

# The Modern Utility: Still a Black Box?

Wall Street bankers say utilities are not effectively telling their story.

BY RICHARD STAVROS

**H**ow do you value an investor-owned utility? Ever since the Enron debacle, the credit crisis and the economic downturn, many in the investment community say that there exists a need for utilities to better communicate their business vision and corporate model—particularly now that the economy is headed into an economic upswing and utilities will have to compete with higher-yielding financial instruments such as U.S. treasuries, or competing equities with higher-paying dividends.

Furthermore, bankers say that it is not that investors and analysts necessarily don't understand the risks, but that up and down Wall Street there are varying levels of how well the utility industry is understood. Also, these Wall Street experts say, industry regulation and regulators need to provide more

clarity about the utility business in areas such as wholesale markets and transmission.

Joseph S. Fichera, chief executive officer of Saber Partners, LLC, an investment bank boutique, explains that many of those who trade equity and debt on Wall Street don't have a clear understanding of the fundamentals, and as a result this causes a lot of volatility in utility financial instruments and how investors perceive the business.

"I would say that many [equity and debt traders on Wall Street] have a minimum level of experience, many don't know the difference between a megawatt, kilowatt, or giga-watt, so what do they trade on?"

Fichera says some securities traders have been basing their buy or selling solely on the so-called "technicals," which essentially uses charts or com-

puter programs to identify price trends in the market. But Fichera is concerned that ignoring the fundamentals in the trading of utility securities simply increases volatility and fails to communicate the long-term risks accurately to investors, or even to the utilities and their advisors.

For example, the volatility created by the liquidity crisis as a result in part due to an overreaction by ratings agencies, has caused many utilities to sometimes underestimate investor demand for their securities and, in some cases, resulted in gross overpayment in their mad dash for liquidity this year. "There was almost a panic approach to raising capital. And in that situation, buyers are king," he says. In fact, there have been specific transactions where utilities have sold debt instruments at an enormous spread, only to find that the very next day in the secondary market the debt instrument tightened by 20 basis points, he says. "That is a huge tightening of the spread. They could have sold that bond at 20 basis points less a day earlier," Fichera says, suggesting that there was a substantial misreading of investor demand and as a result the security was mis-priced.

It is circumstances like these that have prompted Fichera and others to call for an improved dialogue between the industry and Wall Street. He



Joseph S. Fichera, Saber Partners



Jeff Holzschuh, Morgan Stanley



George Bilicic, Lazard



Frank Napolitano, Lehman Brothers

believes that investors recognize there are risks in any investment, but a better understanding of the risks between one entity versus another is needed. Trying to group utilities together is one of the problems, he says. When advising the Texas Public Utilities Commission, Fichera says he held quarterly conference calls with Wall Street analysts and regulators to provide a clear dialogue between regulators and the investment community.

“Companies and their investment bankers need to go back to the old-fashioned practice of getting the credit story out before a deal. They need to speak to a broader range of investors. And rather than following the pack, focus on concentrated parts of the capital markets. In getting the story out, they will broaden the investor base. This means more aggressive marketing with investment bankers that sell the story on a long-term basis, as opposed to just doing transactions.”

### **Shining Light on Evolution**

The restructuring of the industry has altered the way many utilities are run. As a result, many companies offer investors varied risks, growth and value propositions. No longer can investors use a one-size-fits-all valuation of individual utilities, bankers say. That is why Jeff Holzschuh, managing director and head of the global energy and utility group at investment bank Morgan Stanley, believes there is a need to find clarity and transparency. Holzschuh co-chairs the Edison Electric Institute's Wall Street Advisory Group, a subcommittee of the EEI's chief executive officer's committee.

“Historically, each individual company would come to the Wall Street community and come to the ratings agencies independent of each other, but a lot of utility companies have become so different and so varied, there is a

benefit in having a consistent point of view on the fundamental segments of the business. So you don't have many different suggestions to the ratings agency as to how one might treat some aspect of the balance sheet.”

Furthermore, Holzschuh says valuations of the utility industry likely would go up if the industry had better transparency and more consistent methodology in valuing individual utilities.

The intent of the Wall Street Advisory Group, he says, is to assist EEI and the senior managers of these companies to provide real-time Wall Street feedback. So, as they think through issues such as disclosure, how often should they be giving earnings guidance, should there be an open and transparent trading market, are there things that we can do to educate constituents such as ratings agencies and investors,” he says.

Furthermore, Holzschuh believes that this advisory group would provide the industry with perspective on such issues as how to finance transmission, and be responsive to issues as they come up. “In effect what we are going to do is prioritize a list of 20 issues that this group will try to provide some feedback to the EEI CEO group on. The group's mandate is to try to add a perspective and add value in areas where we have specific expertise. It is not to be an academic exercise. It is a much more practical application of those skills.”

### **Regulators and Limited Options Cloud Picture**

Beyond the increased communication that is being sought between utilities and investors, most experts believe that regulators still have to provide a clearer picture to both camps. That is why it is a difficult time in the industry, many say, because utilities have addressed their liquidity issues and now must attempt to plan a strategy or future under a cloud of regulatory uncertainty.

George Bilicic, managing director and group head at investment bank Lazard LLC, has called this time the “year of the strategic planner,” and says that CEOs and CFOs face the difficulty of balancing a utility's regulatory risk with many other concerns.

“The greatest concerns of CEOs and CFOs are: 1) the continued inability to predict ratings agency actions; 2) concerns about what state regulators may do in pending rate cases or in the context of other regulatory proceedings; and 3) continued balance sheet and liquidity challenges as re-capitalization efforts are ongoing,” he says. In addition, if this were not enough, Bilicic notes that those officers must do business in a sluggish economy, in a negative power price and volatile gas price atmosphere, while evaluating how to meet growth challenges in this stringent back-to-basics environment.

For example, according to Bilicic, “it's no longer possible for utilities to pursue earnings growth through strategies based on international, non-utility business or merchant efforts.” Furthermore, Bilicic says that transaction strategies based on interesting themes, but without substantive support, may have difficulty finding acceptance. As a result, according to Bilicic, “companies will need to do more than merely pronounce that a transaction is attractive for reasons of convergence, geographic diversity, scale or other reasons without substantial content to back-up such reasons.”

Frank Napolitano, co-head of the power group at investment bank Lehman Brothers, says that a “track record of credibility needs to be established over the next 12 months. Then companies will be in a position of credibility again and they can say, ‘I am doing the following growth activity for the following reasons and here is why this one is going to work,’ and people will listen with an open mind as

opposed to immediately dismissing it as a mistake," he says. Like Bilicic, he says that greater clarity on the regulatory front is needed before any major investment can be made.

"The future is the question, and thanks to the blackout, it is no longer an industry question but a national question. [Regulatory ambiguity] is forcing people to not spend money because until there is clarity with respect to market structures, market design, market oversight and responsi-

bility there is going to be a natural reticence to not buy things or build things that would be subject to that ambiguity.

"The question is how soon can this ambiguity be clarified ... and everyone will have an answer to that. I don't know that there is going to be any clarity any time soon. So, that will mean that integrated utility companies will have to eventually look at their own financial profile and decide if they have enough organic growth to satisfy their investors' desires and their dividend

desires. If not then those companies are going to be forced to face a question of shrink, which is rarely an acceptable one or, where can I grow into my core areas. Although the growth question is not one that the markets are answering now, the investment community feels that they will be answered shortly. That is when it will get interesting." ■

*Richard Stavros is the executive editor of Public Utilities Fortnightly. Contact him at stavros@pur.com.*

## Business News Bytes

### Entergy Gives Third-Quarter Operational Earnings Guidance

Entergy Corp. said Oct. 9 that it expects to report 2003 third-quarter operational earnings of \$1.55 per share. The Thomson First Call consensus estimate for the quarter is \$1.56 per share. The company affirmed its 2003 operational earnings guidance of \$4.05 per share to \$4.25 per share. Due to Entergy's voluntary severance program, its previously as-reported range of \$4.37 per share to \$4.57 per share will be revised when fourth-quarter results are reported. Entergy-Koch LP, the marketing and trading unit of

the company, continued to perform well and is expected to offset the company's nuclear unit performance. Lower results at Entergy Nuclear are expected due mostly to lost revenues that occurred during the August blackout. In addition, higher refueling outage amortization from late 2002 will likely impact third-quarter results.

### Calpine, San Diego Gas & Electric Sign 10-Year Power Sales Agreement

Calpine Corp. said Oct. 8 that it signed a preliminary 10-year, 570-MW power sales agreement with San Diego Gas & Electric, a subsidiary of Sempra Energy.

Under the agreement, Calpine will supply electricity to SDG&E from its Otay Mesa Energy Center, a baseload generation plant currently under construction near San Diego. Power deliveries to SDG&E are scheduled to begin in 2007. The agreement, when finalized, is subject to approval by the California Public Utilities Commission. Final approval is expected by the end of the first quarter of 2004.

### Creditors Approve PG&E Reorganization Plan

PG&E Corp. subsidiary Pacific Gas & Electric said Oct. 8 that more than 97 percent of its creditors voted to support the reor-

ganization plan between PG&E and the staff of the California Public Utilities Commission. The company provided the preliminary results of the vote to the U.S. Bankruptcy Court at a status conference held Oct. 8 and anticipated submitting the final results the following week. The court confirmation hearings are scheduled to begin Nov. 10. CPUC hearings to consider the proposed settlement were completed on Sept. 26, and the full commission is scheduled to issue its final decision in late December. Pending approval by all parties, PG&E expects to emerge from Chapter 11 in the first quarter of 2004. ■



TOP 15 COMPANIES BY AGGREGATE POWER PLANT OUTPUT (2002)

Name	Ticker	2002 Total Plant Output (MWh)	Total Plant Capacity Factor	Total Plant O&M/MWh (\$/MWh)	Total Plant Fuel Cost/MWh (\$/MWh)	Coal Output as % of Total Output	Nuclear Output as % of Total Output	Gas Output as % of Total Output	Other plant Output as % of Total Output
American Electric Power Co. Southern Co.	AEP SO	198,479,853	57.7%	20.47	14.24	79.3%	10.2%	10.2%	0.3%
Tennessee Valley Authority		182,725,729	55.4%	22.19	15.85	69.8%	15.6%	11.8%	2.7%
Exelon Corp.	EXC	152,342,086	57.4%	16.28	9.86	63.3%	29.9%	0.1%	6.8%
Entergy Corp.	ETR	141,766,292	63.7%	17.83	7.07	6.0%	89.6%	2.7%	1.8%
Xcel Energy Inc. <sup>1</sup>	XEL	123,172,695	50.5%	24.73	16.00	11.8%	59.3%	26.9%	2.0%
Duke Energy Corp.	DUK	120,443,150	42.6%	23.03	17.07	62.1%	11.4%	23.3%	3.2%
FPL Group Inc.	FPL	106,965,481	41.8%	21.39	14.56	40.7%	38.5%	19.3%	1.5%
Progress Energy Inc.	PGN	101,294,568	49.0%	29.53	24.36	6.1%	25.0%	43.6%	25.3% <sup>2</sup>
Dominion Resources Inc.	D	89,255,381	44.9%	24.64	18.72	48.2%	33.8%	9.2%	8.9%
Edison International	EIX	83,306,303	45.4%	19.95	12.96	51.3%	45.1%	4.0%	-0.4% <sup>3</sup>
TXU Corp.	TXU	79,612,832	50.1%	22.80	15.16	62.5%	23.1%	9.9%	4.5%
FirstEnergy Corp.	FE	74,281,416	42.3%	21.94	16.24	53.6%	21.0%	25.5%	0.0%
Calpine Corp.	CPN	71,481,214	63.8%	24.60	10.22	64.9%	34.2%	0.5%	0.4%
Ameren Corp.	AEE	69,398,288	44.2%	34.61	28.68	0.0%	0.0%	91.2%	8.9%
		60,575,907	49.0%	18.75	12.53	82.0%	13.8%	2.3%	2.0%

1. XEL totals include plants held by NRG Energy, Inc. at 12/31/02. 2. 20.7% of FPL's output in 2002 was generated from oil. 3.5% of FPL's 2002 output was generated from non-hydro renewables. 3. Dominion shows a negative number for Other plant as % of the whole because of the use of pumped storage.