

March 25, 2007

Utilities Power Ahead As Market Revives

 By **CHRISTINE BUURMA**

March 25, 2007

As fears of a weakening global economy and concerns about subprime mortgage lending roiled Wall Street in recent weeks, utility stocks held fairly steady.

There's a reason utilities have long been considered the ultimate safe-harbor stocks. Traditional utilities with their fat dividends are the archetypal "widows and orphans" investments, delivering steady income and regular, if modest, appreciation. Meanwhile, a second type of utility company -- the flashier, more growth-oriented merchant power generator -- has flourished in the era of deregulated gas and electric rates.

Mix in merger speculation and soaring power prices, and investors could see the sector continue growing for some time to come.

The stock market bounced back strongly last week, with the Dow Jones Industrial Average gaining 3.1% and the Nasdaq Composite Index rising 3.2%. The two benchmarks are back in the black for the year, up 0.1% and 1.4%, respectively. Meanwhile, the Dow Jones Utility Average gained 4.4% for the week, bringing its year-to-date gain to 9.4% -- even before counting dividends.

One factor pushing up utility prices in recent weeks: An investor consortium's agreement in late February to acquire Dallas-based energy holding company **TXU** for \$32 billion. Other stocks rose on speculation that more mergers are in the offing.


"People are kind of sniffing around the industry to see what kind of company would make the best acquisition," says Judith Saryan, the manager of the \$1.4 billion Eaton Vance Utilities Fund.

Meanwhile, soaring power prices, buoyed by an increase in demand for electricity and in the cost of natural gas, have driven earnings growth across the sector over the past three years.

Utilities have outperformed most other stock sectors over various time periods. Researcher Morningstar says utility stocks returned 1.52% over the month through Thursday, compared with an average loss of 1.45% for all other sectors. Over the past five years, utilities returned an average 17.46% a year, compared to 9.38% for other industries. (All figures include dividends.)

More risk-averse investors should favor traditional utility companies, which deliver electricity direct to consumers. More aggressive investors can look to the merchant, or independent, power-

DOW JONES REPRINTS

 This copy is for your personal, non-commercial use only. To order presentation-ready copies for distribution to your colleagues, clients or customers, use the Order Reprints tool at the bottom of any article or visit: www.djreprints.com.

- [See a sample reprint in PDF format.](#)
- [Order a reprint of this article now.](#)

generation companies, which own and operate power plants that sell their output to the wholesale market.

Merchant power companies can't pass the cost of building power plants and generating electricity on to consumers in the form of rate increases. When power prices fell sharply in 2001 following the collapse of Enron, independent power producers -- many of which had launched aggressive plans to build new natural-gas-fired plants -- landed in dire financial straits.

TXU is one company that has both regulated and merchant operations. But many other power companies sold off their riskier merchant businesses after the 2001-2002 power-market downturn, leaving pure-play regulated utility companies that are less vulnerable to declines in commodity prices.

With those lower-risk regulated companies, "we're really looking at a return to the traditional 'grannies and orphans' utility stocks," says Jon Kolb, a senior equity analyst for Zacks Investment Research in New York.

Traditional Utilities

Traditional utility stocks may prove particularly attractive to baby boomers who are looking for a steady stream of income in retirement but don't want to invest in the bond market, says Lowell Miller, the president of Woodstock, N.Y.-based Miller/Howard Investments and manager of the \$20 million Total Return Utilities Fund. "There's this great wave of a new constituency for dividend-producing stocks," he says.

As electricity demand grows, the need for new power plants and transmission lines is likely to be a boon for utilities, Mr. Miller says. Regulators guarantee utility companies a healthy return on infrastructure investments. Companies like **Northeast Utilities** in Berlin, Conn., and American Electric Power (AEP) in Columbus, Ohio, which have already won regulatory approval for large infrastructure projects, are good bets, he says.

New York's **Consolidated Edison** could prove to be another strong bet in the utility sector, according to Zacks's Mr. Kolb. ConEd has a solid position in the growing New York power market, and Zacks views the utility as a potential takeover target, he says.

However, some companies have become overvalued amid the hype about industry consolidation, analysts say. Shares of TXU rose dramatically after the buyout announcement. **Constellation Energy Group**, a Baltimore-based energy company similar in structure to TXU, has been trading well above Morningstar's fair-value estimate. Both stocks, however, remain below the prices at which Morningstar recommends selling.

Another concern is how state regulators will respond to proposed utility acquisitions, including the TXU deal. Some proposed mergers between large utilities have been scuttled in the past amid opposition from regulators and lawmakers. Midsize utilities have had better luck in winning regulatory approval for mergers. They have been "the biggest beneficiaries of consolidation," says Miller/Howard's Mr. Miller.

Charged Up

The Dow Jones Utility Average has performed strongly in recent years—often beating the Dow Jones Industrial Average—after taking a beating in 2001 and 2002 when energy prices tumbled.

Companies such as **Great Plains Energy** and

Aquila, two Midwest energy holding companies that inked a merger agreement in February, could see significant earnings growth from future acquisitions, experts say.

Independent Power Plays

Consolidation is also expected among independent power generators. "Scale is clearly an advantage in the merchant power sector," says Morningstar analyst Paul Justice. Bigger companies can fund large-scale power-plant projects and can own diversified power-plant fleets.

Merchant power companies with plants in growing electricity markets, such as the Northeast, Texas and California, are poised to be at the forefront of stock gains in the sector, Mr. Justice says. For example, he points to **NRG Energy** in Princeton, N.J., which has valuable power-generation assets in the Northeast and California and a sizable portfolio in Texas.

Edison International, an energy holding company based in Rosemead, Calif., is another attractive stock, analysts say. Increasing natural-gas prices and growing electricity demand have been a boon to Edison, which has a merchant coal-fired power-plant fleet that can generate power more cheaply than natural-gas-fueled plants can.

One thing to keep in mind: If natural gas prices decline, merchant power generators could find it more difficult to turn a profit.

Email: forum.sunday03@wsj.com¹

URL for this article:

<http://online.wsj.com/article/SB117477435001448095.html>

Hyperlinks in this Article:

(1) <mailto:forum.sunday03@wsj.com>

Copyright 2007 Dow Jones & Company, Inc. All Rights Reserved

This copy is for your personal, non-commercial use only. Distribution and use of this material are governed by our [Subscriber Agreement](#) and by copyright law. For non-personal use or to order multiple copies, please contact Dow Jones Reprints at 1-800-843-0008 or visit www.djreprints.com.