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## What's Next in the Electric Utility Industry?

# FINDING NEW GROWTH *for* ELECTRIC UTILITIES

### **“The hook.”**

That is one analyst's description of Warren Buffett's mid-May move to expand his utility investments to the West Coast through Iowa-based MidAmerican Energy's agreement to purchase PacifiCorp for \$5.1 billion. At the time, the legendary investor said he hoped to buy more energy assets over the next decade, adding, “We'll never be a seller, but we're always a buyer.”

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“Buffett got people excited,” former analyst Julie Cannell explains, citing the new crop of value-investors attracted to shareholder-owned electric utilities for the first time since the Enron scandal and energy market crises pushed these stocks sharply lower in 2001 and 2002.

Since then, stock performance for the sector has been exceptional. The debt-to-capitalization ratio has improved tremendously, as have net income, positive free cash flow and general credit quality. Much of this is due to reduced dividend tax rates — which heightened the attractiveness of this dividend-oriented industry — and the industry's shift away from diversified, non-core businesses and back to basics.

But with Buffett's move, Cannell says, the 30-month rise in utility stock values “seemed real” to investors. They finally focused seriously on the industry's growth potential. Moreover, the expectation that new legislation would finally bring industry regulation into the 21<sup>st</sup> century seemed to enhance that potential.

By early August, shortly after Congress passed the Energy Policy Act of 2005, these investors had bid utility stock prices, as measured by the S&P Utilities Index, to the highest levels in five years. This pushed the Utility Index over 165, more than double its mid-October 2002 low of 82.

Calling the new legislation the most significant change in federal utility regulation in 70 years, Federal Energy Regulatory Commission (FERC) Chairman Joseph Kelliher said it is “a very good law” that reflects Congressional desires for a stronger energy infrastructure.

In addition to regulatory changes, the new law “is chock-filled with tax incentives to support new utility infrastructure investment,” wrote Merrill Lynch utility analyst Steve Fleishman. He summarized the key ones as:

- Accelerated tax depreciation for electric transmission and gas distribution (15 years compared with 20 previously)
- Accelerated depreciation of emissions control equipment (seven years compared with 20)



### STOCK PERFORMANCE FOR THE SECTOR HAS BEEN EXCEPTIONAL.

- Two-year extension of the production tax credit for renewables (valued at 1.8 cents per kilowatt hour generated)
- Nuclear incentives, including a production tax credit for new nuclear plants and better tax treatment of decommissioning funds
- Tax deferral on gains from selling transmission assets to an independent transmission organization
- A 20% tax credit for clean-coal facilities

Fleishman also pointed out that “the pollution control incentive has not been well advertised and could help those with large environmental [capital expenditure] mandates.”

The tax changes enhance the dramatic opportunities for investment being created “as the U.S. economy becomes more and more dependent on more and more reliable electric energy,” says Michael Morris, chairman, president and CEO of American Electric Power and chairman of Edison Electric Institute, the trade association for shareholder-owned companies.

Investors in shareholder-owned electric utilities are hooked — and they will remain so. The need for expanded infrastructure and the removal of investment strictures hold the promise for greater growth and better stock performance in the sector.

### Demand Grows

Morris sees those opportunities reflected in, for example, the profit growth potential of coal and nuclear power plants. For a decade now, the need for additional generation has been satisfied by building natural gas-fueled power plants and pressing aging plants into

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**THE U.S. ENERGY  
INFORMATION AGENCY  
(EIA) PROJECTS THAT,  
BY 2025, ELECTRICITY  
DEMAND WILL INCREASE  
NEARLY 50% OVER 2002'S  
DEMAND.**

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service. While these plants and existing transmission infrastructure got the industry through the summer's heat waves and delivered record supplies of electricity, the rising cost of gas made this an expensive effort, Morris explains.

Added to this summer's heat stress have been the larger demands of a growing economy — and that growth is expected to continue. The U.S. Energy Information Agency (EIA) projects that, by 2025, electricity demand will increase nearly 50% over 2002's demand, to 5.47 trillion kilowatt hours. The agency expects the growth to be particularly strong in the commercial sector, where it will average 2.4% per year as rapid additions to commercial floor space, the continuing penetration of new telecommunications technologies and medical imaging equipment and increased use of office equipment overwhelm the expected efficiency gains for electric equipment in the sector.

EIA sees more moderate electricity demand growth in the industrial and residential sectors, projecting averages of 1.3% per year and 1.6% per year, respectively, as they too reflect the greater use of computers, printers and other electrotechnologies, large and small.

### **Building Value in the Rate Base**

According to Cannell (now a consultant specializing in electric utilities who often

testifies in state utility regulatory proceedings), state commissions have also recognized the need for electric company investments triggered by this growth — investments which some have estimated will reach \$12.7 billion by 2030.

Describing most recent rate decisions by these bodies as constructive, she explains that regulators have a "growing awareness of the need to have financially viable" utility companies. While the returns that state commissions have allowed regulated utilities have been reduced as interest rates declined in recent years, the amounts are "still solid," she says.

These returns reflect the profit potential of investments in regulated activities — a utility's rate base. As commissions clear spending on new power plants, environmental controls for older plants, transmission upgrades and other necessary efforts to meet growing demand, the approved spending becomes an investment that expands the utility's rate base.

With a larger base, the company has an opportunity to show earnings growth, which Cannell describes as the "valuation investors really look at" in their search for new investments.

The value of this growth may be surprising. In a research comment written after Congress completed work on this year's energy legislation, Harris Nesbitt electric utilities analyst Michael Worms cited the

law's reliability mandates and production incentives and said that "we look for even greater infrastructure expansion" than the electric power industry has been discussing in its recent growth predictions.

### Growth Through Mergers

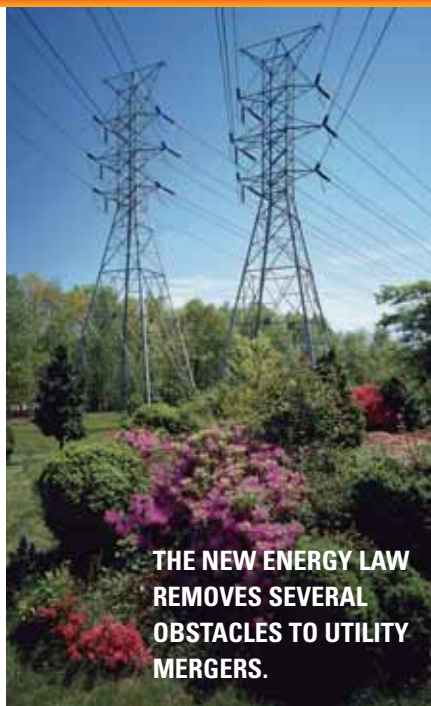
Beyond the potential for profit growth, the new energy law removes several obstacles to utility mergers and also dangles the possibility of higher stock values as non-utility companies — from private equity funds to large manufacturing companies to investment banks — get the chance to buy electric and gas companies. Such purchases had been blocked since the Depression by the Public Utility Holding Company Act (PUHCA), which was repealed by the new energy law.

However, such investments will not be automatic, Worms pointed out, explaining the state and federal regulatory process "remains intact, which could be viewed as a considerable hurdle" to mergers and acquisitions.

Merrill Lynch's Fleishman also cites the impact of state regulation and the enhanced merger oversight granted the Federal Energy Regulatory Commission by the new energy law. But he believes that "PUHCA repeal combined with consolidation trends in the non-regulated power business could spur additional utility M&A activity." He adds, "Nevertheless, this is not exactly a repeal of Glass Steagall," referring to the change in Depression-era banking laws that spurred tremendous consolidation in the financial industry a few years ago. "Remaining FERC and state regulatory obstacles still make utility M&A a difficult process," the analyst explains.

The nontraditional players have attracted the attention of Ken Hurwitz, a partner in Haynes and Boone's energy practice, who sees "financial institutions coming into the [utility] sector." His views were echoed by FERC's Kelliher, who told reporters that utilities "might see more financial industry" interest, adding, "I think this is a good thing, especially for a capital-intensive industry" like utilities.

The commission is "optimistic that PUHCA repeal will bring sorely needed new avenues of capital investment into the U.S. electricity sector, particularly for the transmission grid, where investment has



**THE NEW ENERGY LAW REMOVES SEVERAL OBSTACLES TO UTILITY MERGERS.**

been lagging growth for years," Kelliher's prepared remarks explained.

Hurwitz expects the nontraditional interest to come from someone who has already developed a skill set related to utilities. As an example, he cited the investments GE has already made in the gas industry. Beyond the new investments, he expects the U.S. to "wind up with a smaller number of utilities."

EEI's Morris believes PUHCA's repeal "will add to the asset acquisition game" by lowering "the barriers to non-utilities or international companies."

As a result, he expects others "who think like Buffett" will be making utility investments, which means "capital will flow into this business — as it needs to." ■

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