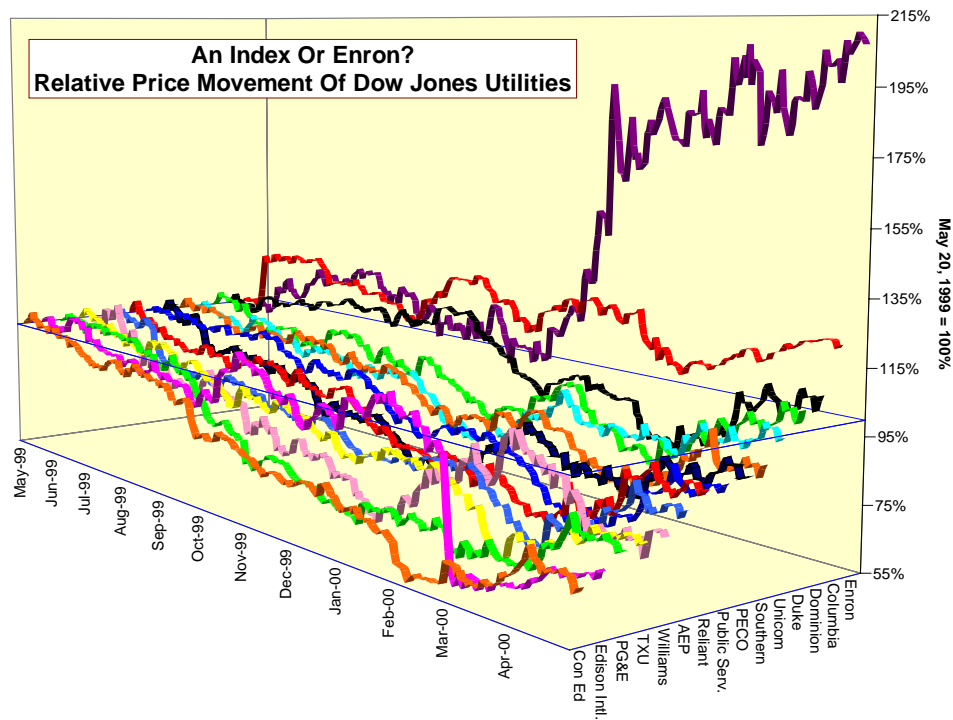


R-E-S-P-E-C-T, That's What These Stocks Get From Me

Utility infielder. Utility rate of return. A software utility. For a word venerated in behavioral economic theory, "utility" doesn't get the respect it deserves in the world at large. Utility stocks, most frequently represented by the Dow Jones Utility Index, long have been scorned as the stuff of widows, orphans, and the sort of chaps not likely to be seen on WWF Smackdown anytime soon. Take your hefty dividend, currently 3.86% on the index, Mr. Milquetoast, and get out of the way while us real men trade.

Excuse me: The DJUA has returned 5.23% since May 20, 1999, including those aforementioned dividends. Not heart-pounding stuff, but it certainly compares well to -0.72% for the Industrials and -23.18% for the Transports. The NASDAQ Composite, in case you are wondering, returned 33.67%, much of which financed the subsequent purchase of antacids and Valium.

The relative performance of DJUA's components over the past year has been anything but uniform, as depicted in the chart below. The companies that are energy producers and traders as well as energy buyers have done quite well. One stock, Enron, which is 12.485% of the index, accounts for just about all of the gain over this period. Columbia Gas, which is also involved in the production side of the business, also has acquitted itself well. On the other side of the ledger, more traditional utilities such as Consolidated Edison and Edison International have performed quite poorly.

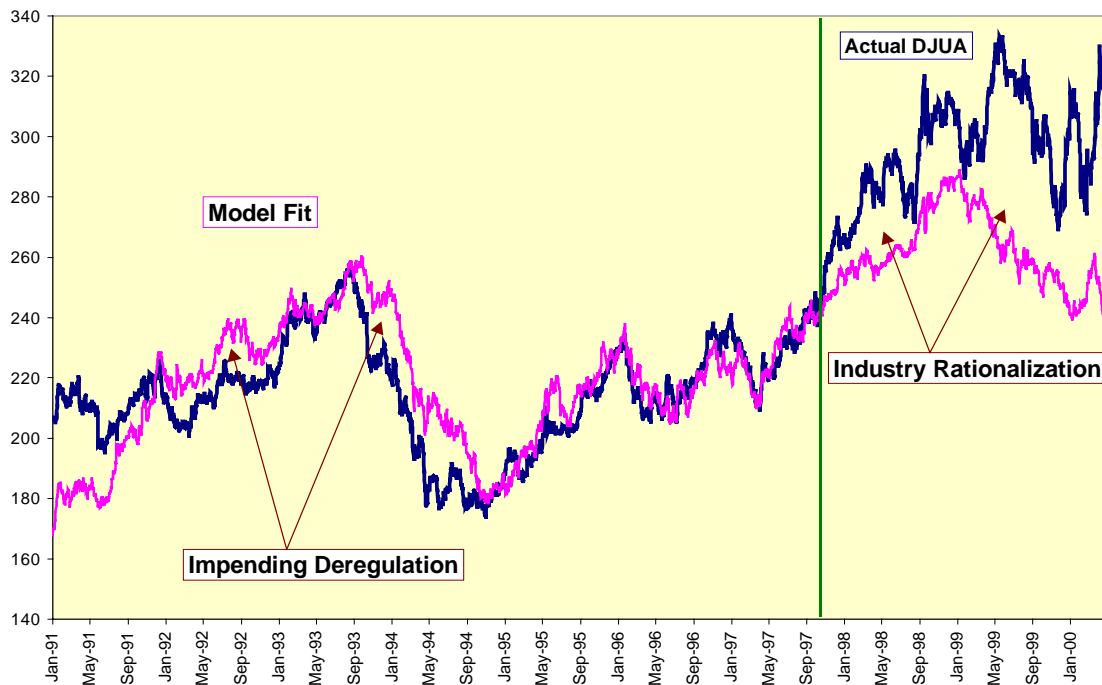


Deregulation And The Role Of Natural Gas

This is not your father's utility industry (see "Dow Averages' Guiding Power Fades Under Digital Sun," December 29, 1999). Traditionally, utilities were said to buy fuel and money. One of the interesting aspects of the DJUA's strong showing is how it has come in the face of rising interest rates and rising fuel prices. On the face of it, their margins should have been squeezed over the past year as operating costs rose. Moreover, in an increasingly competitive and deregulated energy market environment, utilities should find it difficult to pass these increased operating expenses along to customers.

We can construct a simple model using data from January 1991 through September 1997 to explain the DJUA in terms of 1) spot natural gas futures, 2) Ten-year note yields, and 3) the premium of the Ten-year note yield to the earnings/price ratio for the S&P 500. The last variable reflects the risk premium investors are willing to assign to equities (see "Derivatives May Give Clues To Net Stock Prices," January 5, 2000). If we project the model forward to May 2000, we find it expects a much lower value for the DJUA, 239 as compared to the 328 value on May 19, 2000. What accounts for this structural shift?

Utility Index: Actual And Model Data



First, we can observe a prolonged period of lagging DJUA values during the first half of the 1990s as investors worried how the heavily regulated and non-entrepreneurial industry would be able to handle the transition to a competitive market environment. Next, we can observe the extent to which the DJUA outperformed its previous relationship to the three factors in its model. This changed relationship is a function of how well the utility industry adapted to the new, deregulated environment in those markets where deregulation actually occurred.

Natural gas is the most volatile of the physical commodities; its options typically trade over 60% volatility as compared to 25% or so for the S&P 500. Natural gas is becoming increasingly important in the electricity business. The cheapest way for a utility to manage its large swings in peak load demand is to switch a gas-fired turbine -- quite literally a jet engine fueled by natural gas -- on and off. As a result, both natural gas demand and price are developing a secondary seasonality, a large surge in the winter and a secondary move higher in the air conditioning season. This recent development has disrupted the normal inventory cycle for natural gas, and as a result, prices are surging to winter-spike levels in the late spring.

As high as natural gas volatility is, electricity volatility is even higher. It is not unusual to see 200% volatilities for days on end during the summer; these are numbers visited only during events like the October 1987 crash. For a company to be successful in buying volatile fuel and selling more-volatile electricity, it has to be adept at risk management, and this is where Enron, and to a lesser extent Duke and Southern, have stood out from the pack. Firms saddled with regulatory burdens, such as Consolidated Edison, have little incentive to innovate as traders and risk managers, and thus are accorded P/E's of 10.2 while Enron enjoys a P/E of 61.3.

Risk management matters, and as we move from a long period of deflationary commodity prices to something else, we will find just how much Wall Street will pay for trading expertise. Natural gas is a particularly interesting case study as it is used as a feedstock in industries such as fertilizer and petrochemicals as well as a fuel. These industries will be examined next.