

FORTNIGHTLY

THE

40

*BEST ENERGY
COMPANIES*

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High performance. Delivered.

Superior asset management, exceptional cost discipline, and magnificent growth opportunities define the winners of our second annual financial ranking.

BY RICHARD STAVROS

In 2005, the inaugural year of the *Fortnightly 40 (F40)* financial rankings of electric and gas utilities, pipelines, and distribution companies, the industry wanted to know who the best energy companies were, and we told them. Given the increasing diversification of electric utilities into exploration and production (E&P), and E&P companies into local gas distribution and pipelines, operational benchmarking analysis (and other measures) no longer offer meaningful answers to the questions senior executives have about how best to measure their companies.

In fact, the industry and our readers demand a type of analysis that more truly communicates value to future investors, future owners, energy asset operators, regulators, and consumers (*see sidebar; "The Performance Standard," p. 45*).

The *F40* was unveiled in 2005 to critical acclaim. Several top energy companies like MDU Resources and UGI reported their standing in the *F40* in their quarterly earnings, in annual reports, and at shareholder meetings. Furthermore, according to anonymous sources, Kinder Morgan—which topped the list last year as well as this year—presented its *F40* standing as a means to communicate its management value to Canadian regulators as part of the company's high-profile, \$5.6 billion acquisition of Terasen in 2005.

In addition, the *F40* is bolstered further this year by the realization that two of the top companies, Kinder Morgan and Duquesne, are entertaining offers by management and private-equity firm consortiums to take their companies private. Kinder Morgan's \$13.5 billion deal would be the largest management-led buyout in history and one of the largest leveraged buyouts ever.

"At Kinder Morgan Energy Partners, we believe that that offer is a tremendous vote of confidence in the growth opportunities for [us]" says C. Park Shaper, president of Kinder Morgan Inc. (KMI), and Kinder Morgan Energy Partners LP (KMP). "Management and the other sponsors would not be willing to make that offer, to offer the KMI shareholders an 18.5 percent premium, unless they believed that KMP would continue to have great growth opportunities going forward," he says.

And in respect to this year's number 1 ranking, Shaper graciously accepts it: "We are honored that Kinder Morgan Energy Partners would earn that spot."

Even as we have begun to identify the best energy companies via the *F40*, discussions about the ranking are developing into a long-term intellectual debate in financial circles. What is management doing to achieve the *F40* level of performance? What is it about the management of Edison International that returns the company to the list for a second year in row? What is the secret of TXU's success, as it rockets to the middle of the list? And how do LDCs like WGL Holdings (parent of Washington Gas) manage to hold their own with super-growth companies like Energen, an E&P company and LDC? (*Cont. on p. 44*)



**BEST ENERGY
COMPANIES**

Company	Public Utilities Fortnightly Absolute Ranking	3-Year Average Profit 2003-2005	3-Year Average Profit Rank 2003-2005	3-Year Average Dividend Yield 2003-2005	3-Year Average Dividend Yield Rank 2003-2005	3-Year Average Free Cash Flow 2003-2005
Kinder Morgan Energy Partners	1	9.77%	13	6.09%	4	4.13%
DQE Inc.	2	13.85%	7	5.63%	7	2.71%
DPL Inc.	3	14.72%	5	3.99%	44	11.14%
Allete	4	17.18%	4	7.21%	3	14.00%
PPL Corp.	5	12.03%	9	3.29%	55	10.99%
Energen	6	14.02%	6	1.44%	79	7.98%
PG&E	7	17.50%	3	1.10%	81	5.94%
Kinder Morgan Inc.	8	38.19%	1	2.70%	68	36.13%
National Fuel Gas Co.	9	9.30%	17	3.87%	47	9.33%
Southern Co.	10	12.73%	8	4.36%	33	5.66%
Great Plains Energy	11	6.77%	35	5.55%	8	7.06%
EnergySouth	12	11.04%	11	3.01%	63	9.55%
Questar	13	11.96%	10	1.69%	78	5.13%
Equitable Resources Inc.	14	22.30%	2	2.29%	73	-19.85%
TXU	15	6.29%	39	2.02%	76	15.16%
MDU Resources	16	7.66%	28	2.55%	69	2.40%
Ameren Corp.	17	10.24%	12	5.18%	11	5.68%
Edison International	18	8.74%	19	1.98%	77	5.23%
CLECO	19	7.95%	26	4.59%	22	12.31%
Entergy Corp.	20	9.51%	14	2.91%	65	6.87%
WGL Holdings	21	4.92%	59	4.32%	35	4.32%
Exelon	22	8.39%	23	2.93%	64	8.95%
Public Service Enterprise Group Inc.	23	7.53%	29	4.21%	39	1.18%
Sempra Energy	24	8.52%	22	2.89%	67	-2.22%
UGI	25	3.35%	75	3.05%	60	4.74%
Florida Public Utilities	26	6.18%	41	3.28%	56	-2.07%
Otter Tail Corp.	27	5.56%	51	4.12%	41	2.84%
Westar	28	8.84%	18	3.84%	48	6.01%
OGE Energy Corp.	29	3.38%	74	5.16%	13	1.72%
Unisource Energy	30	6.42%	38	2.51%	71	10.29%
Cinergy (Acquired by Duke Energy)*	31	9.49%	15	4.59%	21	0.33%
Progress Energy	32	8.61%	20	5.18%	12	2.89%
Chesapeake Utilities	33	5.18%	54	4.03%	42	0.47%
AGL Resources Inc.	34	9.48%	16	3.68%	51	-3.13%
SCANA Corp.	35	7.19%	33	4.00%	43	-0.08%
Northern Border Partners (Acquired by Oneok Partners)*	36	8.53%	21	7.47%	2	33.31%
Oneok Inc.	37	3.86%	67	3.44%	53	-3.94%
New Jersey Resources	38	2.61%	81	3.11%	59	0.79%
FPL Group Inc.	39	8.38%	24	3.52%	52	-2.06%
KeySpan	40	5.93%	45	4.85%	15	0.50%

*Ranking includes performance of pre-merger companies from prior years.

3-Year Average Free Cash Flow Rank 2003-2005	3-Year Average ROE 2003-2005	3-Year Average ROE Rank 2003-2005	3-Year Average ROA 2003-2005	3-Year Average ROA Rank 2003-2005	3-Year Average Sustainable Growth 2003-2005	3-Year Average Sustainable Growth Rank 2003-2005	Averaged Category Ranks
30	21.23%	4	7.44%	1	7.38%	20	12.0
43	20.74%	5	4.76%	10	10.02%	12	14.0
6	18.02%	7	4.39%	11	6.52%	22	15.8
4	11.65%	34	5.29%	7	3.28%	48	16.7
7	18.11%	6	4.00%	17	10.22%	11	17.5
14	17.02%	9	6.22%	4	14.65%	4	19.3
21	24.95%	3	5.71%	5	23.40%	3	19.3
1	15.56%	16	4.05%	16	7.61%	17	19.8
10	14.81%	19	4.79%	9	7.41%	19	20.2
23	15.02%	17	4.11%	15	4.74%	34	21.7
16	14.76%	20	4.32%	12	3.75%	42	22.2
9	13.35%	23	5.20%	8	6.90%	21	22.5
26	16.90%	10	6.34%	3	11.92%	9	22.7
87	40.99%	2	7.43%	2	26.12%	2	28.0
3	86.21%	1	2.29%	62	32.34%	1	30.3
44	13.03%	25	5.64%	6	9.87%	13	30.8
22	10.23%	49	3.35%	27	1.66%	67	31.3
24	15.86%	14	2.79%	49	12.78%	5	31.3
5	9.88%	53	3.43%	25	2.16%	61	32.0
18	11.07%	41	3.12%	34	6.01%	25	32.8
29	12.21%	30	4.15%	14	4.85%	33	33.3
11	13.51%	22	2.90%	43	4.23%	39	33.7
52	14.87%	18	2.95%	42	5.87%	27	34.5
74	16.67%	11	3.29%	29	12.11%	8	35.2
27	16.51%	12	3.43%	23	9.22%	14	35.2
73	15.80%	15	4.00%	18	10.34%	10	35.5
40	11.54%	37	4.28%	13	3.98%	41	37.2
20	10.13%	51	2.53%	57	5.18%	30	37.3
50	12.69%	26	3.43%	24	4.08%	40	37.8
8	12.09%	31	2.19%	66	8.16%	15	38.2
58	11.04%	42	2.95%	40	2.64%	54	38.3
39	9.71%	54	2.82%	47	2.43%	58	38.3
56	12.39%	29	3.88%	20	4.93%	31	38.7
79	12.48%	27	3.01%	38	5.99%	26	39.5
61	11.56%	36	3.19%	32	4.93%	32	39.5
2	7.65%	69	2.35%	61	-17.03%	87	40.3
81	17.55%	8	3.41%	26	12.24%	7	40.3
54	16.11%	13	3.83%	21	8.13%	16	40.7
72	11.65%	33	3.04%	36	5.42%	29	41.0
55	10.28%	47	2.95%	41	2.99%	50	42.2

Standing in the Pantheon

What does it mean to be on the *F40* in 2006? Jim Hendrickson, lead partner for the North American Utilities Strategy practice at Accenture, says that placement in the *F40* indicates a well-run, solid, asset-intensive business. "If you have year-over-year good predictable operating earnings, you will show up on the *F40*," he says.

Of course, consistent performance over time is the Holy Grail of corporate management, and a focus of many of the executives that made the list. Hendrickson notes that his research and considerable business literature on the subject shows that very few companies achieve sustainable performance over a 10-year period. For utilities, in particular, earnings volatility earns a market discount.

But clearly, being on the *F40* means a company has been consistent on many different measures over a three-year period, says Jean Reaves Rollins, managing partner at the C Three Group LLC.

The *F40* is not forgiving if you fail to maintain sustainable performance.

"If you have one bad year, it's going to take you down in any measure of the key measures that the DuPont Hybrid looks at," Rollins says. (*Rollins, on p. 47, analyzes the F40 model [the Dupont Hybrid] and its predictability of shareholder value.*)

For example, she explains, Duquesne earns high honors this year because in the previous years management sold off many of the disparate businesses. "What the current management did wasn't sexy. They got in there and cleaned the balance sheet up and got it down to a basic business that could be evaluated pretty easily," she says.

Hendrickson and Rollins found mixed results when trying to correlate total return to shareholders (TRS) (a popular performance method) with the *F40* (DuPont Hybrid), but they agree that using the *F40* and TRS models is an effective way to identify corporate performance.

Meanwhile, WGL Holdings Chairman and CEO James H. DeGraffenreid Jr. found this year's *F40* results were consistent with some of the long-term internal benchmarks that his company has used to chart its performance.

"We also put out five years of financial objectives three years ago, where we said we were going to generate free cash flows. ... We said we were going to grow earnings on average 5 percent per year over that five-year period. We said we were going to maintain a strong credit rating, and we are one of the strongest credits in our sector. ... And [we will] maintain our ability to maintain the dividend.



"We really embarked on being a top-tier industrial company operating generation assets as opposed to a utility operating generation assets."

— Mike Childers, TXU

"So, you are seeing the culmination of all of that in the 2003 through 2005 three-year increment that the *F40* measures," DeGraffenreid Jr., says.

John E. Bryson, chairman, president, and CEO of Edison International, also shows exceptional consistency in the management of his company. He says all the *F40* measures became negative during the California crises, which began in the 2000-2001 timeframe. Bryson, in less than five years, not only was able to save his company from the brink of bankruptcy, but exceed the company's performance measures that existed before the crisis. It also didn't hurt that Edison International, which has a large, low-cost coal fleet, is in one of the country's highest-growing service territories: Southern California.

"I think looking at a three-year time horizon is a good way to think about performance," he says of the *F40*'s time frame. "We tend to look at three-, five- and 10-year periods. Ours is a capital-intensive business where there will be times when commodity values are up and commodity values are down. Since we have to operate a company and we have to make long-term capital investments and with long-term returns, we like those kind of time horizons."

Taking a long-term view hasn't hurt Edison International's shareholders. "Edison International returned to shareholders over 300 percent over the three years covered by the *F40*," he explains. In the aggregate over five years through the power crises, Edison International returned 200 percent.

Finally, Mike Childers, CEO of generation development, TXU, tells how the management of his company's generation fleet has changed over the last three years and contributed to the company success and placement on the *F40*.

"We really embarked on being a top-tier industrial company operating generation assets as opposed to a utility operating generation assets. I draw the differentiation there in that, historically, our coal-fired assets operated in the low 80 percent availability capacity factor range. Today, they are operating at 92, 93, and 95 [percent]. Our nuclear plant operated down at the same range; year-to-date in 2006, it is operating at 99 percent. We have done that through a couple of opera-

THE PERFORMANCE STANDARD

The story of the *Fortnightly 40's* development.

By Richard Stavros

Various equity research analysts and Wall Street bankers often have pointed out that more than three quarters of a typical utility's valuation can be attributed to interest rates, dividend policy, and the company's regulatory environment. Furthermore, Mother Nature has on occasion been known to have an even greater influence on quarterly or even annual corporate results. That is why an effective industry benchmark must filter out what is beyond management's control. That is why many energy executives believe there long has been a need for a performance standard that filters out the short-term volatility of the market and other factors, and takes into account more precisely management's contribution to the business over time. This is why the *Fortnightly 40* chose to rank companies on performance over a three-year period. That way short-term price fluctuations in stocks, commodities, weather, and even impacts of regulatory decisions can to a great degree be factored out.

At Heart: A DuPont Hybrid Model

The core of the benchmark used to develop the *Fortnightly 40* is called a hybrid DuPont Model or DuPont Hybrid. It is based on the 80-year old DuPont model that has been growing in favor with the energy finance set, as it can include a series of growth measures that they say makes the model more effective in the 21st century. Developed originally in 1919 by a finance executive at E.I. du Pont de Nemours and Co., of Wilmington, Del., the DuPont system of financial analysis is used by many asset-intensive industries

to evaluate and visualize the critical building that contributes to return on equity and hence shareholder value. The DuPont model uses certain inputs such as sales, cost of sales, fixed assets, and current assets. At successive stages they are added, subtracted, divided, or multiplied until return on equity is reached. The model forms an easy to use and understandable framework with which to investigate the root cause of increasing or declining value. Furthermore, the model can be instructive on ways to increase return on investment: increase sales—either by increasing the price or by selling more units—or decrease cost of sales, fixed assets, and current assets. That is why, within asset-intensive businesses, such as utilities, the model has particular significance.

But after decades of use, many in the finance industry gravitated to more complex modeling techniques with growth measures. For example, the most well known of these is the famed Stern Stewart & Co. economic value added (EVA) framework. EVA won popularity in corporate circles by correlating favorable results with decisions that produce returns that exceed the cost of capital—a formula for creating shareholder value. Furthermore, proponents of EVA say the DuPont model is flawed in that there is inherent guesswork in generally accepted accounting principles that creates room for shortsighted decisions. But many academics say they disagree that the DuPont model significantly is more vulnerable to manipulation than newer methods. They add that valuations by rival methodologies

based on EVA also can involve subjective guessing because cash flows must be estimated in the future. Furthermore, many of the other bells-and-whistles methods involve a significant number of calculations and create opportunities for manipulation, say proponents of DuPont modeling. On the other hand, critics of the old DuPont model also say the model fails to predict future earnings or track costs.

This explains why the reemergence of the DuPont model comes from financial executives who have found new value in adding growth measures to return on investment calculations. Of course, there never will be a performance benchmark that pleases everyone all the time. And many finance executives say that the decision to use the DuPont method or a version of EVA mostly can be attributed to personal preference or corporate culture. Furthermore, many energy finance executives say they use such models in tandem to achieve the most comprehensive results. (*On p. 52 of this issue, Accenture performs its own shareholder value analysis [SVA] of the energy industry.*) We believe that both results, while different, offer valuable insights in to the corporate management of the utility industry.

Sustainable Growth Predictions: More Art Than Science?

The DuPont sustainable growth rate used in our calculations has its critics. *Fortnightly* acknowledges there can be limitations to the ROE analysis, such that it is susceptible to variability in dividend payout, interest expense, and business cycles. Also sustainable growth measures can be affected by consolidated versus segment reporting, accounting issues, interest expense, structural change and the impacts of industry competitiveness. But other growth models (*Cont. on p. 46*)

tional changes in a new system that we dubbed the TXU operating system,” he says.

Childers attributes the improvement in the company's assets management to a series of lean manufacturing approaches that TXU learned from other industries and imported. “We spent a lot of time with Toyota, with Georgia

Pacific, with Boeing, with a lot of major manufacturers who work in commodity-type businesses. We learned and studied from them the lean operating practices of best-of-class and world-class manufacturing capability, and we brought that to our operating system. And our operating statistics have moved from middle of the pack to top tier.”

have been found to lack consensus among those in the industry, and have their own sets of problems in application. Moreover, many of our finance experts find some of the issues with the DuPont sustainable growth rate are rendered moot in combination with the larger model characteristics of the *Fortnightly 40*.

C. Park Shaper, president of two-time winner Kinder Morgan Inc., offers his opinion on the sustainable growth quotient in the *Fortnightly 40* model.

"The truth is, as long as you do everybody the same on those metrics, I don't think it matters. I think the way that you've selected it is the easiest way to do it—the same for everybody. On your growth measure, I think it would be interesting. Sustainable growth implies what is going to happen in the future. This gets a little bit more subjective. [But] there's not really

an objective way to estimate that," he says.

Shaper notes that the DuPont sustainable growth-rate calculation assumes a company must reinvest in order to grow. "I think that's true for a lot of entities."

Naturally, he says, it always is going to be awkward to put all companies in the same position. "You have to make some assumptions and simplify some things. I think what you have started off with is great, and I'm sure you'll continue to make it better. My guess is you'll find some things that you say, hey, this is imprecise in our model but there is just nothing that you can do about it," he explains.

The *Fortnightly* editors welcome further discussion and insight that put the *F40*'s methodology in an even more proper context. We invite industry-wide feedback on how to improve the model

further. ■

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Credits

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Debating the Dividend

There is one measure on the *F40* that energy industry executives still agree to disagree on: payment of the dividend. Many executives believe that payment of dividends reflects a strong balance sheet and optimism about a company's financial performance and its future growth prospects. For some regulated and diversified utilities, it is a source of pride to pay a dividend. But as some companies increasingly earn higher and higher unregulated earnings through high-growth investments, they want to reinvest those earnings to further grow the business.

The contrast between these two views on dividend can be illustrated through the divergent comments of the CEOs from Energen and WGL Holdings. Take the view of WGL's DeGraffenreid Jr. on the dividend.

"We have paid the dividend for 155 consecutive years, and we have raised the dividend for 30 years in a row. I like to point

out that we have paid dividends through the Civil War, the Depression, World Wars I and II, all through the Vietnam conflict, all through the hyper inflation of the 1970s. That is our commitment to financial strength," he says.

But, as stated earlier, not everyone is enamored with paying the dividend. William Michael Warren Jr., chairman of the board and CEO at Energen, has a much different view. He likes everything about the *F40* except the dividend metric.

"Of the list of six that you've given, profitability is a focal point for us. Of your six metrics, five of those six I really pay attention to," he says.

However, "the dividend yield is totally meaningless to me, and ... near meaningless to an MDU Resources or Questar. It should be to any of the companies that have significant non-regulated assets," he says.

Some analysts believe the dividend is the great equalizer between super growth E&P companies on the *F40* and regulated and diversified utilities with lower growth levels. Other analysts believe Energen's view of the dividend may prevail in the end, as more and more utilities earn more from their unregulated operations.

In fact, Energen started as a sleepy Alabama LDC and turned itself in to an E&P powerhouse.

"Ten years ago, 80 percent of our



"Ten years ago, 80 percent of our earnings came from the utility, 20 percent from our E&P business. Today, it is the exact opposite of that."

— Mike Warren, Energen

company earnings came from Alabama gas, the utility. Twenty percent came from our diversified—primarily oil and gas—exploration and production business. Today, it is the exact opposite of that,” Warren says.

Warren notes the transformation began to occur eight to 10 years ago, when several utilities became somewhat discouraged with the slow pace of utility growth and began exploring ways to diversify away from the regulated utility into related

energy businesses to which they could transfer corporate skills. Many of this year’s *F40* companies diversified and found new opportunities in unregulated businesses.

But even as many of these chiefs of diversified companies are happy managing unregulated energy businesses, they have no intentions of leaving their regulated utility roots.

“For us, the utility is a foundational business,” Warren says. “Overall, one of the things the utility has (*Cont. on p. 49*)

LIES, DAMN LIES, AND STATISTICS

By JEAN REAVES ROLLINS

The DuPont Model, like many financial analysis techniques, goes in and out of style. However, many analysts keep it in their bag of tools for evaluating the fundamentals of asset-heavy companies. It has a proven track record, is relatively simple, and provides intra-industry apples-to-apples comparative results. It often is used in conjunction with total shareholder return and other analyses to triangulate corporate values or performance.

During our analysis of the *Fortnightly 40*, the correlation between the results of the DuPont Model and stock-market results for the same group of 102 companies was questioned. This called for a closer examination.

Using the base group of investor-owned electric, gas, and

pipeline utilities, we projected a value of \$100 invested in each as of Jan. 1, 2003, and what the value of that investment would be on Dec. 31, 2005 (adjusted for splits and dividends)—the

same time frame as this year’s *Fortnightly 40* analysis.

Table 1 presents the top 10 in stock-price appreciation.

Using a simple regression analysis, we correlated the ranking results for all 102 companies of the equity analysis against the results of the modified DuPont Model. We found essentially no correlation—or 0.028, to be exact.

However, nasty outliers must be dealt with. We looked at the top 10 again, and decided that the top three performers were seriously struggling with the post-Enron market freefall. All three were trading at or near their historic lows. So we tossed them out of the analysis. When we did this, suddenly, DuPont and stock performance became more highly correlated, at 0.302.

For balance, we then tossed out the bottom three performers (those companies with negative shareholder value, or those that were in bankruptcy during any of the three fiscal years under analysis, had been eliminated from the beginning). Eliminating the bottom three had minimal impact on the correlation, going from 0.302 to 0.29.

So what does this mean? Working with a “clean” data set of companies shows that their DuPont scores relate to the stock values of these companies, and that the higher the Dupont score, the larger the increase in equity values during the same period.

However, how did we choose the outliers to come up with a clean data set? Fig. 1 shows a composite index of the original 102 companies in our sample. It clearly shows that few companies had escaped the decline in the overall market and in the U.S. energy utility market, in particular, during the 2002-2003 timeframe.

Removing all of the companies that had taken significant equity price hits during this period would have left a sample too small for analysis. We removed the top three, believing that their equity price gains were so above average it was likely to skew the results of the analysis. Generally, we would suggest a much more analytic approach to determining what are truly outliers.

We also looked at a number of other potential correlation sets. Table 2 presents the results of this analysis for: a) the complete set of companies; b) the set with the companies with the top three equity increases removed; and c) the set with the top three and the bottom three equity price increases removed.

TABLE 1 TOP 10: STOCK PRICE APPRECIATION

Company	Dec. 31, 2005 Value of \$100 Invested on Jan. 1, 2003	Rank
Williams Cos.	\$730.91	1
TXU	\$575.57	2
AES Corp.	\$456.20	3
Edison International	\$373.37	4
Questar	\$291.49	5
Sierra Pacific	\$281.03	6
PG&E	\$273.54	7
Allete	\$271.37	8
Energen	\$250.83	9
Exelon	\$229.35	10

FIG. 1 THE C THREE GROUP COMPOSITE INDEX

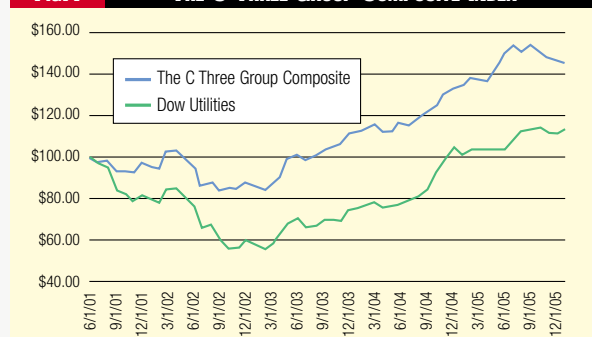


TABLE 2

RESULTS OF SIMPLE REGRESSION CORRELATION ANALYSIS

Source: C Three

Variable	DuPont Model Rank	Stock Price Increase Rank	Possible Interpretations
Stock Price Increase Rank	a. .0289 b. .303 c. .29		1. DuPont and stock price Increases are not related. 2. DuPont and stock price increases are related.
Return on Revenue	a. .665 b. .66 c. .66	a. .015 b. .32 c. .32	1. DuPont highly values net income. 2. The stock market depending on the data set, values net income.
Operating Cash Flow	a. .09 b. .09 c. .078	a. .256 b. .256 c. .253	1. DuPont is consistent in a very slight correlations with operating cash flow. 2. The stock market appears to consistently relate to operating cash flow.
Free Cash Flow	a. .27 b. .30 c. .29	a. .387 b. .23 c. .23	1. Free cash flow is related to both the DuPont and stock increases.
Earnings Per Share	a. .596 b. .569 c. .56	a. (.132) b. .18 c. .17	1. DuPont consistently and highly relates to earning per share. 2. The stock market does not care about earnings per share, or it values it slightly depending on the data set.
Dividends Per Share	a. .246 b. .20 c. .21	a. (.369) b. (.299) c. (.31)	1. DuPont slightly and consistently relates to dividends per share. 2. The stock market consistently relates negatively to dividends per share.
Dividend Pay-out Ratio	a. .33 b. .05 c. .04	a. (.22) b. (.25) c. (.23)	1. DuPont is consistently neutral to dividend pay-out ratio. 2. The stock market consistently relates negatively to dividends out ratio.
% of Non-Regulated Revenue	a. .102 b. .15 c. .13	a. .32 b. .069 c. .04	1. DuPont slightly and consistently relates to the % of non-regulated revenues. 2. Stock price increases are highly related or not related to the % of non-regulated revenues depending on the data set.
% of Non-Regulated Assets	a. .197 b. .27 c. .24	a. .41 b. .25 c. .21	1. DuPont slightly and consistently relates to the % of non-regulated assets. 2. Stock price increases are highly related or slightly related to the % of non-regulated assets depending on the data set.
Sample Sets: a. 102 U.S. IOU energy utilities, those with negative shareholder value or in bankruptcy during any fiscal year from 2003-2005 removed. b. Sample set a. with the top three companies with the greatest increase in equity prices from Jan. 1, 2003, to Dec. 31, 2005, removed. c. Sample set b. plus the bottom three companies with the smallest increase in equity prices removed.			


We learned several lessons through this process:

1. The DuPont Model is highly consistent in its results and the relationship with variables used in the formula itself or with totally independent variables. It also is highly consistent between sample sets. Manipulating the sample set did not have a major impact on results.

2. Equity price correlations are much less consistent, and the correlation results easily can be manipulated by the sample set chosen. Thus, it is much more difficult accurately to interpret true relationships between changes in stock prices and underlying corporate financial metrics.

3. The negative relationship between dividend policies and stock price increases was one area where manipulating the data set did not radically alter the results. However, the old adage,

“correlation does not imply causation,” should be remembered when interpreting these results.

4. “Bottom fishing” can be very rewarding financially. Virtually all of the top 10 companies in equity price appreciation were trading at or near their historic lows on Jan. 1, 2003, irrespective of what the company’s DuPont rank may have been. So while the DuPont model is an excellent tool for providing information on how well a company may be managed, at least from a historic perspective, it may not be the best predictor of how a sometimes irrational stock market may value a company or industry. 

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Fortnightly 40

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done is that it has kept us in touch with the fundamentals of the natural-gas market. On one side of your business you are interfacing with industrial, commercial, and residential customers. You know a lot about supply and demand from that side. And that knowledge is helpful as we think about the future on the oil and gas side as well.”

Edison International's Bryson likes the hybrid model, echoing Warren's view on the gas side. “We like that. We think it is a considerable strength that we encompass in the company—strong regulated and strong competitive business lines in electricity. That gives us an understanding of the total electricity business and the total electricity market that is deep and valuable.”

The King of Energy

Some may be surprised that one company has held the top spot on the *F40* for two years in a row. But a close look at Kinder Morgan shows a company aggressive (some say driven) in rooting out all forms of inefficient allocation of resources.

Kinder Morgan's Shaper, in explaining his company's ethos, makes it sound like a motto: “We are not interested in spending any money that does not further our effort to increase cash flows out of our assets.”

He and his company have been quite serious about extending this ethos to corporate management. “This has been discussed about us before. Rich Kinder earns \$1 per year. He takes no bonus, no options, no restricted stock, and no other form of compensation. Our management salaries have a cap of \$200,000 per year. We do not advertise. We don't name stadiums. We don't fly first class or own corporate air craft.” Furthermore, this tight discipline on expenses not only is observed in the C-suite, but even in the development of new projects.

Shaper says that the master limited partnership (MLP) structure imposes a stricter discipline on Kinder Morgan Energy Partners (KMP) than on other companies.

KMP is obligated to return its cash that it generates to its



“Edison International returned to shareholders over 300 percent over the three years covered by the F40.”

— John Bryson, Edison International

partners. Shaper says that this obligation puts management's focus on generating cash and earning a return on that cash for investors. But because the MLP distributes all of its available cash to investors, when KMP want to make an investment, the company must go back to those investors and make a convincing case.

“We have to go back to investors, and say essentially, ‘Hey, we want to make another investment. This is what the investment is. This is how much it will cost. This is the return that we expect it to generate. Won't you please give us the capital to do it?’” says Shaper. He believes this requires a much different discipline than management teams that retain cash for new investment.

“I think that that discipline, that requirement to go and raise capital for your investments leads to better investments, because you only do it when you are convinced that you are actually going to earn a reasonable return,” he says.

The company does have a few attractive projects in the pipeline that may keep it in the upper ranks of the *F40* for some years to come. Even if the management buyout of Kinder Morgan Inc. would occur, which had not been decided by the company's board of directors at press time, KMP still would remain a public company and be traded on the New York Stock Exchange.

“Looking forward, we are going to get some tremendous growth from some of these natural-gas pipeline expansions. Rockies Express being the largest, it's over \$4.4 billion dollars in total investment, and we will be owning about half of that. It is a fully subscribed project (1.8 bcf per day) running from

Colorado ultimately all the way to the Eastern edge of Ohio. That will drive tremendous growth,” he says.

Then there is the Louisiana pipeline, which will connect to some LNG facilities in Texas and Louisiana, and which the company believes will grow earnings significantly.



“We have paid the dividend for 155 consecutive years, and we have raised the dividend for 30 years in a row. That is our commitment to financial strength.”

— James DeGraffenreid Jr., WGL Holdings




“I think that discipline, that requirement to go and raise capital for your investments, leads to better investments. You only do it when you are actually going to earn a reasonable return.”

– C. Park Shaper, Kinder Morgan

But will the earnings be enough to retain the top spot in 2007? We won't bet against Kinder Morgan. But C Three's Rollins points out that many companies that endured heavy losses from the merchant meltdown will have worked off all of their losses by 2007.

Just look at TXU, Rollins says. It rocketed to the top tier of the list because it rolled off its last bad year in the three-year

guess. But they agree that possessing sufficient, flexible, and low-cost source supply will be a powerful predictor of leadership. Watch these pages to see who makes next year's *Fortnightly 40*. 

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time frame. Companies like AEP also may make strong showings in next year's *F40*, she says.

Who might be the winner next year? Accenture's Hendrickson and C Three's Rollins won't hazard a

THE FORTNIGHTLY 40 — MODEL CHARACTERISTICS

Time Frame: 3-year average.

Stock Price Analysis: 3-year average.

Universe: 100 largest investor-owned power and gas utilities and natural gas pipeline companies.

Components:

1. **Profitability** = Margin = Net Income/Total Revenues.
2. **Dividend Yield** = Annual Declared Dividends/Year-End Stock Price.
3. **Free Cash Flow** = (Operating Cash Flow – Capital Expenditures)/Total Revenues.
4. **DuPont ROE 5 Ratio Model:**
 - a. Earnings after taxes (EAT) = Net Income;
 - b. Earnings before taxes (EBT) = Net Income + Income Taxes;
 - c. Earning before interest and taxes = Net Income = Income Taxes + Interest;
 - d. Revenues = Total Revenues;
 - e. Assets = Total Assets; and

f. Equity = Total Common Shareholders Equity.

DuPont ROE = (EAT/EBT)*
(EBT/EBIT)*(EBIT/Revenues)*
(Revenues/Assets)*
(Assets/Equity).

5. **DuPont ROA** =
(EAT/Revenue)*(Revenue/Assets).

6. **Sustainable Growth** = DuPont ROE*(1-Dividend Payout Ratios).

7. Fortnightly Index

Each company was force-ranked on the above measures from 1 through 100, with 1 being the highest ranking. Each measure was weighted equally. The six measures then were averaged, with the highest average given a ranking of 1 and the lowest, 100.

8. Companies excluded:

- a. Companies that had a negative shareholder equity value during any of the three years in the analysis were excluded (mathematically, the DuPont model cannot contemplate a negative shareholder value).

These include Mirant and Northwestern.

b. Companies that reported net losses for at least two of the three years in the time frame of the analysis:

These include:

- Allegheny Energy
- Aquila
- CMS
- Dynegy
- Energy West
- El Paso
- Reliant Resources
- Semco Energy
- Teco Energy.

Editor's Note: *The financial model, underlying assumptions, and performance criteria of the Fortnightly 40 financial rankings are the sole intellectual property of Public Utilities Fortnightly and its holding company, Public Utilities Reports Inc. Any attempt to reproduce, copy, modify, alter, or use the Fortnightly 40 financial model without the express permission of the publisher will be prosecuted.*