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Analysts: Buffett Likely to Purchase More Gas, Power Utilities

Warren Buffett will wait until Congress repeals the Public Utility Holding Company Act of 1935 (PUHCA) and then is expected to add a few natural gas and electric utilities to his portfolio, CreditSights analysts said in a new report.

Buffett, who purchased the Iowa-based utility MidAmerican Energy two years ago, apparently has shied away from buying more utilities because one more purchase could trigger PUHCA, which provides for Securities and Exchange Commission oversight of both the parent companies and their utility subsidiaries. However, this year, Buffett's companies have purchased properties that fit quite well with utilities: Williams Cos.' Kern River Gas Transmission and Dynegy Inc.'s Northern Natural Gas Co. pipelines. He also was involved in making two high interest loans to cash-strapped Williams and CenterPoint Energy earlier this year.

Noting that Buffett has already stated publicly that he'd like to purchase some U.S. utilities, CreditSights analysts Dot Matthews and Andy Devries pulled together their "top 10" list of what they consider to be Buffett's leading prospects, using past investment history. The only thing Buffett needs before making any new buys is the repeal of PUHCA, they said.

"PUHCA repeal was part of the energy bill that didn't make it through Congress before the session ended," said Matthews. "With the Republicans in control of both Houses, we expect energy legislation of some sort to pass pretty quickly in 2003, and since PUHCA repeal has not been controversial, that provision should be included. Takeover bids from Buffett and others could follow pretty quickly on the heels of repeal."

She said that "as soon as PUHCA is history, Buffett will be in the market, provided he sees companies he wants at prices he wants to pay." She pointed out that David Sokol, "Buffett's utility maven," said in a magazine article last March that Buffett would spend between \$10-\$15 billion on energy sector purchases once PUHCA is repealed. "He was only reiterating what his boss had said in other forums, including before Congress. [His] recent pipeline purchases from distressed sellers underscore his appetite for regulated utility assets. However, he can't buy electric or gas distribution companies without running afoul of PUHCA. This is why he is one of the more vocal supporters of repeal."

So what's considered a Buffett takeover possibility? Alliant Energy leads CreditSights list, followed by Ameren, CenterPoint Energy, Constellation Energy, El Paso Electric, Great Plains, Nicor Inc., OGE Energy, Peoples Energy and Xcel Energy. "Warren Wannabees," those companies Buffett also could be interested in include AEP, Avista, Black Hills Corp., Consolidated Edison, DQE, DTE Energy, Entergy, Idacorp, KeySpan, NiSource, Otter Tail Corp., PNM Resources, PPL Corp., UniSource and Vectren. Companies considered too big or expensive were Dominion Resources, Duke Energy Exelon and Southern. And those companies not on the radar for various reasons were Allegheny Energy, Aquila, CMS Energy, DPL Inc., Dynegy Inc., El Paso Corp., FirstEnergy, Northeast Utilities and PSEG.

The CreditSights analysts expect a "pop" in the entire energy sector from the "first announced takeover, no matter who the buyer is, as investors see the game is afoot." Even bondholders of some of the weaker companies may see a "Buffett Bounce," they said. However, Buffett will not be the only potential buyer, and "he is seen by the Street and by the agencies as among the most benign." In the long run, though, "a Buffett buy would be a positive, because bondholders would get the certainty they crave, and the names would be off the list for potential buyers that might be more reckless."

Using the metrics that made up the MidAmerican purchase (2.4x book value and a 20 price-to-earnings (PE) ratio), Matthews and Devries set up a "rough guide" for potential Buffett picks, post PUHCA's repeal. The seven basic criteria they used for the list included the following:

Total cost: Falling within Buffett's apparent \$10-\$15 billion criteria;

Valuation: Whether a company is actually under-valued;

Geography: Somewhat close to Buffett's Omaha base, i.e., the central part of the country;

No "big" problems: Or problems easily dealt with. For example, they disregarded most merchant energy names, "however cheap, that have serious problems;"

Ratings within the "BBB" range were preferred by CreditSights, because "Buffett might be more drawn to the 'BBB' universe as it would allow for upgrades as he cut costs and improved operations;"

Debt-to-capital: Low ratios were selected, but if there is room for improvement, Buffett could go with high debt-to-capital names, they said.

"All but two of our top 10 Buffett takeover candidates are within a stone's throw, so to speak, from MidAmerican in Iowa and Buffett in Omaha. They also have low price/book ratios and reasonable PE's," said Matthews. "There are drawbacks and downsides to most of our picks, but they all give Buffett an opportunity to buy at or near the lows."