

# The Energy Insider

March 31, 2003



## The Energy Industry's Up a Creek – but Who's Got the Paddle?

From recent headlines you might get the idea that the natural gas and electricity industries are dying a slow and painful death – ready to join the dot.coms and telecoms in the junkheap of overexuberance. Not really. Let's face it, we all continue to use gas and electricity (with no intentions of stopping anytime soon). So the reality is that while the financial and business behavior problems of the wholesale marketing and electric generation sectors continue to skew our perception of the industry, a number of less aggressive utility companies have quietly churned out steady profits. And many Exploration and Production (E&P) firms appear well-positioned to profit impressively from today's high gas prices.

The bottom line is that the energy industry in reality is highly polarized – with two sides eyeing distinctly different business prospects for 2003. For one side the view is gloomy. Companies with large generating assets forced to sell power at market prices and companies with significant wholesale trading activity have good reason to see stormy seas ahead. But for the other side it's literally a new day dawning. Utilities, pipelines and E&P companies that avoided the rush to borrow money to build market-based generation and get involved in the trading craze are looking forward to a year of clear sailing. Who are the winners and losers in this game? Read on to see your prospects for 2003.

### **Breaking up is hard to do....**

Even within the energy industry, we are seeing a high degree of polarization in 2003. For the electric industry, supply suddenly seems robust in all

regions but the Pacific Northwest. That spells low prices and few price spikes over the next couple of years. Good for the consumer, no doubt. But what about the owners of those expensive new generation projects built to satisfy our hunger for more electricity? Meanwhile, low supply and high prices are likely here to stay in the natural gas industry – for at least two to three years while production catches up with current supply tightness. Even more bad news for the generators running on natural gas. High gas prices and low electric prices are an equation none in this sector of the industry enjoys seeing. As if that weren't enough, many of these same players are struggling with increasingly active (and potentially expensive) regulatory investigations into their past business practices. At the same time, they are also subject to the extreme market uncertainty of ongoing changes brought on by FERC's Standard Market Design (SMD) and the push to expand Regional Transmission Organizations (RTO) on the electric transmission system.

Yet on the regulated utility side (you remember them, the stodgy ones earning returns of only 10-12%), a period of favorable regulation appears imminent. The pressure for quick deregulation of retail markets has quickly subsided, slowed by the bankruptcy of PG&E and the near meltdown of Southern California Edison and Nevada Power. And now, rates and returns that could ensure the health of our utilities seem ever so prudent.

### **Where do we fit in?**

Let's dust off the crystal ball and take a look at

what the various energy sectors might expect in 2003:

### **Generating Companies and Wholesale Traders**

As you've probably guessed, this sector will struggle – at least for the short term. Virtually all in this sector with large exposure to selling generation output at market prices or with large volumes of wholesale trading are in deep financial trouble. These entities borrowed heavily to build power plants and trading floors with visions of huge returns. Now they cannot generate the revenues required to maintain an acceptable rate of return on those assets. Moreover, they have virtually no access to capital for refinancing (except at incredible rates and terms) and have the concurrent problem of ongoing regulatory investigations into past practices.

This sector is poised for tumultuous change in 2003. Merchant generation companies will be restructured either by bankruptcy courts or lenders fearful of losing their investment. And as we've seen too much in the past, shareholders will be left with shares worth pennies on the dollar. Over time, this sector will be restructured with considerably lower debt costs. But it may be well past 2003, and probably too late for the current owners of these assets. Of course, as players such as Warren Buffet have noted, these assets are becoming valued so low that it may well be time to start buying into this sector.

### **Utilities**

The stodgy utilities that avoided the temptation to chase high returns during the boom years find themselves newly invigorated. These would be companies whose primary earnings are regulated and serve end-use customers. As the stock market continues to stumble, steady returns and dividends (remember widow and orphan stocks?) are once again an attractive proposition. That's not to say that these companies are without risk. Lower returns based on lower interest rates, loss of sales due to the stagnant economy, exposure to high gas prices, and the potential for huge counterparty risk in supply arrangements all exist. But suddenly these risks appear tolerable when com-

pared to alternate investments. Of course, utilities whose parent companies dabbled in merchant generation and wholesale trading are by no means free and clear. These companies remain at considerable risk for "contagion" (i.e., higher capital costs, regulatory scrutiny, and lack of marketplace trust brought on by risky activities of the corporate parent.)

### **Transmission Companies**

The outlook for the transmission sector, which once consisted of just gas pipelines but has now expanded to include electric transmission companies, is mixed. Many pipelines continue to be solid investments with steady and sure rates of return. But others, with financially troubled parents, are at great risk for contagion. What's more, the FERC's current proceeding that may penalize El Paso Pipeline for its alleged manipulative operating decisions has the pipeline industry running scared. (By now we've all learned that further investigations into market behavior are never a good sign.) And on the electric side, regulatory uncertainty for transcos is the new way of life. RTO and SMD structures are in their infancy and who can say if authorized rates of return will compensate for the risks of doing business in unpredictable market structures?

### **E&P Firms**

Clear sailing! As long as prices hold, get ready for another profitable boom!

### **To sum it all up...**

While the aggressive merchant generators and wholesale traders struggle to survive, more traditional utilities and E&P firms appear well positioned for success – at least in the short term. Meanwhile, regulation of the electric wholesale and transmission markets will continue to evolve, resulting quite possibly in a vibrant electric wholesale marketplace (and a whole new team of players). This may over time – though certainly not this year – create conditions conducive to electric retail customer choice across the United States. And who knows, by that time gas supply may have increased and it will be time for gas companies and electric utilities to start worrying!

## How Does Your Company Rate?

### Merchant Generation and Wholesale Trading Companies

Significant Wholesale Activity	Regulatory/Litigation Issues	Refinancing Issues	Least Exposed
Allegheny Energy Supply Aquila Calpine Dynegy Duke Capital Corp Exeelon Generating Mirant PPL Energy Supply PSEG Power Co. Reliant Resources Williams Companies	Aquila Duke Capital Corp Dynegy Mirant Reliant Resources Williams Companies	AES Corp Allegheny Energy Supply Aquila Calpine Dynegy Mirant Reliant Resources Williams Companies	Ameren Energy Generating Southern Power Co.

### Utilities and Utility Parent Companies

Significant Wholesale Activity	Regulatory/Litigation Issues	Refinancing Issues	Least Exposed
AGL Resources Allegheny Energy American Elec. Power Appalachian Power Co. Arizona Public Service Atlantic City Electric Avista Corp Baltimore Gas and Elec. Central Power & Light CMS Energy Columbus Southern Power Commonwealth Edison Connecticut Light & Power Constellation Energy Group Consumers Power DPL Duke Capital Corp Duke Energy Corp Edison International Entergy Exelon IdaCorp Idaho Power Illinova	American Elec. Power Arizona Public Service Centerpoint Energy Centerpoint Energy CMS Energy Constellation Energy DPL Duke Capital Corp Duke Energy Corp. Edison International El Paso Electric Illinois Power Illinova Nicor Gas Co. Nicor Inc Northeast Utilities Portland General Elec. Xcel Energy	Allegheny Energy Centerpoint Energy Centerpoint Energy CMS Energy Consumers Energy Edison International Illinois Power Nisource NiSource Inc. Northern States Power Pacific Gas& Elec. Pinnacle West Capital Portland General Elec. TECO Energy Xcel Energy	Alabama Power Ameren Corp. AmerenCIPS AmerenUE Atlanta Gas Light Co. Boston Edison Cental Hudson G&E Central Illinois Pub. Svc. Central Maine Power Central Vermont Publ. Svc. Cincinnati G&E Cinergy Cleveland Electric Illum. Consolidate Edison of NY Consolidated Edison Dayton Power and Light Detroit Edison DQE, Inc. DTE Energy Co. Duquesne Light Energy East Corp Georgia Power Co. Green Mountain Power

<p>Indiana Michigan Power                  Indianapolis P&amp;L                  IPALCO Enterprises                  Kentucky Power                  Monongahela Power                  Northeast Utilities                  Northern States Power                  Ohio Power                  Oncor Electric Delivery                  PECO Energy                  PEPCO Holdings                  Pinnacle West Capital                  Potomoc Edison Co.                  Potomoc Electric Power                  PPL                  PPL Electric Utilities                  Public Service Co. of OK                  Public Service Enterprise                  Public Service of Colorado                  Public Service of NH                  Public Service of NM                  SDG&amp;E                  Sempra Energy                  Southwestern Public Serv.                  Tampa Electric                  TECO Energy                  TXU Corp                  TXU US Holdings                  West Penn Power                  West Texas Utilities                  Westar Energy                  Western Mass. Electric                  Xcel Energy</p>			<p>Gulf Power Co.                  Hydro Quebec                  Kentucky Utilities                  KeySpan Corp                  Kinder Morgan Inc.                  Laclede Gas Co.                  Louisville Gas and Elec.                  MidAmerican Energy                  MidAmerican Energy Hold.                  Mississippi Power                  National Fuel Gas Co.                  Northern Indiana Pub. Svc.                  Northern Natural Gas                  Northwest Natural Gas                  NSAR                  NY State Elec &amp; Gas                  OGE Energy Corp                  Ohio Edison                  Oklahoma G&amp;E                  Orange and Rockland Elec.                  Otter Tail Power Co.                  Pennsylvania Power Co.                  Peoples Energy                  Peoples Energy Corp                  PSI Energy                  Rochester Gas &amp; Elec.                  SCANA Corp                  South Carolina Elec. &amp; Gas                  Southern Company                  Southern Union Co.                  Southwest Gas Co.                  Toledo Edison                  UIL Holdings Corp                  Washington Gas Light                  Wisconsin Electric Power                  Wisconsin Energy Corp.</p>
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### Transmission Companies

(Note: most transmission companies are listed in above categories based on corporate parents)

Significant Wholesale Activity	Regulatory/Litigation Issues	Refinancing Issues	Least Exposed
	Texas Gas Transmission Transcontinental	CMS Panhandle	