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PLEASE SEE ANALYST(S) CERTIFICATION AND IMPORTANT DISCLOSURES BEGINNING ON PAGE 24.
Discussion Topics

- The Emerging Capital Cycle
- Cost of Capital Implications
- The Environment – What’s Next
The capital cycle is ramping up. Growth in capex is driven by:
- Environmental requirements – NOx and SOx
- Transmission
- Generation
## Projected Rate Increases (1)

($ in millions)

<table>
<thead>
<tr>
<th>Year</th>
<th>Due to Fuel Costs</th>
<th>Due to Rate Base Investment</th>
<th>Total Rate Increases</th>
<th>Y/Y Increase</th>
<th>Cumulative vs. 2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>$6,929</td>
<td>$1,078</td>
<td>$8,007</td>
<td>6.0%</td>
<td>10.1%</td>
</tr>
<tr>
<td>2006</td>
<td>$11,227</td>
<td>$3,220</td>
<td>$14,447</td>
<td>10.1%</td>
<td>24.4%</td>
</tr>
<tr>
<td>2007</td>
<td>$9,254</td>
<td>$11,047</td>
<td>$20,301</td>
<td>12.9%</td>
<td>39.2%</td>
</tr>
<tr>
<td>2008</td>
<td>$8,238</td>
<td>$12,872</td>
<td>$21,110</td>
<td>11.9%</td>
<td>56.2%</td>
</tr>
<tr>
<td>2009</td>
<td>$4,056</td>
<td>$20,207</td>
<td>$24,263</td>
<td>12.2%</td>
<td>66.0%</td>
</tr>
<tr>
<td>2010</td>
<td>$2,467</td>
<td>$11,488</td>
<td>$13,955</td>
<td>6.3%</td>
<td></td>
</tr>
</tbody>
</table>

- **Y/Y Increase**: 6.0% 10.1% 12.9% 11.9% 12.2% 6.3%
- **Cumulative vs. 2005**: 10.1% 24.4% 39.2% 56.2% 66.0%

- **% Increase Related to Fuel**: 86.5% 77.7% 45.6% 39.0% 16.7% 17.7%
- **% Increase Related to Rate Base Investment**: 13.5% 22.3% 54.4% 61.0% 83.3% 82.3%

(1) Lehman Brothers' regulated coverage universe.

*Source: Lehman Brothers Survey, FactSet.*
Customers Will Be Likely Shocked

% of Consumer Wallet Spent on Electricity

Sources: BEA, EIA, Lehman Projections
Rate Cases On the Rise

Source: Lehman Brothers, Regulatory Research Associates, and Bloomberg.
Regulatory Risk Returns: Historical Allowed Returns Declining

Source: Regulatory Research Associates, FactSet, Lehman Brothers

Average spread since 1980 is 489 bp +/- 107 bp.

Indicated ROE
Y = 0.515x + 0.086
R2=81%

Actual Allowed ROEs
Regulatory Risk Returns: Regulatory Lag Expected

Free Cash versus Return Spreads

Source: FactSet, Lehman Brothers Estimates
Financing Risk Returns: Capital Requirement Increasing

Capital Projections
All Shareholder Owned Utilities

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt</td>
<td>$310,871</td>
<td>$303,508</td>
<td>$323,763</td>
<td>$345,684</td>
<td>$365,660</td>
<td>$386,123</td>
<td>$410,444</td>
</tr>
<tr>
<td>Equity</td>
<td>$219,628</td>
<td>$229,941</td>
<td>$242,626</td>
<td>$258,737</td>
<td>$274,563</td>
<td>$290,715</td>
<td>$308,040</td>
</tr>
<tr>
<td>Total Capital</td>
<td>$530,499</td>
<td>$533,449</td>
<td>$566,388</td>
<td>$604,422</td>
<td>$640,222</td>
<td>$676,838</td>
<td>$718,484</td>
</tr>
<tr>
<td>Equity %</td>
<td>41%</td>
<td>43%</td>
<td>43%</td>
<td>43%</td>
<td>43%</td>
<td>43%</td>
<td>43%</td>
</tr>
<tr>
<td>Retained Earnings less Dividends</td>
<td>$10,241</td>
<td>$10,434</td>
<td>$10,631</td>
<td>$10,832</td>
<td>$11,036</td>
<td>$11,244</td>
<td></td>
</tr>
<tr>
<td>Debt Issued (Retired)</td>
<td>($7,363)</td>
<td>$20,255</td>
<td>$21,922</td>
<td>$19,975</td>
<td>$20,463</td>
<td>$24,321</td>
<td></td>
</tr>
<tr>
<td>Equity Issued (Retired)</td>
<td>($7,291)</td>
<td>$2,251</td>
<td>$5,480</td>
<td>$4,994</td>
<td>$5,116</td>
<td>$6,080</td>
<td></td>
</tr>
</tbody>
</table>

Growth %

<table>
<thead>
<tr>
<th></th>
<th>Retained Earnings</th>
<th>Cash from Operations</th>
<th>CapEx</th>
<th>Dividends</th>
<th>Cash from Operations</th>
<th>CapEx</th>
<th>Dividends</th>
<th>Free Cash, Post Div.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2%</td>
<td>2%</td>
<td>2%</td>
<td>2%</td>
<td>2%</td>
<td>2%</td>
<td>2%</td>
<td>$3,400</td>
</tr>
<tr>
<td></td>
<td>2%</td>
<td>2%</td>
<td>-3%</td>
<td>2%</td>
<td>4-Year CAGR</td>
<td>2%</td>
<td>2%</td>
<td>($13,100)</td>
</tr>
<tr>
<td></td>
<td>25%</td>
<td>10%</td>
<td>2%</td>
<td>2%</td>
<td>LEH Estimates</td>
<td>2%</td>
<td>2%</td>
<td>($40,900)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>($11,600)</td>
</tr>
</tbody>
</table>

Proportion Returned to (Drawn from) Debt

<table>
<thead>
<tr>
<th></th>
<th>100%</th>
<th>90%</th>
<th>80%</th>
<th>80%</th>
<th>80%</th>
<th>80%</th>
</tr>
</thead>
</table>

Proportion Returned to (Drawn from) Equity

<table>
<thead>
<tr>
<th></th>
<th>0%</th>
<th>10%</th>
<th>20%</th>
<th>20%</th>
<th>20%</th>
<th>20%</th>
</tr>
</thead>
</table>

Source: EEI Financial Review.
Financing Risk Returns: Interest Rates are Rising

- Typically, a 10 basis point move in Treasury yields equates to a 1.4% change in value for the utility group

**Implied Forward Rates for 10-Year Treasuries**

(As of November 8)

Source: Lehman Brothers.
Financing Risk Returns: Tax Policy Uncertain

- Current tax policy outlook is stable

- Current dividend tax rate of 15% expires in 2010
  - Next presidential election cycle will likely determine its fate

- We estimate that 8-12% of the value of the group is dependent on maintenance of this policy
Execution Risk Returns:

- Total cost estimates being revised 10-20% or more
  - CCGT estimates up 42%
  - Scrubbers up 20%
  - Nuclear estimates up 100%

- In service dates slipping 6 to 12 months
  - Coal plants are being cancelled
Conclusion: We May Repeat the 70’s

Source: FactSet, Lehman Brothers Estimates
The Environmental Conundrum: The Elephant in the Corner
The Emerging Environmental Picture

More aggressive regulation began with the Clean Air Act of 1990, continued through Clean Air Interstate Rule and Clean Air Mercury Rule.

Emissions that have been regulated are down substantially.

- Likelihood that CO₂ rules have similar effect when implemented?

### Status of Emissions/Pollutant Regulation

<table>
<thead>
<tr>
<th>Pollutant / Emission</th>
<th>Also Known As</th>
<th>Currently Regulated?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nitrogen Oxides (NOx)</td>
<td>Smog</td>
<td>Yes</td>
</tr>
<tr>
<td>Sulfur Dioxides (SOx)</td>
<td>Acid Rain</td>
<td>Yes</td>
</tr>
<tr>
<td>Fine Particulates</td>
<td>Soot</td>
<td>Yes</td>
</tr>
<tr>
<td>Mercury (Hg)</td>
<td>Mercury</td>
<td>Yes</td>
</tr>
<tr>
<td>Carbon Dioxide (CO₂)</td>
<td>Greenhouse Gas / Global Warming</td>
<td>No</td>
</tr>
</tbody>
</table>

*Source: Lehman Brothers.*
The Environmental Angle

- Clean-air and greenhouse gas concerns are shaping the direction of future generation and capital spending decisions

- Carbon rules are arriving in Northeast, California
  - Impact on electricity prices
  - Impact on coal generators
  - Impact on new build for coal
  - Final shape of regional rules to be determined – much still to be decided
    - CO₂ credits granted versus bought?
    - Pricing for credits

- We believe Federal legislation is inevitable in 2009
Cost of SOx and NOx Emissions

- SOx credits ease as we move out the curve, reflecting the market’s understanding of the likelihood of a majority of coal plants having scrubbers installed by that point.

- The weakening in the emissions markets was broadly consistent with commodities pricing through the year.

Source: Bloomberg, Lehman Brothers.
The Cost of Compliance

Costs for 500 MW plant

- **NOx Control**
  - SNCR
  - SCR
  - Cost:
    - SNCR $19/kw
    - SCR $68/kw

- **OFA**

- **Low NOx Burners**
  - Cost: $37/kw

- **Coal Mill**

- **Air Heater**

- **Dust & Hg Control**
  - ESP
  - Cost: $41/kw

- **Baghouse (Activated Carbon Injection)**

- **SO2 & Hg (acid gases) Control**
  - Scrubber
  - Cost: $268/kw

- **Stack**

- **Gypsum**

- **Flyash**

*Source: Lehman Brothers, Southern Company*
With the increasing use of flue gas desulfurization (FGD) and selective catalytic reduction (SCR) devices to limit SOx and NOx emissions, respectively, the aggregate level of emissions since clean air legislation was enacted has dropped notably.

Source: Energy Information Administration.
The growth in CO₂ emissions – still unregulated in the U.S. – when juxtaposed against the successful efforts in curtailing other pollutants, provides a strong case for the coming regulatory schemes.

**CO₂ Emissions 1993-2004**

- Carbon Dioxide Emissions, 1993-2004 (thousands of tons)

Source: Energy Information Administration.
What Will Carbon Taxes Mean?

Impact of CO₂ Emissions on Electricity Supply & Demand

Electricity is an inelastic good, with relatively large price movements yielding much smaller demand changes.

Source: SNL Energy, Lehman Brothers.
A Wide Range of Cost Outcomes

Estimated Cost per Ton of CO2

- RGGI: $1.50
- Lehman: $12.50
- Europe (EU-ETS): $20.00
- Sequestration: $35.00
- Llewellyn Maximum: $80.00

Sources: RGGI documents, Lehman Brothers estimates, Bloomberg, U.S. DOE, EPRI, Powerspan
Analyst Certification:

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3-Underweight - The stock is expected to underperform the unweighted expected total return of the sector coverage universe over a 12-month investment horizon.

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