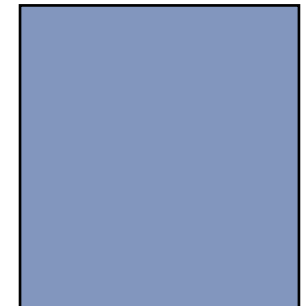
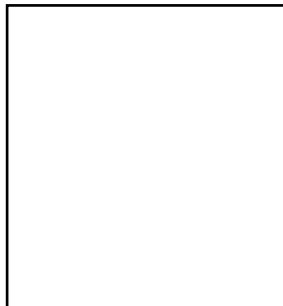
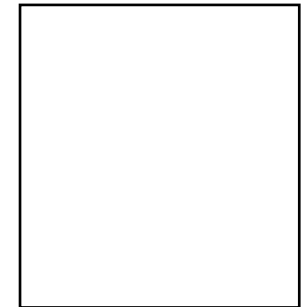
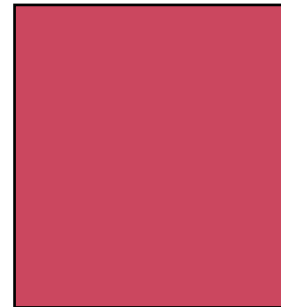


The Next Big Thing for the US Power Sector: 2005 Outlook

Philip W. Smyth, CFA

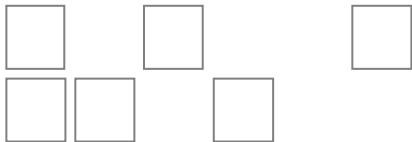
Peak Load Management Alliance Conference

April 28, 2005



Who is Fitch Ratings?

- > Headquartered in NY and London with 49 offices
- > Over 3,100 banks and financial institutions
- > Over 1,200 corporates
- > 89 Sovereigns



Agenda

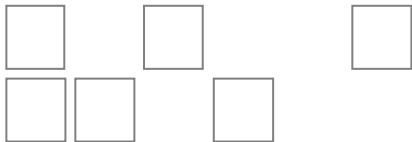
- > Power sector credit environment
 - > Median ratios by sub-sector
 - > Rating actions
 - > Rating outlooks

- > Power sector credit rating drivers

Volatile fuel prices

Rising capital expenditures

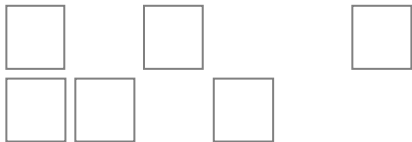
M&A activity



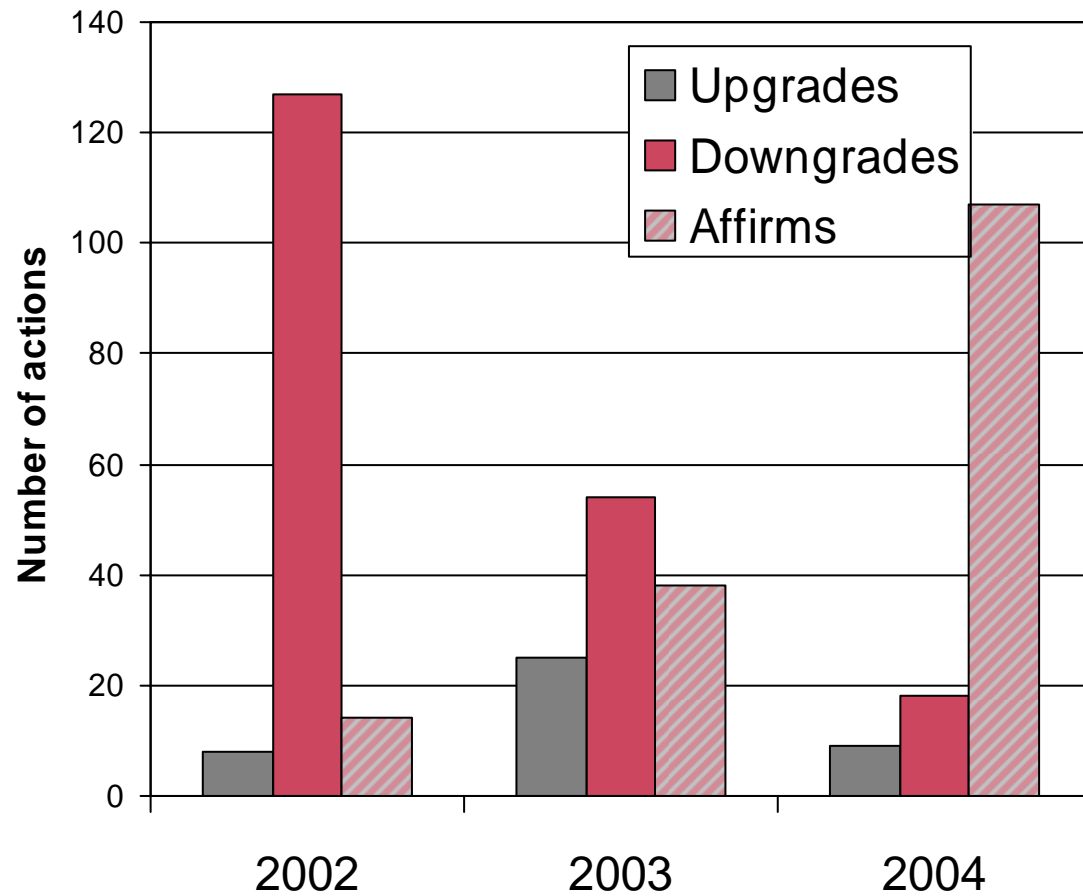
Median Ratings by Sub-sector

12/31/04

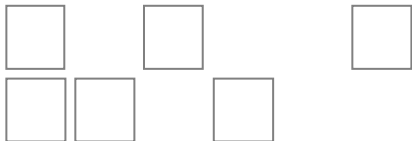
Utility Parent Companies	BBB+
Integrated Utilities	BBB+
Distribution Companies	A-
Pipelines	BBB+
Diversified/Unregulated	BB



Rating Actions 2002-04

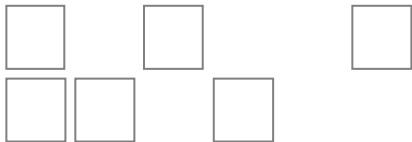


Source: Fitch Ratings, relates to senior unsecured rating actions.



Underlying Cause of Rating Actions

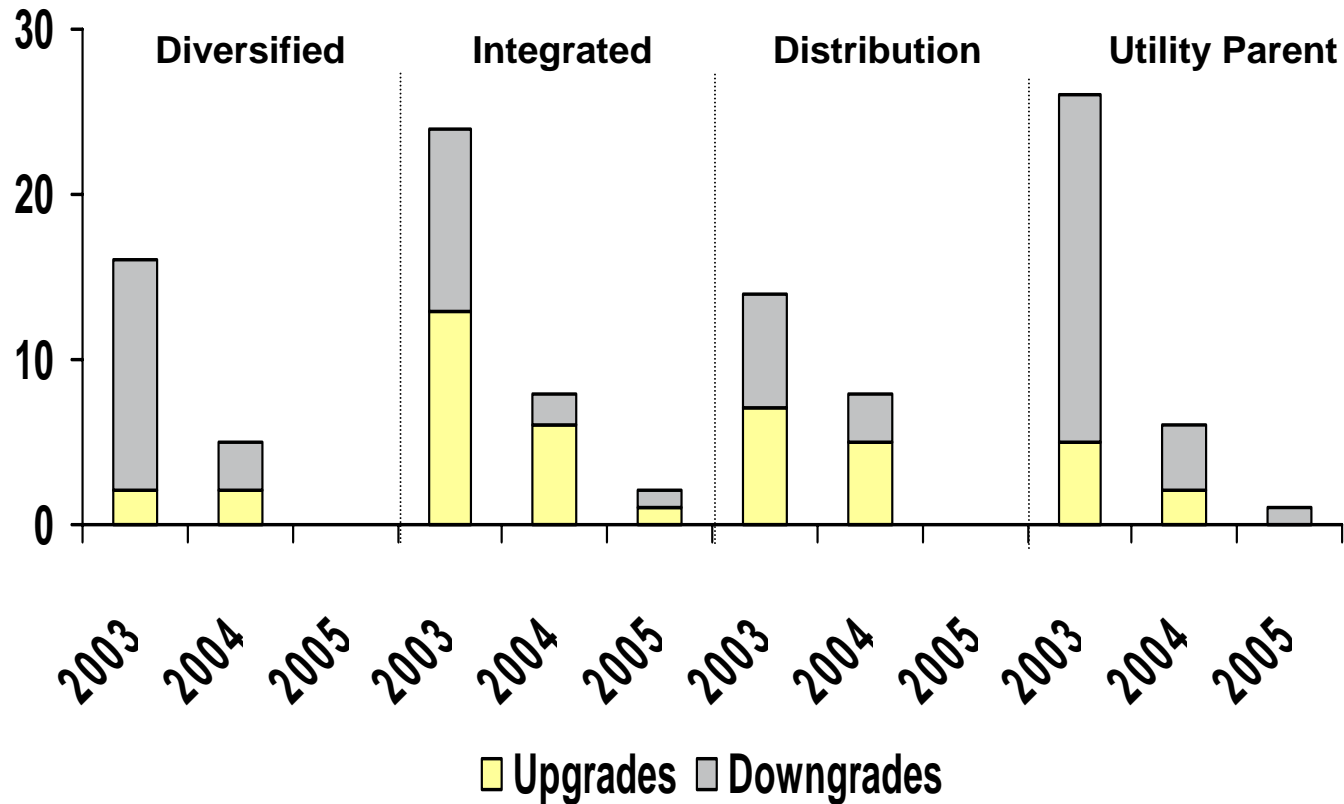
- > **Primary causes of actions in 2002 - 2003**
 - > Linkage with rating of parent or affiliate
 - > Poor performance of diversified businesses
- > **Actions in 2004 -2005 reflect more varied and individual causes**
 - > Individual performance of the entity
 - > More typical 'back to basics' utility issues
 - > M&A activity
 - > Linkage with rating of parent or affiliate



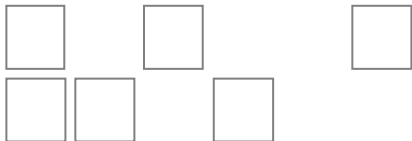
Summary of Ratings Actions

Rating Changes by Sub-sector

2003 to April 11, 2005

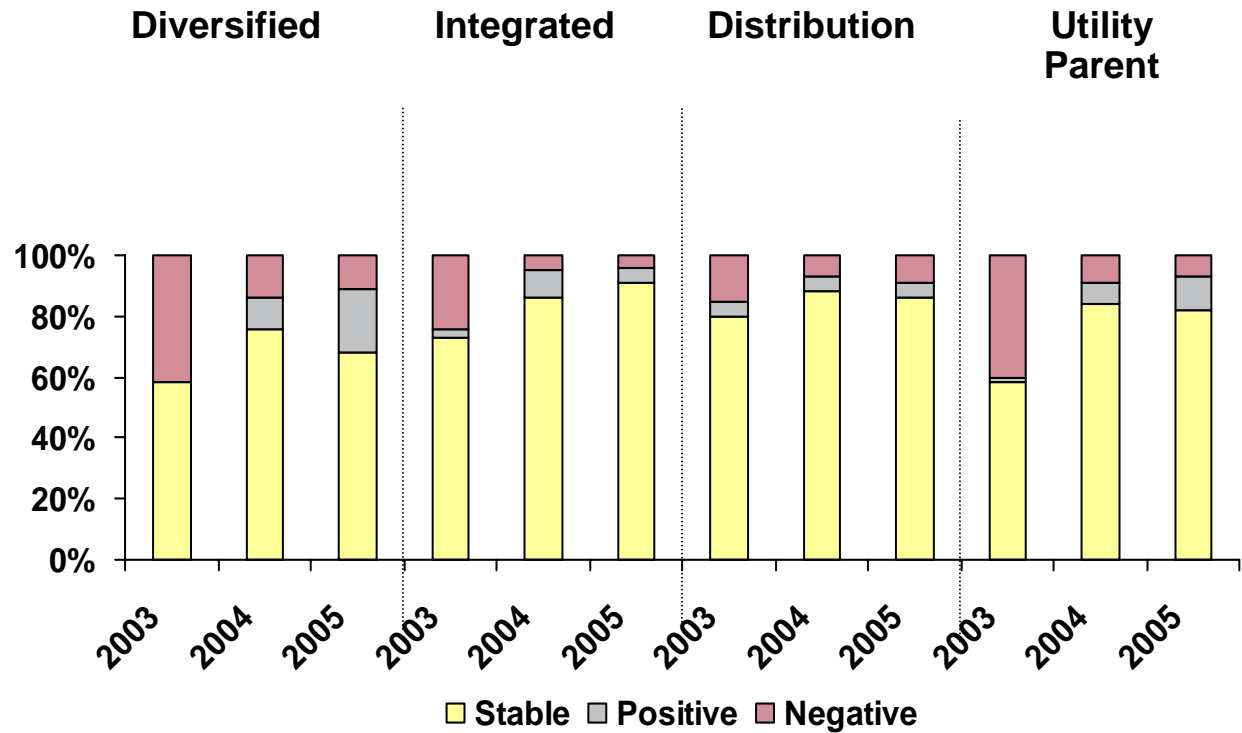


Source: FitchRatings. As of April 11, 2005.

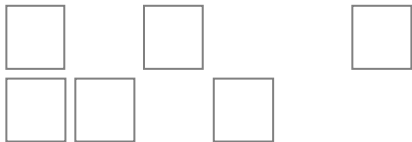


Rating Outlook Distribution

Outlook Distribution by Sub-sector 2003 to April 11, 2005

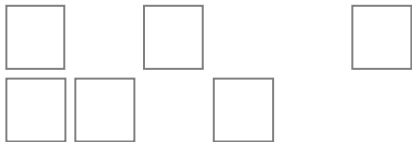


Source: FitchRatings. As of April 11, 2005.



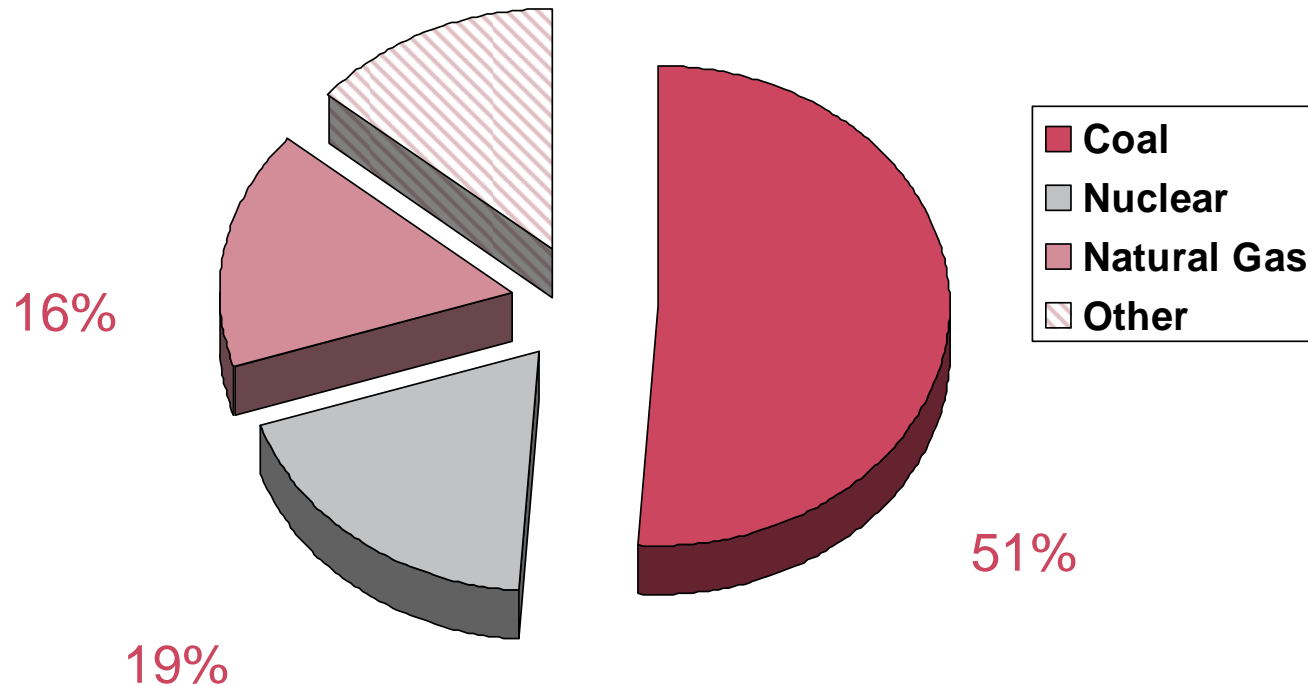
2005 Power Sector Rating Drivers

- > Renewed emphasis on earnings and dividend growth
 - > “Back to basics” strategies mostly complete
 - > Management focus on equity returns could lead to future problems
- > Future challenges:
 - The fuels dilemma
 - Rising capital expenditures
 - M&A activity



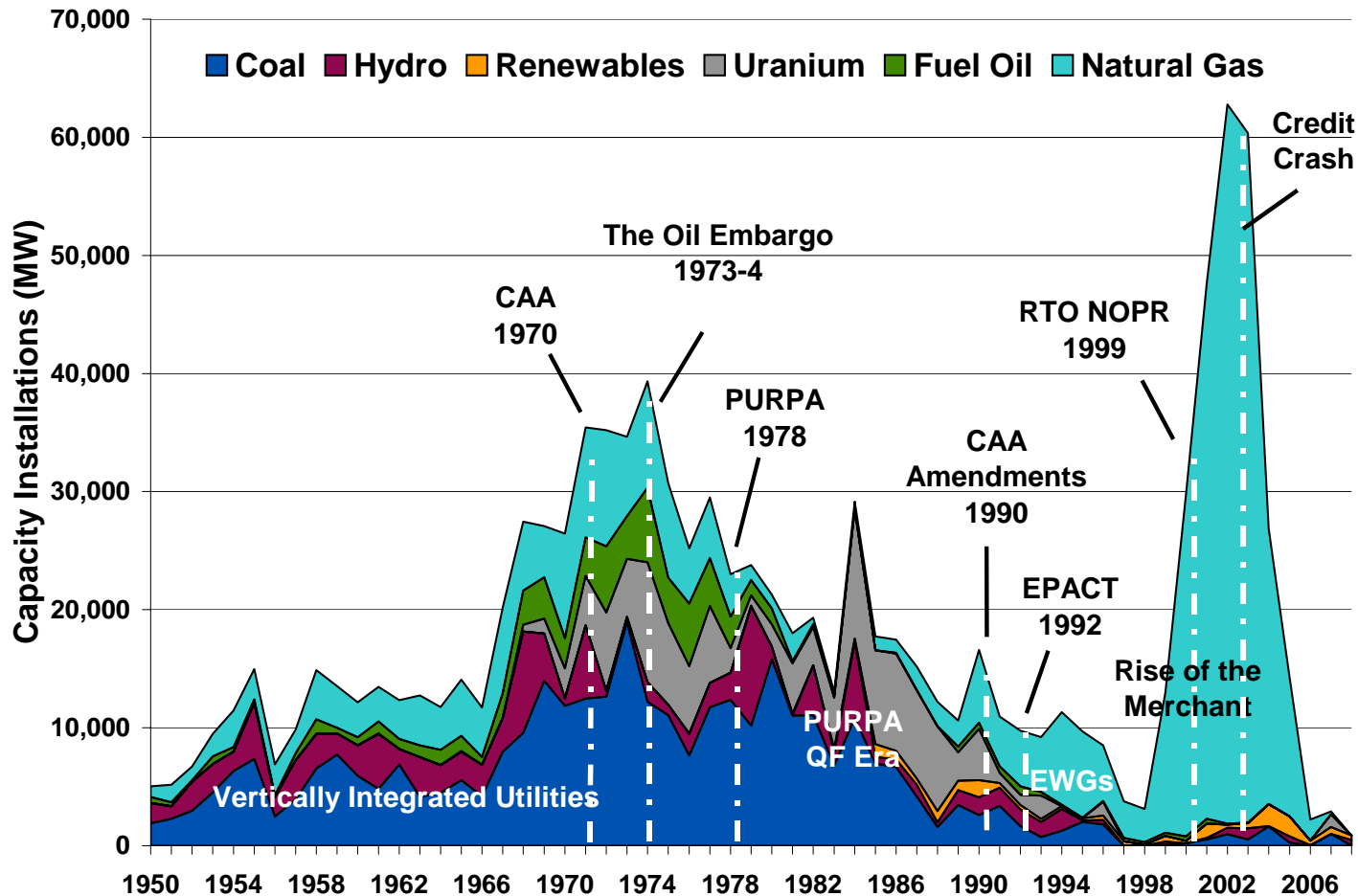
Fuels Mix

2004 U.S. Power Production by Fuel Types



**The Big Three:
Coal, Uranium, and Natural Gas**

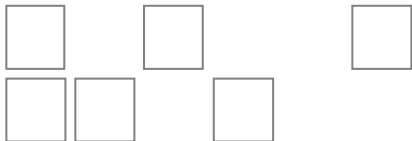
U.S. Fuel Diversity Reflects Historical Power Capacity Additions



Source: Global Energy Decisions, Inc.

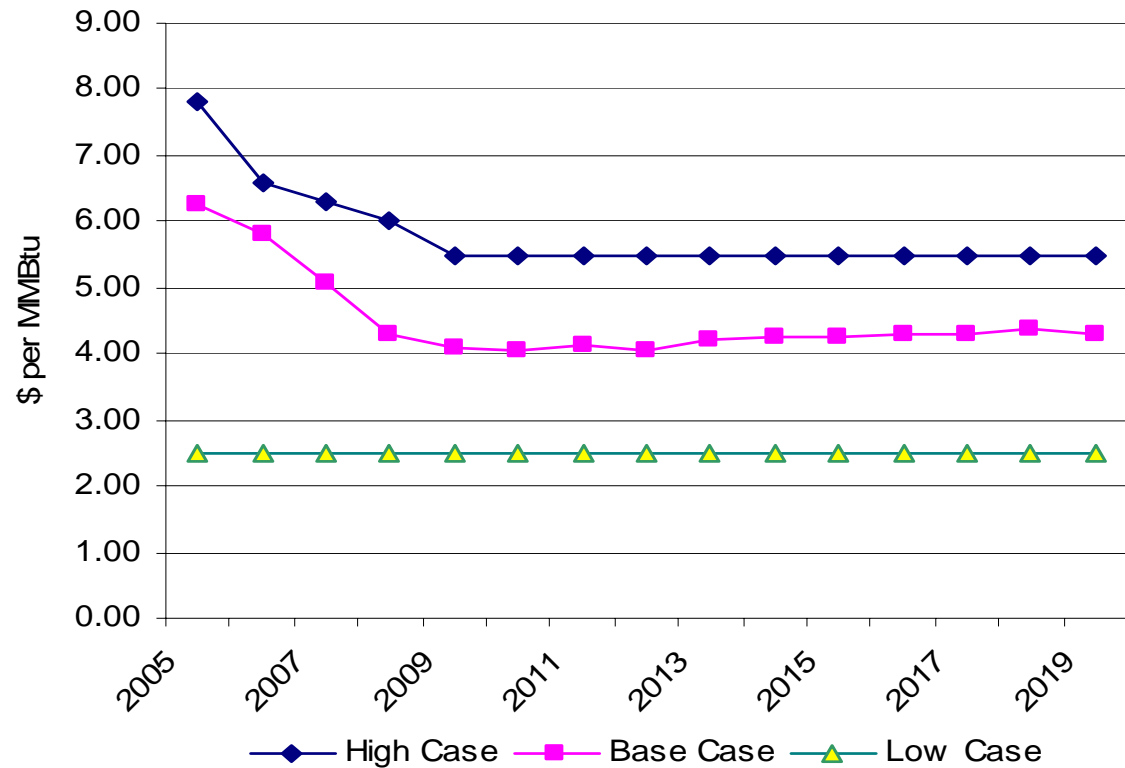
Fuels Dilemma: Gas Price Outlook

- > Fitch gas price forecast raised spring 2005
- > Natural gas production not keeping pace with decline of existing reserves
- > Prices anticipated to remain high and volatile until significant new sources are developed
 - > LNG imports
 - > Increased drilling in new areas; frontier gas
 - > Longer term - coal gasification

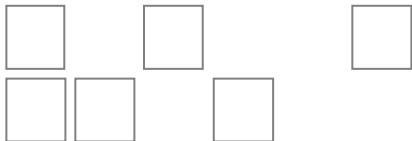


Fuels Dilemma *Natural Gas Price Scenarios*

Average Henry Hub Natural Gas Prices in Fitch Power Models
Semi-annual update, First Half 2005

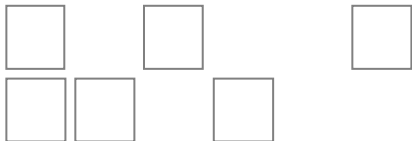


Sources: Fitch Ratings; Global Energy Decisions.



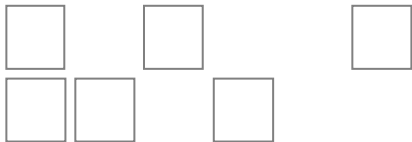
Fuels Dilemma: Coal Price Outlook

- > **Eastern coal**
 - > Production declines, rail bottlenecks, permitting problems
 - > Long-term contracts prices higher, but current high spot prices are not sustainable
- > **Western coal**
 - > Ample reserves
 - > Contract prices will increase modestly
 - > Near term, rail transport constraints limit expansion
- > **Stricter environmental rules in the future will alter capital and operating economics**



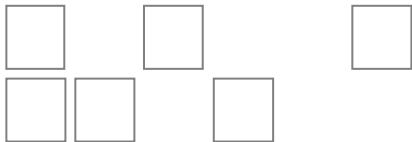
What About Hydro Generation?

- > Hydro generation represents a significant, low-cost resource in the West
 - > Hydro generation represents about 34% of WECC capacity
 - > Approximately 55% of WECC hydro capacity is located in the Pacific Northwest (PNW)
 - > Not a source of new capacity
- > The PNW has experienced a prolonged period of unusually dry weather



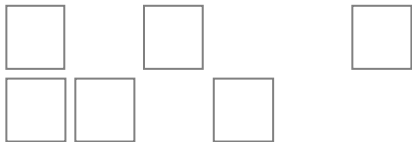
2005 Hydro Outlook

- > Reduced hydro output comes at a particularly inopportune time given high natural gas prices
- > Negative impact expected for investor owned utilities in Pacific Northwest
 - > Coal/nuclear run at high capacity factors
 - > Greater reliance on natural gas and purchase power
- > Public power utilities less affected due to ability to quickly raise tariffs.



2005 Hydro Outlook

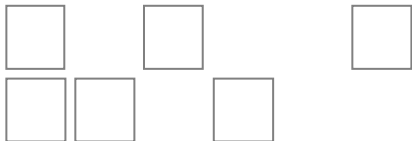
- > Snow pack in the Sierra Mountains well above average
- > Despite low projected PNW stream flows, hydro power should be available for export to CA
- > Supply disruptions in Southern CA possible, but low probability outcome



Fitch Regional Power Market Outlook

- > Demand growth likely to exceed additions to capacity in 2005-2009.

Gas is the marginal fuel that drives power prices. Spark spreads will increase more rapidly.	WECC and ERCOT
With modest demand growth, the number of hours per year that gas is on the margin will rise. Spark spreads will increase more gradually.	New York, New England PJM East
Capacity oversupply continues. Coal is the fuel on the margin; spark spreads for gas low or nil.	ECAR PJM West Entergy, parts of Southeast



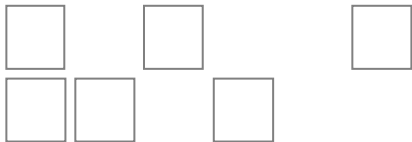
Fuels Dilemma: Credit Implications

<i>Entity</i>	<i>Rising fuel prices</i>	<i>Declining fuel prices</i>
Utilities	<ul style="list-style-type: none"> > Utilities with frozen or capped rates at risk > Utilities with recovery clauses may have large deferrals 	<ul style="list-style-type: none"> > Beneficial cash flow environment > Risk of disallowance of over-market contracts or hedges
Competitive Gencos	<ul style="list-style-type: none"> > Increases cash flow of gencos with coal/ nuclear fleets > Lowers dispatch of gas-fired facilities 	<ul style="list-style-type: none"> > Reduces cash flow for coal/nuclear gencos > Raises dispatch of gas-fired facilities
Energy Retailers	<ul style="list-style-type: none"> > Discourages new entrants, favors incumbents 	<ul style="list-style-type: none"> > Enables new entrants to challenge incumbents

The Fuels Dilemma

Competitive Market Regions

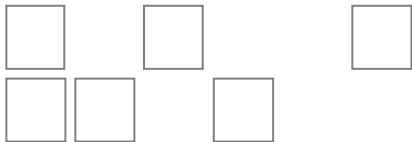
- > **No precedent or model exists in US for planning fuel diversity within a competitive market**
- > **Who will make new capacity investment when demand reduces the present over-supply?**



The Fuels Dilemma

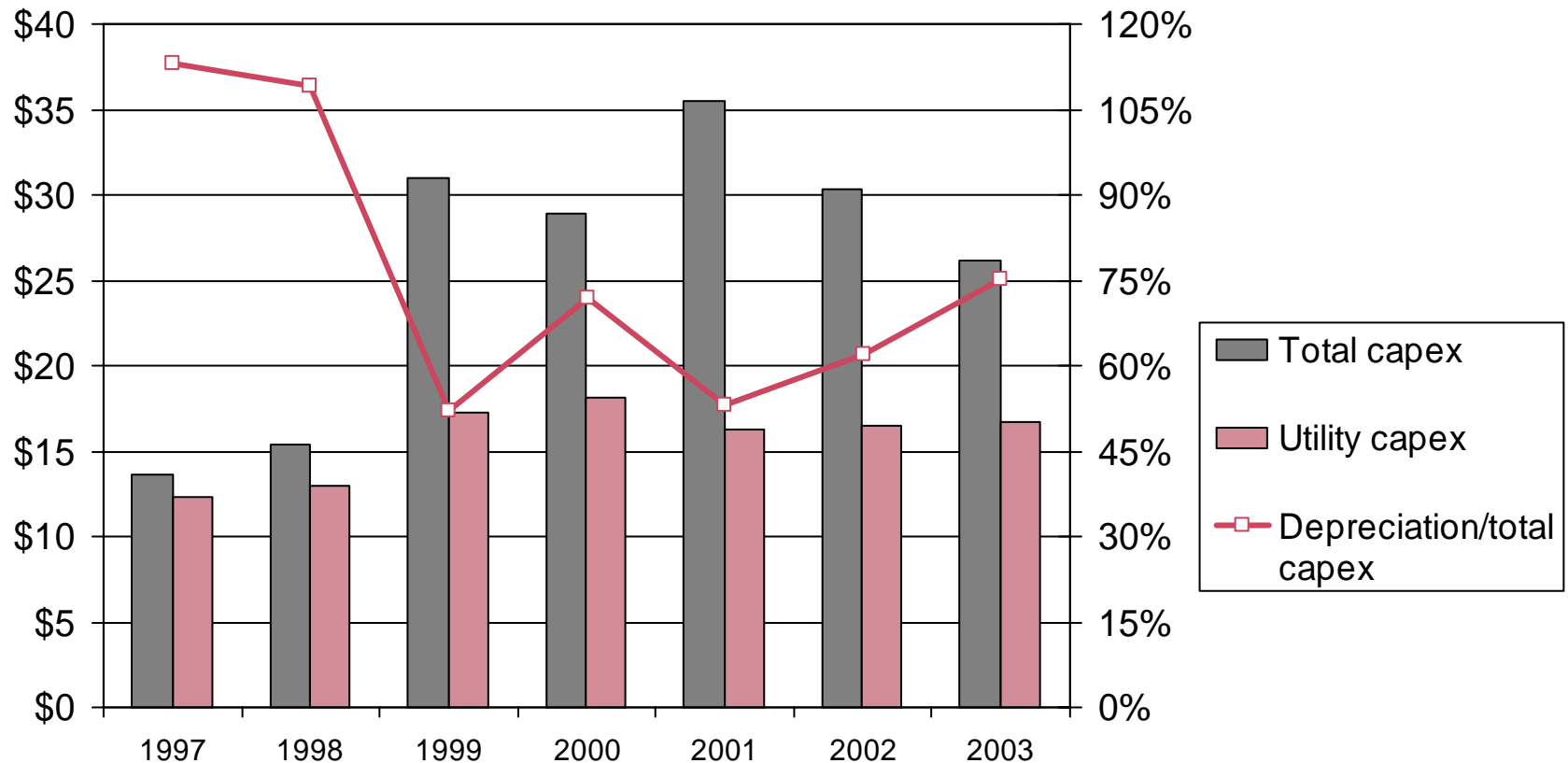
Traditional Regulated Power Markets

- > **Will utilities invest in over-supplied regions to lower dependence on gas**
 - > **New investments could lower utility credit ratings if state regulators delay tariff recovery or challenge prudence.**



Historical Capital Expenditures

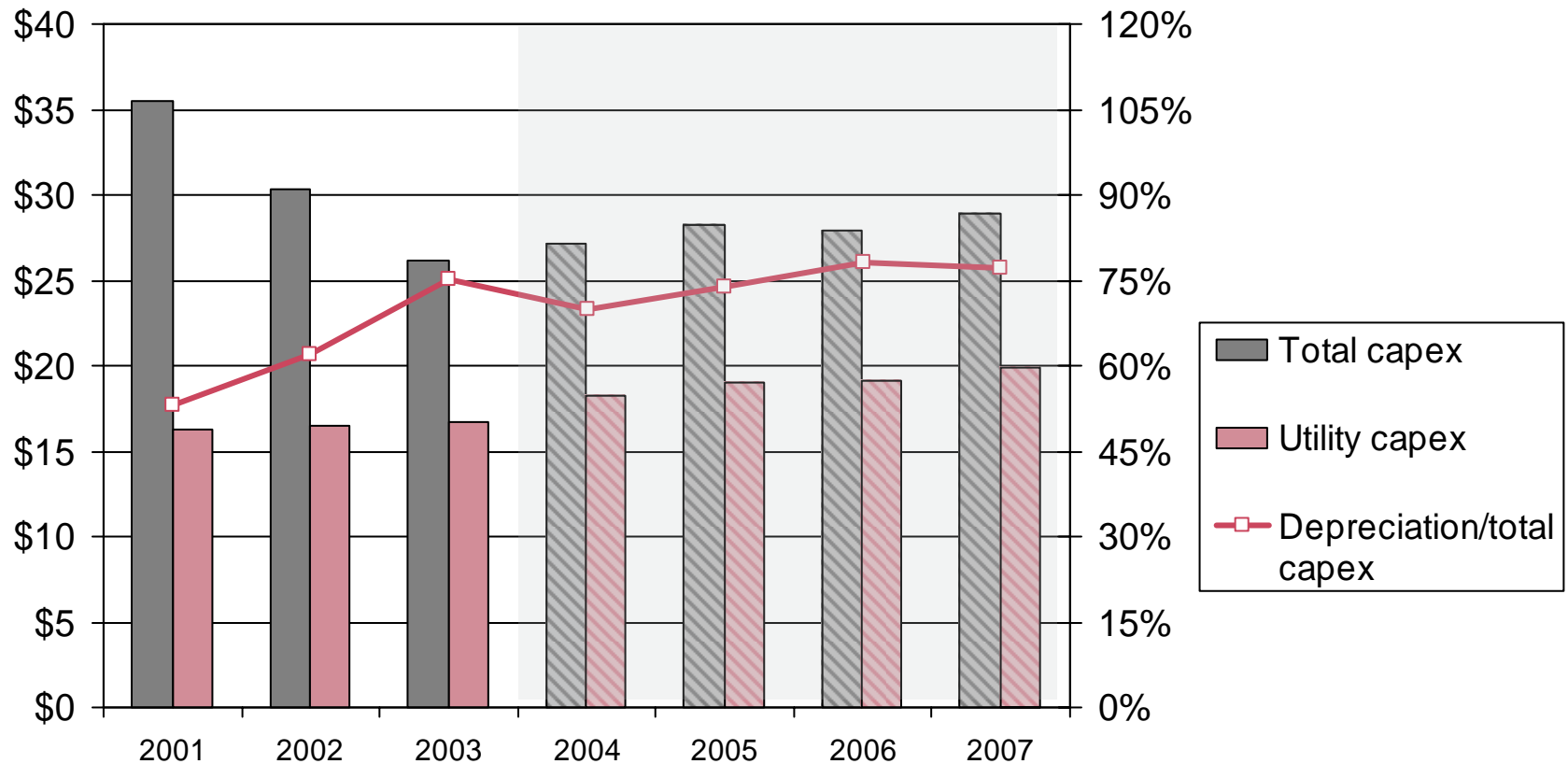
Sample of 20 largest utility groups



Source: SNL Energy Information System.

Forecast Capital Expenditures

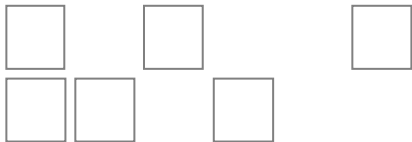
Sample of 20 largest utility groups



Source: SNL Energy Information System, Fitch Ratings.

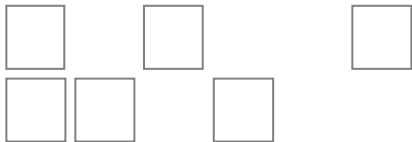
Are Utilities' Projected Capex Budgets Understated?

- > Stricter environmental regulations
- > New electric generation
 - > Coal/clean coal technology
- > If US Congress enacts energy legislation
 - > Mandated reliability standards
 - > Transmission upgrades



Evidence of Rising Capex: New Emissions Regulations

- > **Four major pollutants**
 - > SO₂, NO_x, Mercury, CO₂
- > **Clean Air Interstate Rule: Phased-in reductions in SO₂ and NO_x emissions from 2003 levels at full implementation of**
 - > SO₂: 70%
 - > NO_x: 65%
- > **Mercury Rule: Phased-in reductions designed to reduce emissions by 70% by full implementation.**
- > **Rising allowance credit prices**
- > **Leading to:**
 - > Higher energy costs
 - > Increased leverage
 - > Lower profit margins



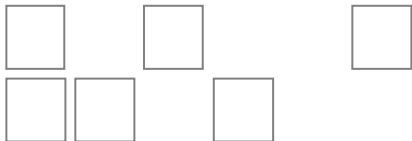
Evidence of Rising Capex

Utility

- > **Reliability of transmission and distribution networks**
 - > Fallout from August 2003 Blackout
- > **Environmental compliance**
- > **Customer and sales growth**
- > **Catch up for under-investment in recent years**

Non-utility

- > **LNG terminals**
- > **Gas storage facilities**



Demand Side Management (DSM)

- > **Benefits of successful DSM:**
 - > Reduce new capacity need (capex)
 - > Reduces fuel consumption
 - > Avoids environmental costs
 - > Shifts dispatch curve

- > **What is lacking:**
 - > Sophisticated metering with two way communication
 - > Time of day pricing
 - > Regulatory incentives for DSM

Capex: Examples of Supportive Regulatory Initiatives

Iowa

Legislation permits pre-approval of recoverable construction costs.

Wisconsin

PSC pre-approved costs and lease agreement for new coal and gas plants.

Alabama

Certified New Plant Adjustment clause minimizes regulatory lag for new plant investment; allows recovery of prospective environmental costs.

California

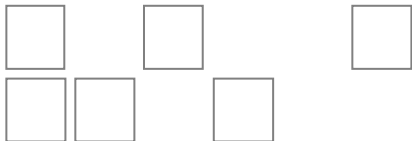
Assembly Bill 57 established policies and cost recovery mechanisms for energy procurement.

Mississippi

Environmental Compliance Plan provides for recovery of approved environmental costs.

Indiana

Regulatory statutes permit environmental CWIP in rate base



The Credit Impact of Higher Capex

Regulated Utilities

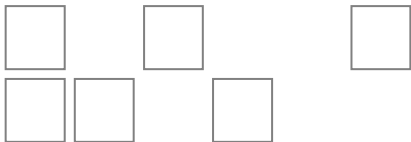
- > **Regulatory risk, recovery lag**
- > **Increased pressure on regulated tariffs**
- > **Higher external financing needs**
 - > Rising leverage
 - > Rising interest expense

Competitive Generators

- > **Market risk for new plant investments**
- > **Margin compression from environmental upgrades and emission credit purchases**
- > **Higher external financing needs**
 - > Rising leverage
 - > Rising interest expense

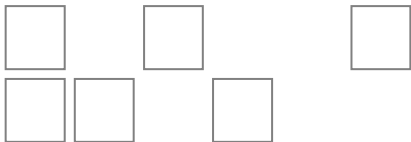
Recent M&A Activity

- > **2002 - 04: Asset divestitures by distressed sellers improved liquidity**
- > **Capital markets buoyant**
- > **Asset sellers expanded excessively into non-regulated activities**
- > **Progression of asset sales 2002-2004**
 - > First:
 - > Pipelines
 - > Contracted power plants
 - > Diversified, non-core operations
 - > More recently:
 - > Out of the money merchant plants



M&A Outlook for Private Equity Investors

- > **Unlikely to acquire utilities**
 - > Recent state rejections of private equity acquisitions by KKR for Tucson Electric Power (AZ) and Texas Pacific Group for Portland General (OR) will discourage future bids.
- > **Sector-specialized investors will focus on asset acquisitions**
 - > Arclight, Ontario Teachers Pension Fund, Energy Investors Funds
 - > Sellers – Asset rich/cash poor
- > **Hedge funds will gain in importance**
 - > Partnerships of private equity firms with hedge funds
 - > Greater willingness to accept commodity price risk



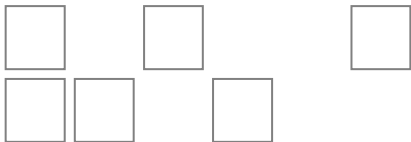
M&A Outlook for Foreign Buyers of US Utilities

In favor:

- > **Weak US Dollar**
 - > US acquisitions are cheap for foreign buyers

Against:

- > **Foreign buyers of US utilities have had mixed results**
 - > Pacificorp / Scottish Power
 - > LGE / PowerGen
 - > More favorable: NEES / National Grid
- > **Too much regulatory risk and uncertainty in US competitive power market assets**



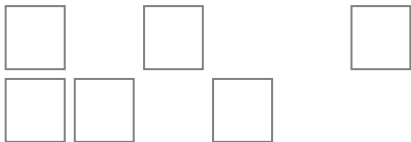
M&A Outlook for Utility Companies

In favor:

- > **Bigger is better: industry attitude; consolidation overdue.**
- > **Consolidation may improve strategic position of participants in open-access power markets**
 - > Exelon/PSEG merger

Against:

- > **State and federal approvals are time-consuming.**
- > **State regulatory proceedings may result in tariff give-backs outweighing benefits.**
- > **Not clear if FERC market-power screens will impede mergers**
 - > Exelon/ PSEG will be a test of acceptable mitigation.



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