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**Ruminations**

**Utilities**  
**Wind's Investment Tax Credit Windfall**

**Comparative Performance**

Column	(1)	(2)	(3)	(4)	(5)	(6)
		Price				
		5/6 intraday	YTD %	3-mos %	6-mos %	1-yr %
S&P 500	SPX	920	2	6	(1)	(34)
Phila. 22 Elec. Index	UTY	361	(9)	(11)	(8)	(32)
SPDR	XLU	27	(8)	(11)	(8)	(33)
Dow Ind.	INDU	8512	(3)	3	(5)	(34)

Source: Bloomberg Financial Service

**Introduction**

Reporting season thus far has been characterized by double-digit declines in industrial usage with revenue drops softened by contracts containing high capacity charges relative to volumes. Utilities stocks have underperformed year to date, while earnings were typically within guidelines wide enough to drive the proverbial truck through. If there's been a theme, it is managements' cautious optimism (fingers crossed), suggesting that the economic decline may be abating.

The 500 pound gorilla in the room is "Climate" legislation (what happened to "Global Warming?"), CO<sub>2</sub> credits and cap and trade. Coal burners are seeking free CO<sub>2</sub> credit allocations, others, immediate auctions of all credits, while pragmatists are concerned that Congress will find revenues generated from cap and trade too tempting not to use them to fund new government spending programs. All in all, it's got to be a bull market for organizations knowing the goings on in the halls of Congress.

**Wind and TARP**

One surprise in the quarter was FPL Group (FPL-\$57-Hold). The company reported adjusted ongoing earnings of \$0.90 a share, 18% above the \$0.76 a share in 2008. Management also raised guidance for 2009 from \$4.05-\$4.25 a share to \$4.20-\$4.40 and boosted its 2010 forecast from \$4.50-\$4.90 a share to \$4.65-\$5.05. Much of the increase is thanks to Uncle Sam and new tax incentives for wind generation (also solar).

Under the American Recovery and Reinvestment Act of 2009, wind generation projects have the option of 1) taking a 30% investment tax credit (convertible or straight) on qualifying investments, or 2) continue to book Production Tax Credits. According to FPL management that decision will be made on a case by case basis. These comments represent our interpretation of Investment Tax Credit reporting based on guidelines issued by FPL Group management during its earnings call.

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**Production Tax Credits:** Heretofore, wind projects received Production Tax Credits of 2-cents a megawatt hour, escalating with inflation for 10-years, ending in year 10. Years 1-5 cash flow benefited from 5-years accelerated amortization and production tax credits, but dropped sharply years 6-10. Production Tax Credits accounted for 80% to over 100% of earnings. Detailed income statements, cash flow and balance sheet forecasts using production tax credits are shown in our FPL Group report dated October 20, 2008.

**Investment Tax Credit:** Remember the three principles of finance – get the cash - get the cash – get the cash. TARP gives companies the opportunity to select, in lieu of Production Tax Credits, a 30% Investment Tax Credit (Grant) on qualifying facilities. Qualifying investment should account for well over 90% of the total. In the case of FPL, a typical 100 megawatt unit would cost about \$205.0 million with the ITC totaling \$57.6 million. According to the legislation, cash is due from the U.S. Treasury the later of 60 days after the COD date or 60 days after the application is filed. Tarp gives wind projects the ability to receive cash quickly and to post a significant one-time benefit to earnings in year 1.

For book purposes, the \$57.6 million reduces the \$205.0 million investment to \$147.4 million. For the IRS, half of the proceeds, or \$28.8 million, reduces the tax base to \$176.2 million. For reporting purpose, the transaction has 2-steps. First, the company normalizes the benefits of the proceeds by offsetting annual depreciation charges of \$8.2 million (\$205 million divided by 25-years) and a credit of \$2.3 million (\$57.6 million divided by 25-years) of Amortized Investment Tax Credit (ITC).

**Table 1**  
**Annual Journal Entry**

	Debit \$-Mil	Credit \$-Mil
Depreciation (IS)	8.2	
Amortization ITC (IS)		2.3

IS-Income Statement

The difference of \$28.8 million between the book base of \$147.4 million and the tax base of \$176.2 million represents larger tax depreciation over book. Tax books then record lower taxable income which translates to lower income taxes (higher earnings) per books. Income per books benefits by the reduction in taxable income multiplied by the tax rate (40% in the case of FPL) of \$11.5 million (\$28.8 million multiplied by 40%). The tax savings are flowed thru in year 1.

## Analyst's Certification

I Raymond E. Moore certify that the views expressed in this research report accurately reflect my personal views about the subject companies and their securities. I also certify that I have not been and will not be receiving direct or indirect compensation in exchange for expressing the specific recommendations in this report. Other FPL Group reports issued by me are: 1/9/06 (\$42) – Not Rated; 8/3/07 (\$56) – Not Rated; 8/9/07 (\$63) – Not Rated; 2/26/08 (\$64) – Hold; 10/20/08 (\$44) – Hold; 11/25/08 (\$48) – Hold; 1/28/09 (\$51) -Hold.

## Important Disclosures

### Guide to Investment Ratings:

**Buy** Total return is expected to exceed significantly the average total return of the analyst's industry coverage universe over the next 12 months.

**Market Perform & Hold** Total return is expected to equal the average total return of the analyst's industry coverage universe over the next 12 months.

**Sell** Total return is expected to significantly under perform (15% plus) the total return of the industry coverage universe over the next 12 months.

### Analyst's Ratings Distribution

		% Investment Banking
Buy	15%	0%
Hold	85%	0%
Sell	0%	0%

The principal risks to the achievement of our price targets include general market trends, disappointing earnings and lower energy prices and adverse regulatory developments

Our target prices are based on projected earnings for the following calendar year, and an assumed price/earnings ratio in line with the company's historical valuation or those of other companies with similar businesses and prospects.



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