it's going to be a carrot and stick approach where there will be additional compensation paid to those units for enhanced reliability, and there's also going to be some enhanced penalties. And I think, as an early model one might look to in that regard, is what New England has done. I think PJM is going to look very carefully at that, so there'll be some more money in the system, but also some more penalties for people who don't perform.

I think generally speaking, PJM wants to be out of the business of managing fuel supply for gas generators. That's become a big issue. It will become a bigger issue, as the stack changes, and the other thing we saw is, obviously, generator non-performance in the winter, which really threatened the reliability of the system. So I figure we will see a proposal sometime in the next month from PJM with action bringing something to FERC, potentially by the end of the year, depending on what the analytics look like.

Jonathan P. Arnold

*Analyst, Deutsche Bank Securities, Inc.*

Q

Would that run on the typical PJM BRAs schedule with an auction in the second quarter, or you see that happening on a different timeframe?

Christopher M. Crane

*President, Chief Executive Officer & Director, Exelon Corp.*

A

Well, I think in the long run it'll do just that. It'll be part of the BRA and the planning parameters we see going into the BRAs. But there is a question about these next few winters, before we could catch up to the BRA schedule. So I think there's going to need to be something that will be supplemental for the coming winters. But again, we need to see what PJM proposes, but I don't think it's just purely the BRA play. I think it's going to affect the next few winters as well.

Jonathan P. Arnold

*Analyst, Deutsche Bank Securities, Inc.*

Q

Okay, so the next month or so, you think that proposal emerges?

Christopher M. Crane

*President, Chief Executive Officer & Director, Exelon Corp.*

A

Yes.

Jonathan P. Arnold

*Analyst, Deutsche Bank Securities, Inc.*

Q

Great. Thank you very much.

**Operator:** Your next question comes from the line of Hugh Wynne with Sanford Bernstein.

Hugh de Neufville Wynne

*Analyst, Sanford C. Bernstein & Co. LLC*

Q

Good morning.

Christopher M. Crane

*President, Chief Executive Officer & Director, Exelon Corp.*

A

Good morning.

**Hugh de Neufville Wynne***Analyst, Sanford C. Bernstein & Co. LLC*

Q

I wanted to follow up on some of the discussion regarding Illinois's response to 111(d). I think that I heard mentioned that that rule provides an incentive to preserve the capacity of the nuclear fleet, and at one point, I also heard mentioned the possibility that Illinois might join REGI. Could you comment more directly on what you've heard regarding the strategies of Illinois and Pennsylvania with respect to their possible response to 111(d), their state implementation plans?

**Christopher M. Crane***President, Chief Executive Officer & Director, Exelon Corp.*

A

Well, I'd say, just first of all, it's very preliminary. So I think there's a couple things that folks are looking for. It's pretty clear that if you lose nuclear plants, your ability to comply with any carbon regime going forward is going to be jeopardized. The plants produce a tremendous amount of zero carbon energy, and so if you lose those, you're going to see a big uptick in carbon emissions. And we've seen that in states where plants have actually retired. I think that's been fully recognized.

What the vehicle for compliance will be is going to be the subject of discussions for, I would guess, at least a year and possibly longer. So I just think it's too early to speculate on where they're going to go. I think some stakeholders see what's been done in the REGI states and find that appealing. There's a lot of green before we get to a solution on that.

**Hugh de Neufville Wynne***Analyst, Sanford C. Bernstein & Co. LLC*

Q

Right.

A

I think the other thing to add is, in conversation, that this is a very complex rule and it takes time to digest it. I think the state wants to ensure they understand the allotment or reduction goals that they were given, that they ensure that they're given a fair shake in that, but it will be, as Joe said, take a while.

A

And if I can just add, you asked about Pennsylvania as well. There, I think the administration has not been predisposed to joining REGI. But the other candidate for governor has indicated as part of his platform that he would join REGI if he is elected. So let's see what the election results look like in November, and that will probably chart the path there.

**Hugh de Neufville Wynne***Analyst, Sanford C. Bernstein & Co. LLC*

Q

Could I just ask a question on that front, the portion of your fleet that's in New York, and in Maryland, of course, is already governed by REGI. Is it important to you and are you making initiatives to see that the rest of your fleet is also governed by similar rules, or do you feel that PJM can operate flexibly with different state implementation plans in different states?

**Christopher M. Crane***President, Chief Executive Officer & Director, Exelon Corp.*

A

Yes, I think we believe the latter. I think REGI is a good choice, but it's just one of the choices. Clean Energy Standard could work. A dispatch model where we price in carbon and the dispatch of resources through the RTOs could work. There are a lot of solutions out there. We have supported the REGI platform and the modelable improvements and we'll continue to support those states that are interested in that model. But it's not the only solution.

**Hugh de Neufville Wynne***Analyst, Sanford C. Bernstein & Co. LLC*

Q

Great. Thank you very much.

**Operator:** Your next question comes from the line of Angie Storozynski with Macquarie Capital.

**Angie Storozynski***Analyst, Macquarie Capital (USA), Inc.*

Q

Thank you. Good morning. So I wanted to go back to the questions about Integrys. So I know a lot of questions have been asked. But have you incorporated the projected uptick in volumes and margins to your retail business in your gross margin projections?

**Joseph Nigro***Executive Vice President, Exelon; Chief Executive Officer, Constellation, Exelon Corp.*

A

No, Angie, we have not.

**Angie Storozynski***Analyst, Macquarie Capital (USA), Inc.*

Q

Okay. So the follow-up question is how should we think about it? I mean how big of a swing could it be? And also is this portfolio short power?

**Joseph Nigro***Executive Vice President, Exelon; Chief Executive Officer, Constellation, Exelon Corp.*

A

First of all, I think the first question is the uptick in volume would probably be approximately 15% to our retail power volumes. And our existing Constellation retail power volumes, on the gas side the uptick in volume would be approximately 30% to the existing Constellation volumes.

**Angie Storozynski***Analyst, Macquarie Capital (USA), Inc.*

Q

Okay. And I'm just trying to figure out if this very long multiple has to do with the fact that the portfolio was short, the 2 times EV to EBITDA?

**Jonathan W. Thayer***Executive Vice President and Chief Financial Officer, Exelon Corp.*

A

Angie, this is Jack. Clearly, Integrys didn't own generation to support that portfolio. They had acquired and hedged it via the open market. It fits nicely with our generation footprint in the states they're active, and this would be an incremental avenue for us to hedge our generation -

**Joseph Nigro***Executive Vice President, Exelon; Chief Executive Officer, Constellation, Exelon Corp.*

A

And I would add to that, Angie. The purchase is a mark-to-market exercise, so regardless if they were long or short, it would be an exercise in just marching to market whatever positions they had on. It's hard to speculate and provide any more information to that.

**Angie Storzynski***Analyst, Macquarie Capital (USA), Inc.*

Q

Okay. That's fine. Now, should we expect that you will give us an updated projections for volumes and then margins for the retail business during the EEI?

**Joseph Nigro***Executive Vice President, Exelon; Chief Executive Officer, Constellation, Exelon Corp.*

A

Yes. That is correct. We will update it for EEI.

**Angie Storzynski***Analyst, Macquarie Capital (USA), Inc.*

Q

Okay. Then, given the correction in solar power curves since June 30, could you give us a sense roughly how they're going to swing? We are seeing currently in your total gross margin for 2015 and 2016 versus what you're showing us on the slides?

**Joseph Nigro***Executive Vice President, Exelon; Chief Executive Officer, Constellation, Exelon Corp.*

A

Yes, if you look at our sensitivity tables that we provide in our hedge disclosures, we show you a \$5 change in power prices for 2014, 2015 and 2016 respectively for PJM West and for NiHub. And we're roughly down about \$3 in 2015 and 2016, respectively. So just backing into the math, it's approximately \$150 million in 2015 and approximately \$250 million in 2016, and you can see that in the sensitivity tables we provide.

**Angie Storzynski***Analyst, Macquarie Capital (USA), Inc.*

Q

Okay. And then, again, going back to the retail business. So I mean just to reconcile your views, so you are expecting, as we do, a growing volatility in power prices and yet you are bulking up your retail business, which tends not to do well in a volatile power price environment. So are you comfortable with the strategy because you're still long power, or is it that you think that you're the last man standing in the retail business and thus, you will be paid for this additional risk that you're assuming?

**Christopher M. Crane***President, Chief Executive Officer & Director, Exelon Corp.*

A


It's definitely not the last man standing. It's a pretty effective market with many participants in it. So I think Joe could continue to cover the strategy; touch that.

**Joseph Nigro***Executive Vice President, Exelon; Chief Executive Officer, Constellation, Exelon Corp.*

A

Yes, I think, Angie, there's a couple of things. I think the first is intrinsically we believe in the logic of matching generation and load, and there's a number of reasons to do that: it's beneficial for us because we don't have to take our power output to the over-the-counter market; the optionality of our units is efficiently matched with these

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load contracts; the locations in which we're selling the load contracts matches nicely to our generation output generally.

I think the second, the other side of it is the volatility piece. These contracts are renewing in a relative frequent period that such the price and the volatility is reflected in those contracts. So it's not like we're being exposed to that. If you go back six months ago, we were saying we didn't think the market was accurately pricing the volatility in the right way, and when it was impacting the way we were executing our own quantities of retail. We have seen that improve, and we thought it would improve and we're comfortable with it because it's an efficient hedge for our total portfolio. And the margins have continued to expand.

Angie Storzynski

*Analyst, Macquarie Capital (USA), Inc.*

Q

Okay, and my last question, not related to the generation business ones. So we're still missing a filing in Maryland for your Pepco acquisition. I mean is there any reason why you're waiting to file in Maryland?

Christopher M. Crane

*President, Chief Executive Officer & Director, Exelon Corp.*

A

Yes, as we previously said, we have multiple filings in at Maryland, and we had to time ourselves in our workload, so we prepared the other ones first. Maryland's on the clock. It's 225 days, so we'll be filing that one very shortly, but it's just the execution of the work we already have. We're in front of the commission in Maryland, and the work that we needed to do in front of the other commissions.

That'll be it, Operator.

**Operator:** Thank you. Thank you. If there are no further questions at this time, I would like to turn the call back over to Ravi Ganti.

Ravi Ganti

*Vice President-Investor Relations, Exelon Corp.*

Thank you, Amy. That brings us to the end of the call. Thank you for joining us. If you have any follow up questions, please contact the IR department. Thank you.

**Operator:** Thank you. This concludes today's conference call. You may now disconnect.

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