



Friday, November 16, 2018 | special comment

## Utilities – First Capacity Auction Clears Above All Expectations

### Utilities, Poland

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Poland's first-ever capacity market auction to secure power capacity for 2021 cleared in range of PLN 218,000-240,000/MW/year, prices well above our PLN 167,000 projection, crushing the market's view that the introduction of the capacity market will have no positive impact on the power sector whatsoever. The actual clearing prices also exceeded the Energy Ministry's preliminary amounts announced in August (which you can read about in our special comment at <https://tinyurl.com/yc6trdqa>).

Yesterday's auction is just the first in a series of three, with auctions for 2022 and 2023 capacity coming in December, at which time we will be able to better quantify the future benefits, taking account also POLPX futures quotes. With that said, already at this stage we feel we can say with some confidence that the current valuations of Polish utilities are poised for upward revisions (keep in mind that installations that fail to sell capacity at the three main auctions can reapply for supplementary auctions).

Looking at contracts awarded to rated generators, Energa and PGE both had great success at the auction, but the three companies that stand to be paid the most for their capacity relative to current market capitalizations are Enea, Tauron, and ZE PAK. In addition, the actual final capacities ordered from refurbishing capacity market units (CMU) might end up higher than indicated in yesterday's announcements, which used the low end of the price range offered as the CMUs wait for the grid operator PSE to confirm prices in a public announcement (the cumulative volume of power ordered per yesterday's updates was 19.4 GW vs. 22.7 GW demanded).

The market's reaction to yesterday's auction results was muted by the suspension of the capacity market in the UK after an EU court overturned an earlier decision by the European Commission to authorize the scheme under state aid rules (Reuters has more at <https://tinyurl.com/yct842nd>), however there is nothing to suggest this is in any way relevant to Poland.

- **The Auction:** The November 15 auction for 2021 capacity cleared in the fifth bidding round in the range of PLN 218,560-240,400/MW/year. CMUs supplied around 26 gigawatts for demanded capacity of 22.732 gigawatts, implying a 14% reduction rate. The TSO will confirm the final price after calculating the costs and benefits using its

algorithms. Prices quoted in the auction were net prices, indicating an annual revenue for the sector from the main auction only of PLN 4.97-5.46 billion. Supplementary auctions which will be held in the future will order between 1.1 and 2.9 GW of additional capacity depending on the quarter.

- **The Payoff:** The calculations below take the auction results and compare them with our predictions as given in a May update on the utilities sector (click to read at <https://tinyurl.com/y9kcv973>). Please note that these calculations are provided for reference purposes only, and that they do not include the potential future capacity revenues from supplementary auctions and from secondary trading of the capacity obligations, nor do they factor in potential adjustments under frequency regulation and replacement reserve schemes (aside from the short-term operating reserve mechanism, "STOR"). Note also that our net payment forecasts assume a decrease in the wholesale power price (or, more specifically, the clean-dark spread) by PLN 17/MWh, representing the average expected impact of the STOR mechanism on current POLPX prices. So far, there is not enough liquidity in POLPX contracts for delivery in 2021 to assess this impact with any degree of accuracy (the price difference between 2021 and 2020 contracts is currently about PLN 5/MWh).
- **Energa** secured agreements for a total of 977 MW of available capacity, including 585 MW under a five-year supply contract – a larger volume than we had forecast in May, owing to higher supplies ordered from hydroelectric plants and higher DSR participation. At the Nov. 15 clearing price, the expected 2021 capacity payments are double what we had assumed, and the net payments after adjustment for the expected fall in power price are four times our May estimate, and they are equivalent to 15% of Energa's current market capitalization (using additional revenue valuation at 4x EV/EBITDA).
- **Enea** secured agreements for a total of 3,473 MW, of which 915 MW under 15-year supply contracts, 2,521 MW under 5-year contracts, and only 37 MW under 1-year contracts. These volumes are slightly lower than we had predicted, resulting from a partial re-qualification of installations for secondary trading, supplementary auctions, and the December auctions. At the clearing price, the expected 2021 capacity payments are 2% lower than we had assumed, and the net payments after adjustment for the expected fall in power price are 5% lower, but they are equivalent to 26% of Enea's current market capitalization (using additional revenue valuation at 5% EV/EBITDA).

### Updated 2021 capacity payments forecast based on the bottom end of the Nov. 15 auction clearing price range

May 2018 Forecast*							Updated Forecast						
Available capacity in 2021 (MW)	Capacity payment (PLN m)	Clearing price per MW/year	Power price drop (PLN / MW)	CDS decline	Net EBITDA impact (PLN m)		2021 capacity ordered (MW)	Clearing price/ MW/year	Capacity payment (PLN m)	change	Net EBITDA impact (PLN m)	change	% of Mcap (4xEBITDA)
Enea	4,641	773	167,000	-17	-471	302	3,473	219,000	759	-2%	288	-5%	26%
Energa	617	103	167,000	-17	-75	28	977	219,000	214	108%	139	396%	15%
PGE	11,028	1,837	167,000	-17	-1,389	448	11,651	219,000	2,546	39%	1,158	159%	21%
Tauron	3,784	630	167,000	-17	-326	304	2,672	219,000	584	-7%	258	-15%	29%
ZEPAK	1,091	182	167,000	-17	-102	80	587	219,000	128	-29%	26	-67%	29%

\*The May forecasts were for 2024 capacity, and they included the Ostrołęka C<sup>1</sup> power plant set to be built jointly by Enea and Energa, excluded from 2021 estimates  
Source: estimates by Dom Maklerski mBanku;

- **PGE** secured agreements for a total of 11,652 MW of available capacity, including 1,944 MW under 15-year contracts and 2,698 MW under 5-year contracts – a slightly larger volume than we had forecast in May, owing probably to higher participation from hydroelectric plants and DSR. At the clearing price, the expected 2021 capacity payments are 39% higher than we had assumed, and the net payments after adjustment for the expected fall in power price are 1.6 times our May estimate, and they are equivalent to 21% of PGE's current market capitalization (using additional revenue valuation at 4x EV/EBITDA).
- **Tauron** secured agreements for an estimated total of 2,680 MW of available capacity (based on a capacity revenue estimate published yesterday at <https://tinyurl.com/y9quu77e>), including 770 MW under 15-year contracts and 1,230 MW under 5-year contracts – a lower volume than we had forecast in May, owing probably to BAT conformity issues and the re-qualification of some of the older units to secondary trading and supplementary auctions. At the clearing price, the expected 2021 capacity payments are 7% lower than we had assumed, and the net payments after adjustment for the expected fall in power price are 15% lower, and they are equivalent to 29% of Tauron's current market capitalization (using additional revenue valuation at 4x EV/EBITDA).
- **ZE PAK** secured agreements for 587 MW of available capacity under 1-year contracts – a lower volume than we had forecast in May, owing probably to BAT conformity issues and the re-qualification of some of the older units to secondary trading and supplementary auctions. At the clearing price, the expected 2021 capacity payments are 29% lower than we had assumed, and the net payments after adjustment for the expected fall in power price are 67% lower, and they are equivalent to 29% of ZE PAK's current market capitalization (using additional revenue valuation at 4x EV/EBITDA).
- **Next Auctions:** The next auction to secure power capacity for 2022 is scheduled for December 5th, 2018, followed by an auction for 2023 on December 21st. On the one hand, this time there will be less coming together of different interests (in the first auction as many as three CMUs were bidding for 15-year supply contracts for large coal-fired power stations), which may lead to more aggressive bidding, but on the other hand the capacity demanded in 2022 and 2023 increases by 0.3 GW and 0.56 GW, respectively, while the capacity available from refurbished installations decreases. Based on this, we do not expect much change in the clearing prices.
- **The UK Case:** The decision by an EU General Court overturning an earlier ruling by the European Commission that the UK's capacity market, launched in 2014, complied with the EU state aid rules, calls on the Commission to look further into whether the UK scheme discriminates against clean generators and gives advantage to fossil fuel installations in terms of demand side response (DSR) technologies (allegations to this effect were brought in 2014 by the clean technology company Tempus Energy). **In our view the UK case has no bearing on Poland, where DSR services participate in capacity auctions on an equal footing. Moreover the statutory two-month post-notification appeals period has already passed. Last but not least, the cancellation of contracts awarded to auction participants would probably entail some form of compensation for the participants affected.**

#### List of abbreviations and ratios contained in the report.

**EV** – net debt + market value (EV – economic value)  
**EBIT** – Earnings Before Interest and Taxes  
**EBITDA** – EBIT + Depreciation and Amortisation  
**PBA** – Profit on Banking Activity  
**P/CE** – price to earnings with amortisation  
**MC/S** – market capitalisation to sales  
**EBIT/ EV** – operating profit to economic value  
**P/E** – (Price/Earnings) – price divided by annual net profit per share  
**ROE** – (Return on Equity) – annual net profit divided by average equity  
**P/BV** – (Price/Book Value) – price divided by book value per share  
**Net debt** – credits + debt papers + interest bearing loans – cash and cash equivalents  
**EBITDA margin** – EBITDA/Sales

**OVERWEIGHT (OW)** – a rating which indicates that we expect a stock to outperform the broad market  
**NEUTRAL (N)** – a rating which indicates that we expect the stock to perform in line with the broad market  
**UNDERWEIGHT (UW)** – a rating which indicates that we expect the stock to underperform the broad market

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**Discounted Dividends (DDM)** – discounting of future dividends; the weak point is high sensitivity to changes in the assumptions as to future dividends made in the valuation model.

**NAV** – valuation based on equity value, one of the most frequently used method in case of developing companies; the weak point of the method is that it does not factor in future changes in revenue/profits of a company.

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