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CONGRESS MAY SPARK ELECTRIC UTILITY TAKEOVERS

Monday's announcement by Duke Energy that it will merge with Cinergy is just the first of many as the electric utility industry consolidates in a fashion reminiscent of the banking industry. During the 1990's, federal regulators relaxed Depression-era rules that forbade banks from engaging in inter-state banking, as strict interpretations no longer made economic sense. Congress finally passed the Financial Modernization Act, eliminating formal restrictions on interstate banking. A consolidation frenzy ensued; in its aftermath, most Americans bank at 20 large companies, not the many hundreds of local institutions they used before.

Now, it's the electric utilities' turn. For seventy years, the SEC has administered the Public Utility Holding Company Act (PUHCA), which places limits on who can own electric or gas utilities. Congress passed PUHCA when the same electric company generated its own power, transmitted it, and then distributed electricity to retail customers. Increasingly, this is no longer the case, and regulators recognize that fact. Just how far the SEC may go will be tested by the Duke/Cinergy announcement. The merger will not survive a strict interpretation of PUHCA's geographical "contiguous" test as shown by the map at http://www.duke-energy.com/company/aboutus/merger/map.asp . Duke's electric customers are in North Carolina while Cinergy's mostly are in Ohio and northern Kentucky. Lawyers apparently have told their CEO's that PUHCA hurdles can be overcome.

When are "PUHCA rules" really rules? That remains in flux. Although the Duke and Cinergy CEOs are celebrating, last week a SEC administrative law judge threw a red flag at American Electric Power, retroactively overturning the company's acquisition of Central & South West Corp and compelling the SEC to revisit its merger approval decision. The two companies are 1,000 miles apart, and he found they are not contiguous.

Congress is Ready to Step In – Again

Most utility CEO's are unwilling to bet their companies making case law. They will wait until the rules are clear before accepting a merger deal. Congress probably will help them. During the last Congress, an energy bill that included PUHCA repeal made it to the Senate floor for final passage. The next stop was President Bush's desk. A November 2003 filibuster launched by Senator Schumer (D-NY) succeeded when only 57 Senators voted to end debate. Five GOP Senators voted with Schumer because they oppose a provision that gave legal liability protection to chemical companies that had manufactured and sold methyl tertiary butyl ether (MTBE), an EPA-mandated gasoline additive. MTBE contaminated some groundwater because commercial distributers stored it improperly underground in containers that leaked. Trial lawyers assert that clean up costs will amount to $29 billion, well above what the storage

tortfeasors, mostly small businessmen, can come up with. If potential defendant companies – such as Lyondell Chemical (**LYO**), Valero (**VLO**), ExxonMobil (**EOM**), and Huntsman Corp (**HUN**) – secure federal exemption from paying what their much smaller, misbehaving customers cannot, then the states will have to ante up.

Assuming the Senate passes its version of energy reform, House-Senate conferees for the energy bill are likely to reach an MTBE compromise. Manufacturers probably will not wriggle off the legal hook completely. However, they could receive $2 billion federal "transition payments" to finance retrofitting their plants under a provision inserted into the House-passed bill. President Bush has offered to broker a final bill, if necessary.

Following their upset defeat last Congress, energy reformers got off to a fast start this year. On April 21, 2005 the House of Representatives passed a bill by a vote of 249 to 183 similar to the bill that made it to the two yard line last Congress.

It is now the Senate's turn to act. The Senate and Energy and Natural Resources Chairman, Pete Domenici (R-NM), plans to push a bi-partisan bill through the Committee by Memorial Day, and then take it the Senate floor soon thereafter. The Senator's bill will be similar to the House bill, and it will include PUHCA repeal. However, Domenici likely first will determine if he can make this year's bill more comprehensive by pushing new reforms sought by the Administration, as well pushing some new ideas of his own.

The White House wants the U.S. to build new refineries, something that it has not done since the 1970s, siting them on abandoned military bases. Many analysts believe that inadequate refining capacity has played a role in raising gasoline pump prices. The Administration also wants to give siting authority to the Federal Energy Regulatory Commission (FERC) to locate one or more new Liquefied Natural Gas (LNG) terminals somewhere on America's coasts. Finally, Domenici thinks the time has come for America to get over the 1979 Three Mile Island accident by authorizing the building of new nuclear power plants, and he will provide assistance to clear away state and local regulatory obstacles, and also possibly provide direct subsidies.

Domenici is unlikely to push these proposals past the point where he no longer garners the sixty votes needed for a final energy bill to clear the Senate. For this reason, Alaska oil drilling will be left out of the bill that reaches the President's desk. Ultimately, the arctic drilling issue will be fought out as part of the budget fight, not the energy bill. CAN gives "Senator Pete" a 60 percent chance of shepherding an energy bill to the President, who would sign it.

<u>How to Play PUHCA Repeal</u>

The odds are high that any energy bill presented to President Bush will repeal PUHCA. Repeal will affect most directly 31 "registered" utility holding companies; a list is available at http://www.sec.gov/divisions/investment/opur/regpucacompanies.htm . Still, the biggest change that PUHCA repeal would bring is the probable entrance of new investors who could decide to snap up many of the 200+ publicly-traded electric utilities. Currently, a non-utility company

cannot take more than a ten percent voting interest in an electric utility without having to divest itself of all non-utility assets because it would now become a “registered holding company” just like the 31 companies noted above – a “poison pill” if there ever was one. Therefore, ExxonMobil, whose market capitalization roughly equals the entire value of all U.S. electric utilities, cannot own more than 10 percent of any of them! Warren Buffett’s hands are tied also, and he wants them untied. He has said that Berkshire Hathaway, which sports a AAA credit rating, will invest $10 billion to $15 billion more in the utility business when PUHCA is history.

In addition to non-traditional investors, stronger utilities also may decide to buy weaker ones when they no longer have to meet the “geographically contiguous” test. Thus, California’s impaired electric utilities, for example, could be bought by stronger east coast utilities. Given that many utilities have weak balance sheets, both equity and fixed income investors of such companies could benefit when stronger companies come a-callin’ with takeover offers.

Investors can take several approaches to utility investing. They may capture potential takeover gains by purchasing the securities of smaller or financially weaker electric companies, and then wait for larger and better off suitors to appear. As Monday’s market reaction to the Duke Power purchase of Cinergy makes clear, the equity value of acquiring companies often goes down while shareholders of the purchased companies pocket double-digit premiums. An efficient way to do this might be to buy an exchange traded fund that specializes in utilities. Two come to mind – **(IDU)** and **(XLU)**. After purchasing either, investors can short the largest electric companies, such as Exelon (**EXC**), Dominion (**D**), or Southern (**SO**), who might be suitors in a post-PUHCA world.

A review of the holdings of the **Gabelli Utility Trust** may inspire other ideas. A representative of this company has stated that it is designed to benefit from PUHCA repeal.

In addition, investors can scan a list of companies that joined the“Coalition to Repeal PUHCA Now!” In 2001, a congressional witness from Xcel presented this list, found at http://banking.senate.gov/01_03hrg/032901/sparby.htm . Coalition members presumably know their best interests better than anyone else.

Electric Companies Planning Transmission Investments Could See a Boost

Policymakers haven’t forgotten what happened to California in 2001 when a shortage of transmission capacity made it impossible to import power to northern California. Nearby generators with transmission capacity enjoyed the sellers’ market of a lifetime. GOP policymakers are determined to avoid a similar episode in the future by giving FERC the authority to pre-empt state and local authorities who refuse to specify pathways for high priority new transmission lines within one year. The House also wants to make transmission investments more profitable. Its bill orders FERC to do an “incentive rate” rulemaking for critically needed lines. FERC now decides how much line owners get paid when their lines are rented by others to ship power. Finally, the House bill also reduces taxes by $1.5 billion over ten years on transmission company investments.

Chronic congestion doomed California ratepayers in 2001. However, congestion frequently happens elsewhere. When it does, sometimes the lowest cost power producers have no way to ship to utilities that want to buy power from them. Now that independent power generators supply forty percent of the country's electricity, solving the transmission shortage problem is a key to the profitability of low cost generators and electric utilities alike.

Congress Should Extend Favorable Dividend Tax Rules This Fall

This fall, Congressional Republicans plan to extend individual income tax rules that limit taxes on dividend income to at most fifteen percent, resetting the date they will expire to December 31, 2010. Under current law, the top rate will revert to 35 percent on December 31, 2008. Using the "reconciliation budget process," Senate Democrats cannot block this extension. It is difficult to imagine a group that will benefit more by the extension, given that dividend income is a major reason why many investors purchase utility shares.

Is Broadband Over Powerlines the Third Wire to the House?

A 21st century utility merger may be driven by ventures into new lines of business altogether. Ultimately, 20 percent of broadband customers may receive their Internet service from electric utilities. The latest broadband over powerline (BPL) technologies match or exceed cable modem speeds and no longer interfere with ham operators. BPL users can take their computers and plug them in anywhere by using an inexpensive attachment. Whether broadband will become an important electric utility profit center depends mostly on marketing skill. If enough households sign up, then utilities will more than recoup their fixed investments with subscriptions prices equaling their competitors. Reportedly, their "costs per home passed" are less than for cable or DSL. An estimated twenty companies are exploring the possibilities, including Ameren, ConEdison, Florida Power & Light, PEPCO, Cinergy, Duke, Idaho Power, PPL, Progress, Pacific Gas and Electric, and Southern. Many electric companies are likely to lease their lines to others at first, rather than enter the business themselves.

Clean Air Regulations Cloud the Picture

Coal-fired electric utilities, which supply 51 percent of the nation's electricity, are a major source of air pollution. While much has been done to clean the air, the Bush White House wants to do more, and it will be expensive. When its legislative proposal to reduce sulfur dioxide, nitrogen oxide, and mercury emissions stalled in the Senate, the EPA decided to implement what it can through two rule makings:

- On March 10, 2005 the Agency issued its "Clean Air Interstate Rule" which will apply to power plants in 28 states, serving 75 percent of the population. The rule will require power plants to reduce their sulfur emissions sharply, from 9.4 million tons annually now to 3.6 million in 2010, and to 2.5 million tons by 2015. The Rule also will require comparable reductions in nitrogen oxide emissions in these states, from 3.2 million tons annually to 1.5 million tons in 2009 and 1.3 million tons in 2015.

- On March 15, 2005, the Agency also issued its "Clean Air Mercury Rule," the first time mercury emissions rules have applied to coal-fired utilities. The Rule will affect five hundred plants and require emissions to fall from 48 tons now to 38 tons in 2010 and 15 tons in 2018.

James Connaughton, the White House appointed Chairman of the U.S. Council on Environment Quality, testified before the Senate on February 1, 2005 that utilities would have to pay "more than $52 billion to install, operate and maintain new, primarily clean coal pollution abatement technology on both old and new power plants" under Bush's Clear Skies initiative. A rough estimate of the cost of the two Rules would be $39 billion. The price tag will go up if "Clear Skies" clears Congress, or if carbon dioxide is one day subject to air pollution controls. Coal-fired power plans generate 32 percent of all U.S. man-made carbon dioxide emissions.

Putting it All Together

Investors in electric utilities have important fundamentals on their side. They face better than "even money" odds that PUHCA repeal will spark unprecedented industry consolidation and that Congress will extend the 15 percent tax rate on dividends for another two years. They also are looking at a growing probability of unexpected telecom revenue. As investors pick through the shopping list, however, they should avoid the largest utilities, which may find themselves competing with Warren Buffett to take over smaller rivals, at premium buy-out prices. They should stay away from the coal bin, too.

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