Game Changer for Energy Dividend Taxation
Jobs and Growth Tax Relief Reconciliation Act of 2003

Summary and Recommendation

We are strongly enthusiastic about the lower dividend tax rate soon to become the law of the land when the President signs in a few days the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA03). First, the tax rate reduction to 15% makes the high dividend income from recommended **Marathon Oil (MRO)**, **PetroChina (PTR)**, **ChevronTexaco (CVX)** and **Royal Dutch (RD)** worth a third more after tax than if the tax rate were 36%. Second, high cash generating energy stocks like recommended **Burlington Resources (BR)** and **Anadarko (APC)** or even ol' **ExxonMobil (XOM)**, the industry leader, could become more attractive with dramatic dividend increases now that the inhibiting double tax has been greatly diminished. Third, the game changer may have the desirable effect of pumping sorely needed equity capital into the energy utility industry whose stocks appear to be owned primarily by retirees whose total income is less than average. Fourth, because it is now more tax-effective for legitimate companies to pay more income to individual savers the pending new law may be a nail in the coffin of high greed partnerships that seem akin to Ponzi income schemes and Insull debt pyramids covered up with Enron accounting.

It Doesn't Get Much Better Than This for Energy Investment

Free money from the Fed, a devalued dollar from the Secretary of the Treasury and now reduced dividend taxation all point in favor of energy investment. The first two are leading indicators of general price inflation. We are already getting natural gas price inflation and the lower dollar seems to assure oil price inflation. Even if we have to wait awhile for higher energy prices we now get paid more to wait. Energy is one of the highest cash flow generating industries that has traditionally paid higher dividends and can now do so more tax efficiently.

Dividends Gain Relative to Interest

A carefully balanced portfolio with dividend paying investments and interest paying investments should rebalance toward dividends. If one can have confidence in the companies as we do for our recommended stocks, that means sell some taxable interest paying investments, buy some energy stocks.

Security Selection Altered for Taxable/Tax-Deferred Investing

Our favorite personal investments given the constraints of our expertise are Treasury Inflation Protected Securities and energy stocks. The imminent new law accentuates the desirability of placing taxable TIPS in a tax-deferred account and lower-taxed dividend paying energy stocks in a taxable account.

Non-U.S. Stocks Eligible for Lower Dividend Tax-Rate

Our reading of JGTRRA03 tells that the lower 15% tax rate also applies to dividends from "qualified foreign corporations". Among the qualifying factors is stock readily tradable on U.S. securities market. On that basis and probably other factors dividends from our recommendations RD, PTR, **Encana (ECA)** and **CNOOC Limited (CEO)** would be taxed more lightly. Annual yields are about 4%, 6%, 1% and 4% respectively.

Royalty Trust Tax Treatment Unchanged

Our interpretation is that because royalty trusts already avoid double taxation there would be no new benefit from the reduction of double taxation. Thus while there may be no new reason to buy recommendations **San Juan Basin Royalty Trust (SJT)** and **Canadian Oil Sands Trust (COS_u.TO)** we think the natural gas exposure in SJT and the oil exposure in COS remain highly desirable. Perhaps royalty trusts may be more attractive acquisition targets for acquirers who might use the assets of the trusts to fund a higher dividend distribution. Meanwhile the success of royalty trusts as investments makes the case for encouraging with tax policy higher income payments by energy producers.

Energy Utilities May Get Welcome Balance Sheet Relief

The energy utilities and their retirement investors are among the prime beneficiaries of the new tax reduction and in our mind are the main political justification for the action. In an industry sense we like to make the parallel with the banking industry around 1990. Our recollection is that after leading banking institutions saw share prices fall to single digits, the political authorities apparently made a point of encouraging banks to borrow short at low rates from the central bank and lend long at high rates to the Treasury. Effectively that pumped equity into bank balance sheets. How much of that behavior was explicit and how much coincidental doesn't matter. Now the Administration and the Congress are essentially encouraging the good old local energy utilities to market new issues of stock that pay after tax income at rates far higher than savings accounts. That should pump equity into the balance sheets of a vital industry that could use it.

From the point of view of investors we quote from the American Gas Association. "Nearly 70 percent of utility stockholders are 65 years of age or older compared to 22 percent for all stockholders. Almost 60 percent have annual household incomes less than $50,000 compared to 25 percent for all stockholders." Sounds like a group that could use a tax break.

How to Spot a Ponzi Scheme

Those same older and less affluent investors who need income are prey for promoters who pay income out of the proceeds of current financing and compensate themselves obscenely as did Carlo Ponzi and his multitude of imitators. For several weeks earlier this year we published regular comparisons of income stocks that included a measure labeled "Dist/Equity Ebitda" (for example see *Natural Gas Royalty Trusts*, March 17, 2003). The implication is that a stock with a ratio less than one is a legitimate dividend payer while a stock with a ratio more than one is paying distributions partly out of the proceeds of debt financing.

Sell-recommended high greed partnerships are highest on the scale, deep into Ponzi territory. Recommended oil producer/refiners, our income recommendations aside from royalty trusts, are at the opposite, healthy end of the measure. Energy utilities in our coverage still paying a dividend also rank well below the Ponzi delimiter.

Should We Buy Energy Utilities?

Game Changer as an investable idea for energy utilities appears to be in the early stages. Though we do not have specific utility stocks to recommend today, we discuss **American Electric Power (AEP)**, temporarily a past favorite.

AEP has different characteristics from natural gas and oil producers that could be advantageous in a diversified portfolio. Should the economic outlook shift more to deflation than we expect, a financially strengthened utility might perform all right.

Fundamentally the strength of AEP is its old coal fired electricity generating plants. The raw material is cheap and the public accepts its environmental drawbacks in existing plants because it is practical to do so. We think there is a lot of money to be made on old coal plants as scarce natural gas sets the electricity price on the margin. Even if AEP does not make all that money because of regulation and because it does not own the coal, it is still in a strong strategic position.

AEP also has a relatively high debt ratio. Yet getting that debt down is one of the implied goals of the new dividend taxation. AEP ought to be selling a lot of stock and the price ought to be good enough to support the offerings. Maybe there will be timing opportunities to buy the stock on equity offering announcements. Stock prices usually drop some to accommodate the increased supply. In AEP's case the positive balance sheet impact might outweigh the equity dilution.

Heretofore, high greed partnerships have been selling a lot of stock. Hands down, we would put our money into AEP if that were the choice.

Might there be an opportunity to leverage an investment in AEP or a comparable energy utility? AEP's dividend in excess of 5% compares favorably with short term interest rates below 2%. The trade could be profitable even if the stock price were simply constant. It seems like our political leaders are encouraging such a trade. Already it may have added some life to utility stocks. At a McDep Ratio of 0.9, AEP is a reasonable value unlevered and we leave the question of leverage up to each investor.

Kurt H. Wulff, CFA

For recent prices and valuation measures see *Meter Reader* and *Natural Gas Royalty Trusts* weekly analyses.