Regulatory Research Associates
REGULATORY FOCUS



Special Study

October 2, 2009

# MAJOR RATE CASE DECISIONS--JANUARY-SEPTEMBER 2009

For the first nine months of 2009, the average of electric equity return authorizations by state commissions was 10.43% (22 determinations) almost identical to the 10.46% average for calendar-2008. The average gas equity return authorization for the first three quarters of 2009 was 10.11% (14 determinations), slightly below the 10.37% average for calendar-2008.

After reaching a low in the early-2000's, the number of rate case decisions for energy companies has generally increased over the last several years. There were 83 electric and gas rate decisions in 2008 versus only 32 in 2001. Increased costs, including environmental compliance expenditures, the need for generation and delivery infrastructure upgrades and expansion, and renewable generation requirements argue for a continuation of the increased level of rate case activity over the next several years. However, cost efficiencies from technological improvements, the use of multi-year settlements, and a reduced number of companies due to mergers may prevent the number of rate cases from increasing significantly further.

We note that electric industry restructuring in certain states has led to the unbundling of rates and retail competition for generation. The state commissions in those states are now authorizing revenue requirement and return parameters for delivery operations only (which we footnote in our chronology), thus complicating historical data comparability. We also note that the current financial uncertainty and resulting increase in corporate debt yields may indicate that utility equity costs have also increased and lead to higher authorized ROEs by commissions. However, increased authorized equity returns have not materialized thus far in 2009.

The table on page 2 shows the annual average equity returns authorized since 1990, and by quarter since 2003, in major electric and gas rate decisions, followed by the number of determinations during each period. The tables on page 3 present the composite industry data for items in the chronology of this and earlier reports, summarized annually since 1996, and quarterly for the most recent seven quarters. The individual electric and gas cases decided in the first nine months of 2009 are listed on pages 4-7, with the decision date (generally the date on which the final order was issued) shown first, followed by the company name, the abbreviation for the state issuing the decision, the authorized rate of return (ROR), return on equity (ROE), and percentage of common equity in the adopted capital structure. Next we show the month and year in which the adopted test year ended, whether the commission utilized an average or a year-end rate base, and the amount of the permanent rate change authorized. The dollar amounts represent the permanent rate change ordered at the time decisions were rendered. Fuel adjustment clause rate changes are not reflected in this study. We note that the cases and averages included in this study may be slightly different from those in our online rate case history database. Any differences are likely the result of this study's inclusion of ROE determinations that are rendered in cost of capital only proceedings in California or that apply only to specific generation plants. Both of these types of determinations are not included in the database, which encompasses major base rate cases only.



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**Average Equity Returns Authorized January 1990 - September 2009**

| Year | Period | Electric Utilities ROE % | (# Cases) | Gas Utilities ROE % | (# Cases) |
|---|---|---|---|---|---|
| 1990 | Full Year | 12.70 | (44) | 12.67 | (31) |
| 1991 | Full Year | 12.55 | (45) | 12.46 | (35) |
| 1992 | Full Year | 12.09 | (48) | 12.01 | (29) |
| 1993 | Full Year | 11.41 | (32) | 11.35 | (45) |
| 1994 | Full Year | 11.34 | (31) | 11.35 | (28) |
| 1995 | Full Year | 11.55 | (33) | 11.43 | (16) |
| 1996 | Full Year | 11.39 | (22) | 11.19 | (20) |
| 1997 | Full Year | 11.40 | (11) | 11.29 | (13) |
| 1998 | Full Year | 11.66 | (10) | 11.51 | (10) |
| 1999 | Full Year | 10.77 | (20) | 10.66 | (9) |
| 2000 | Full Year | 11.43 | (12) | 11.39 | (12) |
| 2001 | Full Year | 11.09 | (18) | 10.95 | (7) |
| 2002 | Full Year | 11.16 | (22) | 11.03 | (21) |
| | 1st Quarter | 11.47 | (7) | 11.38 | (5) |
| | 2nd Quarter | 11.16 | (4) | 11.36 | (4) |
| | 3rd Quarter | 9.95 | (5) | 10.61 | (5) |
| | 4th Quarter | 11.09 | (6) | 10.84 | (11) |
| **2003** | **Full Year** | **10.97** | (22) | **10.99** | (25) |
| | 1st Quarter | 11.00 | (3) | 11.10 | (4) |
| | 2nd Quarter | 10.54 | (6) | 10.25 | (2) |
| | 3rd Quarter | 10.33 | (2) | 10.37 | (8) |
| | 4th Quarter | 10.91 | (8) | 10.66 | (6) |
| **2004** | **Full Year** | **10.75** | (19) | **10.59** | (20) |
| | 1st Quarter | 10.51 | (7) | 10.65 | (2) |
| | 2nd Quarter | 10.05 | (7) | 10.54 | (5) |
| | 3rd Quarter | 10.84 | (4) | 10.47 | (5) |
| | 4th Quarter | 10.75 | (11) | 10.40 | (14) |
| **2005** | **Full Year** | **10.54** | (29) | **10.46** | (26) |
| | 1st Quarter | 10.38 | (3) | 10.63 | (6) |
| | 2nd Quarter | 10.68 | (6) | 10.50 | (2) |
| | 3rd Quarter | 10.06 | (7) | 10.45 | (3) |
| | 4th Quarter | 10.39 | (10) | 10.14 | (5) |
| **2006** | **Full Year** | **10.36** | (26) | **10.43** | (16) |
| | 1st Quarter | 10.27 | (8) | 10.44 | (10) |
| | 2nd Quarter | 10.27 | (11) | 10.12 | (4) |
| | 3rd Quarter | 10.02 | (4) | 10.03 | (8) |
| | 4th Quarter | 10.56 | (16) | 10.27 | (15) |
| **2007** | **Full Year** | **10.36** | (39) | **10.24** | (37) |
| | 1st Quarter | 10.45 | (10) | 10.38 | (7) |
| | 2nd Quarter | 10.57 | (8) | 10.17 | (3) |
| | 3rd Quarter | 10.47 | (11) | 10.49 | (7) |
| | 4th Quarter | 10.33 | (8) | 10.34 | (13) |
| **2008** | **Full Year** | **10.46** | (37) | **10.37** | (30) |
| | 1st Quarter | 10.29 | (9) | 10.24 | (4) |
| | 2nd Quarter | 10.55 | (10) | 10.11 | (8) |
| | 3rd Quarter | 10.46 | (3) | 9.88 | (2) |
| **2009** | **Year-To-Date** | **10.43** | (22) | **10.11** | (14) |

Electric Utilities--Summary Table*

| | Period | ROR % | (# Cases) | ROE % | (# Cases) | Eq. as % Cap. Struc. | (# Cases) | Amt. $ Mil. | (# Cases) |
|---|---|---|---|---|---|---|---|---|---|
| 1996 | Full Year | 9.21 | (20) | 11.39 | (22) | 44.34 | (20) | -5.6 | (38) |
| 1997 | Full Year | 9.16 | (12) | 11.40 | (11) | 48.79 | (11) | -553.3 | (33) |
| 1998 | Full Year | 9.44 | (9) | 11.66 | (10) | 46.14 | (8) | -429.3 | (31) |
| 1999 | Full Year | 8.81 | (18) | 10.77 | (20) | 45.08 | (17) | -1,683.8 | (30) |
| 2000 | Full Year | 9.20 | (12) | 11.43 | (12) | 48.85 | (12) | -291.4 | (34) |
| 2001 | Full Year | 8.93 | (15) | 11.09 | (18) | 47.20 | (13) | 14.2 | (21) |
| 2002 | Full Year | 8.72 | (20) | 11.16 | (22) | 46.27 | (19) | -475.4 | (24) |
| 2003 | Full Year | 8.86 | (20) | 10.97 | (22) | 49.41 | (19) | 313.8 | (12) |
| 2004 | Full Year | 8.44 | (18) | 10.75 | (19) | 46.84 | (17) | 1,091.5 | (30) |
| 2005 | Full Year | 8.30 | (26) | 10.54 | (29) | 46.73 | (27) | 1,373.7 | (36) |
| 2006 | Full Year | 8.24 | (24) | 10.36 | (26) | 48.67 | (23) | 1,465.0 | (42) |
| 2007 | Full Year | 8.22 | (38) | 10.36 | (39) | 48.01 | (37) | 1,401.9 | (46) |
| | 1st Quarter | 8.36 | (9) | 10.45 | (10) | 49.25 | (8) | 802.9 | (9) |
| | 2nd Quarter | 8.21 | (7) | 10.57 | (8) | 47.64 | (7) | 510.5 | (8) |
| | 3rd Quarter | 8.32 | (10) | 10.47 | (11) | 48.96 | (10) | 737.5 | (13) |
| | 4th Quarter | 8.09 | (9) | 10.33 | (8) | 47.58 | (8) | 848.5 | (12) |
| 2008 | Full Year | 8.25 | (35) | 10.46 | (37) | 48.41 | (33) | 2,899.4 | (42) |
| | 1st Quarter | 8.19 | (8) | 10.29 | (9) | 48.52 | (8) | 857.0 | (14) |
| | 2nd Quarter | 8.05 | (9) | 10.55 | (10) | 47.66 | (9) | 1,425.7 | (17) |
| | 3rd Quarter | 8.48 | (3) | 10.46 | (3) | 47.20 | (3) | 317.1 | (7) |
| **2009** | **Year-To-Date** | **8.17** | **(20)** | **10.43** | **(22)** | **47.94** | **(20)** | **2,599.8** | **(38)** |

Gas Utilities--Summary Table*

| | Period | ROR % | (# Cases) | ROE % | (# Cases) | Eq. as % Cap. Struc. | (# Cases) | Amt. $ Mil. | (# Cases) |
|---|---|---|---|---|---|---|---|---|---|
| 1996 | Full Year | 9.25 | (23) | 11.19 | (20) | 47.69 | (19) | 193.4 | (34) |
| 1997 | Full Year | 9.13 | (13) | 11.29 | (13) | 47.78 | (11) | -82.5 | (21) |
| 1998 | Full Year | 9.46 | (10) | 11.51 | 10) | 49.50 | (10) | 93.9 | (20) |
| 1999 | Full Year | 8.86 | (9) | 10.66 | (9) | 49.06 | (9) | 51.0 | (14) |
| 2000 | Full Year | 9.33 | (13) | 11.39 | (12) | 48.59 | (12) | 135.9 | (20) |
| 2001 | Full Year | 8.51 | (6) | 10.95 | (7) | 43.96 | (5) | 114.0 | (11) |
| 2002 | Full Year | 8.80 | (20) | 11.03 | (21) | 48.29 | (18) | 303.6 | (26) |
| 2003 | Full Year | 8.75 | (22) | 10.99 | (25) | 49.93 | (22) | 260.1 | (30) |
| 2004 | Full Year | 8.34 | (21) | 10.59 | (20) | 45.90 | (20) | 303.5 | (31) |
| 2005 | Full Year | 8.25 | (29) | 10.46 | (26) | 48.66 | (24) | 458.4 | (34) |
| 2006 | Full Year | 8.51 | (16) | 10.43 | (16) | 47.43 | (16) | 444.0 | (25) |
| 2007 | Full Year | 8.12 | (32) | 10.24 | (37) | 48.37 | (30) | 813.4 | (48) |
| | 1st Quarter | 8.78 | (7) | 10.38 | (7) | 52.07 | (7) | 129.6 | (7) |
| | 2nd Quarter | 8.28 | (3) | 10.17 | (3) | 51.80 | (3) | 52.0 | (4) |
| | 3rd Quarter | 8.33 | (7) | 10.49 | (7) | 50.58 | (7) | 312.8 | (10) |
| | 4th Quarter | 8.45 | (13) | 10.34 | (13) | 49.25 | (13) | 390.4 | (20) |
| 2008 | Full Year | 8.48 | (30) | 10.37 | (30) | 50.47 | (30) | 884.8 | (41) |
| | 1st Quarter | 8.01 | (5) | 10.24 | (4) | 43.81 | (4) | 156.4 | (7) |
| | 2nd Quarter | 8.05 | (7) | 10.11 | (8) | 48.84 | (7) | 92.5 | (8) |
| | 3rd Quarter | 8.30 | (2) | 9.88 | (2) | 51.00 | (2) | 19.2 | (4) |
| **2009** | **Year-To-Date** | **8.07** | **(14)** | **10.11** | **(14)** | **47.62** | **(13)** | **268.1** | **(19)** |

* Number of observations in each period indicated in parentheses.

## ELECTRIC UTILITY DECISIONS

| Order Date | Company (State) | ROR % | ROE % | Common Eq. as % Cap. Str. | Test Year & Rate Base | Amt. $ Mil. |
|---|---|---|---|---|---|---|
| 1/14/09 | Public Service Oklahoma (OK) | 8.31 | 10.50 | 44.10 | 2/08-YE | 59.3 (1) |
| 1/21/09 | Westar Energy (KS) | --- | --- | --- | --- | 65.0 (B) |
| 1/21/09 | Kansas Gas & Electric (KS) | --- | --- | --- | --- | 65.0 (B) |
| 1/21/09 | Cleveland Electric Illuminating (OH) | 8.48 | 10.50 (E) | 49.00 | 2/08-DC | 29.2 (D) |
| 1/21/09 | Ohio Edison (OH) | 8.48 | 10.50 (E) | 49.00 | 2/08-DC | 68.9 (D) |
| 1/21/09 | Toledo Edison (OH) | 8.48 | 10.50 (E) | 49.00 | 2/08-DC | 38.5 (D) |
| 1/30/09 | Idaho Power (ID) | 8.18 | 10.50 | 49.27 | 12/08-YE | 27.0 (R) |
| 2/4/09 | United Illuminating (CT) | 7.59 | 8.75 | 50.00 | 12/07-A | 6.8 (D,R,2) |
| 2/4/09 | Interstate Power & Light (IA) | --- | 10.10 (3) | --- | --- | --- |
| 2/5/09 | Kentucky Utilities (KY) | --- | --- | --- | --- | -8.9 (B) |
| 2/5/09 | ~~Louisville Gas & Electric (KY)~~ | --- | --- | --- | --- | -13.2 (B) |
| 2/10/09 | Union Electric (MO) | 8.34 | 10.76 | 52.01 | 3/08-YE | 161.7 |
| 3/4/09 | Indiana Michigan Power (IN) | 7.62 | 10.50 | 45.80 * | 9/07-YE | 19.1 (4) |
| 3/11/09 | Entergy Texas (TX) | --- | --- | --- | 3/07 | 30.5 (B,I,5) |
| 3/17/09 | Southern California Edison (CA) | --- | --- | --- | 12/09-A | 308.1 (6) |
| *2009* | ***1ST QUARTER: AVERAGES/TOTAL*** | **8.19** | **10.29** | **48.52** | | **857.0** |
| | ***MEDIAN*** | **8.33** | **10.50** | **49.00** | | **---** |
| | ***OBSERVATIONS*** | **8** | **9** | **8** | | **14** |
| 4/2/09 | Entergy New Orleans (LA) | --- | 11.10 | --- | 12/08-YE | -24.7 (B,7) |
| 4/16/09 | PacifiCorp (ID) | --- | --- | --- | --- | 4.4 (B) |
| 4/21/09 | PacifiCorp (UT) | 8.36 | 10.61 | 51.00 | 12/09-A | 45.0 (B) |
| 4/24/09 | Consolidated Edison of New York (NY) | 7.79 | 10.00 | 48.00 | 3/10-A | 523.4 (D) |
| 4/30/09 | Tampa Electric (FL) | 8.29 (R) | 11.25 | 47.49 *(R) | 12/09-A | 147.7 (Z,R) |
| 5/4/09 | Minnesota Power (MN) | 8.45 | 10.74 | 54.79 | 6/09-A | 21.1 (I) |
| 5/20/09 | Oklahoma Gas & Electric (AR) | 6.43 | 10.25 | 36.04 * | 12/07-YE | 13.3 (B) |
| 5/20/09 | NorthWestern Corp. (MT) | 8.38 | 10.25 | 50.00 | --- | --- (8) |
| 5/20/09 | PacifiCorp (WY) | --- | --- | --- | --- | 18.0 (B) |
| 5/28/09 | Public Service New Mexico (NM) | 8.77 | 10.50 | 50.47 | 3/08-YE | 77.1 (B,Z) |
| 5/29/09 | Idaho Power (ID) | --- | --- | --- | --- | 10.5 (9) |
| 6/2/09 | Southwestern Public Service (TX) | --- | --- | --- | 12/07 | 57.4 (B,I) |
| 6/9/09 | Public Service Co. of Colorado (CO) | --- | --- | --- | --- | 112.2 (B) |
| 6/10/09 | Kansas City Power & Light (MO) | --- | --- | --- | 12/07-YE | 95.0 (B) |
| 6/10/09 | KCP&L Greater Missouri Oper-L&P (MO) | --- | --- | --- | 12/07-YE | 15.0 (B) |
| 6/10/09 | KCP&L Greater Missouri Oper-MPS (MO) | --- | --- | --- | 12/07-YE | 48.0 (B) |
| 6/22/09 | Central Hudson Gas & Electric (NY) | 7.28 | 10.00 | 47.00 | 6/10-A | 39.6 (D) |
| 6/24/09 | Nevada Power (NV) | 8.66 (10) | 10.80 (10) | 44.15 | 6/08-YE | 222.7 (Z) |
| **2009** | ***2ND QUARTER: AVERAGES/TOTAL*** | **8.05** | **10.55** | **47.66** | | **1,425.7** |
| | ***MEDIAN*** | **8.36** | **10.56** | **48.00** | | **---** |
| | ***OBSERVATIONS*** | **9** | **10** | **9** | | **17** |

ELECTRIC UTILITY DECISIONS (continued)

| Order Date | Company (State) | ROR % | ROE % | Common Eq. as % Cap. Str. | Test Year & Rate Base | Amt. $ Mil. |
|---|---|---|---|---|---|---|
| 7/8/09 | Duke Energy Ohio (OH) | 8.61 | 10.63 (E) | 51.59 (E) | 12/08-DC | 55.3 (D,B) |
| 7/14/09 | Southwestern Public Service (NM) | --- | --- | --- | --- | 14.2 (B) |
| 7/17/09 | Avista Corp. (ID) | 8.55 | 10.50 | 50.00 | 9/08-A | 12.5 (B) |
| 7/24/09 | Kansas City Power & Light (KS) | --- | --- | --- | 12/07-YE | 59.0 (B) |
| 7/24/09 | Oklahoma Gas & Electric (OK) | --- | --- | --- | 9/08-YE | 48.3 (B) |
| 8/21/09 | Texas-New Mexico Power (TX) | --- | --- | --- | 3/08 | 12.7 (B) |
| 8/31/09 | Oncor Electric Delivery (TX) | 8.28 | 10.25 | 40.00 | 12/07-YE | 115.1 (D) |
| ***2009*** | ***3RD QUARTER: AVERAGES/TOTAL*** | **8.48** | **10.46** | **47.20** | | **317.1** |
| | ***MEDIAN*** | **8.55** | **10.50** | **50.00** | | **---** |
| | ***OBSERVATIONS*** | **3** | **3** | **3** | | **7** |
| ***2009*** | ***YEAR-TO-DATE AVERAGES/TOTAL*** | **8.17** | **10.43** | **47.94** | | **2,599.8** |
| | ***MEDIAN*** | **8.35** | **10.50** | **49.00** | | **---** |
| | ***OBSERVATIONS*** | **20** | **22** | **20** | | **38** |

GAS UTILITY DECISIONS

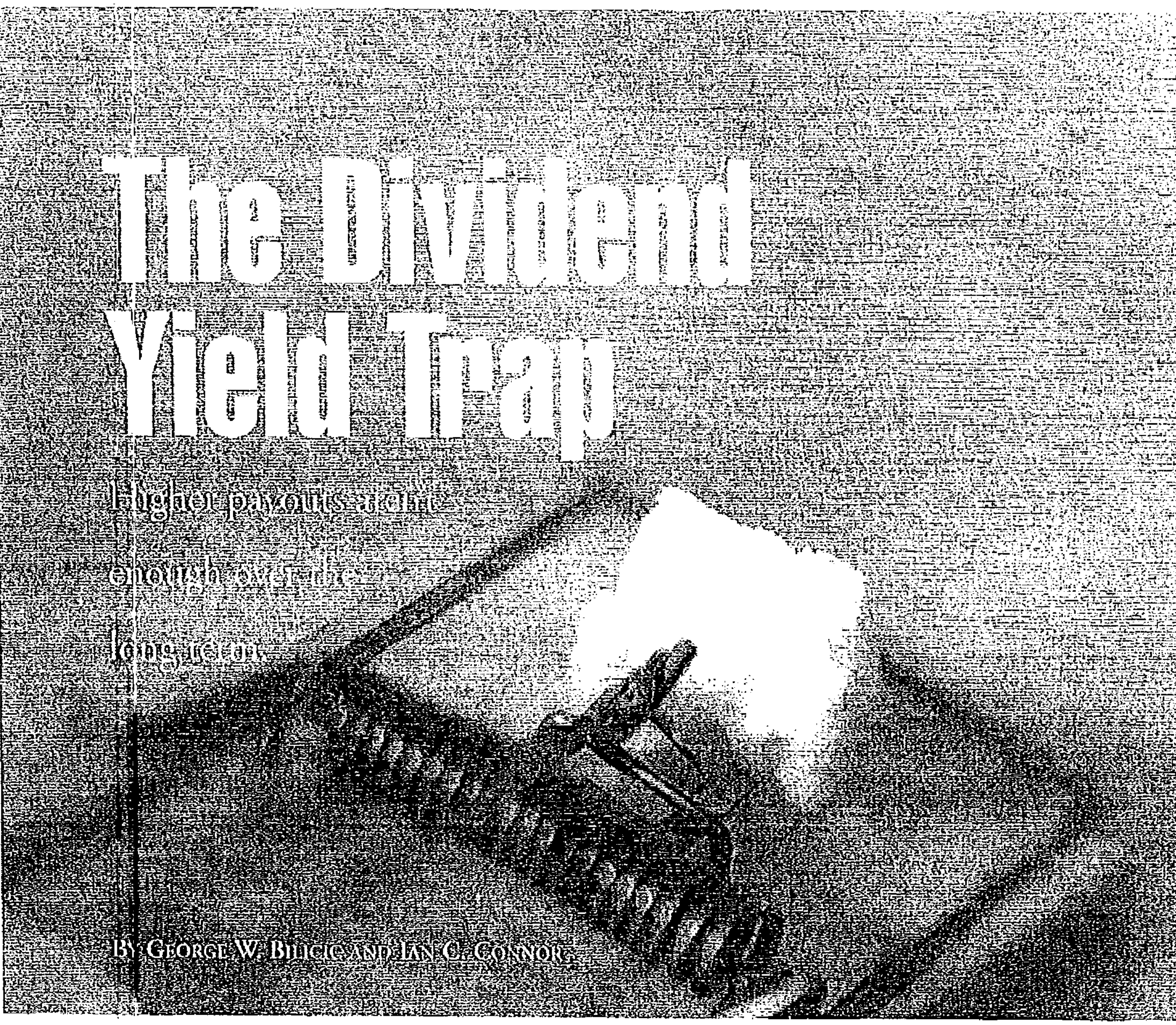
| Order Date | Company (State) | ROR % | ROE % | Common Eq. as % Cap. Str. | Test Year & Rate Base | Amt. $ Mil. |
|---|---|---|---|---|---|---|
| 1/7/09 | Vectren Energy Delivery of Ohio (OH) | 8.89 | --- | --- | 5/08-DC | 14.8 (B) |
| 1/13/09 | Michigan Gas Utilities (MI) | 7.60 | 10.45 | 46.49 * | 12/09 | 6.0 (B) |
| 2/2/09 | New England Gas (MA) | 7.74 | 10.05 | 34.19 | 12/07-YE | 3.7 |
| 2/5/09 | Louisville Gas & Electric (KY) | --- | --- | --- | --- | 22.0 (B) |
| 2/26/09 | Equitable Gas (PA) | --- | --- | --- | 12/08 | 38.4 (B) |
| 3/9/09 | Atmos Energy (TN) | 8.24 | 10.30 | 48.12 | 6/08-A | 2.5 (B) |
| 3/25/09 | Northern Illinois Gas (IL) | 7.58 | 10.17 | 46.42 | 12/09-A | 69.0 |
| **2009** | ***1ST QUARTER: AVERAGES/TOTAL*** | **8.01** | **10.24** | **43.81** | | **156.4** |
| | ***MEDIAN*** | **7.74** | **10.24** | **46.46** | | **---** |
| | ***OBSERVATIONS*** | **5** | **4** | **4** | | **7** |
| 4/2/09 | Entergy New Orleans (LA) | --- | 10.75 | --- | 12/08-YE | 5.0 (B,7) |
| 5/15/09 | Niagara Mohawk Power (NY) | 7.70 | 10.20 (11) | 43.70 | 3/10-A | 39.4 (B) |
| 5/29/09 | EnergyNorth Natural Gas (NH) | 8.28 | 9.54 | 50.00 | 6/07-A | 5.5 (B,I) |
| 6/3/09 | Black Hills/Iowa Gas Utility (IA) | 8.71 | 10.10 | 51.38 | 12/07-A | 10.4 (B,I) |
| 6/9/09 | Peoples Gas System (FL) | 8.50 | 10.75 | 48.51 * | 12/09-A | 19.2 (I) |
| 6/22/09 | Central Hudson Gas & Electric (NY) | 7.28 | 10.00 | 47.00 | 6/10-A | 13.8 |
| 6/29/09 | Minnesota Energy Resources (MN) | 7.98 | 10.21 | 48.77 | 12/08-A | 15.4 (I) |
| 6/30/09 | Connecticut Natural Gas (CT) | 7.92 | 9.31 (12) | 52.52 | 6/08-(13) | -16.2 |
| **2009** | ***2ND QUARTER: AVERAGES/TOTAL*** | **8.05** | **10.11** | **48.84** | | **92.5** |
| | ***MEDIAN*** | **7.98** | **10.15** | **48.77** | | **---** |
| | ***OBSERVATIONS*** | **7** | **8** | **7** | | **8** |
| 7/17/09 | Southern Connecticut Gas (CT) | 8.05 | 9.26 (12) | 52.00 | 6/08-(13) | -12.5 |
| 7/17/09 | Avista Corp. (ID) | 8.55 | 10.50 | 50.00 | 9/08-A | 1.9 (B) |
| 8/27/09 | UGI Penn Natural Gas (PA) | --- | --- | --- | 9/09 | 19.8 (B) |
| 8/27/09 | UGI Central Penn Gas (PA) | --- | --- | --- | 9/09 | 10.0 (B) |
| **2009** | ***3RD QUARTER: AVERAGES/TOTAL*** | **8.30** | **9.88** | **51.00** | | **19.2** |
| | ***MEDIAN*** | **8.30** | **9.88** | **51.00** | | **---** |
| | ***OBSERVATIONS*** | **2** | **2** | **2** | | **4** |
| **2009** | ***YEAR-TO-DATE AVERAGES/TOTAL*** | **8.07** | **10.11** | **47.62** | | **268.1** |
| | ***MEDIAN*** | **8.02** | **10.19** | **48.51** | | **---** |
| | ***OBSERVATIONS*** | **14** | **14** | **13** | | **19** |

**FOOTNOTES**

A- Average
B- Order followed stipulation or settlement by the parties. Decision particulars not necessarily precedent-setting or specifically adopted by the regulatory body.
D- Applies to electric delivery only
DC- Date certain
E- Estimated
I- Interim rates implemented prior to the issuance of final order, normally under bond and subject to refund.
R- Revised
YE- Year-end
Z- Rate change implemented in multiple steps.
* Capital structure includes cost-free items or tax credit balances at the overall rate of return.

(1) Recovery of an additional $22.1 million authorized through adjustment mechanisms.
(2) Second-year distribution rate increase of $19.4 million authorized based on a 7.76% ROR. This increase is subject to adjustment for pension expense.
(3) Adopted ROE applies only to the company's proposed 649-MW, coal-fired Sutherland Unit 4 plant. The company subsequently cancelled plans to construct the plant.
(4) Commission decision modified a settlement. Recovery of an additional $22.5 million authorized through tracking mechanisms.
(5) Indicated rate increase includes a $46.7 million base rate increase offset by a net $16.2 million decrease in revenues collected under certain riders.
(6) Indicated rate increase is retroactive to January 1, 2009 and reflects the one-time refund of a $72.5 million overcollection of postretirement benefits other than pension costs. Additional rate increases of $205.3 million and $219 million authorized for 2010 and 2011, respectively. Rate of return was not an issue in this case.
(7) Rate changes effective June 1, 2009.
(8) Authorized return parameters apply only to the 120-150 MW, gas-fired Mill Creek generating plant.
(9) Rate increase associated with implementation of advanced metering infrastructure. Return parameters are those adopted in the company's previous rate case.
(10) Reflects incentive ROE (and ROR) for demand side mangement programs and the Chuck Lenzie generating plant. Without the incentives, a 10.5% ROE was authorized.
(11) Indicated ROE includes a 20 basis-point premium associated with the multi-year term of the settlement.
(12) Adopted ROE reflects a 10-basis point penalty for billing errors.
(13) Rate base valued as of 12/31/09.

Dennis Sperduto



# The Dividend Yield Trap

## Higher payouts aren't enough over the long term

By George W. Bilicic and Ian C. Connor

The past two years witnessed the ascendancy of dividend yield in the valuations of U.S. electric utilities. The recent primacy of yield in utility-industry valuations is the product of a unique confluence of factors. The collapse of most of the industry's non-regulated growth initiatives has resulted in a market that attributes little value to the industry's growth prospects beyond that which has been historically generated by the expansion of rate base—1 to 3 percent. To the degree that non-regulated growth is credited in the current market, such credit is principally limited to conservative, incremental strategies and even then such strategies are often discounted by the market.

The industry's low regulated growth profile, coupled with the absence of credible, broad-based non-regulated growth strategies, remains the most important strategic issue confronting the industry today.

**Dividend Yield: Current and Long-Term Valuation Considerations**

The significant value implications to the industry of its persistent growth issue are masked by the market's current pursuit of yield, which has marginalized such considerations. Such an exaggerated bias toward yield, however, is episodic: a temporary displacement of fundamental considerations of value based on total return by current U.S. economic policies, principal among them being historically low interest rates and the 2003 dividend tax cut. The former phenomenon is a function of federal stimulus policies reflecting the broader economic uncertainties, which have proven unexpectedly trenchant. In an environment where the benchmark 10-year Treasury is yielding only 4.3 percent and the S&P 500 offers only equivocal returns, the bond-substitute properties of a regulated utility with a comparable or superior dividend yield present a





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compelling alternative to investors.

Such a low interest-rate environment, however, is not sustainable over the long term. As interest rates rise, the industry's yield proposition will diminish relative to government securities, compressing values (*see Figure 1, p. 69*). More importantly, with yield no longer being the principal investment proposition, investors will again begin to discriminate among utilities based upon fundamental considerations of long-term growth and, by extension, total return.

### The 2003 Dividend Tax Cut: Dividend Policies Revisited

Of long-term significance to the U.S. electric utility industry are the value and financial policy implications of the 2003 dividend tax cut. At a minimum, the equalizing of the taxation of dividend yield and capital gain has enhanced the value proposition of the industry. On an absolute basis, the after-tax total return of an illustrative utility with an 8 percent total return comprised of 4 percent dividend yield and 4 percent long-term earnings growth improved from 5.8 percent to 6.8 percent, or 17 percent. On a relative basis, the impact is equally significant. For example, consider two utilities with the same nominal total returns of 8 percent: One utility's return is comprised of 3 percent dividend yield and 5 percent earnings growth; the other utility's return is comprised of 5 percent dividend yield and 3 percent earnings growth. Prior to the dividend tax cut, the higher growth utility's after-tax total return was 6.1 percent, while the higher yielding utility's was 5.6 percent, a 10 percent differential. After the dividend tax cut, each utility offers the same 6.8 percent after-tax total return.[1]

Further, while on a nominal basis the returns of these two illustrative utilities are now the same on a pre- and after-tax basis, the higher dividend-yielding utility arguably offers the better investment proposition on a risk adjusted basis (assuming a sustainable dividend policy). In fact, adjusting for risk, utilities that offer total returns balanced heavily toward dividend yield theoretically may offer better returns than other investments with nominally higher returns but which are weighted significantly toward presumptively riskier non-regulated growth.

Thus, on a risk adjusted basis, a utility offering an 8 percent total return comprised of 5 percent yield and 3 percent growth may be a better return proposition than a utility or other investment opportunity offering a 10 percent total return comprised of 7 percent non-regulated growth and 3 percent yield. The 2003 tax cut accordingly represents a fundamental shift in traditional conceptions of utility total return and valuation that the industry must now consider in aligning their financial, investment, and capital policies.

### Capital Structure Implications

The parameters of this realignment, while important, are not as significant as they might initially appear, however. Indeed, for most of the U.S. electric utility industry that already has a balanced, sustainable dividend policy with payout ratios and growth in line with their peers and the broader industry, there likely is little, if any, need for adjustment. Certainly utilities should avoid exaggerated, unsustainable payout policies to enhance yield to court higher valuations in response to short-term market valuation phenomena, such as the current historically low interest-rate environment.

Conversely, those utilities that have either regulated or non-regulated growth strategies that are viable and receive significant capital markets credit may not have any need for competitive dividend policies from a total return perspective. Nor, in most instances, do such utilities have the capital resources to fund the capital investment of such superior growth strategies as well as sustain dividend payout policies in line with those utilities with lower growth capital requirements.

Finally, in addition to the embedded 2008 sunset provision, current dividend tax policies are subject to political risk, either in the form of the 2004 political elections or fiscal pressure resulting from the United States' currently high deficits. Over-committing to dividend yield exposes a utility to potentially significant adverse consequences if current dividend taxation policies are reversed or amended; such political bets are not in the interests of utilities or their shareholders.

The utilities for which an adjustment of dividend policies is perhaps necessary are those that have traditionally, or recently, neglected yield. Such relative neglect of yield in favor of growth investment was to a significant degree an outgrowth of the unequal tax treatment of dividend versus capital gain income, which discouraged distributing cash directly to shareholders in the form of dividends. However, as noted above, available non-regulated investment opportunities have decreased, and along with them the claims such initiatives once made on utilities' cash flows. As a result, such utilities may still have attractive relative long-term growth rates of 4 to 5 percent based on some residual and viable non-regulated businesses, but their dividend yields are typically only in the range of 2 to 3 percent, resulting in deficient yield and total return propositions relative to their peers and the broader industry, particularly on a risk-adjusted basis. As a result, in the current market environment, such utilities may find themselves trading at a discount.

### Catch-22

Such a valuation discount carries important implications for a utility's equity currency, cost-of-capital, and strategic leverage.



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In some respects, they are caught in a catch-22. Largely foreclosed from pursuing meaningful growth through non-regulated investment, their constrained dividend yield policies, initially conceived with the object of redirecting free cash flow toward such growth investment, now results in a trading discount, impairing the ability of such utilities to pursue the one viable, credible growth strategy that remains accessible to the broader industry: mergers and acquisitions.

Until recently, industry leaders Exelon and FPL were representative of this class of utilities described above. Each was characterized by above-average long-term growth rates, lower-than-average dividend payout, and significant free cash flow after dividends. And, most important, as a result of their low yield and lower total return, each correspondingly traded at a discount to its peers and the broader industry indexes.

Exelon provides a particularly instructive example in this regard. Exelon traded at a persistent discount to its peers and the broader industry since 2003 (and the enactment of the dividend tax cut). Conventional wisdom attributed this discount to its potential 2007 earnings cliff associated with the expiration of the CTC revenue collection. However, from a total return perspective, Exelon's 1.4x P/E-to-total-return ratio was in line with its peers and the broader industry. Notwithstanding its strong long-term earnings growth rate, its dividend yield based on a payout ratio of only 40 percent was 3.3 percent, approximately 15 percent below its peers. Exelon's resulting total return was 8.5 percent, a 9 percent discount to its peers' median of approximately 9.3 percent, or the same discount reflected in its forward P/E. Thus, irrespective of the market's current dividend yield bias in valuations, Exelon properly should have traded at a discount based on fundamental considerations of total return.

Perhaps recognizing this, Exelon, on July 28, 2004, rechanneled a portion of its significant free cash flow to announce that it was raising its dividend 11 percent, to $1.22 per share, and targeting a payout ratio in 2005 of 50 to 60 percent, in line with its peers and the industry. Since Exelon's announcement, its share price has increased approximately 12 percent, creating in excess of $2.7 billion in incremental equity value for its shareholders. Further, Exelon's trading discount to its peers and the broader industry has largely dissipated. Exelon currently trades at a 2005 P/E of 12.6x; a dividend yield of 4.4 percent (based on a 2005 payout ratio of 55 percent); and, based on a *pro forma* 2005 projected total return of 9.7 percent, a P/E-to-total return ratio of 1.3x.[2] Each of these metrics is approximately in line with its peers. As importantly, Exelon's strategic leverage and flexibility to pursue growth also is improved.

A nearly identical set of circumstances and results occurred in respect to FPL and its recent dividend enhancement initiative. By bringing its dividend payout and yield in line with its peers and the broader industry, FPL also effectively addressed its equity discount in the market, and, thereby, improved its strategic leverage and flexibility.

### The Long-Term Premium Determinant: Growth

Notwithstanding the current primacy of yield, once utilities properly calibrate their dividend policies to reflect the new return realities of the dividend tax cut and/or valuation drivers move away from yield as a result of changes in interest rates or otherwise, the long-term growth component of total return will re-emerge as a determinant factor in the industry's sustainable valuation levels and, most importantly, will dictate which utilities are able to command a premium valuation in the market. As noted above, unlike dividend yield deficiencies that (assuming sufficient cash flow generative capacities) can be addressed through the adjustment of financial policies, the avenues available to pursue long-term growth that surpass regulated return levels of 1 to 3 percent are limited. Further, it is almost certainly the case that the current average long-term growth rate for the U.S. electric industry of 4.6 percent is too optimistic.[3] The industry's true long-term growth proposition is closer to 2 to 3 percent, and then only if the industry is able to successfully execute on cost-cutting initiatives. In this regard, it is worth noting that during the past 30 years the industry has achieved a compound average growth rate of only 1 percent.[4]

With current trading multiples implying long-term growth rates for the industry of approximately 4.5 to 6 percent, this apparent growth expectations gap translates into significant potential value compression risk in the industry should the current market's dividend yield bias begin to abate and more balanced considerations of growth and total return re-emerge as appropriately weighted components of industry valuations. With the truncation of the industry's non-regulated growth strategies, there is only one strategy that credibly presents to the industry a broad-based, accessible means of generating meaningful growth to address this deficiency: mergers and acquisitions.

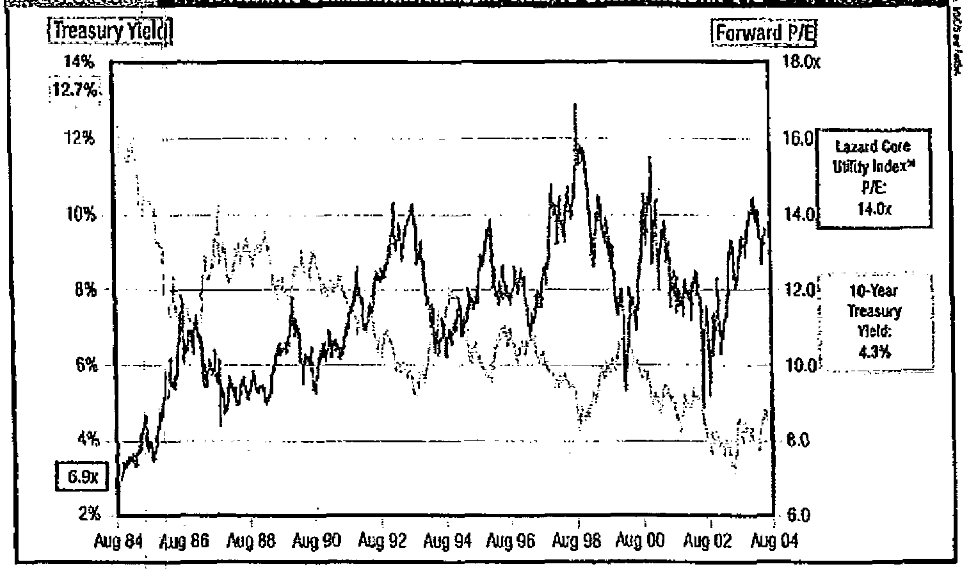
### The Growth Proposition: Mergers & Acquisitions

The value proposition of merger and acquisition strategies is manifest. Cost savings and synergies, derived principally from non-fuel operations and management savings but also variously from the benefits of scale and the transfer of best practices, among others, form the core of the proposition. Such transactions also provide other, less quantifiable, but no less important, benefits, including diversification of market and regulatory risk as well as the financial scale and resources to address the likely future significant capital requirements of the industry



Schedule 21-10

**FIGURE 1 A NEGATIVE CORRELATION: TREASURY YIELD TO UTILITY INDUSTRY P/E**




(a) Lazard Core Utility Index (LCUI) is comprised of Ameren, American Electric Power, Cinergy, Consolidated Edison, Constellation, Dominion, DTE, Duke Energy, Entergy, Exelon, FirstEnergy, FPL, KeySpan, Pinnacle West, PPL, Progress, PSEG, SCANA, Sempra, Southern, Wisconsin Energy, Xcel Energy.

and withstand material adverse operational and financial events.

Even those transactions that are retrospectively deemed unsuccessful were in fact generally able to realize significant synergy and cost saving benefits, often in excess of the targets set at each transaction's public announcement. Where such mergers and acquisitions generally foundered were either in the failure to achieve broader strategic objectives, such as convergence or other revenue-synergies-based strategies, or in simple regulatory or strategic miscalculation. And, while the broader strategic objectives may have proven illusory, the embedded value propositions of cost savings, synergies, and scale remain compelling.

However, the parameters of success in mergers and acquisitions, while manifest and meaningful, are exacting. As a result, such strategies require excellence of conception and execution. The strategic rationales of such transactions must be compelling and accessible to a skeptical investor base, particularly as compared with executing on other growth strategies or even the *status quo*. In this regard, the potential returns must be compelling enough to overcome ostensibly lower-risk means of enhancing shareholder returns, namely share repurchase initiatives.

### Share Repurchase Initiatives: Comparative Return Proposition

The potential emergence of share repurchase initiatives signals and reinforces several important emerging trends in the U.S. utility industry. The first stems from the industry's successful and significant financial and operational retrenchment over the past several years. Industry credit quality has improved and continues to improve markedly (though it is still below pre-1990 levels) as cash flow and earnings increase and debt levels are reduced. The second relates to the limited non-regulated growth strategies available to the industry, which constrain capital investment outlets and create a free cash flow surplus for the industry. Current estimates forecast that the U.S. electric utility industry will generate more than $15 billion annually in free cash flow through 2010.[5] European utilities face a similar projected cash situation, with E.ON alone projected to generate approximately $5 billion to $6 billion annually in free cash flow. As a result, merger and acquisitions strategies (as well as any other growth investment strategies) must compete with capital structure initiatives, such as share repurchase programs, as the most viable means to deliver superior returns and value to shareholders.

The financial proposition of share repurchase programs is relatively straightforward. Such strategies represent an alternative to dividends to distribute excess free cash flow to investors (though the historical tax efficiency component of share repurchase programs relative to dividends was effectively eliminated by the 2003 dividend tax cut). The share repurchase value proposition is effectively a financial mechanism to achieve earnings-per-share accretion by using a lower cost-of-capital (cash/debt) to buy-in a higher cost-of-capital (public market equity), effectively leveraging the capital structure (and inviting negative credit scrutiny) to increase equity returns.

However, while a share repurchase strategy is certainly advisable and beneficial in certain circumstances to enhance equity value, it is also limited and limiting in important respects. While accretive to earnings, such strategies do not alter the fundamental growth profile of a utility, nor do they create incremental enterprise value. Any EPS accretion is effectively "one time" in nature, limited to the duration of the program unless it is fixed and long-term in nature. And even these equity benefits are usually discounted in the market given the typically indicative, changeable parameters and soft commit-



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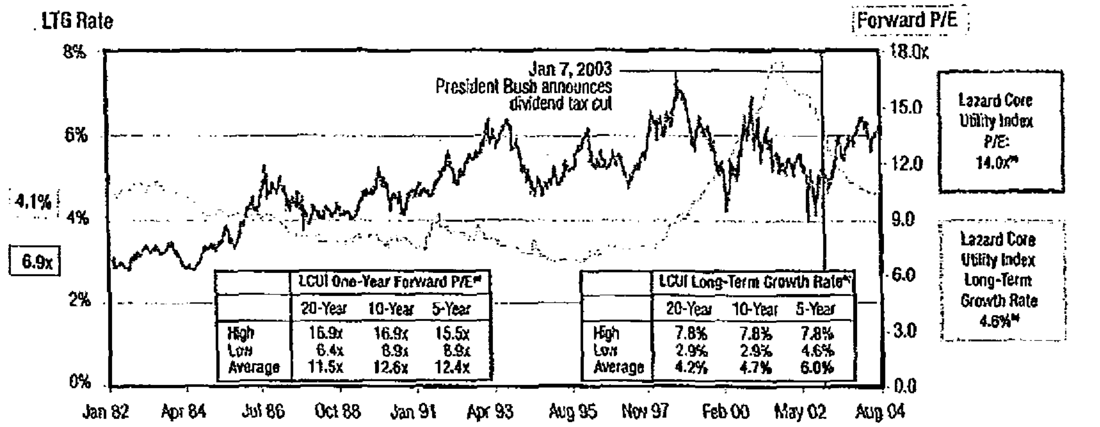
**FIGURE 2 — UTILITY INDUSTRY HISTORICAL VALUATION LEVELS**




| | LCUI One-Year Forward P/E(a) | | |
|---|---|---|---|
| | 20-Year | 10-Year | 5-Year |
| High | 16.9x | 16.9x | 15.5x |
| Low | 6.4x | 8.9x | 8.9x |
| Average | 11.5x | 12.6x | 12.4x |

| | LCUI Long-Term Growth Rate(a) | | |
|---|---|---|---|
| | 20-Year | 10-Year | 5-Year |
| High | 7.8% | 7.8% | 7.8% |
| Low | 2.9% | 2.9% | 4.6% |
| Average | 4.2% | 4.7% | 6.0% |

(a) Lazard Core Utility Index (LCUI) is comprised of Ameren, American Electric Power, Cinergy, Consolidated Edison, Constellation, Dominion, DTE, Duke Energy, Entergy, Exelon, FirstEnergy, FPL, KeySpan, Pinnacle West, PPL, Progress, PSEG, SCANA, Sempra, Southern, Wisconsin Energy, Xcel Energy.

ments that characterize such initiatives, both in terms of timing and magnitude. It is not unusual for companies to announce their intentions to execute a share repurchase program only to later fail to follow through, or to do so at materially lower levels than initially indicated.

Nor are share repurchase programs immune from execution risk. As with any other investment, share repurchases can potentially destroy value to the degree that they are executed at inflated valuations. This is an important consideration for the utility industry in particular at present. As noted previously, the industry currently trades at premium valuation levels relative to historical parameters. Whereas the average one-year forward P/E for the industry during the past 20 years implies sustainable P/E levels of approximately 12.0x, the industry today is trading at a P/E of approximately 13.5-14.0x. (*see Figure 2*).[6] An additional indicator that the industry may be fully valued at present is its relative P/E to that of the S&P 500. The industry historically has traded on a P/E basis at approximately 0.7x the S&P 500; currently, it is trading at approximately 0.9x, a 20 percent premium to historical levels.[7]

As in the case of dividends, then, while share repurchase programs may be tactically or financially appropriate in certain circumstances to enhance total return and shareholder value, they are not typically viable or sustainable strategies to deliver long-term growth and shareholder value, particularly as compared with investment in growth initiatives or mergers and acquisitions. Certainly, with respect to merger and acquisition strategies, share repurchase programs do not capture the same incremental multi-dimensional benefits—most notably the compound strengths of enhanced scale, including cost-of-capital efficiencies, greater regulatory influence, and fuel, geographic and operational diversity, among others.

### The More Things Change...

Ultimately, though the collapse of non-regulated strategies as a solution to the industry's low growth characteristics and the 2003 dividend tax cut have altered the parameters of U.S. utilities in evaluating strategies to increase shareholder value, in many respects the fundamental issue confronting the industry remains unchanged: how to achieve superior long-term growth in an intrinsically low-growth industry. While utilities should continue to evaluate their financial policies and capital structures in respect of dividend yield and share repurchase policies, the answer to the industry's long-term growth issues continues to be the successful execution of merger and acquisition strategies.

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### Endnotes

1. Recognizing that for certain institutional investors such relative tax considerations are immaterial.
2. As of Sept. 3, 2004.
3. Based on average long-term growth rate of component utilities in Lazard Core Utility Index.
4. Source: Bernstein Research Report dated June 2004.
5. Free cash flow defined as cash from operations less capital expenditures.
6. Based on Lazard Core Utility Index.
7. Neither of these historical benchmarks are adjusted for the potential impact of the dividend tax cut on industry values.



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PAGES 3257-3268

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PART 2 — *Selection & Opinion* — OCTOBER 16, 2009


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Faithfully, Jean Bernhard Buttner

## The Value Line View

### In This Issue




The *Selection & Opinion* Index appears on page 3336 (September 4, 2009).



*In Three Parts: Part 1 is the Summary & Index. This is Part 2, Selection & Opinion. Part 3 is Ratings & Reports. Volume LXV, Number 8.*

Published weekly by VALUE LINE PUBLISHING, INC. 220 East 42nd Street, New York, NY 10017-5891.




## ECONOMIC AND STOCK MARKET COMMENTARY

**Some warning shots have been fired.** After months of improving news on the business front, the past couple of weeks have seen the release of somewhat less stellar economic data. This does not suggest that a major reversal in economic fortunes is at hand, as the reports—which have dealt with factory orders, existing home sales, new home sales, payroll declines, consumer confidence, and manufacturing—have been just mildly disappointing. What the reports do imply, however, is that the evolving business upturn may be a checkered affair, with a succession of peaks and valleys along the way.

**These sluggish trends aside, the recession probably ended in the third quarter,** when the U.S. gross domestic product—which had been declining for more than a year—may have risen by 3%, or so. (Note: GDP figures for the third quarter are set for release on October 29th.) The recent softness cited above, however, does suggest that growth during the fourth quarter could be a bit less imposing—perhaps averaging about 2%.

**Meanwhile, we could possibly see some backsliding in 2010.** Our sense is that growth will average 2%, or so, as well next year. However, these gains may not be uniform, as the damage done to the automobile, housing, retail, and manufacturing sectors, for example, has been so extensive that it may take more than a year for these areas to revive. Should this uneven recovery unfold, earnings and the stock market might remain quite volatile. The good news is that such limited growth should keep the Federal Reserve Board from raising interest rates for some time.

**Earnings season is upon us.** The next few weeks should see much of Corporate America issue results for the third quarter. We think earnings will show improvement from earlier in the year. Whether such prospective improvement will be enough to satisfy investors remains to be seen.

**Investors are becoming sensitive to disappointing news,** with the past few weeks often seeing stocks slip on weakening economic data, although they have usually rebounded quickly. We believe the market is now a bit pricey, after rising for months, and may be ripe for some profit taking.

**Conclusion:** We think the overall trend in the economy will be modestly positive over the next few months and that after a period of profit taking, stocks should resume their uptrend. Please refer to the inside back cover of *Selection & Opinion* for our Asset Allocation Model's current reading.

CLOSING STOCK MARKET AVERAGES AS OF PRESS TIME

| | 9/30/2009 | 10/7/2009 | %Change 1 week | %Change 12 months |
|---|---|---|---|---|
| Dow Jones Industrial Average | 9712.28 | 9725.58 | +0.1% | +2.9% |
| Standard & Poor's 500 | 1057.08 | 1057.58 | 0.0% | +6.2% |
| N.Y. Stock Exchange Composite | 6910.88 | 6912.65 | 0.0% | +8.2% |
| NASDAQ Composite | 2122.42 | 2110.33 | -0.6% | +20.3% |
| NASDAQ 100 | 1718.99 | 1710.45 | -0.5% | +28.6% |
| American Stock Exchange Index | 1778.67 | 1786.57 | +0.4% | +15.2% |
| Value Line (Geometric) | 298.87 | 297.82 | -0.4% | +7.1% |
| Value Line (Arithmetic) | 2149.38 | 2144.45 | -0.2% | +36.4% |
| London (FT-SE 100) | 5133.9 | 5108.9 | -0.5% | +10.9% |
| Tokyo (Nikkei) | 10133.23 | 9799.60 | -3.3% | -3.5% |
| Russell 2000 | 604.28 | 602.08 | -0.4% | +7.7% |

# The Stock Market Review: Third Quarter, 2009

**It was the best of times, it was the worst of times.** That quotation from Charles Dickens' 1859 novel, *A Tale of Two Cities*, aptly sums up the first three quarters of 2009 for the stock market. Specifically, after a horrific start to the new year—in which stocks fell to a series of multiyear lows under mounting pressure from an avalanche of disturbing economic news—equities abruptly turned around in early March and staged a dramatic turnaround in the next six months. All told, the stock market, as measured by the Dow Jones Industrial Average, fell from a bit over 14,000 in October 2007, to about 6,500 some 10 weeks into 2009, before righting itself. That awful 17-month stretch saw 401-K's, IRA's, Keough's, and various other retirement plans typically lose a third or more of their value. The ensuing six months reversed a portion of that damage. Still, even with this partial recovery, the Dow still closed the third quarter more than 30% below its record posting in late 2007.

**It continues to be the economy.** The recession, which officially began in December of 2007, just two months after the Dow crested above 14,000, intensified as 2008 wore on, as did the bear market, with both bottoming out in the first quarter of 2009. As business revived in the second quarter, with the U.S. gross domestic product paring its first-quarter decline from 6.4% to just 0.7%, stocks likewise strengthened. Equities recovered further in the summer, with the Dow Industrials (up 15.0%), the S&P 500 (up 15.0%), the NASDAQ (up 15.7%), the small-cap Russell 2000 (up 18.9%), and the Value Line (Arithemtic) Composite (up 25.4%) leading the way higher in the third quarter. Not surprisingly, the nation's economy also fared better, with GDP data (set for release on October 29th) likely showing that the economy grew by around 3% in the recent quarter. Now, the economy will try to maintain this momentum in the final period, which may be difficult given that the news issued over the past fortnight has shown an aggregate deceleration in activity. Time will tell if the 2%, or so, rise in GDP that we estimate for the fourth quarter will satisfy investors following the market's heroics over the past six months. In fact...

**The market is at a crossroads.** As noted, recent economic data have been less reassuring than reports issued during the preceding couple of months. Now, this could be nothing more than normal backing and filling within the parameters of the uneven economic up cycle that we have been forecasting all along. If that is the case, then stocks, following some well overdue profit taking, should resume their rise. This is the most likely scenario, we think. However, should the recent data be suggestive of more serious economic trouble, the road ahead for stocks could be less compelling. We think there is a lesser case for this outcome being realized.

**Keep an eye on the data.** We would pay particular attention to the housing and employment reports, as these sectors are especially critical and have been among the weakest components in the mix. Our sense is that housing demand, home prices, and employment will all continue to lag the recovery cycle.

**Overall, we remain cautiously upbeat.** Our sense is that a definitive bottom was established in the market earlier this year and that, assuming our economic model—which calls for an extended period of uneven, but durable, growth—is near the mark, the stock market, after some possible retrenching, may be headed higher over the next year.

*Harvey S. Katz, CFA*
*Chief Economist*

| | THIRD QUARTER | | | NINE MONTHS | | |
|---|---|---|---|---|---|---|
| | 6/30/09 | 9/30/09 | % Change | 12/31/08 | 9/30/09 | % Change |
| Dow Jones Industrial Average | 8447.00 | 9712.28 | 15.0 | 8776.39 | 9712.28 | 10.7 |
| Dow Jones Transportation Average | 3234.56 | 3799.84 | 17.5 | 3537.15 | 3799.84 | 7.4 |
| Dow Jones Utility Average | 357.81 | 377.23 | 5.4 | 370.76 | 377.23 | 1.7 |
| Standard & Poor's 500 Index | 919.32 | 1057.08 | 15.0 | 903.25 | 1057.08 | 17.0 |
| NASDAQ Composite | 1835.04 | 2122.42 | 15.7 | 1577.03 | 2122.42 | 34.6 |
| NASDAQ 100 | 1477.25 | 1718.99 | 16.4 | 1211.65 | 1718.99 | 41.9 |
| New York Stock Exchange Composite | 5905.15 | 6910.88 | 17.0 | 5757.05 | 6910.88 | 20.0 |
| American Stock Exchange Composite | 1582.02 | 1778.67 | 12.4 | 1397.53 | 1778.67 | 27.3 |
| Russell 2000 | 508.28 | 604.28 | 18.9 | 499.45 | 604.28 | 21.0 |
| Value Line (Arithmetic) Average | 1714.53 | 2149.38 | 25.4 | 1404.78 | 2149.38 | 53.0 |
| Value Line (Geometric) Average | 244.80 | 298.87 | 22.1 | 225.90 | 298.87 | 32.3 |
| Value Line Industrials | 198.02 | 243.80 | 23.1 | 181.38 | 243.80 | 34.4 |
| Value Line Rails | 1966.85 | 2356.02 | 19.8 | 1987.92 | 2356.02 | 18.5 |
| Value Line Utilities | 198.03 | 213.04 | 7.6 | 209.13 | 213.04 | 1.9 |
| London (FT-SE 100) | 4249.21 | 5133.90 | 20.8 | 4434.20 | 5133.90 | 15.8 |
| Tokyo (Nikkei) | 9958.44 | 10133.23 | 1.8 | 8859.56 | 10133.23 | 14.4 |
| Toronto (TSE 300) | 10374.91 | 11394.96 | 9.8 | 8987.70 | 11394.96 | 26.8 |

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# The Value Line View

## In This Issue




The *Selection & Opinion* Index appears in this issue on page 3176.



*In Three Parts: Part 1 is the Summary & Index. This is Part 2, Selection & Opinion. Part 3 is Ratings & Reports. Volume LXV, Number 15.*

Published weekly by VALUE LINE PUBLISHING, INC.
220 East 42nd Street, New York, NY 10017-5891.




## ECONOMIC AND STOCK MARKET COMMENTARY

**On the one hand, homebuilding has stalled.** For example, recently issued figures show that housing starts fell 10.6% in October, a larger decline than expected. That setback followed months of flattish activity. Bad weather and uncertainty about the extension of the home-buyer tax credit—the credits have since been extended—get much of the blame for pushing starts down to their lowest levels since April. Building permits, often viewed as a barometer of future building activity, also fell. Builders, understandably, are quite wary, as foreclosures are rising and supplies of unsold homes—albeit lower than they were—remain too high to stoke a strong building recovery.

**On the other hand, resale activity has come back strongly,** with sales of existing homes now at their highest level in almost two years. Moreover, inventories of unsold homes continue to fall—an encouraging recovery sign. Unfortunately, prices continue to slide as well, and this probably will delay an even stronger comeback, as will the slow response time by lenders, and the still-tight credit conditions. Our feeling is that the worst of the long housing slump is over, but that a sustainable recovery will be a long and uneven process.

**Elsewhere, the U.S. economy is on a three steps forward, two steps backward path.** Reports for October showed a nice rebound in consumer spending, mild strength in industrial production, a lesser increase in the leading indicators than in the prior month, a surprising drop in durable goods orders, and a modest gain in consumer confidence. The U.S. gross domestic product—which rose by a downwardly revised 2.8% in the third quarter—may increase by a slightly more modest 2.0%-2.5% in the current period.

**Meanwhile, we are at an earnings crossroads.** Third-quarter results were better than expected, and totals for the fourth quarter should exceed the prior-year's tallies. However, sales gains remain elusive, and we'll need to see progress here if earnings growth is to be sustained in 2010 at a good level, in our opinion.

**Investors are still buying,** as the stock market is now much more richly capitalized than it was earlier in 2009, when equities were in a freefall.

**Conclusion:** We remain generally constructive on the market, although we acknowledge that valuations are no longer as attractive as they were. Please refer to the inside back cover of *Selection & Opinion* for our Asset Allocation Model's current reading.

**CLOSING STOCK MARKET AVERAGES AS OF PRESS TIME**

| | 11/18/2009 | 11/24/2009 | %Change 1 week | %Change 12 months |
|---|---|---|---|---|
| Dow Jones Industrial Average | 10426.31 | 10433.71 | +0.1% | +23.6% |
| Standard & Poor's 500 | 1109.80 | 1105.65 | -0.4% | +29.8% |
| N.Y. Stock Exchange Composite | 7226.71 | 7170.26 | -0.8% | +34.9% |
| NASDAQ Composite | 2193.14 | 2169.18 | -1.1% | +47.4% |
| NASDAQ 100 | 1801.74 | 1786.25 | -0.9% | +54.7% |
| American Stock Exchange Index | 1825.65 | 1799.87 | -1.4% | +38.3% |
| Value Line (Geometric) | 299.26 | 294.84 | -1.5% | +48.2% |
| Value Line (Arithmetic) | 2176.28 | 2145.89 | -1.4% | +79.8% |
| London (FT-SE 100) | 5342.1 | 5323.9 | -0.3% | +28.2% |
| Tokyo (Nikkei) | 9676.80 | 9401.58 | -2.8% | +18.8% |
| Russell 2000 | 600.15 | 592.58 | -1.3% | +35.7% |

on a plan to ask the state's voters next November to pass $11.1 billion in bonds to help finance new

one of the most complicated issues in our state's history."

cal agencies will do the monitoring.

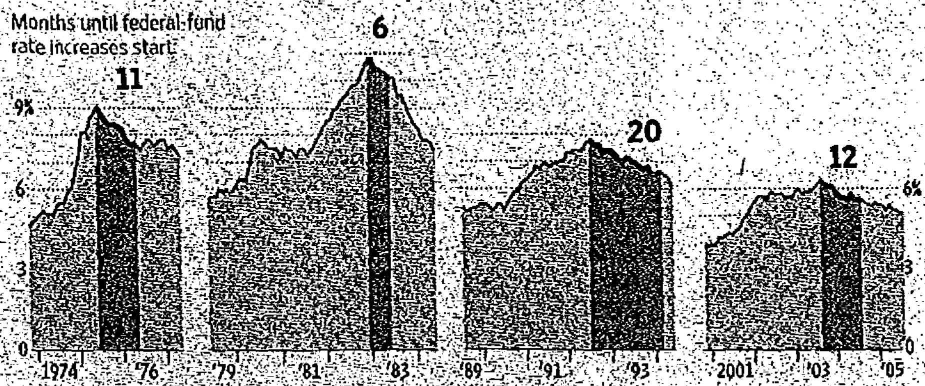
# Fed to Keep Rates Low Despite Pickup

By Jon Hilsenrath

11/4/09 P.A.?

**Jobs Come First**

Historically, the Federal Reserve has waited for the unemployment rate to fall before it has started raising its interest-rate target. Below, unemployment rates before, during and after recent recessions. The current unemployment rate is 9.8%.




Note: In 1976 the Fed raised rates and then lowered them a few months later.
Sources: Federal Reserve Board, Labor Department, Federal Reserve Bank of New York

The Federal Reserve affirmed its plan to keep interest rates "exceptionally low" for a long time despite signs of economic recovery. But the Fed began to lay rhetorical groundwork for an eventual shift in its stance, suggesting that when the unemployment rate falls or if expectations of inflation turn up, it could change course.

"Economic activity has continued to pick up," the Fed said in a statement following a two-day meeting. It noted that consumer spending has improved, housing activity has increased and businesses were retrenching at a slower pace.

Fed officials voted unanimously to maintain their target for the key federal-funds interest rate—at which banks lend to each other overnight—near zero and said they expect to keep it there for an "extended period," which suggested increases are at least several months off.

Central banks in smaller economies—such as Australia, Israel and Norway—have started raising interest rates. But the Fed made clear the U.S. economy isn't nearly strong enough to begin moving in that direction, even though the economy grew at a 3.5% rate in the third quarter and is expected to keep growing into 2010.

While consumers are spending, the Fed noted they were "constrained by ongoing job losses, sluggish income growth, lower housing wealth and tight credit." Meanwhile, "businesses are still cutting back on fixed investment and staffing, though at a slower pace."

Fed officials are wrestling with conflicting challenges. On the one hand, the unemployment rate is so high and other measures of slack in the economy—such as unused factory capacity—are so great that inflation could keep falling even after a recovery takes hold. This low "resource utilization," as the Fed calls it, argues for keeping rates near zero for a long time.

On the other hand, interest rates are so far below normal and the Fed has pumped so much money into the financial system that the central bank runs a risk of creating inflation or new speculative financial bubbles if officials miscalculate and overstimulate the economy.

Officials emphasize that the plan to keep rates low is conditional on the economic outlook. The Fed's much-watched statement included new hints at what could lead it to change its stance, including new qualifiers listing conditions that justify keeping rates low: "low rates of resource utilization, subdued inflation trends and stable inflation expectations."

"I'm quite happy that they started to lay out those conditions," said Richard Berner, chief economist at Morgan Stanley. "At least they told us what they want to look at explicitly." He expects the Fed to begin raising rates in the second half of 2010.

At this week's meeting, Fed officials decided to buy up to $175 billion of corporate debt issued by mortgage giants Fannie Mae and Freddie Mac, rather than the $200 billion previously planned. It marked the first time they had scaled back an asset-purchase program. The Fed said the change reflects "the limited availability" of the debt.

Fed officials may soon talk more about what it would take to get them to begin "normalizing" policy. If so, they are likely to emphasize that any change depends on the economy. In some ways, normalization has already begun. The Fed has completed its plan to purchase $300 billion of Treasury securities and laid out a plan to complete $1.25 trillion in mortgage-backed-securities purchases by the end of March. Programs that offer emergency loans to investment banks and commercial-paper loans are waning.

Three key dates loom on the Fed's calendar. On Friday, the Labor Department will release its estimate of the October unemployment rate and payroll job growth. A rise in the jobless rate, which would signal that slack is still building, could put off talk of rate increases for a while.

On Nov. 16, Fed Chairman Ben Bernanke will speak at the Economic Club of New York, an opportunity to elaborate on his outlook for the economy and rates. On Nov. 25, the Fed will release minutes from this week's meetings, which could reveal the nature of the discussion on when it expects to raise rates.

**WSJ.com**

**QUESTION OF THE DAY:** How will the 9.8% jobless rate change by 2010? Weigh in at WSJ.com/Question.

# Job Losses Continue, but Pace Slackens

By Sudeep Reddy

Significant job losses continued across the economy in October, although the pace of layoffs abated.

Private-sector employment declined 203,000 in October, the seventh-straight month of moderating job losses and the smallest since March 2008 and less than half the cuts made in October 2008.

The reports came against a faster decline in service-sector employment in the Institute for Supply Management's nonmanufacturing survey. The overall ISM reading slipped to 50.6 in October from 50.9 the previous month, showing slightly slower growth for the sector. (Figures above 50 ... in October: real estate, rental and leasing; mining; and management of companies and support services, which includes temp firms.

"The employment piece of the puzzle is what's really holding back this recovery," said Anthony Nieves, a senior vice president at Hilton Hotels Corp. who directs the ISM survey. "Companies are ... ing some workers and expanding work schedules, offering hope that other sectors could follow.

The losses in the ADP report are worse than economists' consensus estimate that employers, including the government, cut 175,000 jobs in October. The Labor Department, which releases its estimate of October employment on Friday, previously re...

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STANDARD & POOR'S Global Credit Portal RatingsDirect®

**Research**

**Summary:**

# Union Electric Co. d/b/a AmerenUE

**27-Aug-2009**

**Credit Rating:** BBB-/Stable/A-3

## Rationale

The ratings on Union Electric Co. (UE) reflect Ameren Corp.'s consolidated credit profile. UE's ratings also reflect its excellent business profile and Ameren's significant financial profile. Ameren's subsidiaries also consist of utilities, Central Illinois Public Service Co., Central Illinois Light Co. (CILCO; a subsidiary of CILCORP Inc.), and Illinois Power Co. Ameren's unregulated businesses include Ameren Energy Generating Co. and Ameren Energy Resources Generating Co. (a subsidiary of CILCO). Ameren also has an 80% ownership of Electric Energy, Inc., which operates non-rate-regulated electric generation facilities. As of June 30, 2009, Ameren had about $8.4 billion of total debt outstanding. Based on the combination of future earnings, cash flow, and capital expenditures, we currently view Ameren as about 60% regulated and 40% unregulated.

In most circumstances, Standard & Poor's will not rate a wholly owned subsidiary higher than the parent. Exceptions can be made on the basis of structural or regulatory insulation, which in the case of UE, in our view, is not present. Therefore, regardless of UE's excellent business profile and relatively healthy financial condition as a stand-alone basis, Standard & Poor's views the rating on UE to be affected by Ameren's non-regulated businesses.

UE's excellent business profile reflects the more recent constructive regulatory order in Missouri that approved an annual electric rate increase of $162 million and also approved a fuel adjustment clause that will allow for the recovery of 95% of the company's fuel and purchase power expenses (after netting for off system sales revenue). Although we recognize that the past winter's ice storms and the ongoing recession will continue to have an impact on the company's load growth and cash flow measures, nevertheless, we view the overall regulatory environment in Missouri as a credit enhancing situation compared to several years ago.

The consolidated satisfactory business profile reflects Ameren's non-regulated businesses, partially offset by the improvements to both the Illinois and Missouri regulatory environments.

The improved Illinois regulatory environment reflects the Illinois Commerce Commission's decision to authorize moderate rate increases for various utilities in 2008 and 2009 without being subjected to overt political influence. Although both Illinois and Missouri continue to have a regulatory lag, we nevertheless view these regulatory environments as credit enhancing compared to several years ago. We also expect that due to the regulatory lag, the company will file more frequent rate cases in both jurisdictions. However, we also recognize that the political will for rate increases could be limited due to the existing deep economic recession.

In June 2009, the company filed for electric and gas rate increases of $219 million in Illinois and in July 2009, the company filed for about $402 million rate increase in Missouri. The commissions' orders are not expected until the second quarter of 2010.

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Continuing to meaningfully weigh on the business profile of the consolidated entity is Ameren's unregulated generation. Although power prices for the unregulated business are hedged for 2009, they have considerable open positions for 2010 (70% hedged), 2011 (40% hedged), and beyond. Energy prices have significantly decreased, and should these lower prices be sustained for the long-term, the non-regulated margins and profitability could be materially affected. Of particular concern is the large capital expenditures required at the unregulated companies needed to meet environmental compliance standards, while relying on falling market prices, due to the economic recession, for recovery. Marginally offsetting these concerns is the company's ongoing effort to reduce its O&M and capital expenditures.

The financial profile of the consolidated entity is maintained as 'significant', enhanced by the company's decision to reduce its dividend by $1 per share, which we view as credit supportive. However, the financial measures for Ameren have remained weak for the current rating, putting pressure on the credit quality of the consolidated entity.

For the 12 months ended June 30, 2009, adjusted funds from operations (FFO) to total debt remained the same as the end of 2008 at 19.3%. Adjusted FFO interest coverage was maintained at 4.9x. Adjusted debt to total capital slid to 57.1% from 57.2% at year-end 2008. Free and discretionary cash flows have continued to remain negative. Given the company's satisfactory business risk profile and present credit rating we expect adjusted FFO to debt to exceed 21%; adjusted FFO interest coverage of 4.0x and adjusted debt to total capital to approximate 55%.

The recession has hurt all of Ameren's businesses. The unemployment rate in Illinois remains higher than the national average and Missouri's is about the same as the national average. All of the company's service territories have seen various degrees of load deterioration due to the recession. As the recession eases we would expect to see some financial improvement to all of Ameren's businesses.

**Liquidity**

The short-term rating on both Ameren and UE is 'A-3', demonstrating adequate liquidity. As of June 30, 2009, Ameren had cash and cash equivalents of about $251 million and about $1.1 billion available on its $2.1 billion revolving credit facilities after reducing outstanding borrowings and letters of credit.

In June 2009, Ameren and its subsidiaries entered into multiyear credit facilities, which cumulatively provide $2.1 billion of credit capacity through 2010 and $1.08 billion through July 2011. The credit facilities require Ameren and its subsidiaries to maintain a maximum debt-to-capital ratio of 65%, with which they comfortably comply. Additionally, the Illinois credit agreement contains a rating condition that requires an investment-grade rating and requires an interest coverage ratio of at least 2.0x, which Ameren considerably exceeded. Long-term maturities are forecasted as manageable for 2009-2011 with approximately $124 million due in 2009, $220 million due in 2010, and $150 million due in 2011.

## Outlook

The outlook for Ameren and its subsidiaries is stable and reflects our expectation that the company has and will continue to effectively manage its regulatory risk during this deep economic recession. A ratings downgrade could result if the consolidated cash flow measures continue to remain weak on a consistent basis, actual capital expenditures rise significantly higher than current estimates resulting in a regulatory disallowance, or a material incident at the regulated nuclear generating facility. A ratings upgrade would be predicated on reducing its market exposure at its unregulated businesses and significant improvement to the company's financial measures.

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