We're most focused on PJM because a large number of merchant plants operate in the region. Specifically, we look for operators of unregulated capacity in PJM's regional transmission organization (RTO) to potentially announce additional asset retirements given the substantial decline in capacity prices in June to $16 per MW-day from $110 per MW-day (see table 3). In addition to Casper and MATS, New Jersey's high energy demand day environmental regulations, effective in 2015, would likely see retirements of about 14 GW in PJM alone through 2021 of older coal units that are unscrubbed, are under 500 MW, and have capacity factors of about 30%.

Table 3

Historic Capacity Prices In PJM Zones

($/megawatt-day)

PJM zones	2009/2010	2010/2011	2011/2012	2012/2013	2013/2014	2014/2015
Auction year	2006	2007	2008	2009	2010	2011
Eastern Mid-Atlantic Area Council	191.32	174.29	110.00	139.73	245.00	136.50
Mid-Atlantic Area Council	191.32	174.29	110.00	133.37	226.15	136.50
Southwest Mid-Atlantic Area Council	237.33	174.29	110.00	133.37	226.15	136.50
Rest of pool	102.04	174.29	110.00	16.46	27.73	126.00
Delmarva Power & Light South	N/A	186.12	110.00	222.30	245.00	136.50
Public Service Electric & Gas	N/A	N/A	N/A	139.73	245.00	136.50
Public Service Electric & Gas North Zone	N/A	N/A	N/A	185.00	245.00	225.00
Potomac Electric Power	N/A	N/A	N/A	N/A	247.14	136.50

N/A--Not applicable. Source: PJM Interconnect Website.

While we still expect price convergence for all capacity zones in the PJM, the incremental 13 GW of deactivation requests could result in a structural shift in RTO capacity prices because it decreases the amount of installed capacity and may also decrease capacity transfers into zones (as is evident in American Transmission Systems Inc. (ATSI) zone. The PJM's latest capacity auction parameter filings suggest transmission constraints are developing across ATSI's region likely due to recent plant retirements. Based on the capacity emergency transfer limit to capacity emergency transfer objective calculations the ATSI zone will likely price high in the 2015/2016 auction.

However, the most significant factor in these auctions is the degree to which EPA-driven retirements or environmental cost amortizations will change the supply curve. Also, a complicating issue is that a generator's deactivation request is reversible. If a generator submits a deactivation request, it does not have to withdraw from the capacity auction; the generator can still submit a sell offer if it decides not to retire. Consequently, there is some uncertainty surrounding eventual retirements. Notwithstanding these shorter-term developments, we believe that prices of all zones will likely converge, after EPA-driven retirements phase concludes, due primarily to transmission upgrades

From a credit perspective, capacity prices have been priced in through our outlook period in the PJM. We assume floor pricing in New England.

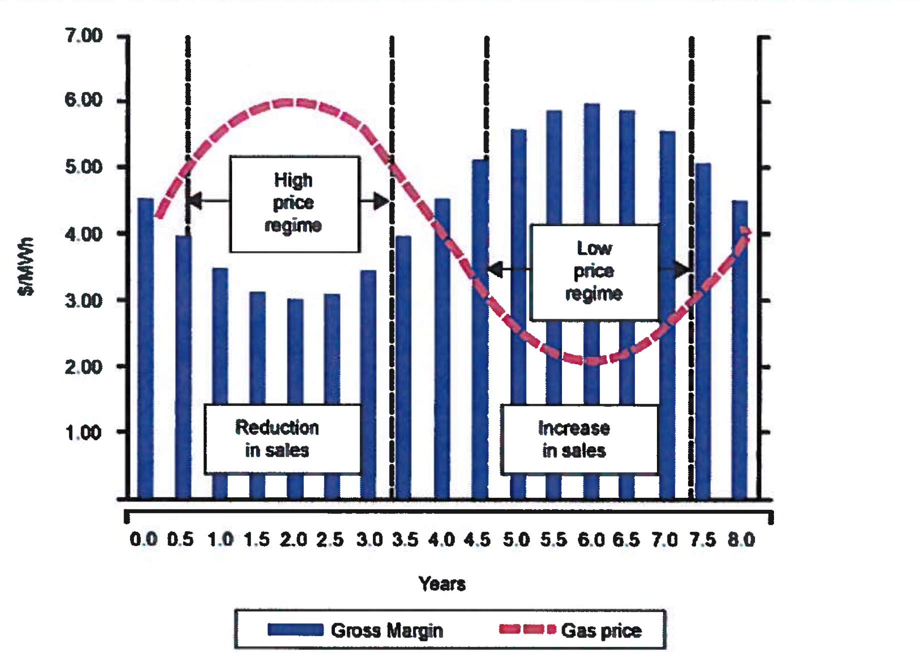
Do you view retail power business as supporting credit?

From a credit standpoint, we view an "asset-lite" retail power business as risky. We view load-following retail power contracts as risky because such contracts can result in large liquidity requirements should prices move adversely from the prices contracted. Furthermore, these contracts expose margins to market risks, including load-shaping, fuel, and volume risks.

However, for merchant generators, retail generally provides some offset to wholesale prices, and merchant generators have increasingly mitigated the impact of declining wholesale prices by expanding their retail business. From a credit perspective, capital charges--including the cost of working capital, credit facilities, contingent collateral, as well as the cost of equity required to cover risk capital requirements--increase roughly in proportion to commodity prices. At high power price levels, capital charges are also high and cut into gross margins. Yet customers are less inclined to lock in prices at these levels. As a result, at elevated prices we expect fixed-price sales to fall, reducing total capital requirements and lifting average margins on existing retail volumes. At low power prices, capital charges decline. While customer migration ensues, gross margins for retail volumes rise due to increasing headroom between locked-in retail prices and wholesale prices. Thus, although the generation business's profitability declines when prices are low, the retail business's profitability improves, and vice versa (see chart 8).

Chart 8

Gross Margin Per Megawatt



Source: Standard & Poor's.

Given the significant volatility of capacity markets, retail operations can mitigate wholesale power risk by blending capacity prices in retail products that bring forward the capacity price uplift in later years. For instance, in the Duke Energy auction in Ohio, FirstEnergy Solutions bid largely into the three-year contracts that cleared substantially higher prices than one-year contracts (see table 4).

Table 4

<table>
<tr><th colspan="5">FirstEnergy's Retail Prices In Duke Auction</th></tr>
<tr><th></th><th>2011/2012</th><th>2012/2013</th><th>2013/2014</th><th>2014/2015</th></tr>
<tr><td>Auction year</td><td>2008</td><td>2009</td><td>2010</td><td>2011</td></tr>
<tr><td>Rregional transmission organization capacity price ($ per MW-day)</td><td>110.00</td><td>16.46</td><td>27.73</td><td>126.00</td></tr>
<tr><td>One-year contract ($ per MWh)</td><td></td><td>49.72</td><td></td><td></td></tr>
<tr><td>Two-year contract ($ per MWh)</td><td></td><td colspan="2">51.10</td><td></td></tr>
<tr><td>Three-year contract ($ per MWh)</td><td></td><td colspan="3">57.08</td></tr>
</table>

MW--Megawatt. MWh--Megawatt-hour.

Related Criteria And Research

- What's Driving The U.S. Merchant Power Sector's Credit Outlook For 2012?, Jan. 11, 2012
- U.S. Merchant Power Sector's Near-Term Economic Prospects Overshadow Longer-Term Environmental Upside, Oct. 12, 2011
- Changes Are Coming For U.S. Coal Markets And Coal-Burning Power Generators As New Environmental Rules Loom, Sept. 20, 2011
- Why Casper, The EPA's Cross-State Air Pollution Rule, Is Spooking the Electricity Sector, Sept. 12, 2011

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Summary:

Exelon Corp.

Credit Rating: BBB/Stable/A-2

Rationale

Standard & Poor's Ratings Services' 'BBB' corporate credit ratings on diversified energy company, Exelon Corp, reflects its consolidated business risk profile, which we view as "strong." Exelon's business risk profile reflects the higher-risk operations of unregulated supply affiliate Exelon Generation Co. LLC (ExGen), which has increased in size to subsume Constellation's unregulated business. Exelon's business risk also reflects the excellent business risk profiles of regulated delivery businesses, Commonwealth Edison (ComEd), PECO Energy (PECO), and Baltimore Gas & Electric Co. (BGE), which have generally predictable transmission and distribution cash flows. Because of ring-fencing, we will continue to deconsolidate BGE and analyze it as an equity investment, counting only distributions to the parent as primary contributions to the parent's credit quality and financial profile.

As of June 30, 2012, Exelon had about $18.4 billion of on-balance-sheet debt. We also impute about $4.6 billion of off-balance-sheet debt on the books for computing financial ratios, pertaining mostly to unfunded pension and other postemployment benefit obligations and power-purchase agreements.

Postmerger, Exelon is now the nation's second-largest regulated distributor of electricity and gas, with 5.4 million customers in Illinois and Pennsylvania and 1.2 million customers in Maryland. Exelon also distributes natural gas to 490,000 customers in the Philadelphia metropolitan area through PECO and 650,000 customers in Maryland. ExGen engages in unregulated energy generation, wholesale power marketing, and energy delivery. The company has long-term exposure to market risk and meaningful exposure to nuclear assets (17,000 megawatts [MW] across 19 units). The company now has about 35,000 MW and 450 billion cubic feet (bcf) (2012 estimates) of natural gas business. The company has recently divested about 2,648 MW of generation to address market power concerns.

Exelon derives a larger proportion of earnings from its regulated and retail operations. Through retail and wholesale channels, ExGen now provides about 170 terawatt-hours (TWhrs), or approximately 5%, of total U.S. power demand. We expect the switched markets in Pennsylvania, Ohio, Michigan, and Arizona to grow at about 10% in the commercial and industrial class and at about 15% in the residential class between 2011 and 2014. The fleet is well positioned to grow where capacity available for competitive supply has room to grow. We expect these incremental revenue streams to make the consolidated Exelon somewhat more resilient to commodity prices. The combination provides ExGen regional diversification of the generation fleet and a customer-facing load business, as generation and load positions are now better balanced across multiple regions. In most locations, ExGen will have adequate intermediate and peaking capacity within the portfolio for managing load shaping (matching resources with energy needs) risks. However, the company will still need to buy and sell length in the market to manage portfolio needs, in our opinion. Moreover, ExGen has a significant open position in the mid-west (exposed to merchant market), and a somewhat tight position in ERCOT and New England, where it has some risk of finding itself short when loads are high, in our opinion.

Supply subsidiary, ExGen's cash flow is sensitive to commodity prices as almost 95% of its premerger generation is nuclear, all of which sliding gas prices are impairing. ExGen's unregulated operations accounted for about 65% of the consolidated enterprise by cash flow and capital spending in 2011. Given that base-load generation is price-taking--it doesn't affect the market price--we expect ExGen's adjusted funds from operations (FFO) to debt to remain volatile--relative to its peers--and we expect it to swing in a band of over 40% in 2011 to about 27% by 2014. For instance, all else remaining equal, we estimate gross margins in 2014 will be lower by about $500 million for every $5 per MW-hour (round-the-clock) decline in power prices, about $215 million for every $0.5 per million cubic feet (Mcf) decline in gas prices, and about $110 million for every $1 per MWh decline in retail margins.

As a result, ExGen's contribution to the overall Exelon cash flow declines to about 55% under our base case, because of the decline in unregulated cash flow when commodity prices fall. However, despite the lower power prices, we view the business risk profile of parent Exelon as strong. We expect financial measures to decline over the next 2-years and the corporate credit ratings reflect our expectation that 2014 will be the trough year. Based on the present forward curve, cash flow measures are still adequate for the rated level in that year. However, as a result of the declining gross margin in forward years, we view Exelon's cash flow adequacy ratio as more akin to the "significant" financial risk profile than the erstwhile "intermediate" one.

We view ExGen's ratable hedging strategy favorably, as it ensures that a high percentage of the company's near-term generation is locked in. Hedging not only protects unregulated generation cash flows from steep price declines, it also provides the company time to adjust its cost structure or its capital structure, should prices remain depressed. However, hedging activities insulate, but do not isolate, power merchants from commodity price effects. Current hedges show the significant value of Exelon's hedging program. Even though these hedges insulate ExGen, perversely, they also show the sensitivity of ExGen's margins to the prospect of a continued shale production onslaught. The decline in mark-to-market value through 2014 shows the limit to which Exelon can hedge--a price-taking fleet can hedge, but only at the prices the market will bear. Also, the gross margin contribution at ExGen will face a decline as higher-priced hedges expire, evident in the drop in wholesale hedged gross margins. Still, the forwards show a contango as reflected in the increase in ExGen's open EBITDA from higher natural gas forwards. Additionally, we believe retail contributions will increase, given the potential for cost savings, volumes gained from the constellation merger, and recent acquisitions (StarTex and MX Energy Holdings).

We view parent Exelon's financial policy and internal funding as "aggressive." The current level of dividends, at about $1.8 billion, results in a dividend payout of about 80%, according to our estimates--meaningfully higher than the 50% to 65% range for peers. Moreover, Exelon's capital spending requirements are significant between 2012 and 2014, at about $18.5 billion. Although utility capital spending tends to be funded in regulated rates (i.e under yjr rate base),unregulated generation will have to fund its own capital requirements and recover them in market prices. However, cash flow from operations will be insufficient for capital spending and dividends, resulting in external needs of financing. We estimate that the funding gap would be greatest in 2014 because of a trough in earnings even as ExGen's requirement to contribute towards Exelon's dividend commitments are the highest internal financing needs of the utilities. This funding gap could widen if the company fails to achieve merger driven O&M savings in its forecast.

We estimate Exelon's incremental long-term financing needs at an average of about $1.4 billion to $1.5 billion in 2014 and 2015. Still, incrementally lower gas prices, combined with higher than anticipated O&M costs, would hurt ExGen's debt protection measures more than the level of new debt financing in ExGen's forecast through 2015.

Under our consolidated base case (we assume lower gas prices and market heat rates that result in power prices roughly 10% lower than the current forward contracts), we expect FFO to total debt of the pro forma company (i.e., Exelon and Constellation combined) to decline to about 25% in 2012 and then to hover at 22% to 23.5% through 2015. We expect free operating cash flow to debt to remain marginally positive even in 2013 and 2014 when we expect financial measures to trough. However, we expect discretionary cash flow (after dividends) to turn significantly negative--in a range between $1.1 and $1.7 billion through the period--mostly because of high capital spending. Similarly, we expect total debt to total capital to be about 57% and debt to EBITDA to hover at about 4.0x. These ratios are still consistent with Standard & Poor's 'BBB' rating guideposts for a financial risk profile we assess as "significant," especially since a meaningful amount of capital expenditure is discretionary. The company's recent decision to defer the LaSalle extended power uprate (EPU) by two years demonstrates flexibility to adjust the program as needed based on market conditions. We estimate that deferring the project by two years will free-up about $400 million through 2014.

Liquidity

The short-term rating on Exelon and affiliates is 'A-2'. Standard & Poor's views the liquidity across the Exelon group of companies as "strong," in light of the debt maturities we expect and available credit facilities. We estimate that sources of cash will exceed the companies' uses by about 2x during the next 12 to 24 months. We expect sources over uses for Exelon and ExGen to remain positive even if EBITDA declines by 50%. In addition, because of Exelon's solid relationships with banks and high conversion of FFO to discretionary cash flow, we believe the company can absorb low-probability, high-impact shocks.

Exelon has sufficient alternative sources of liquidity to cover current liquidity needs, including ongoing capital requirements, moderate capital spending, and upcoming debt maturities. Ironically, a declining power price environment is favorable from a liquidity perspective as cash is being posted to ExGen on its forward hedges. The next large maturities are in 2015 for Exelon and 2014 for ExGen.

In March 2010, ComEd replaced its $952 million credit facility with a three-year, $1 billion unsecured revolving credit facility that expires March 25, 2013. On March 10, 2012, the capacity under Constellation's revolving facility fell to $1.5 billion from $2.5 billion, reducing aggregate bank commitments to $3.2 billion. All facilities reside at the parent level. In addition, Exelon is working through the migration of letters of credit and has a liquidity reduction plan in place that it will finalize toward the end of 2012.

As of July 27, 2012, Exelon, ExGen, ComEd, PECO, and BGE had credit facilities of $2.84 billion, $5.6 billion, $1.0 billion, $0.6 billion, and $0.6 billion, respectively. These facilities expire between September 2013 and March 2017. Availability under these facilities was $2,319 million and $3,807 million respectively for Exelon and ExGen, respectively, and $999 million, $599 million and $564 million for ComEd, PECO, and BGE, respectively. Excluding commercial paper outstanding, the aggregate availability was $7.86 billion.

Outlook

The outlook on the ratings is stable. That said, we believe that higher natural gas production from shale plays and a delay in environment rules related to plant retirements can significantly hurt the company's financial performance. We believe these headwinds have increased and Exelon faces a potential earnings decline in 2014. Should the prevailing commodity environment persist, the company may have to address its declining earnings profile by reducing capital spending. We expect Exelon and ExGen to maintain consolidated FFO to debt in the 22% to 23% and 25% to 27% ranges, respectively, in 2014 to maintain current ratings. We will specifically monitor the expected negative discretionary cash position that results from Exelon's large dividend commitment. A positive outlook--currently not under consideration--can result if natural gas prices stabilize and power prices respond favorably to coal-plant retirements, resulting in an improvement in consolidated FFO to debt levels of over 27%.

Related Criteria And Research

- Liquidity Descriptors For Global Corporate Issuers, Sept. 28, 2011
- Business Risk/Financial Risk Matrix Expanded, May 27, 2009
- 2008 Corporate Criteria: Analytical Methodology, April 15, 2008

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Summary:

Commonwealth Edison Co.

Credit Rating:	BBB/Stable/A-2

Rationale

Standard & Poor's Ratings Services' ratings on Commonwealth Edison Co. (ComEd) reflect the consolidated credit profile of Chicago-based parent Exelon Corp. Exelon's other considerable subsidiaries include regulated PECO Energy Co., unregulated Exelon Generation Co. LLC, and the recently merged assets of the former Constellation Energy Group Inc., including rate-regulated Baltimore Gas & Electric Co. In general, our ratings on ComEd are limited to the lower of our consolidated rating on Exelon or ComEd's stand-alone credit quality. The ratings also reflect ComEd's "excellent" business risk profile and Exelon's "significant" financial risk profile under our criteria.

ComEd's excellent business risk profile reflects its monopolistic, rate-regulated utility transmission and distribution businesses that provide an essential service. ComEd serves about 3.8 million electricity customers in the City of Chicago and the surrounding area. The company's distribution rates are regulated by the Illinois Commerce Commission and the transmission rates, which make up about 23% of the company's rate base, are regulated by the Federal Energy Regulatory Commission. Additionally, we view the distribution and transmission businesses as lower risk than the generation businesses that often included in many fully integrated electric utilities.

ComEd took the initiative in engaging state legislators and regulators to effect reform in the utility regulatory process. As a result, at year-end 2011, the Illinois governor signed into law House Bill 3036 that will allow for a formula process for determining rates, including the recovery of actual costs and a formula for calculating return on equity (ROE). While we initially viewed these developments as potentially enhancing ComEd's credit quality, we think the outcome of ComEd's first rate filing under the new law suggests that the company's management of regulatory risk could remain challenging. In that case, the commission ordered that ComEd reduce rates by more than $165 million, which is more than $100 million lower than ComEd's initial rate case filing. The company requested a rehearing on certain issues of the order and expects a rehearing order by November 2012. ComEd has since filed a second rate case under the new law, requesting a $106 million rate increase and the staff has recommended a $37 million rate increase. We expect that the company will continue to file annual distribution formula rate cases through this streamlined process.

Our corporate credit rating on ComEd incorporates its affiliation with Exelon's competitive energy businesses. The competitive energy businesses' strong business risk profile reflects their ultimate dependence on the market price for electricity, which has recently sharply declined. Although management continues to proactively manage those areas that it can directly influence--including capital spending, operations and maintenance (O&M) costs, and maintaining its hedging strategy--sustained weak power prices will hurt the competitive businesses' cash flow over the intermediate term. Furthermore, prolonged weakness of the power markets, particularly the flattening of the forward curve, could potentially reduce the value of the company's hedging strategy to protect it from weak power prices. Although the company's hedging strategy provides a degree of price insulation over the short term, sustained depressed power prices could eventually undermine this credit enhancement.

The significant financial risk profile reflects Exelon's consolidated financial measures under our base-case scenario that for 2013-2015 funds from operations (FFO) to debt will approximate 22% to 24%. Key assumptions under our base case include lower gas prices and market heat rates that result in power prices that are about 10% lower than the current forward contracts. For the 12 months ended June 2012, adjusted FFO to debt decreased to 28.9% from 34.25% at year-end 2011, and adjusted debt to EBITDA and adjusted debt to total capital weakened to 4.5x and 52.7%, respectively, compared with 2.9x and 55.7% at year-end 2011.

We expect that Exelon's historically positive discretionary cash flow will turn negative, primarily reflecting high capital spending of about $18.5 billion for 2012–2014 and annual dividends about $18.5 billion. We expect that Exelon will meet these cash shortfalls in a manner that is at least credit-neutral. As such under our base-case scenario we expect total debt to total capital to be about 57% and debt to EBITDA to approximate 4.0x.

Liquidity

Our short-term rating on Exelon and ComEd is 'A-2'. We view Exelon's consolidated liquidity as strong and Exelon can more than cover its cash needs for the next two years, even if FFO declines.

Our liquidity assessment is based on the following factors and assumptions:

- We expect Exelon's consolidated liquidity sources (including cash, FFO, and credit facility availability) to exceed its uses by about 1.8x over the next 12 months.
- Debt maturities are material with about $1 billion maturing in 2013 and approximately $1.5 billion maturing in 2014.
- Even if EBITDA declines by 30%, we believe net sources will be well in excess of liquidity requirements.
- The company can absorb high-impact, low-probability events with limited need for refinancing, has the flexibility to lower capital spending, has sound bank relationships and solid standing in the credit markets, and has generally prudent risk management.

In our analysis, we assumed liquidity sources of about $12.5 billion over the next 12 months. We estimate the company will use about $7 billion over the same period for capital spending, debt maturities, working capital needs, and shareholder dividends.

As of July 27, 2012, Exelon, ExGen, ComEd, PECO, and BGE had credit facilities of $2.84 billion, $5.6 billion, $1.0 billion, $0.6 billion, and $0.6 billion, respectively. Availability under these facilities was $2,319 million and $3,807 million for Exelon and ExGen, respectively, and $999 million, $599 million, and $564 million for ComEd, PECO, and BGE, respectively. Excluding commercial paper outstanding, the aggregate availability was $7.86 billion.

ComEd's $1 billion revolving credit facility that expires in March 2017 has a financial covenant requiring that ComEd must maintain cash from operations to interest expense of at least 2x. As of June 30, 2012, ComEd had adequate cushion with respect to this financial covenant.

Recovery analysis

We assign recovery ratings to first-mortgage bonds (FMBs) issued by investment-grade U.S. utilities, which can result in the notching of issue ratings above a corporate credit rating on a utility, depending on the category and the extent of the collateral coverage. We base the investment-grade FMB recovery methodology on the ample historical record of nearly 100% recovery for secured bondholders in utility bankruptcies, and on our view that the factors that supported those recoveries (limited size of the creditor class, and the durable value of utility rate-based assets during and after a reorganization, given the essential service provided and the high replacement cost) will persist. Under our notching criteria, when assigning issue ratings to utility FMBs, we consider the limitations of FMB issuance under the utility's indenture relative to the value of the collateral pledged to bondholders, management's stated intentions on future FMB issuance, as well as the regulatory limitations on bond issuance. FMB ratings can exceed a corporate credit rating on a utility by up to one notch in the 'A' category, two notches in the 'BBB' category, and three notches in speculative-grade categories.

ComEd's FMBs benefit from a first-priority lien on substantially all of the utility's real property, owned or subsequently acquired. Collateral coverage of 1.5x supports a recovery rating of '1+' and an issue rating two notches above the corporate credit rating.

Outlook

The stable outlook reflects Standard & Poor's baseline forecast that parent Exelon's consolidated FFO to debt will approximate 22% to 24% over the next three years. We could lower our rating on ComEd if Exelon's consolidated financial measures weaken so that FFO to debt is consistently below 22%. This could occur if electricity prices remain weak and economic growth is minimal. Because our corporate credit rating on ComEd is limited to the lower of its stand-alone credit quality or our corporate credit rating on its parent, for us to raise our rating on ComEd, we would first have to upgrade Exelon, and ComEd's stand-alone credit quality would have to reflect the higher rating. Although we view a ratings upgrade as less likely, this could occur if Exelon's consolidated FFO to debt is consistently greater than 27%.

Related Criteria And Research

- Business Risk/Financial Risk Matrix Expanded, Sept. 18, 2012
- Liquidity Descriptors For Global Corporate Issuers, Sept. 28, 2011
- Analytical Methodology, April 15, 2008
- Changes To Collateral Coverage Requirements For '1+' Recovery Ratings On U.S. Utility First Mortgage Bonds, Sept. 6, 2007

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Exelon Corp.

Major Rating Factors

Corporate Credit Rating
BBB/Stable/A-2

Strengths:

- Low-cost base-load generation,
- Strong operating track record, and
- Ample available liquidity.

Weaknesses:

- Exposure to market prices of a price-taking fleet,
- Backdated EBITDA profile and potential for a significant decline in cash flow, and
- Aggressive financial policies.

Rationale

Standard & Poor's Ratings Services' 'BBB' corporate credit ratings on diversified energy company, Exelon Corp, reflects its consolidated business risk profile, which we view as "strong." Exelon's business risk profile reflects the higher-risk operations of unregulated supply affiliate Exelon Generation Co. LLC (ExGen), which has increased in size to subsume Constellation's unregulated business. Exelon's business risk also reflects the excellent business risk profiles of regulated delivery businesses, Commonwealth Edison (ComEd), PECO Energy (PECO), and Baltimore Gas & Electric Co. (BGE), which have generally predictable transmission and distribution cash flows. Because of ring-fencing, we will continue to deconsolidate BGE and analyze it as an equity investment, counting only distributions to the parent as primary contributions to the parent's credit quality and financial profile.

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Postmerger, Exelon is now the nation's second-largest regulated distributor of electricity and gas, with 5.4 million customers in Illinois and Pennsylvania and 1.2 million customers in Maryland. Exelon also distributes natural gas to 490,000 customers in the Philadelphia metropolitan area through PECO and 650,000 customers in Maryland. ExGen engages in unregulated energy generation, wholesale power marketing, and energy delivery. The company has long-term exposure to market risk and meaningful exposure to nuclear assets (19,000 megawatts [MW] across 23 units). The company now has about 35,000 MW and 465 billion cubic feet (bcf) (2012 estimates) of natural gas business. The company has recently divested about 2,648 MW of generation to address market power concerns.

Exelon derives a larger proportion of earnings from its regulated and retail operations. Through retail and wholesale channels, ExGen now provides about 170 terawatt-hours, or approximately 5%, of total U.S. power demand. We expect the switched markets in Pennsylvania, Ohio, Michigan, and Arizona to grow at about 10% in the commercial and industrial class and at about 15% in the residential class between 2011 and 2014. The fleet is well positioned to grow where capacity available for competitive supply has room to grow. We expect these incremental revenue streams to make the consolidated Exelon somewhat more resilient to commodity prices. The combination provides ExGen regional diversification of the generation fleet and a customer-facing load business, as generation and load positions are now better balanced across multiple regions. In most locations, ExGen will have adequate intermediate and peaking capacity within the portfolio for managing load shaping (matching resources with energy needs) risks. However, the company will still need to buy and sell length in the market to manage portfolio needs, in our opinion. Moreover, ExGen has a significant open position in the mid-west (exposed to merchant market), and a somewhat tight position in ERCOT and New England, where it has some risk of finding itself short when loads are high, in our opinion.

Supply subsidiary, ExGen's cash flow is sensitive to commodity prices as almost 95% of its premerger generation is nuclear, all of which sliding gas prices are impairing. ExGen's unregulated operations accounted for about 65% of the consolidated enterprise by cash flow and capital spending in 2011. Given that base-load generation is price-taking--it doesn't affect the market price--we expect ExGen's adjusted funds from operations (FFO) to debt to remain volatile--relative to its peers--and we expect it to swing in a band of over 40% in 2011 to about 27% by 2014. For instance, all else remaining equal, we estimate gross margins in 2014 will be lower by about $500 million for every $5 per MW-hour (round-the-clock) decline in power prices, about $215 million for every $0.5 per million cubic feet (mcf) decline in gas prices, and about $110 million for every $1 per MWh decline in retail margins.

As a result, ExGen's contribution to the overall Exelon cash flow declines to about 55% under our base case, because of the decline in unregulated cash flow when commodity prices fall. However, despite the lower power prices, we view the business risk profile of parent Exelon as strong. We expect financial measures to decline over the next two years and the corporate credit ratings reflect our expectation that 2014 will be the trough year. Based on the present forward curve, cash flow measures are still adequate for the rated level in that year. However, as a result of the declining gross margin in forward years, we view Exelon's cash flow adequacy ratio as more akin to the "significant" financial risk profile than the erstwhile "intermediate" one.

We view ExGen's ratable hedging strategy favorably, as it ensures that a high percentage of the company's near-term generation is locked in. Hedging not only protects unregulated generation cash flows from steep price declines, it also provides the company time to adjust its cost structure or its capital structure, should prices remain depressed. However, hedging activities insulate, but do not isolate, power merchants from commodity price effects. Current hedges show the significant value of Exelon's hedging program. Even though these hedges insulate ExGen, perversely, they also show the sensitivity of ExGen's margins to the prospect of a continued shale production onslaught. The decline in mark-to-market value through 2014 shows the limit to which Exelon can hedge--a price-taking fleet can hedge, but only at the prices the market will bear. Also, the gross margin contribution at ExGen will face a decline as higher-priced hedges expire, evident in the drop in wholesale hedged gross margins. Still, the forwards show a contango as reflected in the increase in ExGen's open EBITDA from higher natural gas forwards. Additionally, we believe retail contributions will increase, given the potential for cost savings, volumes gained from the constellation merger, and recent acquisitions (StarTex and MX Energy Holdings).

We view parent Exelon's financial policy and internal funding as "aggressive." The current level of dividends, at about $1.8 billion, results in a dividend payout of about 80%, according to our estimates--meaningfully higher than the 50% to 65% range for peers. Moreover, Exelon's capital spending requirements are significant between 2012 and 2014, at about $18.5 billion. Although utility capital spending tends to be funded in regulated rates (i.e., under rate base), unregulated generation will have to fund its own capital requirements and recover them in market prices. However, cash flow from operations will be insufficient for capital spending and dividends, resulting in external needs of financing. We estimate that the funding gap would be greatest in 2014 because of a trough in earnings even as ExGen's requirements to contribute toward Exelon's dividend commitments are the highest internal financing needs of the utilities. This funding gap could widen if the company fails to achieve merger driven O&M savings in its forecast. We estimate Exelon's incremental long-term financing needs at an average of about $1.4 billion to $1.5 billion in 2014 and 2015. Still, incrementally lower gas prices, combined with higher than anticipated O&M costs, would hurt ExGen's debt protection measures more than the level of new debt financing in ExGen's forecast through 2015.

Under our consolidated base case (we assume lower gas prices and market heat rates that result in power prices roughly 10% lower than the current forward contracts), we expect FFO to total debt of the pro forma company (i.e., Exelon and Constellation combined) to decline to about 25% in 2012 and then to hover at 22% to 23.5% through 2015. We expect free operating cash flow to debt to remain marginally positive even in 2013 and 2014 when we expect financial measures to trough. However, we expect discretionary cash flow (after dividends) to turn significantly negative--in a range between $1.1 and $1.7 billion through the period--mostly because of high capital spending. Similarly, we expect total debt to total capital to be about 57% and debt to EBITDA to hover at about 4.0x. These ratios are still consistent with Standard & Poor's 'BBB' rating guideposts for a financial risk profile we assess as "significant," especially since a meaningful amount of capital expenditure is discretionary. The company's recent decision to defer the LaSalle extended power uprate (EPU) by two years demonstrates flexibility to adjust the program as needed based on market conditions. We estimate that deferring the project by two years will free-up about $400 million through 2014.

Liquidity

The short-term rating on Exelon and affiliates is 'A-2'. Standard & Poor's views the liquidity across the Exelon group of companies as "strong," in light of the debt maturities we expect and available credit facilities. We estimate that sources of cash will exceed the companies' uses by about 2x during the next 12 to 24 months. We expect sources over uses for Exelon and ExGen to remain positive even if EBITDA declines by 50%. In addition, because of Exelon's solid relationships with banks and high conversion of FFO to discretionary cash flow, we believe the company can absorb low-probability, high-impact shocks.

Exelon has sufficient alternative sources of liquidity to cover current liquidity needs, including ongoing capital requirements, moderate capital spending, and upcoming debt maturities. Ironically, a declining power price environment is favorable from a liquidity perspective as cash is being posted to ExGen on its forward hedges. The next large maturities are in 2015 for Exelon and 2014 for ExGen.

In March 2010, ComEd replaced its $952 million credit facility with a three-year, $1 billion unsecured revolving credit facility that expires March 25, 2013. On March 10, 2012, the capacity under Constellation's revolving facility fell to $1.5 billion from $2.5 billion, reducing aggregate bank commitments to $3.2 billion. All facilities reside at the parent level. In addition, Exelon is working through the migration of letters of credit and has a liquidity reduction plan in place that it will finalize toward the end of 2012.

As of July 27, 2012, Exelon, ExGen, ComEd, PECO, and BGE had credit facilities of $2.84 billion, $5.6 billion, $1.0 billion, $0.6 billion, and $0.6 billion, respectively. These facilities expire between September 2013 and March 2017. Availability under these facilities was $2,319 million and $3,807 million respectively for Exelon and ExGen, respectively, and $999 million, $599 million and $564 million for ComEd, PECO, and BGE, respectively. Excluding commercial paper outstanding, the aggregate availability was $7.86 billion.

Outlook

The outlook on the ratings is stable. That said, we believe that higher natural gas production from shale plays and a delay in environment rules related to plant retirements can significantly hurt the company's financial performance. We believe these headwinds have increased and Exelon faces a potential earnings decline in 2014. Should the prevailing commodity environment persist, the company may have to address its declining earnings profile by reducing capital spending. We expect Exelon and ExGen to maintain consolidated FFO to debt in the 21% to 23% and 25% to 27% ranges, respectively, in 2014 to maintain current ratings. We will specifically monitor the expected negative discretionary cash position that results from Exelon's large dividend commitment. A positive outlook--currently not under consideration--can result if natural gas prices stabilize and power prices respond favorably to coal-plant retirements, resulting in an improvement in consolidated FFO to debt levels of over 27%.

Business Description

Chicago-based diversified energy company Exelon operates in 47 states, the District of Columbia, and Canada. Supply subsidiary Exelon Generation Co. (ExGen) is the largest competitive U.S. power generator, with about 35,000 MW of owned capacity. It provides energy products and services to about 100,000 business and public sector customers and about 1 million residential customers. Exelon's utilities deliver electricity and natural gas to more than 6.6 million customers in central Maryland, northern Illinois, and southeastern Pennsylvania.

On March 12, 2012, Exelon completed the merger with Constellation Energy Group Inc. (CEG), with CEG becoming a wholly owned subsidiary of Exelon. CEG's interest in RF Holdco LLC, which held CEG's interest in Baltimore Gas & Electric Co. (BGE), was transferred to Exelon Energy Delivery Co. LLC, a wholly owned subsidiary of Exelon that also owns Exelon's interest in Commonwealth Edison Co. (ComEd) and PECO Energy Co. (PECO). CEG's generation and customer supply businesses were transferred to ExGen. CEG's shareholders received 0.930 shares of Exelon common stock in exchange for each share of CEG.

Business segments

Exelon operates through its four principal subsidiaries: ExGen, ComEd, PECO, and BGE. Subsequent to the merger with CEG in March 2012, ExGen now also includes CEG's customer supply and generation businesses.

ExGen consists of owned, contracted, and investments in electric generating facilities and wholesale and retail customer supply of electric and natural gas products and services, including renewable energy products, risk management services, and natural gas exploration and production activities. ExGen's generation assets are mostly nuclear (55%) and gas (28%). Geographically, the assets are in the Mid-Atlantic (38%) and Mid-West (34%) regions