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Dow Jones Industrials -11051  
Philadelphia 22 Electric Index – 455

**Rating: Hold**

### WPS Resources (NYSE-WPS) Agrees to Acquire Peoples Energy (NYSE-PGL)

Company	Symbol	7/24	Consensus 2007 EPS	Price/ Earnings	Dividend PS	Yield	Shares Mil	Mkt.Cap. \$-Mil
WPS Resources	Wps	52	3.99	12.9	2.30	4.5%	40	2,072
Peoples Energy	Pgl	42	2.02	20.8	2.18	5.2%	38	1,609

(Consensus #s are Bloomberg's. PGL based on fiscal year-end September 30 and WPS calendar year-end.)

#### Opinion

The obvious benefits of the deal are twofold: 1) WPS Resources' shareholders receive \$0.34 a share boost in the dividend, about 8-years growth and a higher pro forma yield from 4.5% to 5.1% and 2) PGL shareholders receive 15% price premium and maintain income. The arbitrage spread of less than 2% indicates little investor doubt that the deal will close. The next two years will be geared to the important but mundane tasks of improving profits at PGL and working off dilution. Until dilution is eliminated and the combination demonstrates visible earnings growth, WPS shares should mirror the performance of the average electric company. We're adding WPS to coverage with a hold rating.

#### The Deal

On July 11, 2006 WPS Resources (WPS) and Peoples Energy (PGL) confirmed, albeit after it had been previously reported in the Wall Street Journal, that WPS had agreed to purchase PGL. The all-stock exchange -- 0.825 shares of WPS for each PGL share -- represented an approximate 15% premium over market and a 97% premium over book. WPS pro forma dividend rises 14% to \$2.64 a share, a level designed to maintain income of PGL holders and provide price support for WPS. After completion, WPS corporate headquarters will relocate from Green Bay, Wisconsin to Chicago, Illinois. The deal is expected to close late 2006 or early 2007.

In its presentation to the investment community, management cited \$80 million in pretax synergies over time after implementation costs of \$200 million. Management expects earnings per share to be accretive to current WPS shareholders in 2008, by inference indicating 2007 results will be dilutive.

#### Pro Forma 2007 and 2008 Earnings

We haven't actively followed WPS or PGL, but consensus earnings estimates for WPS are \$3.69 and \$3.99 a share for 2006 and 2007, respectively. PGL comparable earnings for fiscal years ending September 30 are \$1.75 and \$2.02 a share. In both years,

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earnings are less than its \$2.18 a share dividend. PGL began 2006 with ongoing earnings guidance of \$2.25 to \$2.45 a share (versus \$2.26 a share in 2005), but a combination of mild temperatures, accounting changes and higher operating expenses cut guidance to \$1.65 to \$1.90 a share. Following the merger announcement, management indicated that it has postponed its rate application in Illinois pending completion of the transaction, suggesting that the 2007 consensus could be optimistic.

Table 1 combines 2007 consensus (\$236 million) and divides by pro forma shares (71.5 million). Earnings of \$3.31 a share represent a 17% dilution from WPS stand-alone forecast of \$3.99 a share. Dilution is typically reduced by the creativity of accountants and investment bankers (hence the ever evolving differences between GAAP and ongoing earnings). The likely scenario would exclude from ongoing earnings such pesky items as merger-related charges, severance costs, and perhaps an accounting change. The investment community accepts ongoing earnings while other items treated as one-time are ignored, but as management comments suggest, year one will be dilutive even after separating out various one-time charges. The key to 2008 profits hinges on a turnaround at PGL and the extent of any merger synergies.

Table 1 assumes WPS normalized earnings excluding the merger would have risen 5% to \$4.19 a share in 2008 and that PGL profits would have rebounded to \$2.50 a share, assuming rate relief in Illinois. Pro forma earnings of \$3.68 a share represent a 12% dilution versus WPS stand-alone. By then, merger synergies should boost the bottom line.

Table 1  
Pro Forma 2007/8 Earnings

	2007	2008
WPS Per Share	3.99	4.19
\$ Millions	159	167
PGL	2.02	2.50
\$ Millions	78	96
Consolidated Income	236	263
Pro Forma Shares	71.5	71.5
Earnings	3.31	3.68
Dilution	0.68	0.51
% Dilution	17	12

Synergies of \$80 million work out to \$52 million net of taxes (\$0.73 a share) before sharing with consumers. Assuming synergies are split \$70 million regulated and \$10 million non-regulated and the regulated portion is again split 50/50 between investors and consumers, ongoing earnings would benefit \$0.40 a share. If those savings are linear and accrue over four years, the average annual increment to earnings is \$0.10 a share. Pro forma earnings of \$3.68 a share in 2008 would rise \$0.20 a share to \$3.88 a share, reducing dilution to 7%. The shortfall would become the target of what management describes as rigorous asset-management, i.e., asset sales, debt reduction, etc.

#### Pro Forma Capitalization

WPS management hasn't issued a goodwill number, explaining that several assets such as oil & gas properties are to be revalued. What we do know is that the 0.825 exchange per PGL share works out to a purchase price of \$1,634 million compared to book of \$800 million. Until a better number becomes available, our estimate of goodwill is \$834 million (\$11.67 a pro forma share).

Table 2 lists the capitalization and capital structures from the most recent Annual Reports for WPS and PGL (excludes \$558 million acquisition of Aquila's gas properties). The WPS balance sheet is strong, with common equity accounting for 54% of capitalization and debt only 43.5%. PGL equity is a respectable 46.9%, but management goal had been to raise it to over 50%. Consolidated pro forma capitalization total is \$4,938 million: 40% debt (\$1,949 million), 1% preferred (\$51 million) and 59% common equity (\$2,938 million). Consolidated book value of \$41.11 a share contains \$11.67 a share of non-earning goodwill (at least for the utility). If book value were reduced by goodwill, WPS book value representing earnings power declines by 10% from \$32.76 to \$29.43 a share.

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Earnings of \$3.68 a share in 2008 applied to pro forma book of \$41.11 a share (admittedly a mismatching of time periods but interesting nevertheless), produces a mediocre 9.0% return while the return on book net of goodwill is 12.5%. Assuming, as management maintains, the transaction is non-dilutive (pro forma earnings equal \$4.19 a share in 2008), the return on stated book is 10.4% and 14.2% on adjusted book. Since 2001, WPS return only exceeded 14% in one year - 2002 (14.6%).

Table 2  
Pro Forma Capitalization

Balance Sheet	PGL 9/30/05	WPS 12/31/05	Pro Forma
Long Term Debt	896	867	1,763
Short Term Debt	8	269	277
Net Derivatives	2	(93)	(91)
Total Debt	906	1043	1949
Preferred		51	51
Common	800	1,304	2,938
Total Capitalization	1,706	2,398	4,938
Capital Structure			
Debt	53.1	43.5	39.5
Preferred	0.0	2.1	1.0
Common	46.9	54.4	59.5
Total	100.0	100.0	100.0
Book Value	20.83	32.76	41.11
Goodwill			11.67
Net Book			29.43
Earnings Power 2008			3.68
Dividend			2.64
Payout			72%

#### An Aside on Goodwill

Before FASB issued SFAS 142 in June 2001, management and investment bankers went through all sorts of machinations to avoid purchase accounting and amortization of goodwill. To the rescue came the FASB. SFAS 142 required that goodwill be recorded but rather than amortize the premium (typically over 40 years), it became subject to impairment tests. Impairment charges are treated as one-time, non-cash charges and ignored by the investment community. The result is that management avoids the constant reminder of a decision that depressed profits and bankers could more easily present non-dilutive deals to corporate America. In other words, SFAS 142 was "the accountants' gift to management and investment bankers act." If our estimate of goodwill were amortized over 40 years, earnings would be reduced \$0.29 a share (\$21 million) annually.

## Analyst's Certification

I Raymond E. Moore certify that the views expressed in this research report accurately reflect my personal views about the subject companies and their securities. I also certify that I have not been and will not be receiving direct or indirect compensation in exchange for expressing the specific recommendations in this report. Other reports issued by me are: SCANA Corporation (6/15/06 SCG \$38-Buy); Exelon Corporation (4/27/06 EXC \$58-Hold); Exelon Corporation (3/23/06 EXC \$55-Hold); Exelon Corporation (3/15/06 EXC \$56-Hold); TXU Corporation (2/28/06 TXU \$52-Hold); Constellation Energy (2/24/06 CEG \$58-Hold); Consolidated Edison/KeySpan (2/17/06 – ED-\$45-Hold, KSE-\$36-Not Rated); Exelon Corporation (1/26/06 EXC \$58-Hold); FPL Group/Constellation Energy (1/9/2006 – FPL \$42-Not Rated, CEG \$58-Hold); TXU Corporation (11/18/05 \$50-Hold); Exelon Corporation (10/4/05 \$53-Sell); Constellation Energy (9/13/05 \$60-Market Perform); Exelon Corporation (8/4/05 \$54-Sell); Pinnacle West Capital (7/14/05 \$45-Market Perform); TXU Corporation (6/8/05 \$81-Market Perform); Duke/CINergy (5/17/05 – DUK-\$28, CIN-\$45.50-Both Rated Market Perform); Constellation Energy (5/12/05 \$54-Market Perform); Consolidated Edison (4/18/05 \$42-Hold); CINergy (3/28/05 \$40-Market Perform); Exelon Corporation (3/8/05 \$47-Sell); CINergy (2/23/05 \$41-not rated); PPL Corporation (2/8/05 \$56-Market Perform Upgrade); TXU Corporation (2/2/05 \$72.62-Market Perform); Accounting for Mergers (1/20/05 Exelon \$43-sell, PEG \$51-not rated); TXU Corp (12/6/04 \$61-Market Perform); Constellation Energy (10/22/04 \$40-Market perform); Exelon Corp. (9/9/04 \$38-Sell); Progress Energy (7/14/04 \$42-Under Perform); Southern Co (7/12/04 \$29-Market Perform); Consolidated Edison (6/24/04 \$40-Hold); Scana Corporation (4/7/04 \$36-Buy); Dominion Resources (3/12/04 \$63-Market Perform Upgrade); Duke Energy (1/8/04 \$21-Under Perform); Dominion Resources (1/23/04 \$62-Under Perform); CMS Energy (11/19/03 \$7-Market Perform); Exelon Corporation (10/15/03 \$65-Sell); TECO Energy (6/24/03 \$13-Hold); Northeast Utilities (5/30/03 \$17-Hold); Southern Co (4/9/03 \$28-Hold); CMS Energy (4/3/03 \$5-Sell); Consolidated Edison (3/24/03 \$40-Hold); PPL Corporation (3/12/03 \$34-Under Perform); Exelon Corp (2/26/03 \$49-Under Perform); TXU Corp (2/6/03 \$17, 1/9/03 \$20 both Under Perform); Duke Energy (1/29/03 \$17-Under Perform, 1/17/03 \$18-Under Perform); Dominion Resources (12/27/02 \$54-Under Perform).

## Important Disclosures

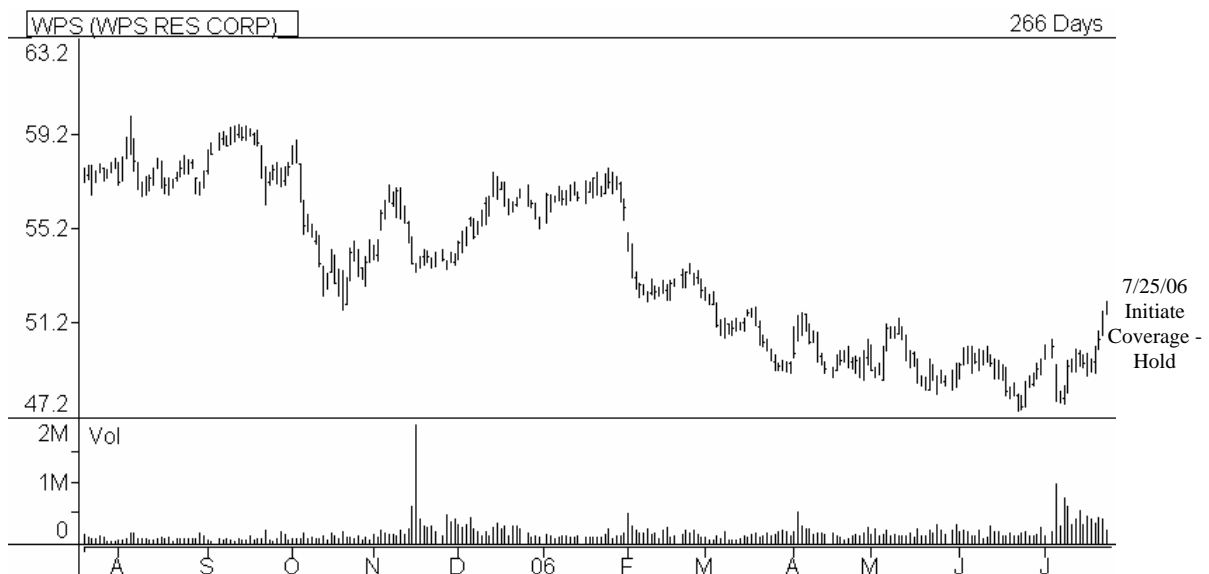
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**Market Perform & Hold** Total return is expected to equal the average total return of the analyst's industry coverage universe over the next 12 months.

**Sell** Total return is expected to significantly under perform (15% plus) the total return of the industry coverage universe over the next 12 months.

Range of Formal Recommendations 16 total 1-buy-14-holds-1 sell



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