Evaluating the Financial Performance of Power Generation Assets II

Cash Flow Risk Analysis and Portfolio Optimization

David Rode
DAI Management Consultants
Dept. of Social and Decision Sciences

Paul Fischbeck
Dept. of Social and Decision Sciences

Steve Dean
DAI Management Consultants
Dept. of Engineering and Public Policy
Four Questions, Two Today

1. Can a methodology be developed that “speeds up” the production cost models?
2. Given such a technology, how can the simulation be made efficient?
3. Given a simulation platform, how can asset values be examined?
4. Given asset values, how can portfolios of assets be optimized?
Diverse Research Applications

• Today’s discussion is meant to illustrate the breadth and diversity of research questions
  – **Corporate Finance**: Merger and Acquisition Analysis
  – **Policy Analysis**: Regulatory Impact Assessment
  – **Managerial Economics and Organizational Behavior**: Internal Incentives and Compensation Structure
  – **Financial Risk Management**: Integration of risk management for real *and* financial assets (more efficient exploitation of “balance sheet” hedges)
  – **Strategic Management**: Optimization and Strategic Planning
Valuing Generating Assets

• The Discounted Cash Flows (DCF) method for power projects requires:
  – Operating Performance of Plant vs Market
    • Capacity Factor
    • Additions and Retirements
    • Network Factors
  – Expense Projections (Costs of Production)
  – Revenues (Market Clearing Prices)
  – Financial Structure (selection of discount rate)
Review of First Presentation

• Neural networks used to model cost-of-production curves
• Market clearing price curves estimated from limited historical data and expert judgment
• Embedded decision makers used to incorporate capacity planning (and other) decisions
• End Result: annual cash flow simulation model for every network plant in a NERC region
COP and Market Clearing Prices

The graph shows the relationship between the Cost of Production (COP) and the Market Clearing Price (MCP) over different percentages of the year. The MCP line is plotted as a black line, while the COP line is plotted as a darker shade of black. The graph indicates three scenarios:

- **MCP > COP**: The Market Clearing Price is higher than the Cost of Production. This occurs for a small percentage of the year.
- **MCP = COP**: The Market Clearing Price equals the Cost of Production. This is observed for a moderate percentage of the year.
- **MCP < COP**: The Market Clearing Price is lower than the Cost of Production. This happens for a large percentage of the year.

The y-axis represents the price per MWh ($/MWh), ranging from $0 to $800, while the x-axis represents the percent of the year, ranging from 0% to 100%.
Cash Flow Analysis

• Incorporation of:
  – Fixed costs
  – Discount rates
  – Salvage values
  – Capital costs

• Performance Metrics
  – Cash flows are generated for every year for every power plant in the region
  – NPVs (or IRRs) are then calculated from estimated cash flows for each multiple year scenario
Single Iteration of Capacity Modification Model

![Bar chart showing net MW addition from 2000 to 2020. The x-axis represents years from 2000 to 2020, and the y-axis represents net MW addition in MW. The chart shows a significant net MW addition in 2002 and 2018, with a peak of around 1,500 MW in 2002. There are smaller additions in other years, with some years showing a net MW decrease.](image-url)
Answering an Open Question

• Would two identical plants at different locations on the network perform differently?
• Our model *does* include network effects, but...
• Finding a test case and “self-selection” bias
  – For example, would a gas plant in the Florida Keys perform differently than one at the northern border (Henry Hub)?
  – Yes, but who would build a gas plant in the Keys?
  – In general, plants are not located in such a way that this hypothesis is easily testable
Today’s Focus: Going Beyond NPV

• The level of detail in cash flow information we can generate for an entire region enables several paths of analysis that extend far beyond just NPV/IRR
  – Influence of various sources of input uncertainty
  – Ranking of relative performance
  – Portfolio-level analysis of risk factors
  – Portfolio optimization

• Keep in mind that having a cash flow model of every power generating asset in a region facilities a unique degree of analysis

• Emissions? Other-than-financial performance measures?
  – Inclusion of 3P
  – Real Options
A Single 13-Year Cash Flow Scenario

- Unit 1, Intercession City (Osceola, S. Central Florida)
- 56.7 MW Fuel Oil Plant
- Operational in 1974
Multiple Cash Flow Paths by Plant Unit 1, Intercession City

Historical Fuel Oil Prices

Projected Fuel Oil Prices

Operating Cash Flow

Low Fuel Oil Prices
High Demand
Low Reserve Margin
Multiple Cash Flow Paths by Class
Pet Coke

No Pet Coke Assets in Operation During 2001
Distributions Both Ways

Operating Cash Flow

- Min
- 5th Percentile
- Average
- 95th Percentile
- Max

Year
Median Cash Flow Paths

![Graph showing median cash flow paths for various energy sources from 2003 to 2013. The graph includes lines for Nuclear, Peaking Oil, Peaking Gas, Pul Coal, Coal CFB, Pet Coke, Steam Oil, Steam Gas, Steam Oil and Gas, Combined Cycle, Adv Combined Cycle, and Adv Comb Turbine. Each line represents the median cash flow for the respective energy source over the years.]
# Performance Measures

<table>
<thead>
<tr>
<th></th>
<th>Nuclear</th>
<th>Peaking - Oil</th>
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<th>Coal - Pulverized</th>
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<th>Steam - Gas</th>
<th>Steam - OillGas</th>
<th>Combined Cycle</th>
<th>Adv Combined Cycle</th>
<th>Adv CT - Simple Cycle</th>
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</thead>
<tbody>
<tr>
<td><strong>Minimum</strong></td>
<td>$(186)$</td>
<td>$64$</td>
<td>$116$</td>
<td>$(30)$</td>
<td>$93$</td>
<td>$117$</td>
<td>$68$</td>
<td>$127$</td>
<td>$81$</td>
<td>$151$</td>
<td>$199$</td>
<td>$141$</td>
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<tr>
<td><strong>5th Percentile</strong></td>
<td>$139$</td>
<td>$153$</td>
<td>$177$</td>
<td>$244$</td>
<td>$304$</td>
<td>$405$</td>
<td>$203$</td>
<td>$222$</td>
<td>$238$</td>
<td>$268$</td>
<td>$314$</td>
<td>$222$</td>
</tr>
<tr>
<td><strong>Average</strong></td>
<td>$527$</td>
<td>$258$</td>
<td>$284$</td>
<td>$615$</td>
<td>$685$</td>
<td>$826$</td>
<td>$366$</td>
<td>$359$</td>
<td>$399$</td>
<td>$437$</td>
<td>$530$</td>
<td>$344$</td>
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<tr>
<td><strong>95th Percentile</strong></td>
<td>$919$</td>
<td>$366$</td>
<td>$377$</td>
<td>$1,008$</td>
<td>$1,071$</td>
<td>$1,236$</td>
<td>$567$</td>
<td>$480$</td>
<td>$580$</td>
<td>$576$</td>
<td>$704$</td>
<td>$443$</td>
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<tr>
<td><strong>Maximum</strong></td>
<td>$1,544$</td>
<td>$565$</td>
<td>$501$</td>
<td>$1,652$</td>
<td>$1,725$</td>
<td>$1,897$</td>
<td>$819$</td>
<td>$537$</td>
<td>$808$</td>
<td>$653$</td>
<td>$797$</td>
<td>$481$</td>
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<tr>
<td><strong>Standard Deviation</strong></td>
<td>$240$</td>
<td>$69$</td>
<td>$62$</td>
<td>$240$</td>
<td>$236$</td>
<td>$253$</td>
<td>$114$</td>
<td>$78$</td>
<td>$105$</td>
<td>$91$</td>
<td>$114$</td>
<td>$66$</td>
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</tbody>
</table>
Probability of “Losing Money” and “Equilibrium” Cash Flows

Equilibrium cash flow is a way of measuring the ability of the assets to cover their fixed (capital) costs.
Applications of Loss Probabilities

• The obvious use is in risk assessment
  – Value-at-Risk (VaR)
  – Conditional VaR (average loss conditional on loss occurring)
  – XLoss (average maximum loss)

• Loss probabilities can be used beyond risk assessment

• Projected loss probabilities can be used to structure financing arrangements
  – Defer payments during years in which probability of loss is high
  – Accelerate payments during years in which probability of loss is low

• Careful structuring of financing can lower the likelihood of financial distress for both investors and lenders
  – Proper financial structure design can generate Pareto improvements for both equity and debt holders
Beta and Market-Relative Performance

• The Capital Asset Pricing Model (CAPM) beta measures the risk of an asset relative to the whole market (for a well-diversified investor)
• Typically, the “market” is unobservable
• Our model is unique in that we actually do have the cash flow performance of the entire market (every plant in the NERC region)
• We can compile a “market index” that measures all assets in the region and therefore compute power generation asset betas
## Asset Class NPV Correlations

<table>
<thead>
<tr>
<th></th>
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<th>Coal - Pulverized</th>
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<th>Coal - Pet Coke</th>
<th>Steam - Oil</th>
<th>Steam - Gas</th>
<th>Steam - Oil/Gas</th>
<th>Combined Cycle</th>
<th>Advanced Combined Cycle</th>
<th>Advanced CT - Simple Cycle</th>
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<tr>
<td>Nuclear</td>
<td>1.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Peaking - Oil</td>
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<td>1.00</td>
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<td></td>
<td></td>
<td></td>
<td></td>
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<td></td>
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<tr>
<td>Peaking - Gas</td>
<td>0.52</td>
<td>0.62</td>
<td>1.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<td></td>
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<tr>
<td>Coal - Pulverized</td>
<td>0.99</td>
<td>0.46</td>
<td>0.51</td>
<td>1.00</td>
<td></td>
<td></td>
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<td></td>
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<tr>
<td>Coal - CFB</td>
<td>1.00</td>
<td>0.46</td>
<td>0.51</td>
<td>0.99</td>
<td>1.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Coal - Pet Coke</td>
<td>1.00</td>
<td>0.47</td>
<td>0.51</td>
<td>0.99</td>
<td>1.00</td>
<td>1.00</td>
<td></td>
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<tr>
<td>Steam - Oil</td>
<td>0.72</td>
<td>0.86</td>
<td>0.52</td>
<td>0.73</td>
<td>0.71</td>
<td>0.72</td>
<td>1.00</td>
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<tr>
<td>Steam - Gas</td>
<td>0.60</td>
<td>0.27</td>
<td>0.82</td>
<td>0.61</td>
<td>0.61</td>
<td>0.60</td>
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<tr>
<td>Steam - Oil/Gas</td>
<td>0.75</td>
<td>0.80</td>
<td>0.68</td>
<td>0.77</td>
<td>0.75</td>
<td>0.75</td>
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<td>0.45</td>
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<tr>
<td>Combined Cycle</td>
<td>0.82</td>
<td>0.50</td>
<td>0.88</td>
<td>0.82</td>
<td>0.82</td>
<td>0.82</td>
<td>0.59</td>
<td>0.88</td>
<td>0.74</td>
<td>1.00</td>
<td></td>
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<tr>
<td>Advanced Combined Cycle</td>
<td>0.85</td>
<td>0.36</td>
<td>0.76</td>
<td>0.85</td>
<td>0.85</td>
<td>0.85</td>
<td>0.48</td>
<td>0.92</td>
<td>0.62</td>
<td>0.95</td>
<td>1.00</td>
<td></td>
</tr>
<tr>
<td>Advanced CT - Simple Cycle</td>
<td>0.66</td>
<td>0.36</td>
<td>0.85</td>
<td>0.66</td>
<td>0.66</td>
<td>0.66</td>
<td>0.35</td>
<td>0.99</td>
<td>0.52</td>
<td>0.91</td>
<td>0.94</td>
<td>1.00</td>
</tr>
</tbody>
</table>
Implications of the Correlations

• Baseload vs Peaking
• Fuel Relationships

• Should diversification priority be:
  – To fuel type first?
  – To operational status first?
  – To technology first?
  – To emissions characteristics first?
• What drives correlation structure?
Basics of Portfolio Analysis

• Portfolio return is a linear function of individual asset returns
• Portfolio risk is a **non**linear function
  – Less-than-perfect correlation can reduce risks
  – Covariance, not variance, is what drives portfolio risks
• The (Finance) Goal: maximum return for minimum risk (variance minimization)
  – Are other portfolios possible?
  – What adjustments on the finance side must be made to accommodate engineering-specific goals?
  – Can this model provide a dialogue between finance and engineering?
The Efficient Frontier

Return

Efficient Frontier

Asset B

Asset C

Asset A

Riskless Rate

Risk
Measuring Efficiency:
The Sharpe Ratio

• The Sharpe ratio is a ratio of return per unit of risk (standard deviation)

• “Efficient” portfolios have high Sharpe ratios, and the portfolio problem can be converted from variance minimization to Sharpe ratio maximization

• Other Measures:
  – **Treynor’s Measure** (excess return per unit of *systematic* risk – Sharpe ratio is per unit *total* risk – is a better measure than Sharpe for large portfolios)
  – **Modigliani² risk-adjusted performance** (Sharpe ratio-analog in percent return terms)
  – **Jensen’s Alpha** (non-equilibrium returns)
Capital Costs and Residual Values

• The cash flows, by themselves, don’t tell the whole story
  – Nuclear cash flows are substantial, but the asset class also has very high capital costs, so returns are low
• Analysis *must* take into account both the capital cost of an asset and any residual value at the end of the analysis period
• Unfortunately, it’s often difficult to obtain this data, or even estimate it
• Still, we must be able to understand its influence on portfolio performance
Does it matter?

What is the net effect on portfolio performance?
Strategic Applications of Portfolio-Level Analysis

• “Visual Portfolio”
• Users can instantly see the portfolio-level impact of individual asset-level events
• Coordination Problems: Often, regional/divisional/local managers may make decisions that improve their position, but are not necessarily beneficial for the entire firm’s portfolio
• The following slides highlight some typical questions that can be addressed with our model
“Default” Portfolio

- Return: $40/kw
- Risk: $99/kw
- MIRR: 11.9%
- Sharpe: 0.40
- Size: 15,000 MW
- Weights: determined by MW size (integer-constrained)
Size Constraints (Divestiture)

- Suppose that regulators require the firm to reduce its holdings to approximately 13,000 MW
- Can the firm use this as an opportunity to improve portfolio performance?
  - Yes!
- Results, however, depend on how sales (and sale prices) are treated and whether or not plants are allowed to add assets as well (so long as the net result is a drop in capacity)
- The “best possible” 13,000 MW portfolio
  - Return: $75/kw
  - Risk: $123/kw
  - MIRR: 12.50%
  - Sharpe: 0.61
  - Size: 12,992 MW
- Sharpe better by 53%
- NPV better by 88%
- Further improvement (to Sharpe = 0.65) is possible by allowing the optimizer to consider repowering of assets
Merger Analysis

• Firm A
  – 7% PkgOil, 57% PkgGas, 8% StmGas, and 28% StmO&G
• Firm B
  – 31% Nuke, 45% Pkg/StmO&G, 24% Adv CC
• Firm C
  – 27% Nuke, 12% PkgOil, 29% StmO&G, 9% CC, 23% Adv CC

• Firm A is considering merging with either B or C
• Which is the better partner?

• Firm A (2,820 MW)
  – Return: $10/kw (11.7% MIRR)
  – Risk: $85/kw
  – Sharpe: 0.12

• Firm B (5,330 MW)
  – Return: $87/kw (12.7% MIRR)
  – Risk: $118/kw
  – Sharpe: 0.74

• Firm C (5,160 MW)
  – Return: $55/kw (12.7% MIRR)
  – Risk: $99/kw
  – Sharpe: 0.56

• Firm A+B (8,150 MW)
  – Return: $60/kw (12.3% MIRR)
  – Risk: $104/kw
  – Sharpe: 0.58

• Firm A+C (7,980 MW)
  – Return: $39/kw (12.3% MIRR)
  – Risk: $92/kw
  – Sharpe: 0.43
Merger Analysis

- Both B and C would improve A’s position
- B and C have equal IRRs and result in post-merger portfolios with equal IRRs
  - IRR can be misleading!
- Portfolio B clearly represents the better partner for A
  - A increases its Sharpe ratio by 483%
  - A+B’s Sharpe ratio is 25% higher than A+C’s
- **Bottom Line:** B is the riskier partner, but that risk is well-compensated
  - Emissions limitations?
Optimal Portfolio with Cash Flow Constraints

• In the previous slides, we have used maximization of the Sharpe ratio as the objective function
• However, firms may have multiple objectives and a diverse set of constraints
• Suppose, for example, a firm wanted an efficient portfolio, but only provided that total portfolio cash flow exceeded a certain minimum level
  – Debt covenants on free cash flow
  – Debt Service Coverage Ratio
Optimal Path Analysis

• Suppose a firm wants to move from Current to Desired, a change of 3,000 MW

• However, it can’t transact more than 500 MW per year
  – Other limitations could include regulatory issues, emissions caps, etc.

• How should it proceed?
  – The shape of the frontier may change over time
  – The dynamics of the market may involve an “indirect” path to Desired

• NOTE: Real options preserve paths
The “Environmental Frontier”
Portfolio Optimization and 3P+CO$_2$

• Until now, the criteria have been exclusively finance-oriented
• However, portfolios can be constructed to satisfy any number of criteria
• The Regulator’s Perspective: Emissions in the objective function
  – Minimize emissions such that risk and return are within acceptable parameters
• The Firm’s Perspective: Emissions in the constraints
  – Maximize Sharpe ratio such that emissions do not exceed a certain level
• The Consumer’s Perspective
  – Minimize total expenditures such that reserve margin levels are sufficient to prevent service interruptions
Emissions Uncertainty in a Portfolio Optimization Framework

• How variable is emissions output?
  – For regulators and environmental stakeholders, the goal may be to “manage” a region’s power assets to minimize the uncertainty over emissions output
  – A minimum variance emissions portfolio

• Stochastic Optimization Criteria
  – Minimize probability that emissions output is greater than cap levels
  – Maximize joint probability that emissions output is below cap and NPV is above threshold
Trading Credits and Expanding the Efficient Frontier

• In the basic model, all assets are power plants
• Suppose new assets – emissions credits – are introduced
• The introduction of these assets into the feasible set Pareto-improves market participants
• In our model, this can be seen directly by noting that the efficient environmental frontier expands “northwest”
  – More efficient combinations of assets are possible
  – On a regional level, the dollar size of the Pareto gain can be quantified
Real Asset Portfolio Applications

- Merger and Acquisition Analysis
- Regulatory Impact Assessment
- Internal Incentives and Compensation Structure
- Integration of risk management for real and financial assets (more efficient exploitation of “balance sheet” hedges)
- Optimization and Strategic Planning
Conclusions

• Having a detailed financial and operational model (incl. emissions) for all assets within a region enables a broad range of analysis previously unavailable.

• One of the chief drawbacks to treating real assets like financial assets in portfolios has been the complexity of measuring risk and return in any objective fashion.
  – One of the advantages is that engineering and regulatory issues (such as emissions control) can be treated at the same level as financial criteria.

• Our neural net-enhanced simulation model, together with Visual Portfolio allows users to explore portfolio-level questions at a “desktop-level”.

• Portfolio analysis of emissions is an open application in the framework.