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Utilities

Sector Analysis

Sector Definition:

The S&P500 utilities sector is composed of two sub-sectors.

<ul style="list-style-type: none"> • Gas <ul style="list-style-type: none"> ○ Upstream (non core function) <ul style="list-style-type: none"> ▪ Exploration and Production ○ Midstream (non core function) <ul style="list-style-type: none"> ▪ Gathering, Processing and Wholesale (interstate and intrastate transmission) ○ Downstream (core function) <ul style="list-style-type: none"> ▪ Retail Distribution (LDCs – Local Gas Distribution) 	<ul style="list-style-type: none"> • Electricity <ul style="list-style-type: none"> ○ Upstream (core function) <ul style="list-style-type: none"> ▪ Power Production ○ Midstream (core function) <ul style="list-style-type: none"> ▪ Transmission and Distribution ○ Downstream (non core function) <ul style="list-style-type: none"> ▪ Retail
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As of 06/30/2004 there are 33 companies in this sector. Utilities have a weighting of 2.87% in the S&P 500. The market cap of utilities is \$1,283B.

Recommendation: Neutral – 2.87%

Looking at

1. Utilities stock price growth (6% YTD - 15 % 1year - 45% 2years)
2. Low Beta (0.6)
3. Expected revenues growth (2.4% expected for this year and 6.4% expected next year)
4. Positive changes in the industry stemming from deregulation.

We expect Utilities to outperform the S&P 500 by a spread of 5 to 10 percentage-point in the short term. Because of the non-cyclical and mostly regulated natures of the sector, this investment would constitute a solid and dependable base for The SMF portfolio. We recommend investing in large players, with

1. higher than average profit margins
2. lower than average operating expenses
3. solid acquisition and diversification plans
4. Stable growth
5. A nuclear generation owner, with diversified operations

A company meeting these criteria should benefit from high gas prices, unfavorable impact of environmental regulations on coal pricing and overcapacity.

Big Picture:

Utilities operate as monopolies and are highly regulated in their core activities where profits are capped as a tradeoff for being given exclusive franchise by their respective states. Two key trends are currently reshaping the industry:

1. Deregulation

For electric utilities, deregulations initiatives have lead to greater competition in the generation and wholesale power markets¹.

For gas utilities, deregulations have lead to greater competition in the wholesale and distribution markets.

As a result of deregulation utilities recently **diversified** into non-regulated activities and **consolidated** to face-off growing competition.

Positive:	Negative:
<ul style="list-style-type: none">▪ Pressure on monopolies will lead to a more competitive industry▪ Diversification will increases returns and hedge against energy price risks▪ Consolidation will<ul style="list-style-type: none">○ Increase returns○ reduce operating expenses and○ Concentration of assets around a smaller number of companies will result in more companies targeting their expenditures on the upgrading of their infrastructure.	<ul style="list-style-type: none">▪ Loss of monopoly positioning/advantage▪ Increased price pressures.▪ Every foray into unregulated activities carries increased likelihood for risks than do regulated utility operations.▪ Lack of expertise and experience

Service and environmental regulations

The Federal Energy Regulatory Commission (FERC) has been active producing regulations for utility companies. The principal drivers for these regulations are

1. Fair pricing
2. Environmental protection
3. Service reliability.

¹ S&P 500 industry survey, August 5, 2004, P.9.

Positive:	Negative:
<ul style="list-style-type: none"> ▪ Strengthen the industry providing more reliable service at fair prices ▪ Prevent black-outs and shortages during high demand periods (summer) ▪ Many of these regulations target coal fired plants. Therefore, we expect a positive impact on atomic and gas fired plants. 	<ul style="list-style-type: none"> ▪ Costs associated with upgrading and maintaining a production facility capable of meeting the maximum demand on its system ▪ Negative impact on coal-fired power plants ▪ Cost associated with building or upgrading a production facility that is environment friendly, for example, one that uses renewable energy to generate power.

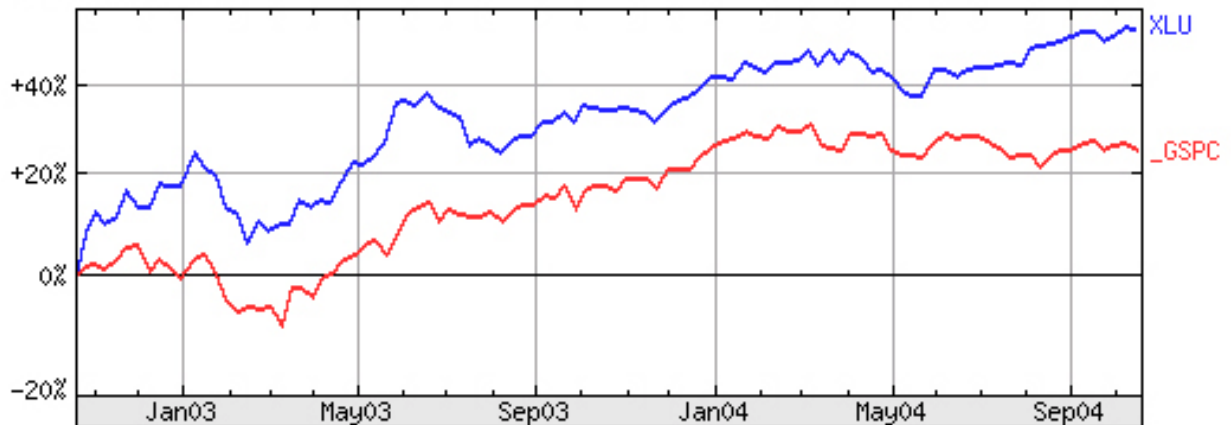
Performance:

From 2001 until 2003, the industry stock performance has been lagging stemming from the 2000-2002 power crisis, increased competition, environmental regulations and higher interest rates.

Nevertheless, since 2003, utilities have gained 50% in value. This performance can be explained by:

- Successful Diversification steps of several key players
- A consolidation of the industry against regulatory pressures.
- A closer regulatory oversight to prevent a new energy crisis similar to the 2000-2002 crisis ².

S&P 500 INDEX
as of 15-Oct-2004



² S&P 500 industry survey, August 5, 2004, P.9

(XLU= S&P 500 Utilities Index)

Key Statistics:

	S&P 500	Utilities
PE ratio	15.9%	13.7%
2005 Earning Growth	10.8%	6.4%
Annualized Dividend Yield	1.8%	3.9%
Price Book Value	3.1	1.7
ROE	18.7%	12%
Beta	1	0.6
EPS growth (2003-2004E)	10.9%	2.4%
EPS growth (2004E-2005E)	6.5%	6.4
Long Term Growth Rate	7	4.8%
Profit Margin	N/A	6.80%

PE ratio:

Utilities PE ratio is close to the S&P average (13.7 VS 15.9 for S&P). This may indicate that investors are setting their expectations high for this sector. These positive earnings expectations may stem from an optimistic outlook on the industry's ability to adjust to the regulatory environment through successful consolidation and diversification.

Dividend Yields:

Utilities Dividend yield is higher than the average S&P 500 dividend yield. Because of this above than average dividend return, dividends will continue to be an important component of investors' total return on electric utilities stocks.

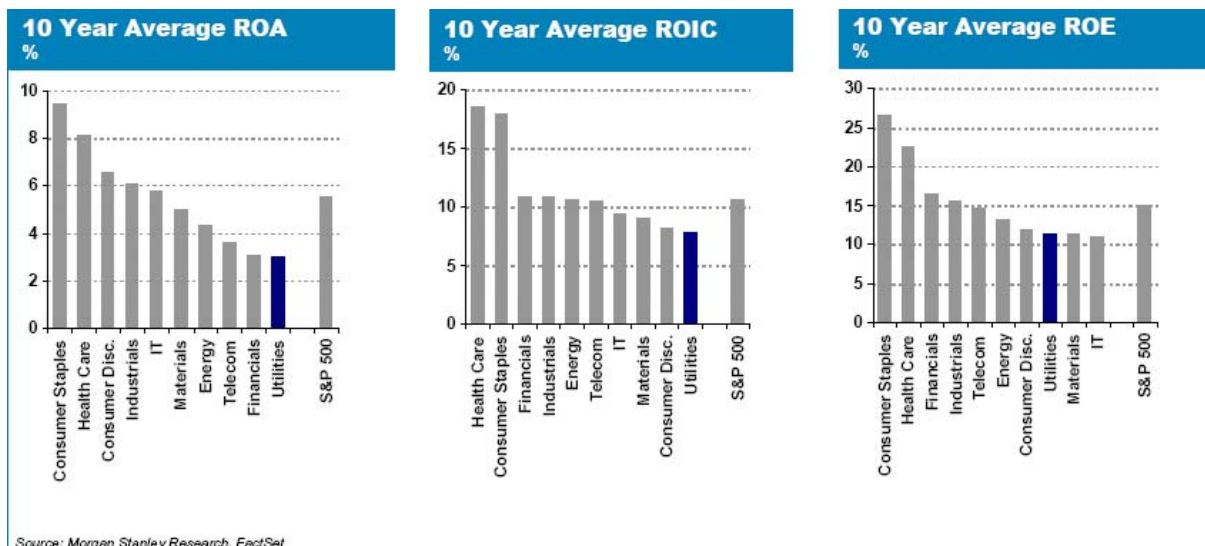
Price Book Value:

Utilities PBV only trades at 1.7X the company book value per share. This is significantly

lower than the S&P 500 PBV (3.1X). This may indicate that the market believes that the Utilities core services infrastructure is not economically viable (for example a nuclear plant). This stems from high investments needed to build and sustain these infrastructure that are not often used to full capacity. A successful consolidation and diversification in the sector should alleviate the infrastructure costs burden as well as increase ROA.

ROE

Utilities ROE is in line with the S&P 500 average although somewhat lower, which should be the case for a regulated industry. This result indicates that the returns have been satisfactory but not high enough to cause regulators to seek a rate cut.



Cross-Industry Comparison:

- Utilities sector has the lowest ROA and the lowest ROIC of any sector in the S&P 500.
- Leverage effect improves the ROE, but not enough to compensate for low regulated Returns and capital intensity.

Sub-Industry : Electricity

Value Line Timeliness: 86(west)88(east)

S&P Outlook : Neutral

Positives:

- Electrical Utilities stocks are up 8.2% YTD, versus a 1.8% increase of S&P 1500
- Profits are expected to increase by 50% from 2000 through 2005
- Electrical companies have successfully hedged coal prices³
- Nuclear power plants owners should continue to benefit from overcapacity⁴
- Improving spark spreads on a relative basis⁵
- A Mild summer
- Improving ROIC across most regions⁶
- An economic recovery should increase electricity demand in such areas as the Northeast, Midwest and California⁷

Negatives:

- Supply: Market is somewhat oversupplied. Currently, the build out in the generation market continues but at a much slower pace since 2003 ⁸.
- Demand : Expected to decrease through 2008⁹
- Revenues are expected to decrease by 13% from 2000 through 2005

³ Lehman Brothers – August 10 2004 – More of the Same – Daniel F. Ford CFA, page 12

⁴ Lehman Brothers – August 10 2004 – More of the Same – Daniel F. Ford CFA, page 9

⁵ Lehman Brothers – August 10 2004 – More of the Same – Daniel F. Ford CFA, page 22,23,24

⁶ Lehman Brothers – August 10 2004 – More of the Same – Daniel F. Ford CFA, page 32

⁷ S&P 500

⁸ Lehman Brothers – August 10 2004 – More of the Same – Daniel F. Ford CFA, page 8

⁹ Lehman Brothers – August 10 2004 – More of the Same – Daniel F. Ford CFA, page 7

- High level of pension costs utilities face could significantly affect earnings
- Some utility holding companies with large energy and trading operations have been hurt with
 - High debt levels
 - Severe liquidity problems,
 - Federal investigations into their trading and accounting transactions

Analysis:

We are expecting competition to remain low in the core services but to be fierce in unregulated services. We are expecting modest growth caused by oversupplied market and decreasing demand. In addition, high infrastructure upgrade and construction costs may restrain earnings growth. Successful utilities will generally be those that pay down debt and provide stable earnings and dividend growth. We also expect the sector to pay fewer dividends as electrical utilities will reinvest their earnings in their infrastructure in order to diversify and meet regulatory requirements. Opportunity is in continued diversification and consolidation, as well as successful hedging of energy sources.

Major Players:

The AES Corp, **Xcel Energy Inc**, Avista Corp, Exelon corporation, Entergy corporation, Tennessee Valley Authority, Dominion Resources.

Sub-Industry : Gas

ValueLine Timeliness: 96 **S&P Outlook:** Slightly negative

Positives:

- Over the past ten years, natural gas utilities have outperformed the electric utilities.
- Revenues are expected to increase by 40% from 2000 through 2005
- Year to date through September 17, the S&P Gas Utilities Index rose 7.1%, versus a 1.8% increase in the S&P 1500.
- S&P 500 reports that 90% of natural gas utilities are planning to hedge some portion of their gas supply. This trend will make the industry less vulnerable to gas price fluctuations.
- From 1999 to 2003, electrical gas-fired capacity increased by 102%¹⁰. Continuing this trend, we expect electrical utilities to continue their move towards gas-fired plants and thus increase demand for natural gas.

Negatives:

- Profit Margins are expected to decrease 17% from 2000 through 2005.
- We believe the positive stimuli of the 2003 dividend tax cut and historically low interest rates have been fully discounted in gas utility shares.
- We are concerned that high natural gas prices could lead to further bad debt expense for gas utilities.
- Over the next two to three years, we look for earnings growth at gas utilities to be well below that of the S&P 1500 stemming from a 1% to 2% demand growth.¹¹
- Profits from regulated operations are down because of milder weather conditions.¹²

¹⁰ Lehman Brothers – August 10 2004 – More of the Same – Daniel F. Ford CFA

¹¹ Global Insight

¹² Valueline – September 17 2004 – Natural Gas Distribution

- Income from non utility activities is also lower because of decreased volatility in natural gas prices.¹³

Analysis:

The Lower profit margins trend stems from increased competition, milder weather and less volatile gas prices. We are expecting modest revenue growth due to continued low demand levels and bad debt expenses from rate payers caused by high fuel supply costs. This decrease in revenue will be somewhat offset by utilization of gas fired electrical plants. We do not expect gas utilities stocks to continue their rally as we expect long term interest rates to rise by the end of 2005¹⁴. We also expect the sector to pay fewer dividends as gas utilities will reinvest their earnings in their infrastructure in order to diversify and meet regulatory requirements. The biggest opportunity is in diversification (gas exploration and production, natural gas gathering and processing, storage, energy trading, natural gas marketing¹⁵) and successful gas prices hedging,

Major Players:

LEADING NATURAL GAS MARKETERS <i>(Ranked by 2003 gas volume)</i>				LEADING LOCAL DISTRIBUTION COMPANIES — 2003 <i>(Ranked by millions of natural gas customers served, as of December 31)</i>		
	NORTH AMERICAN NATURAL GAS VOLUME (AVG. BIL. CUBIC FEET/DAY)			2003 WHOLESALE ELECTRIC VOLUME (MIL. MEGAWATT HOURS MARKETED) ¹		
	2002	2003	% CHG.	GAS CUSTOMERS	ELECTRIC CUSTOMERS	
1. BP	15.5	20.2	30.1	Sempra Energy	6.21	1.30
2. Sempra	9.3	11.2	20.2	PG&E	3.90	4.90
3. Coral (Shell)	8.8	9.2	5.4	NiSource Inc.	3.28	0.44
4. ConocoPhillips	5.8	8.8	52.2	Center Point Energy	3.04	1.84
5. Mirant	21.1	7.2	(66.0)	Keyspan Corp.*	2.50	1.00
6. ExxonMobil ¹	9.0	6.7	(25.3)	Nicor	2.08	0.00
7. Cinergy	3.7	4.1	11.0	ONEOK	1.99	0.00
ChevronTexaco ²	NA	3.9	NA	AGL Resources	1.84	0.00
8. El Paso ³	13.1	3.7	(71.6)	Xcel Energy**	1.76	3.29
9. Tenaska	2.8	3.5	25.9	Dominion	1.70	2.23
10. Nexen	2.4	3.2	37.2	CMS Energy	1.67	1.75
11. Encana	2.8	3.0	9.1	Public Service Enterprise Group	1.67	2.03
12. ONEOK	2.7	2.8	2.8	Total	31.6	18.8
13. Williams	4.1	2.7	(33.3)			
14. Reliant	9.5	2.5	(73.8)			
15. Entergy-Koch	2.0	2.3	15.0			
Total (excl. Chevron)	112.3	91.0	(19.0)			

NA-Not available. ¹Electric volumes reported by firms that are FERC jurisdictional generally include US volumes, but exports going to or coming from Canada that fall under FERC tariffs are also included. ²ExxonMobil includes equity volumes from 40% ownership in Duke Energy Trading and Marketing (DETM). ³ChevronTexaco figures are for 3H '03; it began selling its own gas in April 2003 (previously Dynegy marketed Chevron's gas). ⁴El Paso's 4Q volumes are estimated due to delay in its SEC filings. NOTE: Dominion Resources and American Electric Power do not report natural gas trades or volumes to index gatherers. Standard & Poor's believes these companies are among the leading gas and electric marketers.
Sources: Platts; company reports.

*Electric customers managed for the Long Island Power Authority. **Figures for Xcel exclude Wyoming operations (31,000 natural gas and 38,000 electric customers) that it agreed to sell on January 13, 2004.
Source: Company reports.

¹³ Valueline – September 17 2004 – Natural Gas Distribution

¹⁴ SP500 predictions

¹⁵ Valueline – September 17 2004 – Natural Gas Distribution