
CAPITOL ANALYSTS NETWORK, INC.

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THE WARREN BUFFETT ELECTRIC UTILITY PARTY

Imagine you own out-of-the money warrants on five companies, and on your birthday, you unexpectedly receive warrants on 402 other companies, some already in the money. Before the 107th Congress adjourns in October, shareholders of electric utilities or natural gas retailer distributors may have such a reason to celebrate. There is a 60 percent chance Congress will send to President Bush a major energy bill before adjournment. If it does, the bill is almost certain to include the electric utilities not so secret birthday wish – repeal of the Public Utility Holding Company Act (PUHCA).

How Many Years Does It Take to Reform Outdated Laws?

Congress passed PUHCA in 1935 after dishonest insiders running multi-state utilities had defrauded shareholders using phony accounting and other connivers gouged ratepayers by bamboozling weak state regulators who couldn't figure out the shell games played across state lines. In response, the newly created Securities and Exchange Commission (SEC) was tasked to attack both problems. Cleaning up the accounting scams took 15 years as utilities were forced to simplify their corporate structures and divest their holdings while state governments beefed up their auditing teams.

Congressional efforts to shut down the interstate shell games had one unfortunate consequence; it deformed the electric utility industry in ways that still hurt it and its customers today. Most destructive, it severely limits mergers by making illegal, with very few exceptions, interstate combinations that don't involve utilities sharing a border. Of the 407 publicly traded electric utilities, approximately 50 have market caps of \$1 billion or more. If each of these 50 shares a border with four other companies, then the number of possible significant mergers is limited to 151. If *any* two utilities, anywhere, could merge, then the number of merger combinations soars to 2,450. As a result of PUHCA, many profitable mergers cannot take place now.

From the days of President Reagan, the SEC has supported neutering or repealing PUHCA, stating that the Act has outlived its usefulness and does more

harm than good. Here is representative language found on page 121 of the SEC's 1995 major PUHCA study prepared and issued during the Clinton Administration, found at <http://www.sec.gov/news/studies/puhc.txt> :

“Today, however, efficiency considerations may argue in favor of allowing holding companies to own utilities in noncontiguous states. Consumers in different states often have different demands for energy, and a company serving several states may make more efficient use of its generation and transmission facilities. Also, there are often significant administrative cost savings from utility mergers, savings that have little to do with whether the utilities serve contiguous areas.”

PUHCA also undermines shareholders by preventing talented executives elsewhere in the energy industry food chain from seizing control of poorly run utilities. Just like utilities, large oil, natural gas, or coal producers cannot make significant investments in two or more electric utilities unless the utilities share an interstate border. The same restriction applies to large industrial electricity users, like General Motors or Alcoa that might want to vertically integrate. the message is clear: external corporate efficiency experts need not apply.

Besides blocking efficiencies and giving succor to mediocre entrenched utilities executives who cannot be disciplined by other market players, PUHCA imposes other costs on shareholders. Utilities must wait for SEC staff approval before they issue debt securities, a costly provision when interest rates are rising. “Registered utility holding companies”, those covered by PUHCA, also cannot meaningfully diversify into non-utility related investments.

When PUHCA is repealed, it's likely that merger activity will pick up sharply once deal making become legal. Just how long does it take for someone to spot free cash on the sidewalk and pick it up? Presumably, shareholder prices of those taken over also will rise.

Warren Buffett, The Sage from Omaha, Weighs In

The sage from Omaha has said that if Congress repeals PUHCA he will plow at least \$10 billion more into the electric utility industry and its \$300 billion market cap. In 2000, Berkshire Hathaway bought a 76 percent interest in

MidAmerican Energy Holdings Co. – but apparently under PUHCA Berkshire can only vote 10 percent of its MidAmerican shares and he isn't interested in buying shares of bordering companies. Given Buffett's ability to draw other investors' attention wherever he goes, this signal flare from Omaha alone warrants the attention of energy investors. The PUHCA debate deserves their careful scrutiny.

Who's on the PUHCA List

According to the Edison Electric Institute, the dominant trade association of privately owned electric utilities, 35 companies now must "register" with the SEC and submit to PUHCA restrictions. This is how SEC Commissioner Isaac Hunt Jr. described them in his testimony before the Senate Energy Committee on February 7, 2002:

"Despite their small number, registered holding companies account for a significant portion of the energy utility resources in this country. As of September 30, 2001, the 27 registered holding systems (which included 35 registered holding companies) owned 133 electric and gas utility subsidiaries, with operations in 44 states, and in excess of 2500 nonutility subsidiaries. In financial terms, as of September 30, 2001, the 27 registered holding company systems owned more than \$417 billion of investor-owned electric gas and utility assets and received in excess of \$173 billion in operating revenues. The 27 registered systems represent over 40% of the assets and revenues of the U.S. investor-owned electric utility industry and almost 50% of all electric utility customers in the United States."

Holding Companies Registered Under the PUHCA as of December 31, 2001

	<u>NAME</u>	<u>GAS/ELECTRIC</u>
1	AGL Resources	G
2	Allegheny Energy	G&E
3	Alliant Energy Corp.	G&E
4	Ameren Corp.	G&E
5	American Electric Power Inc.	E
6	Cinergy Corp.	G&E
7	Central and South West Corp.	E

8	Columbia Energy Group	G
9	Conectiv Inc.	G&E
10	Consolidated Natural Gas Co.	G
11	Dominion Resources	G&E
12	Emere Inc.	E
13	Energy East	G&E
14	Entergy Corp.	E
15	Exelon Corp.	E
16	Exelon Energy Delivery Co.	E
17	Exelon Generation Company	E
18	Exelon Venture Company	E
19	FirstEnergy Corp.	G&E
20	Great Plains Energy Incorp,	G
21	Keyspan Corp	G&E
22	National Fuel Gas	G
23	National Grid Group PLC	E
24	National Grid USA	E
25	NiSource Inc. Holding Co	G&E
26	Northeast Utilities	G&E
27	PECO Energy Power Co.	E
28	Powergen PLC ADS	G&E
29	Progress Energy, Inc	G&E
30	Scana	G&E
31	Scottish Power ADS	G&E
32	Southern Company	E
33	Unitil Corp	G&E
34	WGL Holdings Inc	G
35	Xcel Energy Inc	G&E

Source: Edison Electric Institute

Waiting On Congress

On August 2, 2001, the House passed HR 4, the Securing America's Future Energy Act of 2001. The Senate passed its version of HR 4 on April 25, 2002. Negotiators for the two bodies soon will begin lengthy negotiations to iron out the differences between the two bills. Although the House bill is silent on PUHCA reform, repeal has long been a goal of the House GOP. Consequently, House negotiators will eagerly accept the Senate position – outright repeal with some auditing functions shifted from the SEC to the Federal Energy Regulatory Commission, or something similar.

Unfortunately, unwrapping the utilities' birthday present won't be that easy. HR 4 covers controversial topics where the House and Senate start far apart, including drilling in the Arctic National Wildlife Reserve (ANWR), raising fuel economy standards for autos and light trucks. Also, the House wants to provide twice as much in tax incentives as the Senate, and the two bodies mostly target different energy production and conservation efforts.

These differences have a 60 percent probability of being resolved before adjournment this year. Consequently, it's more likely than not that Mr. Buffett will be wearing a birthday party hat soon. They can come to the party, too.

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