Winners and Losers in Restructuring: Assessing Electric and Gas Company Financial Performance

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Introduction

The era of electric and natural gas industry restructuring ushered in by Congress and implemented by FERC and state public utility commissions has now been in place for more than five years. In the wake of these momentous shifts in regulatory policy, electric and gas companies have responded with fundamental changes in their business strategies. Some have decidedly "stuck to their knitting," while others have merged, sold assets, invested overseas and in new businesses, and in some cases completely abandoned their historic business roots. With the economic downturn, the collapse of merchant generators and the decided slowdown in industry restructuring, the time is opportune to examine corporate winners and losers from this unprecedented round of industry restructuring.

Winners and losers in the battle of restructuring can be measured from a variety of perspectives. The major constituents, however, are clearly shareholders and investors on one hand and consumers on the other. The focus of this analysis is the shareholder. In examining the impacts on shareholders, we look to a variety of related metrics that speak to financial performance.

Our analysis focuses on total shareholder return for the group of 64 companies that compose the Fortune 1000 energy companies.[2] Within this mix is a combination of utilities, pipelines, energy merchants and independent generators with diverse business strategies. Aligning companies with their returns to shareholders paints a dramatic picture of widely differentiated financial performance. The degree of variation is particularly notable in light of an industry once noted for its stable returns appealing to the most conservative investors.

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[2] Includes all companies listed in the "Energy," "Pipelines" and "Utilities: Gas and Electric" industries of the Fortune 1000 index as compiled on April 14, 2003. Excludes USEC, Agway, Hawaiian Electric and Adams Resources (not comparable business models); Reliant Resources, Mirant Corporation, Plains All America Pipeline and Enterprise Products Partners (insufficient public stock price history); and Oglethorpe Power (private).

Figure 1 (following page) illustrates annualized shareholder returns[3] measured over the five-year period from 1998 to 2002. This time frame is long enough to capture the impacts of strategic decisions that take years to unfold. The companies are arrayed according to their total five-year performance, grouped by quartiles. Based on shareholder return, and an underlying examination of the basic differences in the business models of these companies, several conclusions may be drawn:

- Over the five-year period, the median of the annualized shareholder returns for the entire group of companies was 2.6%. Only 39 of the 64 companies in the group returned positive results to their shareholders over the period. While this is a poor performance for utilities by historical standards, the group still outperformed the S&P 500 companies, which posted a median 1.3% annualized shareholder return over the same five-year period.

- Six companies in the group scored in the top quartile in annualized shareholder return for each of the five-year, three-year and one-year periods ending December 31, 2002:

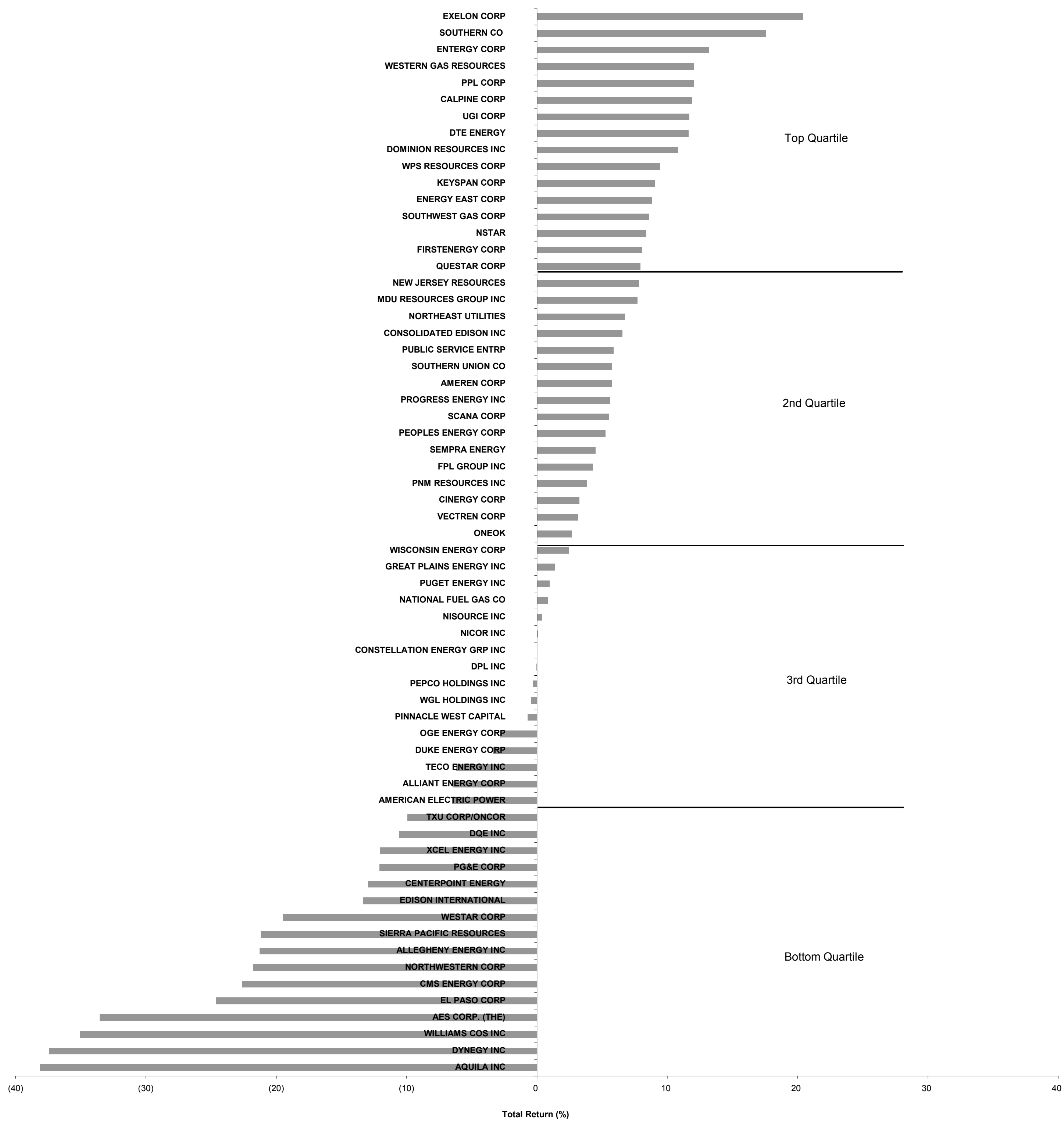
Companies Ranking in Top Quartile for One, Three and Five-Year Annualized Shareholder Return

Company	5-Year Average Annual Return	Rank	3-Year Average Annual Return	Rank	1-Year Average Annual Return	Rank
EXELON CORP	20.4%	1	18.5%	13	14.2%	10
SOUTHERN CO	17.6%	2	30.8%	2	17.6%	4
ENTERGY CORP	13.2%	3	25.3%	5	20.3%	3
UGI CORP	11.7%	7	29.8%	3	30.1%	1
WPS RESOURCES CORP	9.5%	10	23.0%	6	12.2%	11
QUESTAR CORP	7.9%	16	26.6%	4	14.3%	9

The companies listed above can be considered shareholder return "all-stars" for their consistency of top-quartile performance. **Exelon Corporation** takes top honors for total return over the five-year period, **Western Gas Resources** leads the three-year average return category, and **UGI Corporation** holds the leading position for one-year results, ending December 31, 2002.

[3] Annualized rate of shareholder return from January 1, 1998 through December 31, 2002, reflecting price appreciation plus reinvestment of monthly dividends and the compounding effect of dividends paid on reinvested dividends. Source: CompuStat.

Figure 1.
Annualized Shareholder Return, 1998-2002



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Gauging Performance: 1998-2002

- The top quartile utility companies have largely drawn their revenue from historic investments in regulated utility assets. The companies that derived 75% or more of their fiscal 2002 revenue from regulated assets had a five-year annualized shareholder return of 3.7% though 2002. Companies with less than 75% regulated revenues had only a 1.1% annualized return for the same period.

- Companies that invested heavily in the "merchant generation" business – those with a significant independent generation, marketing and trading component – dominate the bottom quartile of five-year shareholder returns. While seeing their stock price valuations and shareholder returns soar through the latter part of 2000, merchants have since plummeted in value, reversing previous gains (e.g., **Aquila, Dynegy, Williams, AES, El Paso,** and **CMS**). Interestingly, despite its recent losses **Calpine Corporation** managed a top-quartile 11.9% annualized return over the period that resulted from its spectacular price appreciation during the boom in merchant power development.

- Companies with regulated natural gas assets have generally out-performed the sector (e.g., **Western Gas Resources, UGI Corporation, Keyspan Corporation**). Those companies deriving 50% or more of their revenues from gas-based operations earned a median annualized return of 4.5% over the five-year period, compared with the 2.6% group median.

- Companies operating in states where restructuring has been faster to implement have, in general, fared better than their peers. Using a system to score companies from 0 to 3 points based on the degree to which they operate in a restructured environment, we found that those companies with top quartile shareholder returns had a score of 1.8 (moderate/active restructuring). This can be compared with an average score of 1.3 (moderate/limited restructuring) for companies in the bottom three quartiles.[4]

  California is a notable exception to the above point, as two of the three major investor owned utilities in the state have floundered under California's pioneering restructuring program. **Edison International** and **PG&E** are among the bottom quartile companies for shareholder return over the five-year period. Both companies were subject to rate freezes during the sharp run-up in California wholesale prices in 2000-2001, resulting in multi-billion dollar losses. Exacerbating this problem, both companies made significant

[4] Based on EEI and DOE data, using a Lexecon scale as follows: 0 = No restructuring activity, or restructuring suspended or repealed; 1 = Restructuring adopted but only large customers granted retail access; 2 = Full retail restructuring adopted; 3 = Retail restructuring implemented on or before January 1, 2001. Company scores were calculated as an average of the scores for each state in which a company has core operations.

investments overseas or in merchant generating businesses. In contrast, **Sempra** was able to recover its stranded costs in advance of the price run-up and avoid the rate freeze problem. Sempra also invested less heavily in merchant businesses and overseas ventures, while the dominant gas utility portion of Sempra's business helped sustain the company's financial performance through restructuring.

- Companies with substantial foreign investments have in general seen substandard financial performance. Investments in Europe, Australia, and Latin America proved uneconomic for most of these companies. The successful utility operations of **PPL Corp.** have served as an effective hedge to the company's significant exposure to foreign markets (19.9% of 2002 total revenue), and have protected its top-quartile shareholder return.

5-Year Annualized Shareholder Return for Companies with the Largest Share of 2002 Revenue from International Operations

Company	International Revenue as % of Total Fiscal 2002 Revenue	5-Year Annualized Shareholder Return	Rank
AES CORP.	75.8%	-33.6%	61
PPL CORP	19.9%	12.0%	5
WILLIAMS COS INC	15.1%	-35.1%	62
DYNEGY INC	13.5%	-37.4%	63
EL PASO CORP	11.4%	-24.6%	60
EDISON INTERNATIONAL	10.1%	-13.3%	54
AQUILA INC	9.5%	-38.2%	64
TXU CORP/ONCOR	8.6%	-9.9%	49
ALLIANT ENERGY CORP	7.7%	-6.5%	47
NATIONAL FUEL GAS CO	7.4%	0.8%	36

- Debt leverage, often considered a powerful instrument to boost equity returns, has in many cases exhibited a negative impact. For the companies with top-quartile five-year average annual shareholder return, the median debt to capital ratio for the five-year study period was 61%, but was 69% at companies with bottom quartile returns. While debt leverage is of course an indispensable business tool, these results may indicate too much of a good thing for some of these companies. High debt at the merchant generators that facilitated rapid growth has also greatly magnified the plight of this sub-sector during the past year. Above average debt leverage was, however, not a hindrance to companies operating in stable regulatory environments with proven business models (e.g., **PPL Corp., UGI Corp.**).

Five-Year Annualized Shareholder Returns of the Ten Most Levered Companies

Company Name	Average Debt / Capital (1998-2002)	5-Year Annualized Shareholder Return
AES CORP.	81.2%	-33.6%
CMS ENERGY CORP	80.8%	-22.6%
UGI CORP	80.3%	11.7%
EDISON INTERNATIONAL	80.1%	-13.3%
CALPINE CORP	77.5%	11.9%
CENTERPOINT ENERGY	76.4%	-12.9%
NORTHWESTERN CORP	76.3%	-21.7%
PPL CORP	74.9%	12.0%
TXU CORP	72.7%	-9.9%
PSEG	70.6%	5.9%

- Companies employing the "asset light" strategy have been penalized in investor returns, most notably in the past 18 months (e.g., **Aquila** and **Dynegy**). Others, however, such as **Western Gas Resources** and **New Jersey Resources** have sustained strong shareholder returns despite their strongly asset leveraged (high Sales/Assets ratio) operating model. This may be a case of the strength of the regulated gas business allowing the greater asset leverage. For the five years of our study, companies with top-quartile shareholder returns had a median Sales/Assets ratio of 42% for that period, as compared to a Sales/Assets ratio of 49% for bottom-quartile companies.

Five-Year Annualized Shareholder Returns of the Most Asset-Light Companies

Company	Sales / Assets (Average 1998-2002)	5-Year Average Annual Shareholder Return
WESTERN GAS RESOURCES INC	207%	12%
AQUILA INC	205%	-38%
DYNEGY INC	168%	-37%
NEW JERSEY RESOURCES	117%	8%
NORTHWESTERN CORP	84%	-22%
CENTERPOINT ENERGY	80%	1%
UGI CORP	79%	12%
CINERGY CORP	76%	3%
WPS RESOURCES CORP	75%	9%
NICOR INC	74%	0%

- Companies with upstream investments in oil & gas reserves have benefited from these investments over the five-year period. There are 18 companies in our selected universe that own proved reserves of oil and gas. The median five-year average annual shareholder return for these companies was 5.4%, as compared to a median return of 2.6% for the selected universe of 64 companies.

Five-Year Annualized Shareholder Returns of Owners of Oil & Gas Reserves

Company	5-Year Annualized Shareholder Return
WESTERN GAS RESOURCES	12.0%
CALPINE CORP	11.9%
UGI CORP	11.7%
DTE ENERGY	11.6%
KEYSPAN CORP	9.1%
FIRSTENERGY CORP	8.0%
QUESTAR CORP	7.9%
MDU RESOURCES GROUP INC	7.7%
PROGRESS ENERGY INC	5.6%
PEOPLES ENERGY CORP	5.2%
ONEOK	2.7%
NATIONAL FUEL GAS CO	0.8%
NISOURCE INC	0.4%
WGL HOLDINGS INC	-0.4%
TECO ENERGY INC	-6.2%
TXU CORP/ONCOR	-9.9%
EL PASO CORP	-24.6%
WILLIAMS COS INC	-35.1%

- Despite a sector-wide strategic drive over to achieve scale over the last five years, we can find no statistical evidence that shareholders have benefited. Larger companies, as measured by annual revenue, have not produced superior returns to their smaller competitors. This result could be indicating that recent additions to scale were done more for diversification than for trying to maximize profitability through scale in a specific business line (e.g., electric delivery).

- Transforming mergers have had questionable value for shareholders. Among the group of 64 companies, 18 (28%) were formed during the 1998-2002 period as a result of one or more business combinations consisting of a target company with market value of at least 50% of the value of the acquiring company. The median average annual return for these merged companies was 0.0%, as compared to the 2.6% group median for the period. This statistic masks a number of successful mergers, such as **Exelon** (PECO/Unicom), **Dominion Resources** (Dominion/CNG), and **Keyspan** (Keyspan/Eastern Enterprises), as measured by their top-quartile shareholder returns.

- As expected, companies in our group were rewarded for generating earnings efficiently from their respective capital bases. Top-quartile performers had a median Return on Capital Employed (ROCE)[5] of 3.2% for the five-year period, while bottom-quartile performers had a median ROCE of negative 0.7%. ROCE, it can be argued, is a more stable measure of financial performance than shareholder returns since it depends on

[5] Return on Capital Employed = Net Income / (Total Assets – Current Liabilities)

earnings, not volatile stock prices. It is also evident that markets do not always reward current earnings, as evidenced by companies such as **NICOR, Inc.** and **TECO Energy, Inc.**, both of which had top-quartile ROCE and only 3rd quartile shareholder return.

Five-Year Annualized Returns of Companies with Highest Five-Year Average ROCE[3]

Company	5-Year Average ROCE	5-Year Average Annual Shareholder Return
NICOR INC	6.4%	0.1%
NEW JERSEY RESOURCES	5.9%	7.8%
QUESTAR CORP	5.9%	7.9%
TECO ENERGY INC	5.7%	-6.2%
FPL GROUP INC	5.5%	4.3%
VECTREN CORP	5.3%	3.2%
MDU RESOURCES GROUP INC	5.1%	7.7%
SEMPRA ENERGY	5.1%	4.5%
PEOPLES ENERGY CORP	5.0%	5.2%
AMEREN CORP	4.9%	5.7%

Looking Forward

The pace of electric and gas restructuring has slowed, and uncertainty over many important restructuring issues still hangs like a heavy cloak over the energy industries. But markets and companies are not standing still. The looming question is: Which companies are best positioned to achieve top financial performance in the next five years, and what strategic choices and franchise positions will achieve these superior results? The past, as our investment advisors remind us, is not necessarily an indicator of future performance. Then again, history reminds us that those that fail to heed the mistakes of the past are doomed to repeat them. So what lessons are relevant and applicable for the foreseeable future?

- Regulated rate of return utility businesses are back in favor, and are likely to remain so for some time. Allowed ROEs in 2002 rate cases averaged 11.1%[6], according to Regulatory Research Associates, Inc., and many utilities are able to earn above these rates through innovative ratemaking, favorable franchise characteristics, and attention to operating costs. Lacking many attractive investment alternatives, these returns can be compelling to value and growth investors alike.

- Deregulation has certainly been a factor affecting financial performance of the industry or individual companies. No doubt, some models of restructuring placed the utility at greater risk, but the financial outcome has

[6] Average of Electric Utilities (11.16%) and Gas Utilities (11.03%). Source: Regulatory Research Associates, "Regulatory Focus, Major Rate Case Decisions, January 1990-December 2002."

been more driven by the strategic choices made by companies and the resulting impacts on investor confidence and capital flow. Looking forward to additional restructuring at both the state and federal levels, perhaps more important than the degree of continued industry restructuring will be the willingness of regulators to lay out a clear path, and stick to their public policy commitments. Regulatory certainty and a fair treatment of stranded costs resulting from restructuring create an atmosphere of investor confidence.

- In light of the mixed nature of post-merger experiences in recent years, the value of mergers will be questioned in terms of their value to shareholders and by the regulators on behalf of ratepayers. Merger activity has slowed considerably as the strategic mandate to merge has given way to reduced expectations for synergies absent a cohesive restructuring model for the nation's utilities. Nonetheless, mergers can be expected to resume, albeit at a slower pace. We would expect mergers of a more conservative electric-electric and electric-gas distribution nature to emerge. Those with modest premiums and guaranteed ratepayer savings can be expected to win board and regulatory approvals.

- Exiting businesses can enhance shareholder value, as notably exhibited by **Southern Company's** spin-off of **Mirant Corp**. Implementation of Standard Market Design by FERC, particularly in light of FERC's proposed policy of equity premiums for independent Transco's, will prompt the careful evaluation of spinning off transmission assets in the next few years.

- Transmission is emerging as both an opportunity and a potential drain on the balance sheet given the direction of FERC policy on Standard Market Design and formation of regional transmission organizations. Decisions regarding the restructuring of transmission – and the continuing uncertainty over investment recovery rules – will be important drivers of financial performance in the next five years.

- Foreign ventures are fraught with peril. Companies investing overseas require substantial balance sheets, a patient investment horizon, and a tolerance for political risk. Overseas capital flows will likely subside until a compelling case can be made for value added through foreign expansion for U.S. utilities.

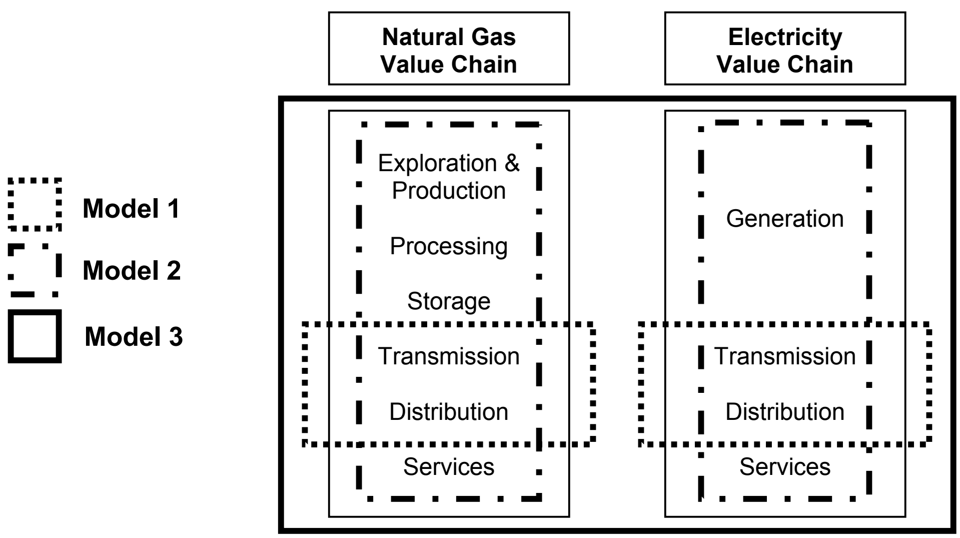
- Not to be overlooked are the opportunities presented by the sharp reversal in fortune by the companies with substantial portfolios of merchant assets. Those companies with "dry powder" on their balance sheets are well positioned to grow through selective acquisition, and capitalize on "cash flow" valuations without the strategic premiums witnessed over much of the prior five years.

- In the aftermath of restructuring, litigation remains a significant problem for about twenty companies. Claims against electric and gas companies accused of market manipulation in the California market amount to at least $8.9 billion, and with civil findings of antitrust damages, damages may be trebled.

Conclusions

The restructured utilities industry is now a diverse mix of companies with some well-differentiated business models. Financial performance, as measured through shareholder returns and related metrics, is now as varied as the broader market. Companies that have ventured well beyond core utility businesses have been penalized, particularly in the past two years. Unregulated subsidiaries and overseas investments have more often detracted from core utility performance than enhanced it. In light of these outcomes, many utilities have recently announced a return to their regulated utility roots. Nonetheless, future performance will undoubtedly continue to be as varied as the strategic options. We see three enterprise models emerging from this environment:

Emerging Enterprise Models in the Energy Value Chain



Model 1 – Focus on Electric or Gas T&D

This model is a return to the pre-restructuring era, where the regulated franchise represents the core business, but the nature of the business must evolve to fit the new market paradigm. Earnings growth will be a factor of innovation with incentive rates, rate base additions of new transmission and distribution assets, cost management, growth in the service area, and accretive mergers.   Examples of Model 1 include **Southern Union** (Gas Distribution), **NStar** (Electric T&D) and **EnergyEast** (Electric T&D and Gas

Distribution). Emerging transcos such as **National Grid, TransElect** and **TransLink** also fit this model.[7]

Model 2 – Focus on Vertically Integrated Gas or Electric Operations
In addition to the core utility franchise, earnings growth and diversification will be sought through investments in core competitive enterprises, including: Generation and Energy Services. Wholesale Marketing and Trading operations, once considered a profit center, are increasingly considered a risk management function. Companies representing this business today include: **FPL Group**, **Southern Company and Entergy Corp.** (vertically integrated electrics), and **ONEOK** and **Questar** (vertically integrated gas companies). Companies such as **Exelon Corp**. or **Keyspan Corp.** represent a hybrid model that combines an integrated electric business with gas distribution.

Model 3 – Extensive Integration of Gas and Electric Value Chains
For these companies, the regulated utility will serve as part of a diversified portfolio of energy operations, including upstream (production, LNG, generation), midstream (gathering, processing, transmission, storage, marketing & trading), and downstream (distribution, retail marketing, energy services) segments. In the wake of **Enron's** demise, and the liquidity problems facing companies such as **Williams** and **Dynegy**, the diversified model has fallen out of favor for the time being. We believe, however, that a handful of companies, which might include **Duke Energy** or **Dominion Resources** will ultimately present a less leveraged view of the diversified model in coming years. These companies will challenge their utility competitors with the potential upside from their unregulated investments and earnings protection through physical hedging throughout the energy value chain.

If repeal of the Public Utility Holding Company Act (PUHCA) survives in the energy legislation working its way through Congress, it can be expected to facilitate additional investment in unregulated subsidiaries, and ease the process of interstate and foreign mergers. It also remains a possibility that the energy "majors" may look downstream to utility franchises as an investment option for the cash flow emanating from substantially higher oil and gas prices. With this growing investment latitude, the onus will shift more fully to management to satisfy consumer and shareholder requirements through carefully planned strategy. More than ever, winners and losers will be determined by the quality of these strategic decisions.

[7] National Grid, TransElect and TransLink were not included in the Annualized Shareholder Return rankings.