**The Clean Power Plan is likely to increase ITC's long-term investment opportunities.**



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**Analyst Note**

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by Charles Fishman, 04/06/2015

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**Analyst Note** 04/06/2015

We are reaffirming our fair value estimate of $39 per share after the Federal Energy Regulatory Commission ruled to reduce ITC Midwest LLC’s ROE incentive adder for independent transmission ownership (Transco Adder) to 50 basis points from 100 basis points. ITC’s wide moat and stable moat trend rating are unchanged.

On March 31, FERC issued an order reducing the Transco Adder in a split decision, with two of the five commissioners issuing a dissenting opinion. ITC Midwest’s allowed ROE is currently 12.38% and includes a 100-basis-point Transco Adder and a 50-basis-point adder for being a member of the Midwest Independent System Operator, or MISO. The MISO base rate is currently under FERC review in another proceeding that is not expected to be decided until the middle of 2016. Following the pending base rate decision, ITC Midwest’s total allowed ROE will be required to be within a zone of reasonableness determined by an updated discounted cash flow analysis. We note that the upper end of the zone of reasonableness in the June 2014 ISO New England decision was 11.74% and we expect ITC Midwest’s total allowed ROE to decline to near this level from the current allowed ROE of 12.38%. The FERC order is consistent with our assumption of a 100-basis-point decline in average allowed ROE across ITC’s entire system between 2014 and 2018.

Commissioners Phillip Moeller and Tony Clark issued a dissenting opinion and stated that the decision sends the wrong message at the wrong time due to the needed for more transmission investment. The two commissioners pointed to the need for more transmission investment due to new regulation such as the EPA’s Clean Power Plan. We reiterate our opinion that the CPP will likely drive additional transmission investment.

**Investment Thesis** 02/23/2015

ITC's wide moat and the Federal Energy Regulatory Commission's desire to improve the U.S. electricity transmission grid (by providing incentive rates to independent transmission companies) have produced healthy returns on capital and strong earnings growth for ITC since its IPO in 2005.

ITC's rates are based on allowed returns on equity that are relatively high compared with state-allowed returns for most other utilities. However, ITC's average allowed returns will probably decline during the next five years. We believe the continued low interest rate environment and FERC's new methodology for calculating allowed ROE in the June 2014 ISO New England decision increase the downward pressure on transmission investment allowed ROE. Despite this pressure on allowed returns, we still expect ITC's increasing capital expenditures to drive approximately 10.5% average annual earnings growth and 13% annual dividend increases during the next five years.

FERC stated in the ISO New England decision that transmission ROEs should be greater than state commission ROEs for generation and distribution investments in order to increase investment levels and attract low-cost capital. Public policy to increase grid reliability, enhance wholesale market competition, and facilitate transmission of wind and other renewable generation to customers drives this support. We believe these trends combined with FERC policy are likely to continue for the foreseeable future, keeping ITC's wide moat intact and providing returns well above the company's cost of capital.

FERC's formula-based rate mechanism is more transparent and regulatory decisions are less influenced by politics than state utility commissions. This favorable regulatory framework covers 100% of ITC's revenue and provides predictable earnings and cash flow. We believe the reduced risk associated with FERC regulation results in a lower average cost of capital than the typical utility.

**Economic Moat** 02/23/2015

We believe ITC's efficient scale competitive advantage gives it a wide moat. Competitors have little incentive to build competing transmission lines if one that ITC owns already is serving a market's full capacity. Capital costs for new transmission lines are too high and incremental benefits too low to offer sufficient returns on invested capital for two competing transmission owners. In addition, ITC benefits from regulatory protection. FERC approves new transmission lines only if there is a demonstrated need for new capacity.

In exchange for regulatory protection, ITC must charge rates based on a formula that allows ITC to recover its expenses and earn a return on investment. The formula rate mechanism considers forecast expenses, investment base, revenue and network load each year then adjusts annually to true-up ITC's returns. This rate treatment is more investor-friendly than typical backward-looking rates that require a utility to invest the capital before collecting a return on that capital. We believe the transparency and predictability of the formula-rate mechanism results in a below-average cost of capital for ITC and supports stable cash returns.

The economic benefits of transmission investment in the United States have led FERC to offer higher returns for independent transmission companies, like ITC, than for integrated utilities. FERC has two primary objectives: First, to improve grid reliability that was shown to be inadequate during the 2003 blackout that stretched from Ohio to New York City. Second, FERC wants wholesale power markets to be more competitive by providing increased access to different generation sources over a larger geographical area. FERC also must support energy policy initiatives such as reducing greenhouse gas emissions and optimizing advancements in technology, like horizontal drilling and fracking, that have driven down the price of natural gas and made natural gas-fired generation competitive with coal-fired and nuclear plants.

Apart from regulatory considerations, ITC's transmission assets offer two economic benefits that should allow it to continue earning economic returns. First, ITC's lines can arbitrage rate differences from one region with excess low-cost power to a constrained region with high energy costs. As long as customer costs for the transmission investment are lower than the energy cost savings, regulators should use incentives to encourage development. Second, transmission is the only way to support state and federal renewable energy policy. If costs to produce renewable energy locally are higher than the cost for transmission and renewable energy in another region, regulators can offer incentive returns to encourage transmission development.

ITC's first development project, the 13-mile 230-kilovolt Jewell-Spokane transmission connection in southeastern Michigan, is an example of the customer cost savings. Total project costs were about $8 million and the line has improved reliability and saved electricity customers roughly $60 million per year since 2004. The extra cost of ITC's FERC-allowed 13.88% ROE compared with the 10% ROE for the state-regulated utility is about $300,000 per year, a fraction of the annual customer savings that has been realized.

ITC's competitive advantages and the favorable FERC regulation have allowed ITC to earn well above its cost of capital since the company became public in 2005.

[**Valuation**](http://quicktake.morningstar.com/StockNet/StockValuation.aspx?Country=USA&Symbol=ITC&culture=en-US) 02/23/2015

We have increased our fair value estimate for ITC Holdings to $39 per share from $37 per share. The increase is driven by increased confidence that investment opportunities will be available for the foreseeable future. To reflect this increased confidence, we have increased the earnings before interest annual growth rate during Stage II (beginning in 2019) of our discounted cash flow model to 8% from 7%. Management has recently made upbeat comments on potential development projects in the Southwest Power Pool and the Lake Erie Connector. In addition, we believe the EPA's proposed Clean Power Plan will increase transmission investment across the country, but especially in MISO. The region relies on coal-fired generation and a significant portion would retire and be replaced by natural gas combustion turbines and wind farms. The change in generation mix will drive transmission investment. The Lake Eire Connector or projects associated with the Clean Power Plan will likely not contribute to earnings until beyond 2018. We expect earnings growth to drop to about 10% annually during the next five years as ITC grows larger, incremental projects come in with lower allowed ROEs, and rate base growth slows. Still, this growth rate will probably continue to beat peers. Our fair value estimate implies a 18.7 times multiple on our 2015 EPS estimate, approximately 10% higher than the implied earnings multiple for our U.S. utilities sector coverage. We believe this premium is justified because of ITC's industry-leading growth prospects and returns on capital. We have recalibrated our capital cost assumptions to better align with the returns equity and debt investors are likely to demand over the long run. We now assume a 7.5% cost of equity, down from 8%. This is lower than the 9% rate of return we expect investors will demand of a diversified equity portfolio. Our pre-tax cost of debt assumption rises to 5.8% from 4.8% as we incorporate a normalized long-term real rate environment and normalized credit spreads. A 2.25% long-term inflation outlook underpins our capital cost assumptions. However, the two changes offset and there was no change in our 6.1% cost of capital.

**Risk** 02/23/2015

In our opinion, FERC’s formula rate-setting methodology is the most stable and least subject to political influence of any utility regulation in the United States. Therefore, we believe there is little risk of adverse regulatory decisions that would affect cash flows, earnings, or returns. However, there is risk that FERC may lower allowed ROEs for transmission investment. That said, we think the risk that FERC-allowed returns would fall below the average 10% state-level utilities returns is small.

We believe the most significant risk for ITC is an acquisition that is too expensive or requires a rate freeze that materially hurts earnings. That said, management has been disciplined in past acquisitions. It has agreed to returns below that which FERC has allowed, but higher than typically allowed by state regulators.

**Management** 02/23/2015

We assign ITC's management team an Exemplary stewardship rating due to management's vision and execution of strategy. ITC's management team provided a clear explanation of strategy at its IPO in 2005 and then executed this strategy. The IPO was an unqualified success and the acquisitions of METC and ITC Midwest proved to be good use of shareholder capital. In addition, management has completed development projects on budget and on schedule.

Joseph Welch, chairman, president, and CEO, is one of the few entrepreneurs who also has shown excellent financial management and shareholder stewardship. Since joining Detroit Edison, a subsidiary of DTE Energy, in 1971, Welch has spent his entire career in the utilities industry. He founded ITC and has served as its first and only president and CEO since it began operations in 2003. He has served as chairman of ITC's board of directors since 2008.

In recent years, Welch's total compensation has ranged between $8 million and $11 million. About 65% of compensation for senior management is incentive-based. Total shareholder return has exceeded 300% since the company’s IPO, so we believe Welch's compensation and that of other senior managers is appropriate.

**Overview**

Profile:

ITC Holdings Corp. is the U.S.’ only publicly traded pure-play independent electric transmission company. ITC began operations in 2003 with the acquisition of DTE Energy’s transmission system in Michigan. The company conducted an IPO in 2005. ITC has been one of the fastest-growing utilities during the last decade and now has more than 15,600 miles of high-voltage transmission lines and supporting facilities in seven U.S. states. The company owns no generation, but transmits over 26,000 megawatts of peak load on its transmission systems.