



# EQUITY RESEARCH

**November 27, 2009**

**CURRENT PRICE:** \$36.14  
**RATING:** OUTPERFORM  
**PRICE TARGET:** \$42.00  
**CURRENT YIELD:** 4.8%

## EPS Estimates - Non-GAAP

	DEC 08A	DEC 09E
1Q	\$1.00 A	\$0.97 A
2Q	\$0.50 A	\$0.68 A
3Q	\$0.94 A	\$0.99 A
4Q	\$0.72 A	\$0.64 e
	<b>\$3.16</b>	<b>\$3.28</b>

## Trading Data

52-WEEK PRICE RANGE: **\$38.24-\$27.14**  
SHARES OUTSTANDING: **597.2(M)**  
MARKET CAP: **\$21,583(M)**  
AVG. DAILY TRADING VOLUME: **3.41(M)**  
S&P 500: **1,091**

## Valuation Data

BOOK VALUE: **\$18.97**  
PRICE TO BOOK: **1.9X**  
DIVIDEND: **\$1.75**

## DOMINION RESOURCES (NYSE:D)

*Initiating Coverage with an Outperform Rating*

### HIGHLIGHTS

- One of largest US electric utilities
- Reduced operating risk to business model
- Potential for 2010-2011 earnings growth acceleration
- 4.8% dividend yield & potential for future increases
- \$42/share price target

### INVESTMENT THESIS

Given the current economic recession, and uncertain length of its duration, investors should consider high-yielding dividend equities operating in predictable industries. One such company is Dominion Resources (D-\$36.14), providing energy/energy services to the mid-Atlantic area. The company pays an attractive dividend yield of 4.8%. Future earnings growth may allow D to increase the annual dividend. Profitability could increase from favorable regulatory rate rulings, improvement in natural gas prices, and company efforts to manage/reduce operating costs. Given D's attractive dividend yield, and our price target of \$42/share, these shares are recommended for income/growth investors.

### COMPANY SUMMARY

Dominion Resources, headquartered in Richmond VA, is one of the largest US electric utilities. The company has three operating units: Dominion Virginia Power, Dominion Generation, and Dominion Energy. Dominion Virginia Power operates D's regulated electric distribution, transmission and un-regulated retail business (gas & electric). The electric distribution business provides electricity to 2.4 million customers in VA/NC, and 1.6 million un-regulated retail energy customer accounts in 12 states. Dominion Generation operates the electric generation plants for D. This unit has 27,500 megawatts of generation capacity and 67% of this generation goes to D's regulated electric customers in VA/NC with the remaining 33% allocated to the non-regulated customers in the northeast US and the Mid-Atlantic areas.

*For Important Disclosure information regarding the Firm's rating system, valuation methods and potential conflicts of interest, please refer to the last page of this report.*

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Dominion Energy operates the natural gas pipeline/storage business, a liquefied natural gas terminal at Cove Pt. Maryland, and Dominion East Ohio. Energy assets include 14,000 miles of natural gas transmission, gathering and storage pipelines. Since 2003 dividend has grown from \$1.29/share to \$1.75/share and operating earnings increased from \$2.26/share to \$3.16 in 2008. D's 2008 revenues, on a GAAP basis, totaled \$16.29 billion and net income totaled \$1.83 billion

## **BUSINESS STRATEGY**

Management made a strategic decision to lower its earnings exposure to commodities a couple of years ago and reduced the overall size of operations to emphasize regulated operations. Management believes, despite the current US economic slowdown, there are opportunities for revenue growth going forward during the next 2 years. This could come from favorable regulatory rulings, positive commodity pricing, potential O&M expense reduction, and lowering financing costs.

The company has filed a rate case with the State of Virginia seeking increases in base rates for regulated customers and seeking adequate return on equity levels on its plants/projects.

During 1H09 D filed a rate case for generation and distribution rates at Virginia Power. In 2008, for electric/transmission projects, the company was allowed a return on equity (ROE) of 11.4%. For 11 selected new projects (\$900 million), D received incentive ROEs of 125-150 basis points above the 11.4% rate. It is anticipated Virginia regulators could rule on the rate case during the first half of 2010. Additionally, requests have been filed for increased revenues for Demand-Side Management Programs and requested riders for the VA City Hybrid and Bear Garden facilities. Favorable results could increase revenues for D.

Favorable pricing for natural gas in the future could benefit D's merchant generation operations in New England. There has been a lack of new generation plant construction in this region. An improving US economy could increase kilowatt (Kwh) demand in New England, subsequently raising the price of electricity and improve profitability at D's merchant generation business.

The recent farm-out of D's acreage position in Marcellus generated cash for the company and allowed it to maintain a royalty stake in the property. Management plans to use some of the cash proceeds to focus on other energy projects. In addition, D kept ownership of the natural gas above & below the Marcellus formation. An increase of discoveries at these levels could generate additional cash flow from the Marcellus property.

D is currently pursuing several projects to provide transportation of gas from the Marcellus property, where current pipelines are unable to offload existing gas production, and to connect to the new Kinder Morgan Rockies Express Pipeline. The Kinder Morgan pipeline will transport natural gas from the Rocky Mountains east towards Ohio. D has entered into a joint venture with Williams Company (WMB-\$19.97) to build a pipeline designed to carry this gas from Ohio, and the Marcellus property, to the eastern US. Transporting of gas through these pipelines may generate additional revenues/profits for D.

Management believes there is potential for improving internal operating margins through operating/maintenance costs (O&M) and financing costs. Non-fuel O&M expenses currently are approximately \$3 billion/year and D believes costs could potentially be reduced depending upon regulators' decision on the Virginia rate case. The company believes it has taken steps



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to lower financing costs on short-term notes having moved \$750 million from fixed rate notes to Libor-plus. Moving to Libor-plus provides the benefit of lower interest rates available in the short-term credit markets. D has hedged the majority of these positions in case short-term interest rates begin to rise.

While exiting a good portion of its commodity-sensitive businesses D could benefit in the future from higher natural gas prices. The recent implosion of the commodity bubble caused a decline in virtually all commodity prices. Natural gas, trading at almost \$12/Bcf in 2008, now trades around \$6.50/Bcf. Traders priced in a slowing US/World economy forecast into the current pricing of commodities. However, as natural gas prices declined so has the amount of drilling for gas. This potentially creates a shortage, due to supply constraints, should demand for natural gas increase as the US economy emerges from the recession which could be bullish for the pricing of this fossil fuel. Rising natural gas prices in the future could increase profitability at several of D's operating units and thus increase overall earnings.

## RECENT EARNINGS

D reported 3Q09 GAAP earnings of \$1/share vs. \$0.87/share during 3Q08. Non-GAAP earnings, or those from continuing operations, were \$0.99/share vs. \$0.94/share during last year's comparable quarter. Improved non-GAAP earnings came from higher regulated electric utility and gas transmission profits, higher profitability in the unregulated retail energy marketing operations, lower financing costs, and a decline in the income tax rate. These were partially offset by unfavorable weather in D's service territory, lower margins in merchant generation, and decreased profits from producer services. When comparing comparable quarters, total operating expenses declined to \$2.5 billion from \$3.3 billion due to lower electric fuel/other energy-related purchases (\$1.07 billion vs. \$1.4 billion), purchased electric capacity (\$96 million vs \$102 million), purchased gas costs (\$279 million vs \$694 million), and other taxes (\$104 million vs.\$109 million). These were partially offset by an increase in other operations/maintenance costs (\$709 million vs. \$701 million) and higher depreciation/depletion/amortization expenses (\$274 million vs. \$259 million). Income from operations rose to \$1.09 billion from \$1.07 billion. During the quarterly conference call, management affirmed operating earnings guidance for 2009 of \$3.20-\$3.30/share and \$3.20-\$3.40/share during 2010.

## OUR THOUGHTS

We are initiating coverage of D, paying a current dividend yield of 4.8%, with an Outperform rating for several reasons. First, a favorable decision from Virginia regulators in the pending rate case could increase overall revenues for D from its regulated businesses and lead to potential margin improvement. Second, improving natural gas pricing in the commodity markets could raise profitability in the merchant generation business given the company's concentration of generation facilities in the New England region. Additionally, rising natural gas prices may also be an indicator of an improving economy which could also increase industrial Kwh sales for the electric utility industry and raise operating revenues. Third, the Marcellus & pipeline initiatives may be an added source of revenues/profits for D during the next two years and add to overall earnings. Growing revenues, coupled with the company's recent cost control initiatives, could increase D's profit margins, ROA/ROE ratios, and lead to future earnings growth in 2010-2011.

Management's goal of paying out 55% of earnings, as dividends, augurs well for shareholders seeking rising income streams. Earnings growth may generate increasing dividends for shareholders in the future. Given D's quality of earnings, due to the



reduced risk in its business model, attractive 4.8% dividend yield, and the potential of future earnings growth, may cause an increase in investor demand for this company's stock. This could materialize from a positive rate decision in VA, rising natural gas prices, and recovery in the US economy. These shares are recommended for income/growth investors seeking a high dividend yield from D while awaiting for share price appreciation. Our price target is \$42/share, equating to 12.8x multiple of our 2009 earnings estimate of \$3.28/share. These shares are rated Outperform.

## **RISKS**

There is no guarantee D will improve earnings/cash flow. Declining US electric sales volumes may hurt the company's revenues and profits. Rising interest rates, higher fuel prices, negative rate case decisions, tax issues, or rising operating costs could negatively impact D's earnings. D's stock may be adversely impacted by negative equity/credit markets, terrorist attacks, and failure to comply with Sarbanes Oxley guidelines.

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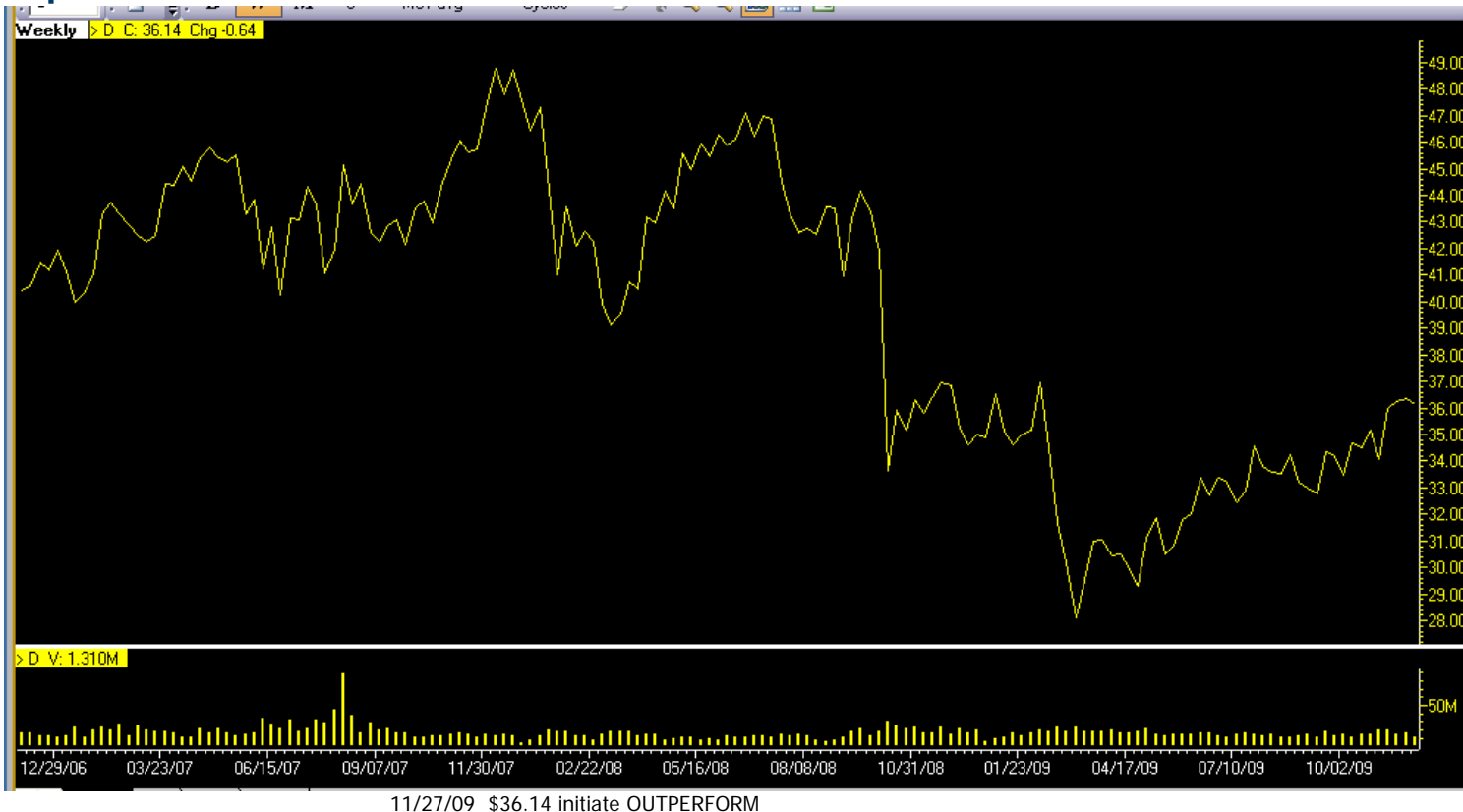


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Dominion Resources  
(in millions, except per share data)

	1Q98	2Q98	3Q98	4Q98	FY08	1Q09	2Q09	3Q09	4Q09e	FY09e
Operating Revenue	\$4,099	\$3,363	\$4,209	\$3,966	\$15,637	\$4,510	3,388	\$3,623	\$3,518	\$15,039
Operating Expenses										
Electric fuel/other energy-related purchases	781	786	1,380	1,072	4,019	1,141	996	1,072	1,088	4,297
Purchased electric capacity	107	97	102	105	411	108	105	96	103	412
Purchased gas	985	614	594	782	2,975	952	339	279	420	1,990
Other operations & maintenance	764	836	695	812	3,107	773	773	709	744	2,999
Depreciation, depletion, & amortization	254	257	259	265	1,035	278	272	274	276	1,100
Other taxes	147	106	109	118	470	147	105	104	112	468
Total operating expenses	3,038	2,696	3,139	3,154	12,027	3,399	2,590	2,534	2,734	11,257
Income from operations	1,061	667	1,070	812	3,610	1,111	798	1,089	784	3,782
Other income	31	19	61	30	141	45	52	72	38	207
Income before interest & income taxes	1,092	686	1,131	842	3,751	1,156	850	1,161	822	3,989
Interest & related charges	219	205	218	208	850	223	221	217	220	881
Income before income taxes	873	481	913	634	2,901	933	629	944	602	3,108
Income taxes	295	188	368	212	1,063	364	219	348	223	1,154
noncontrolling interests		4			4		4	4	3	11
Operating Earnings	\$578	\$289	\$545	\$422	\$1,834	\$569	\$406	\$592	\$382	\$1,949
Operating Earnings per Share	\$1.00	\$0.50	\$0.94	\$0.72	\$3.16	\$0.97	\$0.68	\$0.99	\$0.64	\$3.28
Items excluded from operating earnings (net of taxes)	102	9	-37	-74	0	-321	48	2	0	-271
Reported Net Income	\$680	\$298	\$508	\$348	\$1,834	\$248	\$454	\$594	\$382	\$1,678
Reported Earnings Per Common Share-Diluted	\$1.18	\$0.51	\$0.87	\$0.60	\$3.16	\$0.42	\$0.76	\$1.00	\$0.64	\$2.82
Average shares outstanding, diluted	578.4	580.7	582	582.1	582.1	585.7	594	596.3	596.3	596.3

## Important Disclosures



Steven Marascia certifies, with respect to the companies or securities that he analyzes, that (1) the views expressed in this report accurately reflect his personal views about all of the subject companies and securities and (2) no part of his compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this report.

Steven Marascia owns shares of Dominion Resources.

Capitol Securities and employees of Capitol Securities may own shares of Dominion Resources.

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- (2) Neutral – The stock's total return including dividends is expected to be in line with the industry or market average of +/- 10% over the next twelve months.
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The distribution of investment ratings for all companies in our coverage universe are as follows: (1) 100%, (2) 0%, (3) 0%

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For regulatory purposes, our ratings of Outperform, Neutral and Underperform most closely correspond to Buy, Hold and Sell, respectively.

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