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UPDATE: With prices improving, fewer consequences for AES to retain DPL assets

By Dan Testa

Less than four months after disclosing plans to sell roughly 3.5 GW of generating capacity in Ohio under its DPL Inc. subsidiary, AES Corp. on July 14 said it has decided to retain the plants.

In a news release, AES cited the potential recovery of power prices, as well as capacity prices in PJM Interconnection LLC, as the justification for hanging onto and continuing to run the generating assets. Of the 3,453 MW of DPL assets, 2,897 MW of capacity owned by Dayton Power and Light Co. will be transferred to a separate affiliate as part of Ohio's transition to a competitive market.

Morgan Stanley analyst Stephen Byrd attributed the decision to AES' apparent inability to get the prices for the asset the company was seeking. "Based on our conversation with the company, it appears that bids were not sufficient and did not incorporate robust forwards for energy/capacity or the optionality around any Ohio subsidies (including longer-term contracts and/or re-regulation)," Byrd wrote in a July 14 note.

AES announced that it was retaining the DPL assets in pre-trading hours and saw its shares trade lower throughout the day, finishing down 1.43% at $15.19 on above-average trading volume.

During its first-quarter earnings call May 8, members of AES management said they were in the second round of discussions with potential buyers. Morgan Stanley expressed surprise the sale did not occur, given how strong power prices and capital markets have been recently. The average clearing price to come out of PJM's most recent Reliability Pricing Model auction, released May 23, was $120 per MW-day. That result more than doubled the price cleared in the prior-year auction.

Because the DPL assets are no longer a drag on earnings, the lack of sale does not prompt any major changes in Byrd's view of the earnings or valuation prospects for AES. He estimated roughly breakeven results at DPL generation from 2015 through 2017. Keeping the DPL assets is a disadvantage for AES, according to Morgan Stanley, in the sense that the company was making good progress divesting noncore assets and simplifying its overall business model. Selling the DPL assets was a key part of that strategy.

In moving to sell the DPL assets, AES was in good company as a number of large, diversified utilities took steps in recent months to decrease their exposure to merchant volatility, from PPL Corp.'s plans to spin off its competitive PPL Energy Supply LLC business and merge it with assets from Riverstone Holdings LLC as a stand-alone independent power producer, to Exelon Corp.'s plans to acquire Pepco Holdings Inc., thus increasing its regulated earnings power.

Morgan Stanley, however, sees the news of AES holding onto the assets as more negative for its peers. "This is due to the view that a more robust price should have been received for the assets given elevated forward energy prices, dramatically improved capacity results, access to cheap debt capital, and a relatively scrubbed coal fleet," Byrd wrote. But the AES decision does support Morgan Stanley's more bearish view on power prices in PJM and what is described as the "relative unattractiveness" of baseload coal and nuclear in the region, with more value in peaking and intermediate gas generation.

AES said it would provide more details on the decision during its second-quarter earnings conference call, scheduled for Aug. 7.