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Dow-Jones Industrials 13,432
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FPL Group
(FPL-NYSE-\$56-Not Rated)
Wind Power Arithmetic

Sell Side Likes Wind

At the July 30, 2007 second-quarter earnings call, FPL's Chief Financial Officer, Moray P. Dewhurst, offered a "rule of thumb" for determining wind profits; each 100 megawatt project produces earnings of \$0.01 a share (\$4 million) to \$0.015 a share (\$6 million). His statement made for easy extrapolation. FPL plans to add 8000-10000 megawatts through 2012. If each 1000 megawatts generated \$40 million to \$60 million, wind profits will increase anywhere from \$320 million-\$600 million to a total of \$480 million-\$840 million (assuming the same conversion factor for existing generation). Dewhurst forecast consolidated earnings per share at the high end of \$3.35-\$3.45 in 2007, \$3.70-\$3.90 in 2008, and, assuming 10% annual growth, \$5.60 in 2012.

The sell side likes the story. The call was followed by at least 3 upgrades to Buy: Wachovia, HSBC and UBS. According to Bloomberg Financial Service, FPL Group has 18 active recommendations, including 12 buys, 6 holds, 0 sells. (Absence of a formal report prevents us from issuing a rating on FPL Group.) The company's largest holders include: Wellington Management (19.6 million shares); Capital Research (19.1 million); Barclays (17.0 million); Pictet Asset Management (13.9 million); Hotchkis & Wiley (13.3 million); State Street Corporation (12.7 million); Massachusetts Financial Services (11.7 million); Vanguard Group (10.6 million); Franklin Advisors (9.4 million).

Introduction

Wind generation is praised by the "greens" as Carbon Dioxide (CO₂) free. Skeptics cite its damage to the landscape, noise, limited reliability and high cost. "Tweeners" support it provided it's in someone else's backyard. Buyers use wind to meet renewable portfolio standards. For investors, the lure is tax benefits via 5-year accelerated depreciation and production tax credits.

FPL Group, the nation's largest wind proponent with 4,057 megawatts of operating capacity, detailed wind economics at its April 30, 2007 first-quarter earnings call and again at a Deutsche Bank Conference on May 30, 2007. Major takeaways include cash on cash returns of 10%-12% and returns on equity ranging from the high-teens to low-twenties.

Other economic parameters cited by management include: 1) purchased power prices of \$30-\$40 a megawatt-hour for 15-25 years; 2) production tax credits - \$20 per megawatt-hour escalating with inflation; 3) 2007 capital costs - \$1,650-\$1,850 per kilowatt; 4) accelerated depreciation - 5 years; 5) typical size - 50-150 megawatts; 6) capacity factors - 35%-43%; 7) production costs - \$3.8-\$4.2 a megawatt-hour; and 8) an initial capitalization profile of 50% debt - 50% equity. We assume book depreciation - 40 years and pretax interest expense - 6%. Production tax credits (PTCs) are scheduled to expire on projects initiated after 12/31/08, but proponents are seeking, and we expect Congress, to grant a 10-year extension.

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Rates of return calculations require refinement. Who, for example, has ever sat through presentations by corporate management or investment bankers that didn't promise at least a 20% return on anything? In the case of wind projects, earnings are relatively stable with returns on equity in year 1 in the 5%-8% area. Next, cash flow (depreciation - deferred taxes from 5-year accelerated depreciation - earnings) is transferred via a dividend entry to the Parent. The difference between cash flow transferred and earnings lowers the project's equity component. Return on common rises as the equity component declines (denominator), not because earnings increase (numerator).

Table 1 presents a wind power matrix based on the high, low and average guidelines issued by FPL management.

Table 1
Wind Power Matrix
(Based on April 30, 2007 First-Quarter Earnings Call - Slide 16)

Column	(1)	(2)	(3)
Company Input	High	Low	Average
Capital Costs 2007 Kilowatts (Kw)	1,850	1,650	1,750
Typical Wind Size 50-150 Megawatts (Mw)	150	50	100
Investment \$-millions	278	83	175
Tax Depreciation 5-years	56	17	35
Capacity Factor (35-43%)	43%	35%	38%
Production Cost per Mwh	4.2	3.8	4.0
Purchase Power Mwh -15 to 25 years	40	30	35
Production Tax Credit (PTC) \$20 Mwh.	20	20	20
Capital Structure			
Debt	50%	50%	50%
Equity	50%	50%	50%
Estimated Debt Cost	6.0%	6.0%	6.0%
Book Depreciation 40-years (Shields est.)	6.9	2.1	4.4

Table 2 presents theoretical income statements and profitability comparisons for a typical 100 megawatt project under 4 scenarios: 1) no tax benefits; 2) tax benefits, 3) tax benefits plus cash flow transfer, and 4) tax benefits plus a combination of cash flow transfer and debt retirement.

Scenario 1 - Column 1 - No Tax Benefits

The typical \$175 million, 100 megawatt project without tax benefits would generate little if any profits, more likely lose money. A capacity factor of 38% and \$35-mwh purchase contract produce revenues of \$11.7 million. Operating expenses (\$5.7 million), interest costs (\$5.3 million) and taxes (\$0.2 million) leave \$0.5 million for earnings. Return on common works out to only 0.5%; return on investment - 3.3% and cash flow coverage of interest - 1.9 times.

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Scenario 2 - Column 2 - Accelerated Depreciation & Production Tax Credits

The \$30.6 million difference between straight line depreciation of \$4.4 million and \$35.0 million from 5-year accelerated depreciation creates deferred taxes of \$10.7 million at a 35% rate. Production tax credits at \$20 a megawatt-hour at a 38% capacity factor add \$6.4 million to earnings. Profits of \$7.1 million represent an 8.1% return on an \$87.5 million equity component, nowhere the high-teens to low-twenties cited by management. Return on investment rises to 7.1% (up from 3.3%) and cash flow coverage of interest increases to 5.2 times (versus 1.9 times). (Our estimated profit level is somewhat higher than the \$4-\$6 million guideline per 100 megawatts cited by management, but close enough.)

Scenario 3 - Column 3 - Up-streaming Cash Flow to Parent

Reported earnings are unchanged to scenario 2 at \$7.1 million, but cash flow totaling \$22.2 million is transferred to the Parent as dividends. The \$15.1 million difference between the \$22.1 million transferred less \$7.1 million in earnings reduces the equity component of the investment to \$72.4 million. Earnings of \$7.1 million represent a return on common of 9.2% versus 8.1% in scenario 2. By year 4 the equity component could decline to \$27 million, raising the return on common to 26%.

Scenario 4 - Column 4 - Up-streaming Cash Flow & Debt Repayment

Scenario 4 takes scenario 3 out one year and assumes a \$5.8 million debt repayment based on a 15-year pay down and \$16.6 million transfer to the Parent. Earnings increase to \$7.3 million (up from \$7.1 million) representing the interest saving from debt retirement. Return on common rises to 11.6%, up from 9.8%. Return on investment rises to 8.4% versus 7.7%.

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Table 2
Theoretical Income Statement
(100 Megawatt Capacity)

Column	(1)	(2)	(3)	(4)
	Year 1		Year 2	Year 3
Income Statement	No Tax Benefits	Accel. Dep. PTC	Accel. Dep. PTC	Accel. Dep. PTC
Revenues	\$-Mil	\$-Mil	\$-Mil	\$-Mil
Megawatt Hour Sales	11.7	11.7	11.7	11.7
Total Revenues	11.7	11.7	11.7	11.7
Operating Expenses				
Production Costs	1.3	1.3	1.3	1.3
Depreciation	4.4	4.4	4.4	4.4
Total Operating Expenses	5.7	5.7	5.7	5.7
Operating Income	5.9	5.9	5.9	5.9
Interest Expense	5.3	5.3	5.3	4.9
Pretax Income	0.7	0.7	0.7	1.0
Taxes @ 35%				
Depreciation Tax Deferral		10.7	10.7	10.7
Tax Credits		(10.5)	(10.5)	(10.3)
Net Taxes before Production Credits	0.2	0.2	0.2	0.4
Production Tax Credits	0.0	(6.7)	(6.7)	(6.7)
Total Taxes	0.2	(6.4)	(6.4)	(6.3)
Net Income	0.5	7.1	7.1	7.3
Cash Generated & Uses				
Net Income	0.5	7.1	7.1	7.3
Tax Deferrals	0.0	10.7	10.7	10.7
Depreciation	4.4	4.4	4.4	4.4
Total Cash After Interest	4.8	22.2	22.2	22.4
Cash Paid to Parent			22.2	16.6
Debt Retirement				5.8
Investment				
Debt	87.5	87.5	87.5	81.7
Equity	87.5	87.5	72.4	63.2
Total	175.0	175.0	159.9	144.8
Profitability Measures				
Return on Common	0.5%	8.1%	9.8%	11.6%
Return on Investment				
Oper. Income after Income Taxes	5.7	12.4	12.4	12.2
Return	3.3%	7.1%	7.7%	8.4%
Cash Flow Coverage Interest				
Cash Plus Interest	10.1	27.5	27.5	27.3
Interest Expense	5.3	5.3	5.3	4.9
Coverage	1.9	5.2	5.2	5.6

Other Risks

Wind profits stem from tax benefits and what Big Brother giveth can be taken away. Operating economies reflect high capital costs and minor operating expenses. Construction delays, such as experienced in proposals to build offshore facilities off Long Island and Cape Cod, could kill projects. Regulatory support for rate base recognition could wane if costs become excessive or other renewable sources such as solar, geothermal, and biomass become more competitive.

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.

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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	20%	0%
Hold	80%	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.



Important Disclosures, continued

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