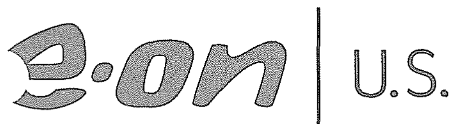


RECEIVED
FEB 14 2008
PUBLIC SERVICE COMMISSION

Elizabeth O'Donnell
Executive Director
Kentucky Public Service Commission
211 Sower Boulevard
Frankfort, KY 40601

E.ON U.S. LLC
State Regulation and Rates
220 West Main Street
PO Box 32010
Louisville, Kentucky 40232
www.eon-us.com

Rick E. Lovekamp
Manager - Regulatory Affairs
T 502-627-3780
F 502-627-3213
rick.lovekamp@eon-us.com

February 14, 2008

THE APPLICATIONS OF BIG RIVERS ELECTRIC CORPORATION FOR: (I) APPROVAL OF WHOLESALE TARIFF ADDITIONS FOR BIG RIVERS ELECTRIC CORPORATION, (II) APPROVAL OF TRANSACTIONS, (III) APPROVAL TO ISSUE EVIDENCES OF INDEBTEDNESS, AND (IV) APPROVAL OF AMENDMENTS TO CONTRACTS; AND OF E.ON U.S., LLC, WESTERN KENTUCKY ENERGY CORP., AND LG&E ENERGY MARKETING, INC. FOR APPROVAL OF TRANSACTIONS – Case No. 2007-00455

Dear Ms. O'Donnell:

Enclosed please find and accept for filing the original and six (6) copies of E.ON U.S. LLC 's response to the Attorney General's Initial Request for Information dated February 1, 2008, in the above-referenced matter.

Also enclosed are an original and ten (10) copies of a Petition for Confidential Protection regarding information provided in response to Question Nos. 83, 100, and 101.

Should you have any questions or need any additional information, please contact me at your convenience.

Sincerely,

Rick E. Lovekamp

cc: Parties of Record

VERIFICATION

STATE OF KENTUCKY)
) SS:
COUNTY OF JEFFERSON)

The undersigned, **Paul W. Thompson**, being duly sworn, deposes and says that he is the Senior Vice President, Energy Services for E.ON U.S. LLC that he has personal knowledge of the matters set forth in the responses (Question Nos. 13-16, 80-87, 90, 94, 95, 100-101, 104-108, 118, and 122a), and the answers contained therein are true and correct to the best of his information, knowledge and belief.

PAUL W. THOMPSON

Subscribed and sworn to before me, a Notary Public in and before said County and State, this 14th day of February, 2008.

Tammy J. Elzy (SEAL)
Notary Public

My Commission Expires:

November 9, 2010

VERIFICATION

STATE OF KENTUCKY)
) SS:
COUNTY OF JEFFERSON)

The undersigned, **David Sinclair**, being duly sworn, deposes and says that he is the Vice President, Energy Marketing for E.ON U.S. LLC that he has personal knowledge of the matters set forth in the responses (Question Nos. 13-16, 26d, 85, 86, 90, 94-96, 100-101, 104-108, 118, and 122a), and the answers contained therein are true and correct to the best of his information, knowledge and belief.

David Sinclair
DAVID SINCLAIR

Subscribed and sworn to before me, a Notary Public in and before said County and State, this 14th day of February, 2008.

Tammy J. Ely (SEAL)
Notary Public

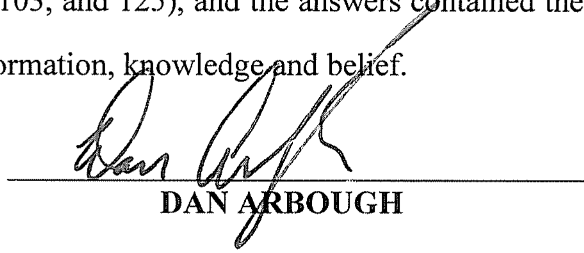
My Commission Expires:

November 9, 2010

VERIFICATION

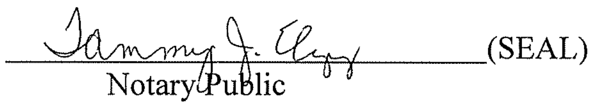
STATE OF KENTUCKY)
) SS:
COUNTY OF JEFFERSON)

The undersigned, **Dan Arbough**, being duly sworn, deposes and says that he is the Treasurer, for E.ON U.S. LLC that he has personal knowledge of the matters set forth in the responses (Question Nos. 24, 103, and 125), and the answers contained therein are true and correct to the best of his information, knowledge and belief.



DAN ARBOUGH

Subscribed and sworn to before me, a Notary Public in and before said County and State, this 14th day of February, 2008.



(SEAL)

Notary Public

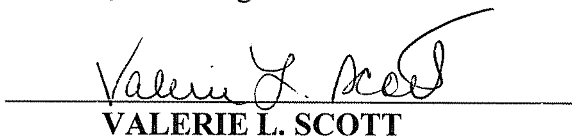
My Commission Expires:

November 9, 2010

VERIFICATION

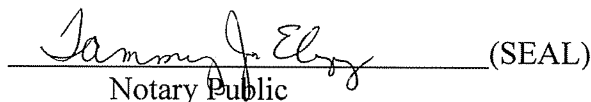
STATE OF KENTUCKY)
) SS:
COUNTY OF JEFFERSON)

The undersigned, **Valerie L. Scott**, being duly sworn, deposes and says that she is the Controller, for E.ON U.S. LLC that she has personal knowledge of the matters set forth in the responses (Question No. 25 and 97-98), and the answers contained therein are true and correct to the best of her information, knowledge and belief.



VALERIE L. SCOTT

Subscribed and sworn to before me, a Notary Public in and before said County and State, this 14th day of February, 2008.



(SEAL)

Notary Public

My Commission Expires:

November 9, 2010

VERIFICATION

STATE OF KENTUCKY)
) SS:
COUNTY OF JEFFERSON)

The undersigned, **Russel "Rusty" A. Hudson**, being duly sworn, deposes and says that he is the Director, Energy Services Accounting and Budgeting for E.ON U.S. LLC that he has personal knowledge of the matters set forth in the responses (Question No. 99, 102, and 126), and the answers contained therein are true and correct to the best of his information, knowledge and belief.

Russel A. Hudson
RUSSEL A. HUDSON

Subscribed and sworn to before me, a Notary Public in and before said County and State, this 14th day of February, 2008.

Tammy J. Elzy (SEAL)
Notary Public

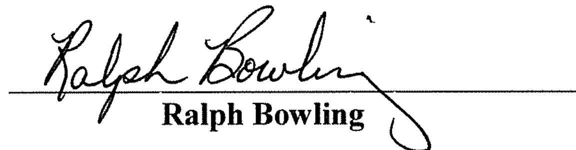
My Commission Expires:

November 9, 2010

VERIFICATION

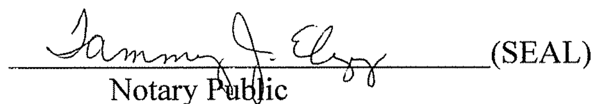
STATE OF KENTUCKY)
) SS:
COUNTY OF JEFFERSON)

The undersigned, **Ralph Bowling**, being duly sworn, deposes and says that he is the Vice President, Power Operations for Western Kentucky Energy Corp. that he has personal knowledge of the matters set forth in the responses (Question No. 134), and the answers contained therein are true and correct to the best of his information, knowledge and belief.



Ralph Bowling

Subscribed and sworn to before me, a Notary Public in and before said County and State, this 14th day of February, 2008.


(SEAL)
Notary Public

My Commission Expires:
November 9, 2010

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE APPLICATIONS OF BIG RIVERS ELECTRIC CORPORATION FOR: (I) APPROVAL OF WHOLESALE TARIFF ADDITIONS FOR BIG RIVERS ELECTRIC CORPORATION, (II) APPROVAL OF TRANSACTIONS, (III) APPROVAL TO ISSUE EVIDENCES OF INDEBTEDNESS, AND (IV) APPROVAL OF AMENDMENTS TO CONTRACTS; AND OF E.ON U.S., LLC, WESTERN KENTUCKY ENERGY CORP., AND LG&E ENERGY MARKETING, INC. FOR APPROVAL OF TRANSACTIONS	)	CASE NO. 2007-00455

RESPONSE OF
E.ON U.S. LLC
TO THE
AG'S INITIAL REQUEST FOR INFORMATION
DATED FEBRUARY 1, 2008

FILED: February 14, 2008

E.ON U.S. LLC

Response to the AG's Request for Information
Dated February 1, 2008

Case No. 2007-00455

Question No. 13

Witness: Paul Thompson / David Sinclair

Q-13. Under the existing Lease Agreement, state the entity which is responsible for capital investments necessary to meet "clean air" requirements, emission standards and any other environmental rules and requirements.

a. State how the costs of those investments are recovered, and which entity pays for those costs ultimately under the Lease Agreement, and how that entity pays for such costs.

A-13. a. With respect to Green Station, Wilson Station, Coleman Station and Reid Station, Big Rivers and Western Kentucky Energy Corp. (WKE) each have an obligation, during the 25-year term of the 1998 transactions, to fund a certain percentage of the costs for capital investments necessary to meet "clean air" requirements, emissions standards and other environmental rules and requirements. The allocation of such costs and the method for their payment/recovery are set forth in the following contract provisions:

- July 15, 1998 Lease and Operating Agreement: Article 7, Article 8 and Section 10.2.
- April 6, 1998 New Participation Agreement: Section 24.1.
- June 15, 1998 Second Amendment to New Participation Agreement: Section 20.6 (pgs. 3-9) and Section 23.8 (pg. 13).
- July 15, 1998 Third Amendment to New Participation Agreement: Section 9, Section 10 and Section 11.
- April 18, 2000 Letter Agreement: Section I (pgs. 2-20), Section II (pg. 20) and Section III (pgs. 20-28).
- August 22, 2002 Fifth Amendment to New Participation Agreement: Sections 1, 2, 3 and 4.

With respect to Station Two, Big Rivers, WKE and the City of Henderson Utility Commission (City Commission) each have an obligation (in the case of WKE, only during the term of the 1998 transactions) to fund a certain percentage of the costs for capital investments necessary to meet "clean air" requirements, emission standards and other environmental rules and requirements. The allocation of such costs for Station Two as between WKE and the City Commission during the 25-year term of the 1998 transactions, and as between Big Rivers and the City Commission following the expiration or early termination of the 1998 transactions, and the method for their payment/recovery, are set forth in the following contract provisions:

- August 1, 1970 Power Plant Construction and Operating Agreement: Sections 13.6, 13.7, 14 and 16
- August 1, 1970 Power Sales Contract: Section 6 and 9
- May 1, 1993 Amendments to Contracts: Sections 5.6 and 5.7
- April 1, 2005 Amendments to Contracts: Article II – Section 4.20, and Article III – Sections 301A, 302, 303, 304, 305A, 305B, 306, 307, 308 and 312
- July 15, 1998 Agreement and Amendments to Agreements: Sections 9.8 and 9.10
- April 1, 2005 Amendatory Agreement: Section 10

The allocation of such costs for Station Two, as between Big Rivers and WKE, during the term of the 1998 transactions and the method for their payment/recovery are set forth in the following contract provisions:

- July 15, 1998 Agreement and Amendments to Agreements: Sections 9.8, 9.10 and 10.36
- April 1, 2005 Amendatory Agreement: Section 10
- July 15, 1998 New Participation Agreement: Section 24.1

E.ON U.S. LLC

**Response to the AG's Request for Information
Dated February 1, 2008**

Case No. 2007-00455

Question No. 14

Witness: Paul Thompson / David Sinclair

Q-14. Under the existing Lease Agreement state the entity which is responsible for incurrence of operating expenses necessary to meet "clean air" requirements, emission standards and any other environmental rules and requirements.

a. State how the costs of those operating expenses are recovered, and which entity pays for those costs ultimately under the Lease Agreement, and how that entity pays for such costs.

A-14. a. Generally speaking, with respect to Green Station, Wilson Station, Coleman Station and Reid Station, WKE has an obligation to fund substantially all operating expenses required, during the term of the 1998 transactions, for the operation, maintenance and repair of those generating units. See Section 5.2.2 of the July 15, 1998 Lease and Operating Agreement.

However, with respect to certain operating expenses for those generating units that may have become required, or may become required, by reason of certain changes in laws, rules or regulations (or certain changes in the regulatory interpretation of laws, rules or regulations) that have occurred, or may occur, following the July 15, 1998 transaction closing between Big Rivers and WKE (referred to in the 1998 transaction agreements as "Incremental Environmental O&M" costs), Big Rivers and WKE each have an obligation (during the term of the 1998 transactions) to fund a certain percentage of those operating expenses. The allocation of such Incremental Environmental O&M costs between Big Rivers and WKE, and the method for their payment/recovery, are set forth in Section 2.3.3 and Article 7 of the July 15, 1998 Lease and Operating Agreement.

With respect to Station Two, during the term of the 1998 transactions the City Commission and WKE each have an obligation to fund a certain percentage of the operating expenses for Station Two, which are generally tied to the "capacity shares" of the output of Station Two that are contractually allocated to the City Commission and WKE, respectively.

Following the expiration or early termination of the 1998 transactions, the City Commission and Big Rivers have an obligation to fund those same percentages of the operating expenses for Station Two. The allocation of those expenses as between the City Commission, on the one hand, and WKE or Big Rivers (as applicable), on the other hand, and the method for their payment/recovery, are set forth in the following contract provisions:

- August 1, 1970 Power Plant Construction and Operating Agreement: Sections 13.6, 13.7, 14 and 16
- August 1, 1970 Power Sales Contract: Sections 6 and 9

Generally speaking, with respect to Station Two during the term of the 1998 transactions, WKE has an obligation to fund substantially all of the operating expenses required for the operation, maintenance and repair of Station Two and allocated to WKE (and not the City Commission) as described above. However, with respect to certain operating expenses for Station Two that may have become required, or may become required, by reason of certain changes in laws, rules or regulations (or certain changes in the regulatory interpretation of laws, rules or regulations) that have occurred, or may occur, following the July 15, 1998 transaction closing between Big Rivers and WKE (referred to in the 1998 transaction agreements as "Henderson Incremental Environmental O&M" costs), Big Rivers and WKE each have an obligation (during the term of the 1998 transactions) to fund a certain percentage of those operating expenses. The allocation of such Henderson Incremental Environmental O&M costs between Big Rivers and WKE, and the method for their payment/recovery, are set forth in the following contract provisions:

- July 15, 1998 Agreement and Amendments to Agreements: Sections 9.8 and 9.9
- April 1, 2005 Amendatory Agreement: Section 19.5 (pgs. 20-21)

E.ON U.S. LLC

Response to the AG's Request for Information
Dated February 1, 2008

Case No. 2007-00455

Question No. 15

Witness: Paul Thompson / David Sinclair

Q-15. State the reasons why it is not in the public interest to simply continue the Lease Agreement under its present terms. Also, state any necessary revisions to the Lease Agreement that would make it such that it could be continued in the public interest.

A-15. It is not in the public interest to continue the Lease Agreement under its present terms because those terms prevent Big Rivers from resuming its interrupted mission as an electric generation and transmission cooperative that generates power for its member cooperatives and that is financially able to control its own destiny. Continuation of the Lease Agreement is a continuation of Big Rivers' current inability to respond to the changing power needs of Western Kentucky and to finance electricity infrastructure improvements vital to the economic development efforts of its Members and their communities. In addition, continuation of the Lease Agreement would result in continued uncertainty of supply for the Smelters, whose continued operations are dependent upon a continued, stable source of reasonably priced power. The public interest is served not by continuing the present arrangement, the unwinding of which has been decided upon by every principal involved, but by approval of the transaction proposed, particularly in light of the favorable terms offered to Big Rivers.

E.ON U.S. LLC

Response to the AG's Request for Information
Dated February 1, 2008

Case No. 2007-00455

Question No. 16

Witness: Paul Thompson / David Sinclair

Q-16. State the reasons why it is not in the public interest to simply continue the Purchase Power Agreement under its present terms. Also, state any necessary revisions to the Purchase Power Agreement that would make it such that it could be continued in the public interest.

A-16. See Response to Data Request 15.

E.ON U.S. LLC

Response to the AG's Request for Information
Dated February 1, 2008

Case No. 2007-00455

Question No. 24

Witness: Dan Arbough

Q-24. Provide copies of each (U.S.) Equities analyst report on E.ON since January 1, 2005.

A-24. Attached please find the accessible historical analyst reports for E.ON along with the current reports for the analysts that regularly follow E.ON. Note that the reports were limited in 2006 because many of the analysts were prohibited from commenting on E.ON due to the fact that their firms were involved in E.ON's bid for Endesa. Not all historical reports were provided because E.ON does not retain historical reports and only select brokers make their reports available through the data archive service utilized by E.ON.

2005 ANALYST REPORTS

E.ON

E.ON walks away from SPW

Overweight

€78.50

21 November 2005
Price Target: €91.00

Utilities Research

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Olek Keenan, CFA
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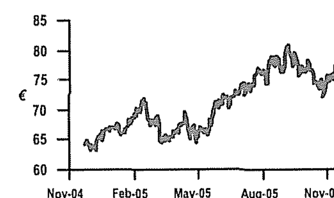
olek.keenan@jpmorgan.com

- **E.ON announced yesterday that it had ceased discussions with ScottishPower over a potential acquisition**. SPW's board chose not to continue with E.ON's final bid of 570p, saying it would not recommend it to shareholders nor allow E.ON due diligence access to its books
- **Under the City Code E.ON is now unable to revise its offer for 6 months** unless specific external conditions occur. E.ON had already raised its bid twice from its initial level. We would not rule out a revised later bid, but view it as far from certain
- **Our previous analysis concluded E.ON could pay a maximum of 625p for SPW and not destroy value**, but we noted this would be a very full price. E.ON clearly concluded a price above 570p would give away too many benefits to SPW shareholders
- **We view this as solid evidence of E.ON's fiscal prudence.** Assuming E.ON does not raise its offer for SPW in the future then it still has more than €20bn of financial firepower, but we believe investors should be reassured by E.ON's approach to the SPW bid. A major share buyback programme or value return is now a more likely scenario, in our view.
- **We continue to see E.ON as one of the most attractive utilities in Europe.** We reiterate our Overweight recommendation and 12 month, sum of the parts based target price of €91

Price Performance



	YTD	-3M	-6M	-12M
Absolute	16.8%	-0.5%	16.7%	22.4%

Source: RIMES, Reuters

E.ON (EONG.DE;EOA GR)

	2004A	2005E	2006E
Adj. EPS FY (€)	5.77	5.95	6.87

Source: Company data, Reuters, JPMorgan estimates. EPS adjusted for exceptionals.

Company Data	
Price (€)	78.50
Date Of Price	21 November 05
52-week Range	63.05 - 80.97
Mkt Cap (€ bn)	51.5
Fiscal Year End	Dec
Shares O/S (mn)	656

J.P. Morgan Securities Ltd.

See page 9 for analyst certification and important disclosures, including investment banking relationships. JPMorgan does and seeks to do business with companies covered in its research reports. As a result, investors should be aware that the firm may have a conflict of interest that could affect the objectivity of this report. Investors should consider this report as only a single factor in making their investment decision. Customers of JPMorgan in the United States can receive independent, third-party research on the company or companies covered in this report, at no cost to them, where such research is available. Customers can access this independent research at www.morganmarkets.com or can call 1-800-477-0406 toll free to request a copy of this research.

Newsflow summary – E.ON walks away from SPW

E.ON and ScottishPower announced yesterday that they had ceased acquisition discussions

E.ON and ScottishPower announced yesterday that they had ceased acquisition discussions after the SPW board refused to recommend E.ON's third and final offer, of 570p per SPW share plus all dividends between now and the date of closure (estimated by both parties as spring 2007)

E.ON raised it's offer twice, but by only 4% altogether

Bid details – two raised offers, but only a 4% increase in price . . .
ScottishPower's news release detailed the three offers made by E.ON.

- Initially E.ON bid 575p per SPW share less any dividends paid prior to completion.
- This was subsequently raised to 564p less dividends paid excluding a maximum 24p/share of ordinary dividends (including the 5.2p Q2 dividend announced on November 10th)
- The final offer of 570p with no dividend restrictions valued ScottishPower at £11.3bn.

Yesterday SPW also announced that it would pay a Q4 2005/06 dividend of 9.4p on top of the current 5.2p dividend commitment for Q3, leading to a full year 2005/06 dividend of 25.0p. SPW has now committed to grow dividends by at least 7% annually thereafter.

Assuming SPW will now dispense with its previous policy of three equal Q1-Q3 dividends and a balancing Q4 dividend and instead pay equal quarterly dividends we estimate dividends of 26.5p would be likely by spring 2006. E.ON therefore raised its bid by 21.5p in all, only 4% of the final bid price.

... and nothing but surprise and disappointment to show for it
E.ON's proposals were dependant on 1) the disposal of PacifiCorp 2) necessary regulatory clearances and 3) the unanimous recommendation of the SPW board. The rejection of the offer by the SPW board effectively ruled out achieving these criteria at the first hurdle. E.ON professed to be "surprised and disappointed" that the board of ScottishPower would not recommend its bid to shareholders, or indeed even allow it due diligence access.

Key issue was the low price and 12m regulatory timeframe

Price and timing the main issues, but regulatory hurdles could have been tough
Both parties estimated that the regulatory hurdles for such a deal would have taken 9-12 months to complete which, combined with further negotiations, would mean the deal was unlikely to close before spring 2007. Discounting back the 570p offer price at 6% (lower rate as dividend payments would still be received) gives a current price of 530p, close to where SPW's share price closed yesterday. We believe this 12m regulatory delay was a key factor in determining the board's rejection of the offer. However, it is also unclear whether regulatory approvals would have been as easy to obtain as previously thought either. Both EU and UK authorities have made negative comments on energy consolidation in the previous 2 weeks, and further potential delays to the process could also have influenced SPW's decision.

Ian Mitchell
(44-20) 7325-8623
ian.e.mitchell@jpmorgan.com

E.ON chose to walk away rather than surrender all synergies to SPW shareholders

E.ON appears unwilling to surrender all synergies to SPW shareholders

Our previous analysis (see our report "*E.ON and RWE: CEO Tour report - Upgrading E.ON price target to □91 and RWE to □61*, October 19th) concluded that E.ON could conceivably bid a maximum of 625p for ScottishPower without breaching its acquisition criteria and, at a stretch, not be accused of overpaying. However, we noted that this valuation was at aggressive multiples, especially on a sum of the parts basis, and gave up not only all expected synergies but also some balance sheet re-gearing benefits to ScottishPower shareholders.

Our take out multiple valuation of SPW published in this report was 591p (see below), assuming therefore that E.ON's valuation matched our own this would mean it was unwilling to surrender 21p of the 82p of synergies we estimated were possible from a deal.

Table 1: Scottish Power – SOP valuation on acquisition multiples (including £140m of synergies, value return via buyback) reaches 591p

Take out valuation	£m	Per share (p)	Explanation
Distribution - Scotland RAB	1,503	109	15% premium
Distribution Manweb RAB	1,043	76	15% premium
Transmission	690	50	15% premium
Supply	1,770	129	£300/customer, 5 9m customers by end March 2007
Generation	3,077	224	DCF, new entrant gas, £300/kW coal
PPM	1,279	93	10x EV/EBITDA
Enterprise Value	**9,363**	**680**	
Net debt	(2,362)	(172)	March 2007e
Synergies	1,134	82	NPV of £140m of pre tax synergies
Equity Value (p)	**8,135**	**591**	

Source: JPMorgan estimates

E.ON cannot alter its bid for 6m unless certain conditions occur

Will E.ON raise its bid?

Under the City Code E.ON is now unable to announce a revised offer or possible offer for SPW for the next 6 months unless

- The board of ScottishPower agrees
- A third party announces an offer or possible offer
- SPW announces a material acquisition or disposal excluding the $4.5bn value return from the PacifiCorp sale
- SPW or a third party announces a whitewash proposal or reverse takeover in respect of SPW
- If any principal UK generation, distribution or supply companies announce a transaction or possible transaction

We believe E.ON will wait until the completion of the PacifiCorp sale is imminent before considering raising its offer

These appear to leave the door open for a potential increased offer should anything material happen to change the UK utility sector. Interestingly, even another bid for Drax by International Power would allow E.ON to revise the terms of its offer for ScottishPower. However, we do not expect a revised bid in the near term. In our view E.ON is more likely to wait until the completion of the PacifiCorp sale is imminent (expected May-Nov 2006) and then consider whether to revise its terms based on the SPW share price performance in the meantime.

Back to the question of reinvestment – but E.ON's prudence has been demonstrated

Fiscal prudence demonstrated – reinvestment risk should reduce, in our view

We have consistently argued that E.ON's share price performance has been held back by its strong balance sheet and perceived reinvestment risk. One of the reasons we favoured a bid for SPW was that such an acquisition, even at a full price, would at least remove the "worst case scenario" factored into the E.ON share price. However, although the same questions on cash redeployment may now return we believe E.ON's decision to walk away from SPW and maintain discipline should reassure investors, and perceptions of reinvestment risk should recede

Value return more likely, but expect no announcement before March 2006

No change to value return stance, but this could change by March 06

E.ON is currently committed to raising its dividend payout to 50-60%. We estimate E.ON's dividend yield at 3.5% in 2005, 4.2% in 2006 and 5.1% in 2007, by which time it will be on an 18% premium to the sector average. In addition E.ON has committed to pay 100% of the proceeds from the sale of its Degussa stake (expected in 2006) back to shareholders, adding another 6% special yield. This makes E.ON an attractive income play in its own right. However, assuming it does not raise its offer for SPW we would expect strong pressure on management for a regearing of the balance sheet (currently €3bn net cash) through a value return. Such an announcement is unlikely before the FY 2005 results in March 2006 but could provide further upside.

Valuation

We value E.ON on a sum of the parts basis with a 12m price target of €91. We believe it remains cheap and attractive and reiterate our Overweight recommendation

Table 2: E.ON – new sum of the parts suggests price target of €91/share

	Method	WACC	EV (€m)	EV per share	% of Total EV	EV per 2006 EBITDA
Central Europe	DCF	6.7%	39,223	**59.5**	43.7	6.7
Pan European Gas	DCF	6.7%	13,298	**20.2**	14.8	6.4
UK	DCF	6.7%	10,491	**15.9**	11.7	6.1
Nordic	DCF	6.7%	8,352	**12.7**	9.3	6.7
US Midwest	DCF	6.7%	3,717	**5.6**	4.1	6.4
Other/consolidation	DCF	6.7%	(1,222)	**(1.9)**	(1.4)	6.9
Total core businesses			**73,860**	**112.1**	**82.3**	**6.5**
Degussa	market value	42.9%	2,999	4.6	3.3	
Gazprom	market value	6.4%	6,511	9.9		
Other financial holdings	book value		6,331	9.6	7.1	
Total fin and industrial holdings			**15,841**	**24.0**	17.7	
Total Enterprise Value			**89,700**	**136.1**	100.0	7.8
Net debt (cash)	JPMe 2005e		(1,996)	(3.0)		
Minority interests	JPMe 2005e		5,247	8.0		
Pension liabilities	JPMe 2005e	100.0%	8,778	13.3		
Nuclear liabilities	JPMe 2005e	100.0%	13,778	20.9		
Environmental & person provisions	JPMe 2005e	100.0%	3,722	5.6		
Total adjustments to EV			**29,528**	**44.8**		
Total fair value (equity value)			**60,172**	**91.3**		

Source: JPMorgan estimates

Risks to our price target and recommendation

Despite proving its fiscal prudence with a low bid for SPW, E.ON still has substantial capital to deploy and its investments will likely remain a key driver of stock performance. The other main risk is regulation, where a lack of clarity from 2007 could give downside risk to earnings, though we believe our forecasts are currently conservative.

Financial forecasts

Table 3: E.ON segmental EBIT forecasts

	2004	2005E	2006E	2007E	2008E	2009E	2010E	CAGR 04-09E
Central Europe	3,602	4,055	4,542	4,854	5,180	5,211	5,203	7.7%
Pan European Gas	1,428	1,424	1,586	1,690	1,718	1,749	1,781	4.1%
UK	1,017	1,071	1,141	1,205	1,235	1,266	1,298	4.5%
Nordic	701	710	790	837	887	934	984	5.9%
US Midwest	349	359	382	387	402	407	413	3.1%
Other/consolidation	(314)	(280)	(217)	(195)	(189)	(183)	(177)	-10.2%
Core business	**6,783**	**7,339**	**8,226**	**8,778**	**9,233**	**9,384**	**9,501**	**6.7%**
Viterra	471							
Degussa	107	87	109	110	111	112	114	1.0%
Non core business	**578**	**87**	**109**	**110**	**111**	**112**	**114**	**-27.9%**
Total EBIT	**7,361**	**7,426**	**8,335**	**8,888**	**9,344**	**9,496**	**9,615**	**5.2%**

Source: Company data, JPMorgan estimates

Table 4: E.ON P&L forecasts

	2004	2005E	2006E	2007E	2008E	2009E	2010E	CAGR (%) 2004-09E
Total external revenues	**49,103**	**50,342**	**52,504**	**54,960**	**57,127**	**58,258**	**59,411**	**3.5**
% growth	*5.8*	*2.5*	*4.3*	*4.7*	*3.9*	*2.0*	*2.0*	
Total operating costs	**(34,686)**	**(35,825)**	**(36,842)**	**(38,465)**	**(39,929)**	**(40,775)**	**(41,661)**	**3.3**
% growth	*3.9*	*3.3*	*2.8*	*4.4*	*3.8*	*2.1*	*2.2*	
EBITDA - adjusted (excluding equity investments)	**9,823**	**9,808**	**10,760**	**11,367**	**11,875**	**12,082**	**12,269**	**4.2**
EBITDA margin (%)	*20.0*	*19.5*	*20.5*	*20.7*	*20.8*	*20.7*	*20.7*	
EBITDA - reported (inc equity investments)	**10,520**	**10,505**	**11,457**	**12,064**	**12,572**	**12,779**	**12,966**	**4.0**
EBITDA margin (%)	*21.4*	*20.9*	*21.8*	*22.0*	*22.0*	*21.9*	*21.8*	
Depreciation, accruals, writedowns	(3,159)	(3,079)	(3,123)	(3,176)	(3,228)	(3,283)	(3,352)	**0.8**
of which amortisation of goodwill	0	0	0	0	0	0	0	
EBIT -adjusted (excluding equity investments)	**6,664**	**6,729**	**7,638**	**8,191**	**8,647**	**8,799**	**8,918**	**5.7**
EBIT margin (%)	*13.6*	*13.4*	*14.5*	*14.9*	*15.1*	*15.1*	*15.0*	
EBIT - reported (inc equity investments)	**7,361**	**7,426**	**8,335**	**8,888**	**9,344**	**9,496**	**9,615**	**5.2**
EBIT margin (%)	*15.0*	*14.8*	*15.9*	*16.2*	*16.4*	*16.3*	*16.2*	
Internal operating profit	**6,221**	**6,630**	**7,552**	**8,127**	**8,605**	**8,768**	**8,898**	**7.1**
Operating margin (%)	*12.7*	*13.2*	*14.4*	*14.8*	*15.1*	*15.1*	*15.0*	
Net extraordinary gains (losses)	**578**	**829**	**0**	**0**	**0**	**0**	**0**	
Pre-tax profit - pre exceptionals	**6,221**	**6,630**	**7,552**	**8,127**	**8,605**	**8,768**	**8,898**	**7.1**
Pre-tax profit - reported (post exceptionals)	6,799	7,459	7,552	8,127	8,605	8,768	8,898	5.2
Total income taxes	(1,947)	(2,489)	(2,509)	(2,687)	(2,832)	(2,873)	(2,903)	
Minority interests	(504)	(517)	(536)	(554)	(573)	(591)	(609)	
Income/loss from cont ops - reported (post excep)	**4,348**	**4,452**	**4,507**	**4,886**	**5,200**	**5,304**	**5,386**	**4.1**
Net reported income	**4,339**	**7,452**	**4,507**	**4,886**	**5,200**	**5,304**	**5,386**	**4.1**
EBITDA - reported (inc equity investments)	**10,520**	**10,505**	**11,457**	**12,064**	**12,572**	**12,779**	**12,966**	**4.0**
% growth	*11.2*	*(0.1)*	*9.1*	*5.3*	*4.2*	*1.6*	*1.5*	
EBIT - reported (inc equity investments)	**7,361**	**7,426**	**8,335**	**8,888**	**9,344**	**9,496**	**9,615**	**5.2**
% growth	*18.2*	*0.9*	*12.2*	*6.6*	*5.1*	*1.6*	*1.2*	
Avg. number of shares (million)	657	659	659	659	659	659	659	
Adjusted earnings	3,790	3,918	4,527	4,906	5,220	5,324	5,406	**7.0**
Effective tax rate (%)	*28.6*	*33.4*	*33.2*	*33.1*	*32.9*	*32.8*	*32.6*	
Reported EPS (from continuing ops)	6.62	6.76	6.84	7.41	7.89	8.05	8.17	4.0
Reported EPS (from net income)	6.61	11.31	6.84	7.41	7.89	8.05	8.17	4.0
Ordinary EPS - pre goodwill	**5.77**	**5.95**	**6.87**	**7.44**	**7.92**	**8.08**	**8.20**	**7.0**
Gross dividend per share (€)	2.35	2.82	3.38	4.06	4.22	4.39	4.57	13.3

Source: Company data, JPMorgan estimates

Table 5: E.ON balance sheet forecasts

	2004	2005E	2006E	2007E	2008E	2009E	2010E	CAGR (%) 2004-09E
Assets								
Intangible assets	3,788	3,788	3,788	3,788	3,788	3,788	3,788	
Tangible assets	43,563	40,068	41,928	43,789	45,647	48,060	50,436	
Financial assets	17,263	17,263	17,263	17,263	17,263	17,263	17,263	
Goodwill	14,454	14,454	14,454	14,454	14,454	14,454	14,454	
Total fixed assets	**79,068**	**75,573**	**77,433**	**79,294**	**81,152**	**83,565**	**85,941**	**1.1**
Non current deferred tax assets	1,359	1,517	1,581	1,654	1,719	1,753	1,788	
Inventories	2,647	2,678	2,792	2,920	3,034	3,095	3,157	
Receivables	16,170	15,514	16,151	16,871	17,508	17,848	18,195	
Total cash and equivalents	14,818	22,425	25,171	26,562	27,846	28,601	29,401	
Total current assets	**33,635**	**40,617**	**44,113**	**46,354**	**48,388**	**49,544**	**50,753**	
Total assets	**114,062**	**117,706**	**123,128**	**127,301**	**131,259**	**134,862**	**138,482**	**3.4**
Liabilities								
Capital Stock	1,799	1,799	1,799	1,799	1,799	1,799	1,799	
Additional paid in capital	11,746	11,746	11,746	11,746	11,746	11,746	11,746	
Accumulated other comprehensive income	268	268	268	268	268	268	268	
Retained earnings	20,003	22,803	25,397	27,674	29,883	32,301	34,710	
Treasury Stock	(256)	(256)	(256)	(256)	(256)	(256)	(256)	
Minority interests	4,144	5,247	5,247	5,247	5,247	5,247	5,247	
Total shareholder equity	**37,704**	**41,607**	**44,201**	**46,478**	**48,687**	**51,105**	**53,514**	**6.3**
Pension provisions	8,589	8,778	8,971	9,168	9,370	9,576	9,787	
Nuclear provisions	13,481	13,778	14,081	14,390	14,707	15,031	15,361	
Other provisions	12,172	12,172	12,172	12,172	12,172	12,172	12,172	
Total provisions	34,242	34,728	35,224	35,731	36,249	36,779	37,320	
Non current deferred tax liabilities	6,687	6,973	7,269	7,605	7,901	8,060	8,221	
Total debt	**20,301**	**20,429**	**20,721**	**21,053**	**21,346**	**21,503**	**21,662**	**1.2**
Payables	3,627	3,760	3,920	4,101	4,261	4,346	4,434	
Other operating liabilities	11,501	11,314	11,792	12,334	12,814	13,070	13,330	
Total liabilities	**114,062**	**118,809**	**123,128**	**127,301**	**131,259**	**134,862**	**138,482**	**3.4**

Source: Company data, JPMorgan estimates

Table 6: E.ON cash flow statement forecasts

	2004	2005E	2006E	2007E	2008E	2009E	2010E	2004-09E
Group Cash Flow Statement								
Net Reported Income pre minorities	4,843	7,970	5,043	5,440	5,773	5,895	5,995	**4.0**
Increase/(decrease) in provisions	(482)	916	760	806	783	671	685	
Deprec., amortiz., accruals, writedowns	3,256	3,079	3,123	3,176	3,228	3,283	3,352	
Cash flow	**7,617**	**11,964**	**8,926**	**9,422**	**9,784**	**9,849**	**10,032**	**5.3**
(Increase)/decrease in net working capital	(767)	856	185	209	185	99	101	
(Investment) in fixed assets	(2,712)	(4,183)	(4,183)	(4,183)	(4,239)	(4,890)	(4,961)	
Disposals / (acquisitions) of fixed assets	3,457	0	0	0	0	0	0	
Net investment in financial fixed assets	(2,573)	4,600	(800)	(15,853)	(847)	(806)	(767)	
Surplus from operations	**5,022**	**13,237**	**4,127**	**(10,405)**	**4,883**	**4,252**	**4,405**	**(3.3)**
Dividends paid	(1,598)	(2,028)	(2,337)	(2,709)	(3,155)	(3,262)	(3,373)	**15.3**
Free cash flow after dividends	**3,424**	**11,210**	**1,790**	**(13,114)**	**1,728**	**990**	**1,031**	**(22.0)**

Source: Company data, JPMorgan estimates

Companies Recommended in This Report (as of COB 21 November 2005)
E.ON (EONG.DE/€78.50/Overweight), E.ON (EON/$31.54/Overweight), ScottishPower (SPW.L/569p/Neutral), ScottishPower (SPI/$37.09/Neutral)

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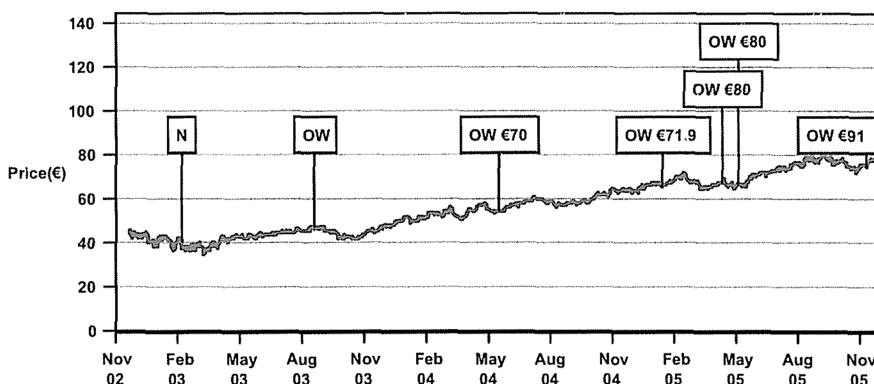
E.ON (EONG.DE) Price Chart



Date	Rating	Share Price (€)	Price Target (€)
06-Feb-03	N	40.65	-
19-Aug-03	OW	47.72	-

Source: Reuters and JPMorgan; price data adjusted for stock splits and dividends.
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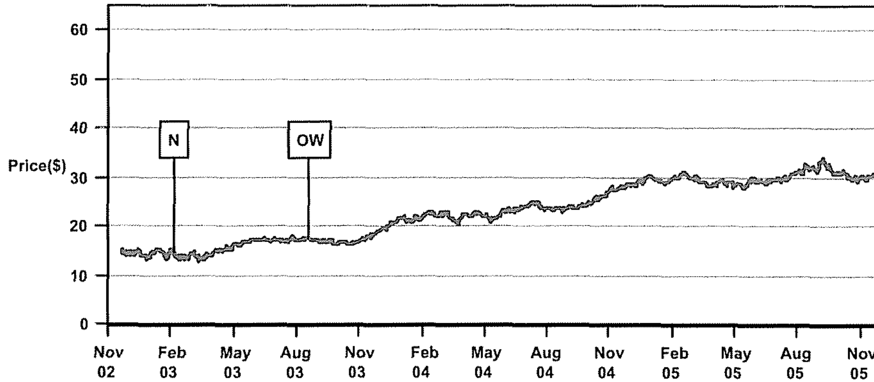
JPMorgan ratings: OW = Overweight, N = Neutral, UW = Underweight.

E.ON (EON) Price Chart



Date	Rating	Share Price ($)	Price Target ($)
06-Feb-03	N	14.55	-
19-Aug-03	OW	17.70	-

Source: Reuters and JPMorgan; price data adjusted for stock splits and dividends.
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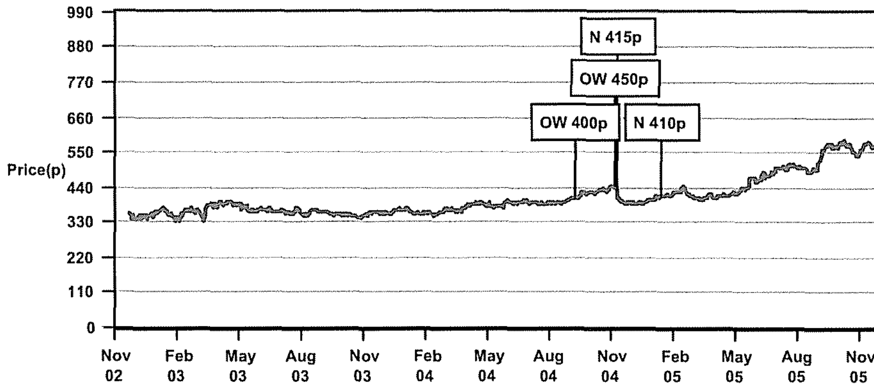
ScottishPower (SPW.L) Price Chart



Date	Rating	Share Price (p)	Price Target (p)
07-Sep-04	OW	408	400
10-Nov-04	N	431	415

Source: Reuters and JPMorgan; price data adjusted for stock splits and dividends.
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JPMorgan ratings: OW = Overweight, N = Neutral, UW = Underweight.

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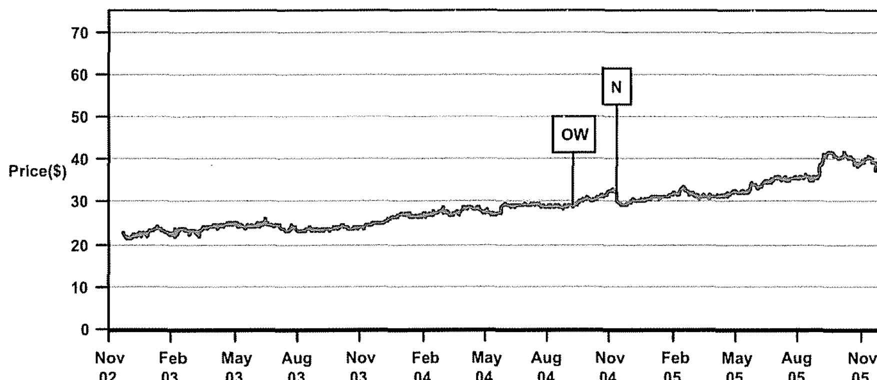
ScottishPower (SPI) Price Chart



Date	Rating	Share Price ($)	Price Target ($)
06-Sep-04	OW	29.07	-
10-Nov-04	N	32.16	-

Source: Reuters and JPMorgan; price data adjusted for stock splits and dividends.
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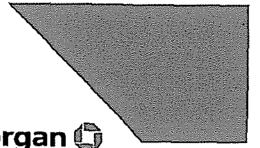

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See page 7 for Analyst Certification and Important Disclosures

7 January 2005

BUY (1)
Medium Risk (M)

E.ON (EONG.DE)

Target price raised to €75 per share

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Year to Dec	Sales (€m)	EBITDA (€m)	EPS (€)	EPS (Old) (€)	P/E	P/E Relative	FV/ EBITDA	Net DPS (€)	Div Yield (%)
2002A	36,624	7,558	3.05	3.05	22.0	1.2	8.7	1.75	2.6
2003A	46,364	9,458	4.34	4.34	15.5	0.9	6.9	2.00	3.0
2004E	47,854	10,486	5.45	5.43	12.3	0.8	6.3	2.50	3.7
2005E	47,726	11,393	6.09	6.04	11.0	1.1	5.8	3.13	4.7
2006E	46,274	11,523	5.99	6.25	11.2	1.2	5.7	3.91	5.8

52W Price Range: €67.19 to 49.27

				Price Performance (%)	Ytd	-1m	-3m	-12m
Expected Share Price Return	11.8%	Shares Outstanding	692.0m	Absolute	-0.10	5.30	10.50	33.30
Expected Dividend Yield	3.7%	Market Cap.	€46,433.2m	Relative to Local	-1.14	2.68	4.05	25.07
Expected Total Return	15.5%	ROE (Curr Yr)	12.0%	Relative to DJ STOXX	-0.94	3.35	6.32	19.63

Sources: Company reports and Smith Barney estimates

Price: €67.10	Target: €75.00	Rating: Unchanged	EPS: Changed

Europe

Summary

- **E.ON still looks cheap on most multiples and our SoP valuation is now €75 per share**
- **We look for optimism on dividends and financial targets to support the shares in the coming 2-3 months**
- **But matching (or beating) expectations on 10 March without provoking a political backlash is a key challenge for E.ON**
- **Newsflow on disposals should also be helpful in 2005**
- **We are keeping our Buy/Medium Risk rating, and we are raising our target price from €70 to €75 per share**

Opinion

Investment Thesis

E.ON has been a strong performer over the last few months and we are happy to keep E.ON as one of our top-five stocks for the opening stages of 2005 as set out in an accompanying sector report published today[1]. The stock remains attractive on most valuation multiples and on a sum-of-parts basis and we are raising our target price today by €5 to €75 per share. We also believe the newsflow should be supportive over the coming months on the back of

[1] See *Utilities 2005 Substantial value in selected stocks* 7 January 2005

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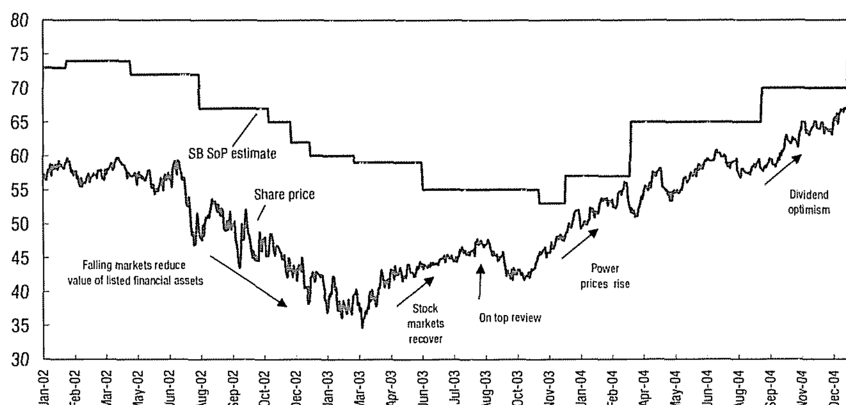
potential disposals and as a result of potential upward revisions to dividend policy and to E.ON's medium-term financial targets.

Figure 1. E.ON share price and sum-of-parts estimate (€)



Source: Reuters and Smith Barney analysis

We believe our forecasts are conservative with regard to the impact of German wholesale power prices, while as discussed in the sector report[1], we think the threat from regulation in Germany is manageable and is more than taken into account in our financial forecasts.

The critical event for the company over the next few months, however, is likely to be the FY04 results announcement on 10 March. The key issues where there is scope for excitement concern:

- dividend policy; and
- medium-term financial targets.

Dividend policy

E.ON has repeatedly indicated that its dividend policy is under review, with CEO Wulf Bernotat stressing that *at least* 10% annual dividend growth should be expected to 2006. Our own forecasts call for 25% annual growth on the basis of a target payout ratio of 65% in FY06. Were E.ON to commit to such a policy on 10 March, we are confident that the shares would show immediate further upside from current levels. However, anything less than 20% dividend growth for FY04 with no upward revision to future dividend plans is likely to prove disappointing.

Financial targets

Figure 2 compares E.ON's current financial targets with our own forecasts for the group. These targets were set in August 2003 as a result of the "on.top" review initiated by Bernotat as incoming CEO. At the time, we thought the targets were pretty undemanding and we continue to expect E.ON to be able to beat them handsomely.

Figure 2. Medium-term financial targets

	ROCE	Cumulative cash flow FY03-FY06	Dividend per share
On.top target	>10.5% in FY06E	€21bn of operating cash flow €9.5bn of free cash flow	>10% annual growth FY03-FY06E
Smith Barney estimate	12.6% in FY06E	€25bn of operating cash flow €11.6bn of free cash flow	25% annual growth FY04E to FY06E following 14% growth for the FY03A dividend

Source: E.ON and Smith Barney

For now, we think there is scope for more optimism on both dividend policy and the financial targets to continue to support the shares. However, it has to be acknowledged that E.ON's supervisory board in the past has tended to be

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wary of being too bold about such matters. We think it has tended to err on the cautious side given perceived dangers of a regulatory or political backlash within Germany. Bernotat's ability to match (or even beat) market expectations, whilst not stirring up a hornet's nest in the German market, will be a key test of his mettle as chief executive, in our view.

Disposals

Aside from the FY04 results announcement, we expect a series of disposals during 2005 which could potentially drive the shares higher.

Figure 3. Remaining disposals

Item	Anticipated value	Comment
100% of Viterra (real estate)	€5.5bn enterprise value, €1 8bn equity value	Includes €2 7bn of net debt (at 31/12/03) and €1bn of provision and minority interests Value based on a 10% discount to the audited market value of the housing assets at 31/12/03 published by Viterra
42 86% of Degussa	€2.4bn at the current Degussa share price	
50.10% of Connect Austria	€0 4bn	Smith Barney telecom team estimate based on value of Connect Austria in France Telecom's accounts
100% of Ruhrgas Industries	€0.7bn	Industry multiples
Total proceeds	€5.3bn plus €2.8bn of net debt deconsolidated	

Source: Smith Barney

Most excitement concerns the real estate business Viterra, which should be a reasonably straightforward disposal in current market conditions. Hopes have been raised that E.ON will use the proceeds of these disposals to pay a special dividend to shareholders. This is something we have tended to be sceptical about, given the track record of E.ON and the tendency of the supervisory board to be conservative in such matters.

Investment and acquisitions

But the E.ON story it is not all about higher returns to shareholders. E.ON is a company which continues to invest in acquisitions and in new projects. In fact, the E.ON share price has been surprisingly resilient to announcements of new investments over the last few months.

- On 4 November, E.ON announced it had agreed to buy gas assets from Mol in Hungary representing a total commitment of €2.1bn. This appeared to us a very full price for these assets, based on the limited financial information that has so far been made available.
- On 17 December, E.ON set out its investment plans for FY05-FY07, which indicated a total spend of €18.7bn, of which €6.1bn was to be spent on financial assets and €12.6bn on fixed assets. This compares with our expectations of a budget in the region of €13bn. In part, the discrepancy arose because E.ON had explicitly factored in €2bn to be spent on upstream gas assets, which is in line with our expectations but not something we had built into our estimates. But there is still a further €4bn of additional investments over and above our expectations.

Figure 4. Additional fixed asset investments contemplated by E.ON

Project	Cost	
Two power stations in Italy	€800m	Likely to be value enhancing at current power prices
Renewable energy projects in the UK	€800m	Needed to satisfy renewable obligations and reflected in power prices paid by end customers
Other power generation projects	€800m	€300m on unspecified renewables, €500m of unspecified other plant (includes part of cost of conversion of Isle of Grain in UK)
Additional gas storage and transportation infrastructure	€600m on pipes, €400m on storage	Includes gas pipes to the UK market and elsewhere
Electricity transmission and distribution	€600m	Returns will depend on regulatory regime
Other	€200m	

Source: E.ON and Smith Barney

Most of these additional investments appear broadly reasonable in our view and are fully taken into account in our revised valuation and financial forecasts. However, the initial share price reaction was unsurprisingly negative, with the shares falling some 2% on 17 December, although this was quickly recovered in subsequent days.

Valuation

Our latest sum of parts valuation is set out in Figure 5. This has risen by €5 since our last published valuation, partly as a result of rolling forward the valuation date by one year to 31 December 2005 which accounts for €2.2 per share of upside.
We have also revised upwards our valuation of the gas distribution assets within the Central Europe (West) division. Our previous valuation was looking exceptionally conservative at an implied FY05E EV/EBITDA multiple of around 3.5x, and we have lifted this to a more conventional 7.0x leading to a further €2.4 of extra value.

The other main changes we have made are to factor in the financial assets at their (marked-to-market) balance sheet value at 30 September 2004 (providing an extra €2.1 per share of value) and to build in the new investments announced in at the end of 2004,including the Hungarian gas acquisition with an estimated negative hit on value of €0.7 per E.ON share.

Figure 5. E.ON Sum of Parts

	Value (€m)	Value per share (€m)	Method	FY05E EBITDA (€m)	Reality check
Central Europe	32,172	46	Chiefly based on DCF of component parts	5,166	6 2x FV/EBITDA multiple in 2005E
Pan-European gas	9,454	14	DCF/RAB benchmarking	1,612	5 9x FV/EBITDA multiple in 2005E
UK	10,631	15	£0 3m per MW, £160 per customer and RABs	1,607	6 6x FV/EBITDA multiple in 2005E
Nordic	8,848	13	Assumed EBITDA multiple	1,180	7 5x FV/EBITDA multiple in 2005E
US-Midwest	4,118	6	Assumed EBITDA multiple	549	7 5x FV/EBITDA multiple in 2005E
Corporate centre	-1,624	-2	Assumed EBITDA multiple	-232	7 0x FV/EBITDA multiple in 2005E
Total core businesses (ex associates)	63,599	92		9,882	6.4x FV/EBITDA multiple in 2005E
Non-core (Viterra)	5,536	8	Estimated value of real estate portfolio	622	8 9x FV/EBITDA multiple in 2005E
Financial assets	17,475	25	Actual book value at 30/9/04	889	
Total	86,610	125		11,393	7 6x FV/EBITDA multiple in 2005E
Net cash	-7,003	-10	Forecast book value at 31/12/05		
Pension liabilities	-7,731	-11	Forecast book value at 31/12/05		
Nuclear liabilities	-8,295	-12	Based on Smith Barney model - current book value is €12 3bn		
Other liabilities	-6,646	-10	Based on Smith Barney model - current book value is €13 0bn		
Minorities	-4,725	-7	Forecast book value at 31/12/05		
Net equity value	52,210	75			

Source: Smith Barney

The main valuation ratios are set out in Figure 6. The FY05 and FY06 multiples for suggest that at the sector average a share price in the range of €67-77 can be supported on our forecasts.

Figure 6. German Utility Valuation Ratios

	FY04E	FY05E	FY06E
PE (pre-exceptional, pre-goodwill)			
E ON	12 3	11 0	11 2
RWE	14 4	10 0	8 6
Sector average	13 5	12 0	11 3
E ON share price at sector average	73	**73**	**67**
RWE share price at sector average	40	52	56
EV/EBITDA (adjusted)			
E ON	7 7	7 2	7 1
RWE	7 0	6 7	6 1
Sector average	7 9	7 2	6 8
E ON share price at sector average	71	**68**	**63**
RWE share price at sector average	57	51	55

EV/EBITDA (adjusted, pre associates)			
E.ON	6.6	6.1	6.0
RWE	6.6	6.3	5.7
Sector average	6.9	6.7	6.3
E.ON share price at sector average	71	**75**	**71**
RWE share price at sector average	48	48	53
Dividend yield			
E.ON	3.7%	4.7%	5.8%
RWE	3.3%	3.8%	4.4%
Sector average	5.2%	4.6%	5.1%
E.ON share price at sector average	48	67	77
RWE share price at sector average	27	36	37

Source: Smith Barney estimates

Risks

We rate E.ON Medium Risk. The risk rating on the stock is derived after consideration of a number of factors. These factors include an assessment of industry-specific risks, financial risk and management risk. In addition, we consider historical share price volatility, based upon the input of the Smith Barney quantitative research team, as a possible indicator of future stock-specific risk. Risks elsewhere include regulatory risks in both the gas and the electricity markets in Germany as well as the risk that E.ON may pay too much for future acquisitions. In addition, the group's financials are complex and transparency is not all it could be. For example, provision movements complicate the reconciliation of profit and loss account to cash flow, and the divisional profit breakdown provided is at a higher level than we would like. With regard to the investment thesis and achievement of our target price, these could be undermined by renewed competition in German generation, or by regulatory change proving more severe than we currently anticipate. In addition, E.ON may make acquisitions and has a track record of paying prices above our view of fair value. Finally, if competition does erupt in the German gas market, then Ruhrgas would probably need to renegotiate its long-term gas purchasing and this might not prove to be a smooth process.

Financial forecasts

Our latest financial forecasts are set out below. We assume a US$/€ rate of 1.35 for 2005 against 1.25 previously and we have also revised our forecast to take into account the first stage of the Hungarian gas acquisition and the revised investment plan for fixed assets as announced in December.

The net impact on earnings is a 1% upgrade to our FY05E earnings estimate, but a 4% downgrade to that for FY06E.

Figure 7. Divisional Breakdown (€m)

Adjusted EBIT	2003A	2004E	2005E	2006E	2007E	2008E
Central Europe	2,979	3,447	3,993	4,171	4,154	4,125
Pan-European Gas	1,463	1,530	1,777	1,668	1,598	1,491
UK	610	1,003	1,074	1,045	1,077	1,109
Nordic	546	770	772	831	894	961
US-Midwest	317	350	371	350	357	364
Corporate centre/consolidation	-319	-294	-269	-244	-244	-244
Core businesses	5,596	6,805	7,718	7,821	7,836	7,806
Viterra	456	419	428	436	445	454
Degussa	176	105	105	105	105	105
Total continuing operations	6,228	7,329	8,250	8,362	8,386	8,365

Source: Company reports and Smith Barney estimates

Figure 8. Key financial figures

	2003 A	2004 F	2005 F	2006 F	2007 F	2008 F
EPS from ongoing operations (€)	5.37	7.21	5.89	5.79	5.70	5.61
EPS from discontinued operations (€)	1.74	0.00	0.00	0.00	0.00	0.00
Total reported group EPS (€)	7.11	7.21	5.89	5.79	5.70	5.61
Adjusted EPS (€)	4.34	5.45	6.09	5.99	5.89	5.80
DPS (€)	2.00	2.50	3.13	3.91	4.02	4.14
Cashflow/share (€)	9.6	10.1	10.3	10.5	10.6	10.6
Free cash flow (€m)	2,878	3,740	2,432	2,569	2,627	2,685

Net cash (debt) (E ON definition) (€m)	-7,855	-6,085	-7,003	-6,944	-7,364	-7,825
Gearing	26%	18%	20%	20%	20%	21%
Payout ratio based on clean earnings	46%	46%	51%	67%	71%	74%
EBITDA/net interest expense	8.5	11.7	11.5	11.5	11.0	10.6

Source: Company reports and Smith Barney estimates

Figure 9. Group financial forec asts (€m)

Profit and Loss	**2003 A**	**2004 F**	**2005 F**	**2006 F**	**2007 F**	**2008 F**
Sales	46,364	47,854	47,726	46,274	46,144	46,277
Operating costs	37,814	38,241	37,223	35,654	35,458	35,574
EBITDA before associates	8,550	9,612	10,504	10,619	10,686	10,702
EBITDA including associates	9,458	10,486	11,393	11,523	11,605	11,638
Depreciation	-3,230	-3,097	-3,117	-3,284	-3,362	-3,436
Restructuring costs and non-operating earnings	-479	-50	-200	-200	-200	-200
Operating profit	4,223	6,147	6,587	6,525	6,502	6,432
Associates & income from investments	908	874	889	904	920	936
EBIT	6,228	7,389	8,275	8,240	8,244	8,203
Interest income of long-term provisions	-486	-516	-521	-541	-561	-582
Other net interest income	-1,107	-899	-989	-1,005	-1,050	-1,099
Financial exceptionals including profits on disposals	1,514	1,132	0	0	0	0
Pre-tax profit	5,538	7,254	6,487	6,424	6,371	6,269
"Internal operating profit"*	6,228	7,329	8,250	8,362	8,386	8,365
Tax	-1,124	-2,039	-2,111	-2,090	-2,071	-1,999
Minorities	-464	-487	-512	-537	-564	-592
Discontinued items/other	697	0	0	0	0	0
Net attributable profit	4,647	4,728	3,864	3,797	3,736	3,678
Adjusted net attributable profit	2,837	3,573	3,994	3,927	3,866	3,808

*Pre-tax profit before restructuring costs, non-operating earnings and financial exceptionals

Cash flow	**2003 A**	**2004 F**	**2005 F**	**2006 F**	**2007 F**	**2008 F**
Gross cash flow	5,538	6,540	6,632	6,769	6,827	6,885
Capex	-2,660	-2,800	-4,200	-4,200	-4,200	-4,200
Acquisitions	-6,536	-2,129	-1,271	0	0	0
Disposal proceeds	7,463	2,636	0	0	0	0
Dividends	-1,621	-1,791	-2,078	-2,510	-3,046	-3,147
Issue/(redemption) of group equity	-7	0	0	0	0	0
Other/change in scope of consolidation	2,966	0	0	0	0	0
Change in net debt	5,143	1,956	-918	59	-419	-462

Balance Sheet	**2003 A**	**2004 F**	**2005 F**	**2006 F**	**2007 F**	**2008 F**
Intangible assets	4,114	3,778	3,469	3,186	2,925	2,686
Property plant and equipment	42,836	45,004	47,667	48,866	49,965	51,469
Financial assets	17,725	16,826	17,270	17,722	18,182	18,650
Stocks	2,477	2,514	2,552	2,590	2,629	2,668
Receivables	18,025	18,146	18,270	18,395	18,524	18,655
Cash and equivalents	10,795	5,000	5,000	5,000	5,000	5,000
Other assets	1,923	1,923	1,923	1,923	1,923	1,923
Total assets	97,895	93,191	96,150	97,683	99,149	101,052
Debt	-19,631	-11,880	-12,798	-12,739	-13,159	-13,620
Provisions	-34,206	-34,485	-35,152	-35,841	-36,553	-37,289
Trade creditors	-3,778	-3,854	-3,931	-4,009	-4,089	-4,171
Other liabilities	-13,571	-13,358	-13,290	-13,326	-12,927	-12,532
Minorities	-4,625	-4,674	-4,725	-4,779	-4,835	-4,894
Shareholders Funds	29,774	32,630	33,945	34,679	35,276	36,235

Source: Company reports and Smith Barney estimates

ANALYST CERTIFICATION

Appendix A-1

I, Daniel Martin, hereby certify that all of the views expressed in this research report accurately reflect my personal views about any and all of the subject issuer(s) or securities. I also certify that no part of my compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report.

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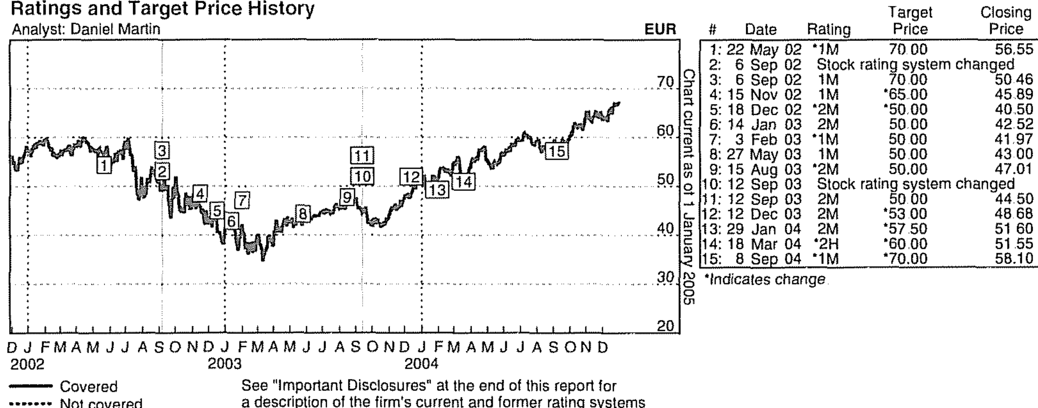
E.ON (EONG.DE)



#	Date	Rating	Target Price	Closing Price
1:	22 May 02	*1M	70.00	56.55
2:	6 Sep 02	Stock rating system changed		
3:	6 Sep 02	1M	70.00	50.46
4:	15 Nov 02	1M	*65.00	45.89
5:	18 Dec 02	*2M	*50.00	40.50
6:	14 Jan 03	2M	50.00	42.52
7:	3 Feb 03	*1M	50.00	41.97
8:	27 May 03	1M	50.00	43.00
9:	15 Aug 03	*2M	50.00	47.01
10:	12 Sep 03	Stock rating system changed		
11:	12 Sep 03	2M	50.00	44.50
12:	12 Dec 03	2M	*53.00	48.68
13:	29 Jan 04	2M	*57.50	51.60
14:	18 Mar 04	*2H	*60.00	51.55
15:	8 Sep 04	*1M	*70.00	58.10

*Indicates change.

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Data current as of 31 December 2004	Buy	Hold	Sell
Smith Barney Global Fundamental Equity Research Coverage (2598)	39%	42%	18%
% of companies in each rating category that are investment banking clients	56%	55%	44%
Utilities -- Europe (30)	37%	53%	10%
% of companies in each rating category that are investment banking clients	82%	75%	67%

Guide to Fundamental Research Investment Ratings:

Smith Barney's stock recommendations include a risk rating and an investment rating.

Risk ratings, which take into account both price volatility and fundamental criteria, are: Low [L], Medium [M], High [H], and Speculative [S].

Investment ratings are a function of Smith Barney's expectation of total return (forecast price appreciation and dividend yield within the next 12 months) and risk rating.

For securities in developed markets (US, UK, Europe, Japan, and Australia/New Zealand), investment ratings are: Buy [1] (expected total return of 10% or more for Low-Risk stocks, 15% or more for Medium-Risk stocks, 20% or more for High-Risk stocks, and 35% or more for Speculative stocks); Hold [2] (0%-10% for Low-Risk stocks, 0%-15% for Medium-Risk stocks, 0%-20% for High-Risk stocks, and 0%-35% for Speculative stocks); and Sell [3] (negative total return).

Investment ratings are determined by the ranges described above at the time of initiation of coverage, a change in risk rating, or a change in target price. At other times, the expected total returns may fall outside of these ranges because of price movement and/or volatility. Such interim deviations from specified ranges will be permitted but will become subject to review by Research Management.

Your decision to buy or sell a security should be based upon your personal investment objectives and should be made only after evaluating the stock's expected performance and risk.

Between September 9, 2002, and September 12, 2003, Smith Barney's stock ratings were based upon expected performance over the following 12 to 18 months relative to the analyst's industry coverage universe at such time. An Outperform (1) rating indicated that we expected the stock to outperform the analyst's industry coverage universe over the coming 12-18 months. An In-line (2) rating indicated that we expected the stock to perform approximately in line with the analyst's coverage universe. An Underperform (3) rating indicated that we expected the stock to underperform the analyst's coverage universe. In emerging markets, the same ratings classifications were used, but the stocks were rated based upon expected performance relative to the primary market index in the region or country. Our complementary Risk rating system -- Low (L), Medium (M), High (H), and Speculative (S) -- took into account predictability of financial results and stock price volatility. Risk ratings for Asia Pacific were determined by a quantitative screen which classified stocks into the same four risk categories. In the major markets, our Industry rating system -- Overweight, Marketweight, and Underweight -- took into account each analyst's evaluation of their industry coverage as compared to the primary market index in their region over the following 12 to 18 months.

Prior to September 9, 2002, the Firm's stock rating system was based upon the expected total return over the next 12 to 18 months. The total return required for a given rating depended on the degree of risk in a stock (the higher the risk, the higher the required return). A Buy (1) rating indicated an expected total return ranging from +15% or greater for a Low-Risk stock to +30% or greater for a Speculative stock. An Outperform (2) rating indicated an expected total return ranging from +5% to +15% (Low-Risk) to +10% to +30% (Speculative). A Neutral (3) rating indicated an expected total return ranging from -5% to +5% (Low-Risk) to -10% to +10% (Speculative). An Underperform (4) rating indicated an expected total return ranging from -5% to -15% (Low-Risk) to -10% to -20% (Speculative). A Sell (5) rating indicated an expected total return ranging from -15% or worse (Low-Risk) to -20% or worse (Speculative). The Risk ratings were the same as in the current system.

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Research Alert

European Equity Research

J.P. Morgan Securities Ltd.

London, January 11, 2005

E.ON

Removing from Analyst Focus List after Strong Performance

Overweight
€66.43

Price Target : €72.00

Utilities

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EONG.DE

Year End - Dec	2003	2004E	2005E	2006E
Adj EPS (€)	4.88	5.44	5.93	6.39
P/E	13.6	12.2	11.2	10.4

Company Data	
52-Wk Hi/Lo	€68.15-49.40
Mkt.Cap ($bn)	57.2
Mkt.Cap (€ bn)	43.6
Free Float	91.0%
Net Debt (for EV) (€ mm)	6,672
Total No. of Shares (mm)	656.0
RIC	EONG.DE
BB	EOA GR

We are removing E.ON from the Analyst Focus List (AFL). Within the sector we still view E.ON as a sector Top Pick but no longer expect it to outperform the broader index against which the AFL is benchmarked.

- Strong performance: E.ON was added to the AFL on May 17, 2004 at a price of €55. It has increased by more than 20% compared to a Eurotop 300 market performance of less than 10%.
- Raise our 12-month, DCF-based SOP price target to €72 (from €70): We have updated our valuation to reflect 2006E multiples. Our increased valuation puts E.ON at a 2006E EV/EBITDA of 7.0x
- Difficult to outperform market from here: Since the AFL is benchmarked against the market and not the sector, we have removed the stock from the list as we do not expect utilities to outperform the broader market in 2005.
- Still a top pick with in the sector: We still see E.ON as able to offer an attractive total return of more than 15% when including dividends and special dividend potential. Therefore it remains a sector top pick.
- Reiterate Overweight: With valuation upside potential, dividend pick-up and our expectation that the company will raise 2006 earnings targets in March 2005, we still view EON as having an attractive combination of fundamental value and positive catalysts

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E.ON - our DCF-based SOP Price Target raised to €72 suggests almost 10% upside potential

€m

	Method	WACC	EV €m	EV per Share	% of Total EV	EV per 2006E EBITDA
Central Europe	DCF	7.4%	37,485	**57.1**	47.0	6.7
Pan European Gas	DCF	7.4%	13,472	**20.5**	16.9	6.7
UK	DCF	7.4%	9,565	**14.6**	12.0	6.6
Nordic	DCF	7.4%	7,884	**12.0**	9.9	6.3
US Midwest	DCF	7.4%	3,775	**5.8**	4.7	6.5
Other/consolidation	DCF	7.4%	-2,755	**(4.2)**	(3.5)	10.9
Total core businesses			**69,426**	**105.8**	87.1	6.5
Viterra		90% of IC	3,866	5.89	4.9	6.8
Degussa	market value	42.9%	2,400	3.66	3.4	
Non equity consol. financial holdings		book value		3,993	6.09	5.0
Total financial and industrial holdings			**10,903**	**10,259**	**15.64**	12.9
Total Enterprise Value			**79,684**	**121.5**	100.0	7.0
Less:		% of book				
Net debt (cash)	12/31/04E bs		6,672	10.2		
Minority interests	09/30/04 bs		4,387	6.7		
Pension liabilities	09/30/04 bs	100%	7,638	11.6		
Nuclear liabilities	31/12/03 bs	100%	13,758	21.0		
Total adjustments to EV			**32,455**	**49.5**		
Total fair value (equity value)			**47,230**	**72.0**		

Source: JPMorgan estimates

Risks to our target price

The key driver of our E.On valuation remains electricity prices. A fall in prices in Germany would negatively affect E.On's earnings and valuation. On the upside, a strong improvement in prices would cause us to increase our target price. Further risk lies in reinvestment decisions and regulatory announcements.

Companies Recommended in This Report

E.ON (EONG.DE/€66.43/Overweight)

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JPMorgan

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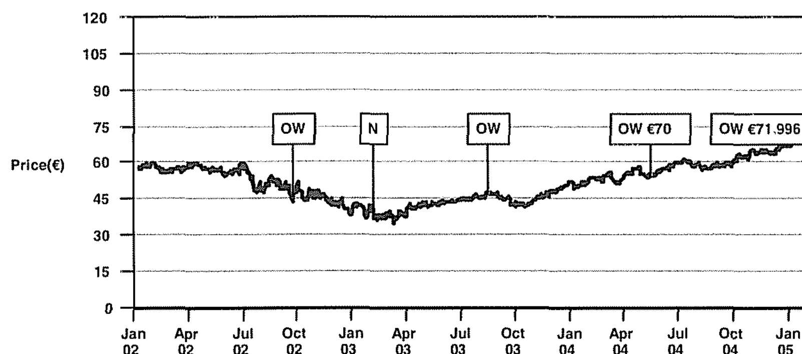
E.ON (EONG.DE) Price Chart



Source: Reuters and JPMorgan; price data adjusted for stock splits and dividends.
This chart shows JPMorgan's continuing coverage of this stock; the current analyst may or may not have covered it over the entire period. As of Aug. 30, 2002, the firm discontinued price targets in all markets where they were used. They were reinstated at JPMSI as of May 19th, 2003, for Focus List (FL) and selected Latin stocks. For non-JPMSI covered stocks, price targets are required for regional FL stocks and may be set for other stocks at analysts' discretion.
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JPMorgan Equity Research Ratings Distribution, as of December 31, 2004

	Overweight (buy)	Neutral (hold)	Underweight (sell)
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IB clients*	44%	44%	32%
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*Percentage of investment banking clients in each rating category.
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Merrill Lynch | *In-depth Report* | Germany
Electric Utilities / ADR

28 January 2005

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E.ON

Best Platform, Still Some Upside

BUY

Reason for Report: Re-instatement of Coverage

Volatility Risk: LOW

Price - Local / ADR: EUR67.8/ $88.81

12-Month Price Objective: EUR75 / $98.26
Date Established: 28-Jan-2005 / 28-Jan-2005

Estimates (Dec)	2003A	2004E	2005E	2006E	2007E
Reported EPS	6.04	6.76	5.75	6.52	6.66
Adjusted EPS	4.42	5.62	5.84	6.52	6.66
P/E	15.3	12.1	11.6	10.4	10.2
CEPS	8.5	9.3	11.9	13.1	13.4
Free CFPS	4.40	5.79	6.27	7.44	7.88
DPS	2.00	2.30	2.65	3.05	3.25
Yield %	3.0	3.4	3.9	4.5	4.8
Price/FCF	15.4	11.7	10.8	9.1	8.6
Net Debt	7855	6391	5186	3627	1689
EBITDA	9458	10464	11093	11721	11858
ADR Adjusted EPS	$5.58	$7.64	$7.64	$8.52	$8.71
ADR Free CFPS	$5.55	$7.87	$8.20	$9.73	$10.29
ADR DPS	$2.52	$3.13	$3.46	$3.99	$4.25

Opinion & Financial Data

Investment Opinion – Local:	A-1-7
Investment Opinion – ADR:	A-1-7
Mkt. Value (EUR mn)/ Shares Outstanding (mn):	44674 / 659
Book Value/Share (Dec-03):	45.385
Price/Book Ratio:	1.49
ROE 2004E Average:	14.5%
Net Debt/Net Equity:	22.8%
Est. 5 Year EPS Growth:	5.3%
2004E P/E Rel. to Mkt:	84%

Stock Data

52-Week Range – Local:	68.13-50.50
52-Week Range – ADR:	$91.2-$61.7
Symbol / Exchange – Local:	EONAF / Frankfurt
Symbol / Exchange – ADR:	EON / New York
Bloomberg / Reuters:	EOA GR / EONG.DE
Shares/ADR:	1.00
Exchange Rate:	EUR0.77/USD
Free Float:	91%

All figures are in Euro except where otherwise noted.
Note: Due to currency factors, the investment opinion of the ADR may differ from the underlying share.

Highlights:

- **We are re-instating coverage with a BUY recommendation and a EUR75/share PO.**
- Strategically, E.ON looks the best placed among European utilities to capitalise on the changes underway in the industry. Liberalising markets and the progressive convergence of power and gas look set to create new avenues of growth. The strengthening balance sheet ratios underscore E.ON's capacity to fund growth.
- **Russia and upstream gas bring new risks.** Both have appeared on E.ON's radar, with the potential to differentiate and perhaps transform the company over time. However, the associate risk profiles are much higher than is typical for European utilities.
- **Power Prices Drive Profits.** We expect higher power prices to be the main factor behind rising profits over the next few years, partly offset by tightening regulation in Germany.
- **Strong DPS Growth, Possible Capital Return.** We forecast DPS growth of 15% p.a. for 2004E-06E, before slowing in line with EPS. Non-core disposals could lead to a capital return of c10% of market cap in 2005E/06E.
- **10% Upside to ML Valuation.** Our sum-of-parts based PO of EUR75/share implies around 10% upside for the shares. This would put E.ON on a sector average 2005E EV/EBITDA multiple of 7.5x which we think appropriate given the prospective returns offset by the increasing risk profile. We prefer RWE, the more defensive play, on valuation grounds.
- The risks to our valuation are lower wholesale electricity and gas prices. E.ON is also exposed to regulatory risk through its transmission and distribution businesses.

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Refer to important disclosures on pages 38 to 40. Analyst Certification on page 35. Price Objective Basis/Risk on page 35.

Executive Summary

We are re-instating coverage with a BUY recommendation and a EUR75/share Price Objective. Strategically, E.ON looks the best placed among European utilities to capitalise on the changes underway in the industry, from liberalising markets to the progressive convergence of power and gas. There are also increasing risks, shorter term from German regulation, but more importantly from the emergence of Russia onto the investment horizon.

Despite these concerns, the shares still look reasonable value in a sector context even after the good performance of the last two years. Total annual returns are likely to exceed the sector at least through to 2006E, and these may be boosted by a capital return to shareholders in the next twelve months. We believe RWE is currently more attractive than E.ON, on valuation grounds and with its lower risk profile.

From Europe to World Leader

E.ON has transformed itself from domestic conglomerate to Europe's biggest energy utility, with a portfolio of mainly vertically integrated power and gas assets across Europe, and in the USA.

It is clear from management's stated aspiration – to be the 'world's leading power and gas company' – that the portfolio will continue to evolve. We think that amongst Pan-European utilities, E.ON has the best platform to capitalise on continued liberalisation and privatisation of power and gas markets.

The spread of E.ON's power assets across Europe is already beyond that of most of its peers. Ruhrgas is likely to be central to future growth from this platform as power/gas convergence gathers pace over the next decade. Gas procurement should improve the integration of the existing power portfolio, and Ruhrgas will be the vehicle for entering some new markets such as Italy.

Russia and upstream gas have appeared on E.ON's radar, with the former in particular holding the potential to differentiate and perhaps transform E.ON over time.

The operating and financial risks involved in both of these new ventures, and in Russia's case political risks, are dimensionally different to the rest of E.ON's portfolio. Management's enthusiasm has been appropriately tempered with caution, ahead of clarification of the Gazprom JV at the end of 2005.

The growing FCF generation looks strong – better than E.ON's EUR2.4bn p.a. target on our forecasts. Strengthening balance sheet ratios underscore E.ON's capacity to fund growth.

In this note, we examine the opportunities and risks ahead for E.ON. We have focused our analysis on those assets, markets and financial drivers which may be subject to change or uncertainty in the medium term.

Earnings, Dividends, Returns

The rise in power prices across most of northern Europe, allied to E.ON's 'on.top' programme, should underpin a progressive rise in profits over the next few years. However, onto this positive backdrop we have overlain a conservative view of the outcome of German regulation, assuming E.ON loses 4% of Group EBIT, net of cost cuts. Our forecasts are also tempered by ML exchange rate assumptions for EUR:US$ and EUR:GBP.

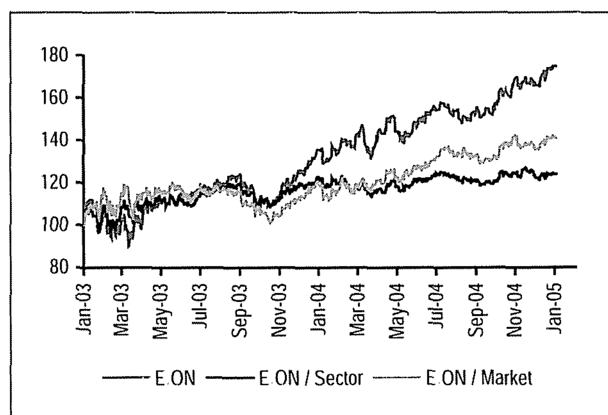
We expect strong growth in operating profits in 2004E, a function of stronger power prices, cost-cutting and new acquisitions. We expect the benefits from our power price assumptions (which are based on the EEX forward curve) to be the main factor behind rising profits over the next few years, partly offset by tightening regulation in Germany.

We forecast a 5% fall in 2004E reported EPS to EUR6.76, affected by one-off items. Our recurrent EPS forecast for 2004E is EUR5.6, an increase of 27% on 2003A. The more modest 5% CAGR for 2004E-09E reflects the negative effect of regulation in the latter years. We assume cost-reductions in response, but new cost-cutting targets likely await clarity on regulatory tariffs, probably late in 2005E.

E.ON's dividend policy has been among the most aggressive in Europe in the last few years. We expect 15% p.a. for 2004E-06E, then slowing in line with EPS. Our forecasts suggest a pay-out ratio of c50% into the medium term.

Ordinary dividends could be supplemented in 2005 and 2006 by capital returns or a share buy-back, given strong FCF generation and potential disposals. The planned sale of Viterra in 2005E (boosted by buoyant German real estate transactions), Degussa (2006E) and other assets could realise EUR9bn gross. These may provide scope for a Centrica-style return, of perhaps 10% of market capitalisation and would still leave the balance sheet overall unscathed for the future investment plans.

Chart 1: E.ON Price Performance



Source: Datastream

Refer to important disclosures on pages 38 to 40.

Valuation

Our sum-of-parts analysis suggests a value for E.ON of EUR75/share (Table 1). The SOP is based on DCF of the constituent businesses, or where appropriate industry/trade sale values. The SOP implies a 2005E EV/EBITDA of 7.5x, broadly in line with the Pan-European sector average. The shares are currently trading on 7.2x.

Table 1: SOTP Summary

Division	EUR m	EUR p.s.	%EV
Central Europe	38,162	55	45%
Pan-European Gas	11,227	16	13%
United Kingdom	9,284	13	11%
Nordic	8,924	13	10%
LG&E	3,649	5	4%
Gas Financial Assets	5,069	7	6%
Corporate Center	-1,724	-2	-2%
Core Energy Business	**74,591**	**108**	**87%**
Viterra	6,174	9	7%
Degussa	2,701	4	3%
Enterprise Value	**83,467**	**121**	**97%**
Treasury Shares	2,242	3	3%
Total Enterprise Value	**85,709**	**124**	**100%**
Net Financial Debt	-6,391	-9	-8%
Provisions	-22,981	-33	-28%
Nuclear	-14,121	-20	
Pension	-6,835	-10	
Mining / Environmental	-2,025	-3	
Minority Interests	-4,635	-7	-6%
Equity Value	**51,701**	**74.7**	**62%**

Source: Merrill Lynch estimates

We believe the shares justify a sector-average multiple, balancing E.ON's potential growth prospects and financial strength against potential increasing risk. **We also believe, that the German utilities are more attractive than other European utilities**, particularly those in Iberia (political uncertainty) and in the UK (full valuations). A sector average multiple for E.ON implies upside of around 10%. The SOP of EUR75 therefore becomes our Price Objective.

The projected 19% total annual returns for 2004E-06E (FY1 yield plus DPS growth) may understate the potential returns given the scope to return capital.

Table 2: Valuation and Trading Multiples

	EV/EBITDA		P/E	
	2005E	CAGR	2005E	CAGR
E.ON @ Trading Price	7.2x	3.4%	11.6x	5.2%
E.ON @ PO	7.5x	3.4%	12.8x	5.2%
RWE	6.7x	3.9%	10.0x	9.1%
European Competitive Market	7.7x	5.8%	12.2x	9.3%
European Utilities	7.6x	4.7%	13.2x	7.8%

Source: Merrill Lynch estimates

Table 3: Valuation and Trading Multiples

	Div Yield		FCF Yield	
	2005E	CAGR	2005E	CAGR
E.ON @ Trading Price	3.9%	9.4%	8.1%	9.1%
E.ON @ PO	3.5%	9.4%	7.4%	9.1%
RWE	3.8%	10.0%	13.0%	n.m.
European Competitive Market	4.3%	10.7%	n.a.	n.a.
European Utilities	4.4%	8.6%	n.a.	n.a.

Source: Merrill Lynch estimates

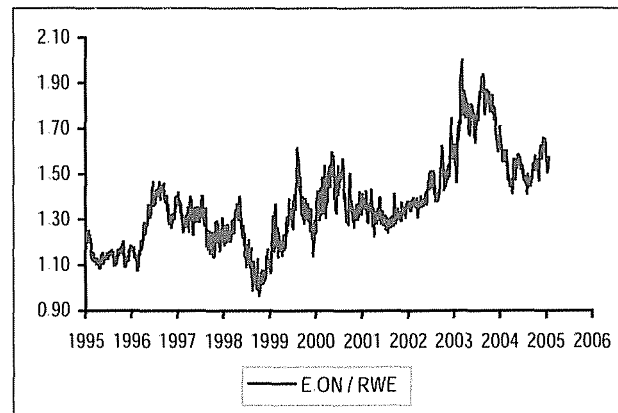
E.ON versus RWE

The two German companies tend to trade in a relative tight band over time (see Chart 2). This trend has continued, despite the divergence in strategies and portfolios over the last few years. E.ON is a 'pure' power/gas play; RWE has the extra 'limb' of water. Our compare and contrast in summary form is as follows:

- **E.ON:** a simpler, arguably more scalable strategy focused on power and gas markets in Europe, but with potentially increasing operational risk in Russia and upstream gas.
- **RWE:** more complex, less integrated business model, with less overt growth potential; but with tighter geographical focus and more defensive due to a higher proportion of regulated earnings.

Valuation-wise, we think RWE is a more compelling BUY than E.ON at current prices. The comparative multiples generally show E.ON to be trading at a premium to RWE, suggesting the market has perhaps more fully understood and embraced the E.ON's strategy. We believe that the premium to RWE may not be justified going forward, given E.ON's increasing risk profile.

Chart 2: Share Price - E.ON Relative to RWE



Source: Datastream

E.ON Full Year Results

E.ON is due to report its full year numbers on Thursday March 10th.

CONTENTS

■ Section		Page
Executive Summary		2
From Europe to 'Global'	1.	5
E.ON's Pan European Model	2.	7
The Future of Power is Gas	3.	11
E.ON and GazProm	4.	17
Regulation: Ex-Ante - Positive in Concept?	5.	20
Power Markets	6.	22
Financials	7.	26
Valuation	8.	33

Refer to important disclosures on pages 38 to 40.

1. From Europe to 'Global'

E.ON has already transformed itself from domestic conglomerate to Europe's biggest energy utility. It is clear from management's stated aspiration – to be the "world's leading power and gas company" – that the portfolio will continue to change. With markets in and around Europe liberalising, opportunities will no doubt abound in the years ahead. E.ON's starting platform also looks among the best-placed to take advantage; its balance sheet capable of funding progressive expansion. Our chief concern is the changing risk profile.

The Landscape

The transformation to energy utility was swift . . .

E.ON has already metamorphosed from unwieldy German conglomerate into Europe's biggest energy utility in a comparatively short period of time. Not that the process is finished, with gaps in the portfolio and residual non-core assets still to be disposed of. However, the main building blocks are largely in place, which in our view give E.ON a head start among Pan-European aspirants.

. . . the approach to growth is now more measured

Importantly, after the frantic portfolio changes around the turn of the millennium, management appears to recognise need for a measured approach to growth. The strategic emphasis has shifted from 'focus and growth' to the new mantra of '*Integration and Performance*'. This is consistent with CEO Wulf Bernotat's stated aim to run an integrated energy business, rather than collection of utilities.

Big opportunities lie ahead for E.ON

European power and gas markets are still in the relatively early stages of liberalisation and deregulation. Although E.ON may be 'pausing for breath', more opportunities will present themselves over the second half of this decade.

The main industry drivers which we think will shape E.ON's strategy going forward are:

- **Politics and Deregulation**: EU-wide market liberalisation will accelerate through the rest of the decade. Accession and other adjacent countries will continue to need capital and may present relatively cheap acquisition opportunities. The EU's emphasis on interconnection will progressively increase the scope for cross-border trade.
- **Gas as a Vehicle for Growth**: The power companies are long term growth plays on gas, given the projected CCGT build across Europe. Armed with Ruhrgas, one of European gas's Big Four, E.ON looks well placed to capture the growth.
- **Tightening Power Markets**: With old plants needing to be replaced next decade, the power industry is in all probability in the early stages of an up-cycle for prices, which could last beyond the rest of the decade. The scale of future investment in new capacity required is uncertain, particularly in Germany, with EU/national politics key swing factors.
- **Geography**: Just as the Germans were scuppered by geographical location at the start of the liberalised era now it's an advantage. Dominating Central European power and gas markets should be easier from Germany (or indeed France) than island markets, and competition in M&A may be reducing to an extent, with EDF otherwise engaged. E.ON's relative proximity to Russia could open up a new vista of opportunities, albeit with new risks attached.
- **Size**: Scale brings E.ON two things. First, economies of scale, which should, as markets liberalise, work increasingly Pan-Europe-wide. Secondly, the financial capacity to do the deals.

E.ON's existing platform gives it a far better springboard to exploit new opportunities than when it started out; and arguably a better platform than any of its peers.

Refer to important disclosures on pages 38 to 40.

The company has made it clear that acquisitions will primarily be on bolt-on deals for the time being at least and is fairly clear about which markets it is targeting. The screening process also appears sensible (if somewhat textbook) – E.ON essentially wants the right target, for the right price. The recent acquisitions of MOL (Hungary), Distrigaz Nord (Romania) and in Bulgaria seem to tick most of the boxes to the outsider.

How to balance growth with dividends?

Expectations have also grown that E.ON will announce a major cash return with its results in March 2006. We expect management will want to strike a balance between rewarding shareholders in the short term, and maintaining flexibility for its medium term growth aspirations.

What About the Risks?

Is Russia a new frontier for a European utility?

The flip side of the story is the increasing risk associated with this potential growth story in our view. Firstly, Russia and upstream gas. Not much is really known about what E.ON intends to do (we discuss the options on in detail later). But both upstream and Russia are new territories for E.ON and Ruhrgas, despite the comfort factor of the existing relationship with Gazprom. Arguably both are outside the 'normal' risk envelope for any European utility. Clarification of the funding commitment to Russia, unlikely till end 2005, should help.

The increasing geographical spread is another risk worth monitoring. E.ON already runs operations in and between over a dozen countries. Ever diversifying the portfolio further must by definition present ever-increasing challenges for management.

Refer to important disclosures on pages 38 to 40.

2. E.ON's Pan European Model

E.ON has established a Pan-European portfolio in power and gas, which in spread and scale is ahead of most of its rivals. We assess the strengths and weaknesses. There are still significant gaps, notably attractive markets like Italy and Poland; and gas outside Germany and the UK.

A Skeleton in Need of Flesh

Veba started the ball rolling for what is now the strongest platform in the industry

The transformation of Veba, a domestic, electricity-based conglomerate, into today's 'Global' E.ON has happened over a comparatively short period of time. The first significant deal was the merger between the northern German utility Veba and the Bavarian counterpart Viag on 2000. From this base, and over the course of five years, E.ON now has arguably the strongest platform of any European utility across Northern and Eastern Europe, as well as assets in North America.

Three landmark deals created the platform.

- **Veba/Viag (2000):** the merger of the two German businesses established a strengthened domestic energy position but importantly a strategic North (Veba)-South (Viag) axis running the length of the country. This laid the ground for subsequent bolt-on deals in adjacent countries, and was the ideal base onto which Rughrgas could be overlain. Veba-Viag was openly described as a 'first step' but also created meaningful synergies in itself.
- **Powergen (2001)**: Although the subsequent write down spoke volumes for the price paid, the UK idea was essentially a sound one. The UK was opportunity-rich and, though an 'island market', a good place to work in competitive markets, deal with cutting edge regulation and generally do business. Gas/power convergence was in advance of the rest of Europe. The expansion of gas interconnection to Europe in the coming years provides the scope to bring Powergen closer to Ruhrgas and the core E.ON Energie business. Powergen was also a backdoor route to the US market, LG&E a 'good idea at the time' but perhaps a mixed blessing with hindsight.
- **Ruhrgas (2004):** Strategically, Ruhrgas looks like E.ON's trump card for the long term, the biggest buyer and shipper of gas in Europe's biggest market, but essentially an under-developed business. The motives behind the acquisition have been well aired – an odd mixture of E.ON's corporate ambition, and the Federal government's energy policy. Ruhrgas can underpin E.ON's likely move into gas-fired power generation over the next decade, and 'oil the wheels' of the integration of the Europe-wide power and gas acquisitions. E.ON's capital can fund Ruhrgas' ambition to move upstream, and internationally. Together, the combination of E.ON and Ruhrgas is a step ahead of the rest of the industry in creating a Pan European gas/power convergence play.

Eastern Europe has been the latest focus

E.ON has filled in gaps around this platform – even before the platform was in place. The other important strategic moves have been **Sydkraft**, which has brought a prominent position in the Nordic market; and the shift into **Eastern Europe** which has been the main thrust of growth investment in 2004. In the last few months E.ON has committed cEUR2.4bn of capital to acquisitions in Romania, Bulgaria and Hungary – the scale of capital indicating that these are bolt-on, incremental steps. However, all of the Eastern European acquisitions – and indeed Sydkraft - have commercial synergies with the rest of the European business as well as potential for growth.

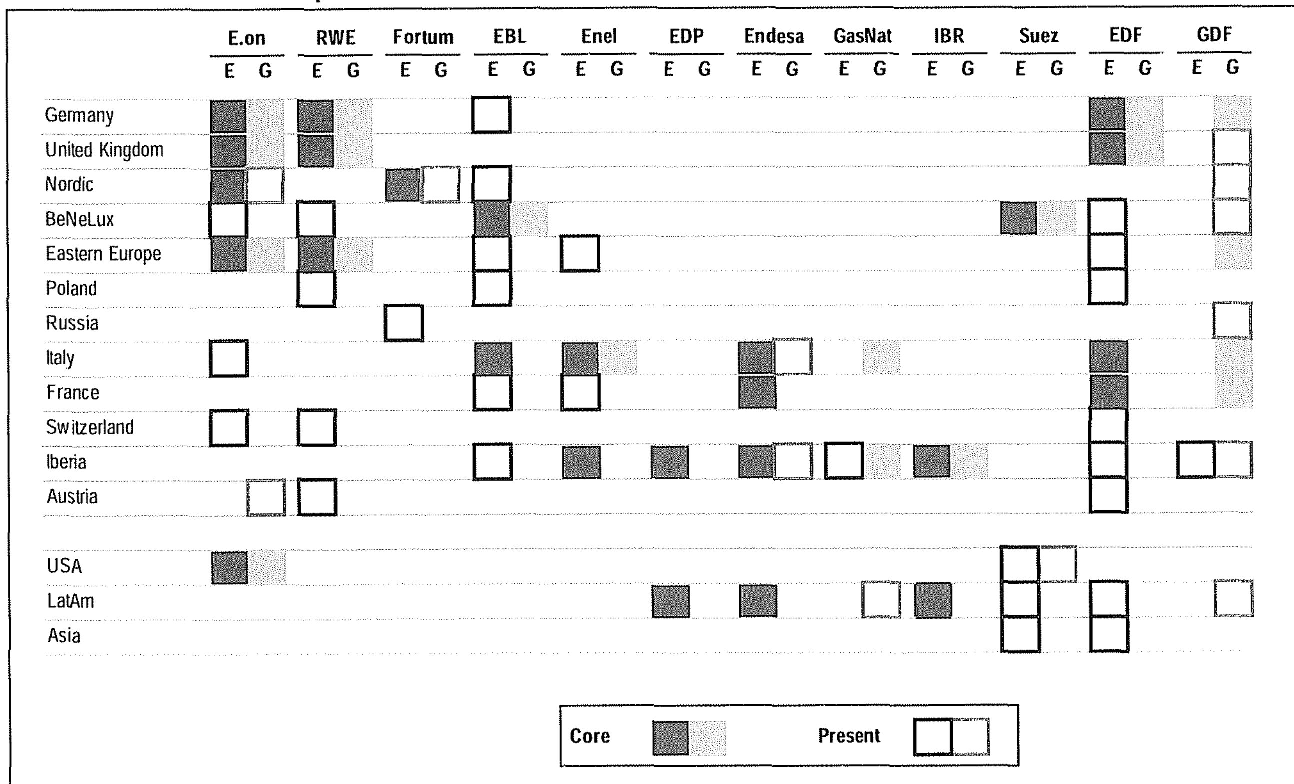
Chart 3: E.ON'S Market Positions in Eastern Europe

Source: E.ON

E.ON's platform beats most of the industry already

E.ON's 'global portfolio' is shown in comparison with its peer group in Chart 4. E.ON's 'Pan-European-isation' in electricity (E) and gas (G), in contrast to most of its peers, is self-evident; though so too are the gaps. The current platform, with the geographic axis in Central Europe and dual-pronged gas and power strategy, may give E.ON the best starting position in the industry to capitalise on next phase of a changing market as liberalisation accelerates.

Chart 4: Who's Who in Pan-European Power and Gas



Source: Company Reports, Merrill Lynch estimates

Refer to important disclosures on pages 38 to 40.

Where Next?

US capital might get rechannelled into Europe

Perhaps the biggest unanswered question in E.ON's global portfolio is where the USA fits in. The sheer scale of the opportunities in Europe, and around its fringes, suggests to us that E.ON will likely sell out of the USA, and re-channel capital nearer to home.

The next phase of E.ON's energy portfolio evolution therefore is more than likely to involve continued incremental acquisitions in and around Europe. The December presentation on investment plans outlined EUR6.1bn of financial investments, around half of which is for commitments already made in Europe (e.g. Sydkraft, MOL). This leaves around EUR2.0bn for upstream gas, EUR0.6bn for other investments in Central Europe, and EUR0.3bn unidentified. This expenditure excludes any 'medium-sized' acquisitions, to which E.ON is not averse, should the right entry to the right market emerge.

Our analysis of E.ON's portfolio shows there are still gaps and opportunities to consolidate in markets where E.ON already has a starting position. These include the **Netherlands**, where unbundling could lead to M&A; **Switzerland** and **Austria**. Equally there are assets in the portfolio which may not stand the test of time. The portfolio, and our thoughts on E.ON's priorities, are shown in Table 4.

Some markets new to E.ON are on the front burner:

- **Russia:** New market, new industry – upstream gas. Russia is arguably a key area for growth for E.ON, a potentially transforming opportunity but with attendant risk. E.ON signed an MOU with Gazprom in August 2004 which will explore JVs in gas production in Russia, gas transport to Europe, power generation in Russia, and the expansion of infrastructure to market gas in Europe. The attractions to E.ON are fairly obvious; GazProm aims to leverage off E.ON to access European downstream markets. We explore the opportunities with Gazprom in a later section, and those in Russian power.
- **Italy:** The most accessible of the three major western European economies in which E.ON has yet to establish market share of any material scale (France and Spain are the others). The initial opportunity is for Ruhrgas to sell gas to a JV building CCGTs – Italy has the highest wholesale power prices (and indeed gas prices) in Europe. There is considerable scope to participate in the consolidation of a fragmented gas distribution industry in the medium term. Downstream electricity, where the residential segment is dominated by Enel and municipalities would likely involve a joint venture.
- **Poland:** A major EU accession economy, adjacent to Germany, with a potential market size around half that of Germany itself; and with important linkages with Germany, Czech Republic, Slovakia and Hungary, and the Baltic region. Political issues have thus far largely thwarted German ambitions; it may take some years for this part of the E.ON jigsaw to fall into place on any scale. However, plans to privatise the Polish gas trunk pipeline could present Ruhrgas with an entrée. Electricity supply market opening (52% to date, 6,000 new eligible customers in 2004) provides some interest.

Some markets look far too tough just now

Certain big markets just look like too much hard work at present, though in time the barriers to entry may fall. **Spain** has an unresolved political and regulatory climate, more limited trading linkages with the rest of mainland Europe and is very expensive for acquisitions. **France**, another large market and on E.ON's doorstep, poses significant challenges to the outsider. Creating positions in these markets for the time being at least does look more trouble than it's worth – particularly when there are better-fit opportunities elsewhere, and where the competition for assets may be less intense.

Those markets in which E.ON has starting positions, but which are exit possibilities include:

- **USA:** LG&E looks increasingly like a 'stranded asset', to the outside observer, with limited inter-action with the rest of E.ON. The recent regulatory deals in Kentucky, and cost cutting are improving returns. The forthcoming US Energy Bill and fresh discussions on the repeal of PUHCA (the bill which currently restricts utility consolidation) may help facilitate a sale for E.ON to a domestic player rather than create a launching pad for expansion. E.ON has put the asset under review and intends to make a decision on LG&E's future by 2006. A new wave of M&A may have begun in the USA with Exelon's bid for PSE in December, which, if successful (completion is targeted for Q1 2006), can only enhance E.ON's options.
- **Finland:** Fortum stated its intention to exercise a call option in January 2005 on 65% of the shares in Espoon Sahko (otherwise known as E.ON Finland) which has around 200,000 electricity and 200,000 gas customers near Helsinki. If concluded, the deal will net E.ON EUR390m. The minority 35% is owned by the City of Espoo. We think the sale of this isolated position in Finland by E.ON would not materially affect its overall Nordic position, which would then be concentrated in Sweden around Sydkraft.

Table 4: E.ON s European Portfolio

Market	Desirability	Comment	Challenge/Fill in Potential
Existing Markets			
Germany	High	Home Franchise	Lack of downstream gas; long term CCGT build
United Kingdom	High	Liberalised, transparent regulation	Gas procurement; CCGT build; network M&A possibilities
Italy	High	Liberalising, high wholesale prices, interconnection	Ruhrgas/CCGT opportunities
Hungary	High	Good sized gas market	MOL acquisition establishesd major power/gas position
Sweden	High	Liberalised, consolidation potential	Strong potential growth in long term gas usage
Slovakia	High	Core to E Europe axis	Upstream power; Ruhrgas procurement
Czech Republic	High	Core to E Europe axis	Upstream power; Ruhrgas procurement
The Netherlands	Medium	Liberalised, high gas penetration, gas/power potential	Unbundling yet to happen; changes/opportunities may increase
Bulgaria	Medium	Acquiring distribution assets Q1 2005	New market; limited experience of liberalisation
Romania	Medium	Acquiring gas and power discos H1 2005	New market; limited experience of liberalisation
Switzerland	Medium	Hydro power, peak output	Opportunity constraint
Austria	Medium	Hydro power, peak output	Opportunity constraint
USA	Low	Unlimited potential for growth via M&A	Minimal synergies with Europe bar LNG
New Markets - Tier 1 Targets			
Russia	High	Upstream gas, electricity chain	Scale of commitment, synergies ex-gas; lack of liberalisation.
Poland	High	Size of market, adjacency	Political issues; limited liberalisation; heavy state involvement
Denmark	Medium	Self sufficient in gas	Industry privatisation/consolidation underway; political issues
Other Markets			
Belgium	Medium	Gas/power interconnection hub	Strong incumbent; complex liberalisation process; ownership restrictions
Finland	Medium	Liberalised	Lack of scale; probably selling to Fortum
France	Low	Regulatory immaturity; exporter to Germany	Strength of dominant incumbent; limited opportunities
Spain	Low	Growth market of scale	Lack of entry opportunity/synergies; regulation/politics/cross shareholdings
Slovenia	Low	Extension of Slovak axis	Small market

Source: Merrill Lynch estimates

Refer to important disclosures on pages 38 to 40.

3. The Future of Power is Gas

The European gas industry, once something of a closed club, is in a state of change. Liberalising markets, power/gas convergence and increasing import dependency are the driving forces. We argue that there is a big opportunity for larger power-based companies, like E.ON, to capitalise on these changes.

The Club Opens Up

The gas industry, in most countries, has operated in a parallel universe to electricity in most of Europe. Structurally, the two industries are very different, most notably upstream. Gas typically is sourced a long way from the consumer, which has necessitated a different approach to infrastructure.

The industry in most countries has been based around a club of traditional national incumbents, vertically integrated in gas from procurement to downstream. These companies were created or expanded from more localised predecessors with the arrival of natural gas in the 1960s and 1970s, and were national vehicles for industry expansion.

By and large, the industry is still set up this way - Gas Natural, Ruhrgas, Gaz de France and Gasunie, and ENI (through its various subsidiaries) still dominate their own national markets. The exception is the UK where British Gas was split into three constituent parts – upstream, regulated pipes and supply - during the 1990s.

Ruhrgas' PanEuropean position is still pretty modest

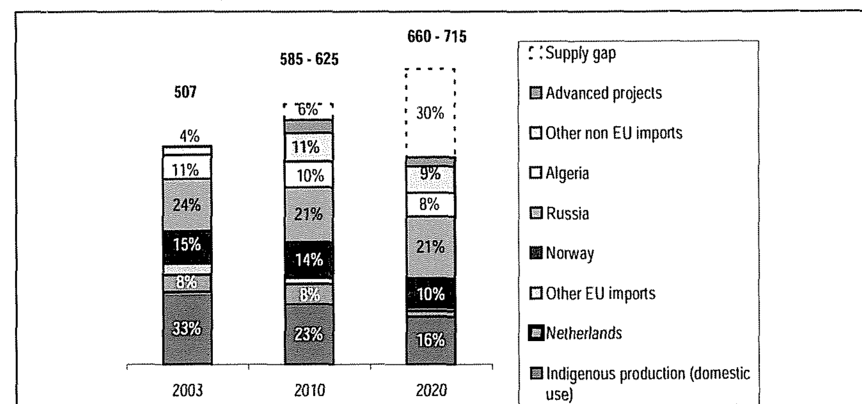
The industry is still therefore fragmented across the continent, with consolidation yet to get going. We have shown detail of the industry structure in each of the main gas markets – market size, supply sources, infrastructure etc in Table 5. We have also show E.ON and Ruhrgas' market shares in each of the markets the company operates. These underline how much of the European market even Ruhrgas, a Top 4 European gas company has yet to penetrate.

Change is underway as markets liberalise, although the pace is creeping rather than revolutionary. Things could speed up over the remainder of this decade, in our view, driven by two main factors.

■ Import Dependency Favours Scale

EU import dependence is set to increase from 39% to about 70% in 2010 (including Norway as a European producer). Local, cheaper, and more flexible supplies in the UK and Netherlands will progressively be replaced by flatter profile imports from the three main suppliers Norway, Russia and Algeria; relative newcomers like Egypt and Libya; fresh faces like Qatar, Malaysia and others will diversify the source pool.

Chart 5: EU s Growing Import Dependence



Source: Merrill Lynch estimates

The gas industry, including Ruhrgas, is responding by moving upstream for direct access to supply. Equity gas provides a degree of security of supply, portfolio flexibility and helps risk management. Upstream gas also offers higher returns, but with commensurate risks. The high capital intensity of upstream, in particular reserve replacement, means only the biggest utilities are likely survive in an arena which is new to most utilities. Third party producers, like Gazprom, will tend to want to deal with the big volume buyers, and those with the best credit quality.

Growth is from Power

Electricity companies will be the main buyers of incremental gas for gas-fired power stations. EU gas demand is expected to increase by 35-40% by 2020. Almost two-thirds of incremental demand is likely to be from the power sector, with gas the fuel of choice for most of the new build power stations. Liberalised gas supply market positions will be a natural complement.

Power companies will therefore naturally embrace gas, as E.ON, and others, have already begun to do. Gas utilities will in turn need to adapt to competitive power markets upstream and downstream to capture the growth opportunity. Some gas companies used to operating as a protected monopoly may find this transition more difficult than others.

Refer to important disclosures on pages 38 to 40.

Table 5: The European Gas Industry and E.ON s Market Positions

		EU15	Austria	Belgium	Czech Rep	Germany	Spain	France	Hungary	Italy	Nether-lands	Poland	Portugal	Sweden	Slovakia	UK
Size of the Market																
Inland Sales	Bcm	428.0	9.4	17.4	9.6	90.0	25.8	47.6	14.3	76.3	42.9	3.2	12.7	1.0	6.6	96.5
Residential Customers	000s	n.a.	n.a.	2,503	2,564	17,590	64	10,676	3,038	15,050	na	683	6,056	52	1,424	21,153
Non-Residential	000s	n.a.	n.a.	105	173	760	3	546	182	970	na	18	17	3		422
Total Customers	000s	84,888	1,310	2,608	2,738	18,350	5,305	11,222	3,220	16,020	6,850	701	6,073	55	1,424	21,575
E.ON s market share																
E.ON's no.of Customers	000s				1,500	1,063			260	600				25	343	2,700
E.ON's Market Share	%				55%	6%			8%	4%				45%	24%	13%
E.ON's Gas Sendout	Bcm					59.5									7.0	
The Importance of Gas																
Share of Energy Consumption	%	25%	22%	25%	19%	22%	16%	14%	45%	35%	46%		11%	1%	32%	41%
Consumption per Head	mcm	1,132	1,166	1,683	939	1,090	628	793	1,421	1,358	2,657		1,209	116	1,220	1,642
Population	m	378	8	10	10	83	41	60	10	56	16		11	9	5	59
Size of Gas Infrastructure																
Storage Capacity	Bcm	59.5	2.8	0.7	3.2	18.6	1.5	11.0	3.4	16.8	3.5	0.0	1.4	0.0	2.0	3.9
Employees		168,685	2,700	3,700	682	34,000	4,765	28,000	6,423	30,000	9,350	815	35,000	200	5,659	51,600
Pipeline Length Transmission	km	185,750	5,400	3,693	3,638	61,000	10,691	35,750	5,278	31,220	11,600	1,402	15,451	530	6,196	19,424
Pipeline Length Distribution	km	1,228,644	26,000	51,117	67,481	314,000	37,457	176,340	72,409	197,000	123,500	9,359	219,720	2,000	23,837	262,000
Self Sufficiency																
Indigenous Production	Bcm	214	2	0	0	20	0	2	3	14	63		0	0	0	105
Net Imports	Bcm	214	7	17	9	73	26	45	12	61	-20		3	1	7	-8
from EU Member States	Bcm	-1	0	8	0	18	0	7	1	8	-37		0	1	0	-8
from non-EU Members	Bcm	216	7	9	9	55	26	38	11	53	17		3		7	
Relative Import Dependency	%	50%	79%	99%	98%	81%	100%	95%	84%	80%	-47%		24%	102%	99%	-9%
from EU Member States	%	0%	4%	45%	0%	20%	0%	16%	8%	10%	-86%		0%	102%	0%	-9%
from non-EU Members	%	50%	75%	54%	98%	61%	100%	80%	76%	70%	39%		24%	0%	99%	0%

Source: Merrill Lynch, Eurogas. 2003 data

Refer to important disclosures on pages 38 to 40.

Power Gas Convergence – The Model

The basic model of power and gas is based around harnessing synergies from three segments of the value chain:

- **Economies of Scale in Retail Supply**: The high fixed costs of supply (billing, customer service etc) means that it's essentially a numbers game once the IT platform is in place. The same billing system needed for 5 million electricity customers costs much the same as for 10 million dual fuel. UK has proven the test case competitive markets; the price paid of up to 1.25x annual bills (for a low margin business) by E.ON itself for the TXU customer franchise illustrative of the economics. Six years on, competition is being aggressively driven by the logic of reducing unit costs by winning customers. Leading player Centrica (British Gas) is expected to have lost up to 1 million customers in 2004 alone to its competitors, including E.ON.
- **Commercial/Risk Management**: The buzz word is 'optionality' - the full potential for arbitrage and risk management is only open to those players involved both in upstream and downstream gas and power. Operating in liberalised, liquid markets is a pre-requisite. Multiple procurement and supply sources increase optionality i.e. a vertically integrated company with a diversified generation portfolio, upstream gas and contract gas purchases has multiple choices where to source and sell or burn a single therm of gas. The choice will be determined by profitability and risk management.
- **Infrastructure Management:** The co-management gas/water infrastructure has generally been thought technically more appropriate, but there is an increasing trend towards power/gas networks. Best practice, logistics, systems operations and more efficient financial management are among the potential gains. Regulation is likely to limit the upside potential over time; but networks provide stable income streams. Again, the UK has been at the forefront of such mergers with National Grid Transco and the recent sale of distribution assets by NGT to SSE and United Utilities.

It's easier for a power company to embrace gas than the other way round

Power companies should have a competitive edge over their gas peers, in the initial stages of convergence all things being equal. A gas company can just as easily build CCGTs to compete in electricity as a power company builds a presence in gas. However, it should be easier for a diversified, vertically-integrated electricity company to embrace gas, including CCGTs, than for a pure gas company to develop a competitive fuel mix in power.

The industry has of course anticipated and begun to adapt to these changes, with gas companies like Centrica and Gas Natural acquiring electricity customers and establishing upstream power positions to meet customer demand. Similarly, power companies are moving in the other direction into gas, with E.ON perhaps the most committed via the purchase of Ruhrgas and with ambitious expansion plans for gas.

Access to gas should get easier over time

The main stumbling block for power companies has of course been access to gas, with take-or-pay positions of the incumbent gas company somewhat protected by implicit or explicit EU legislation and national legislation. E.ON, through the Ruhrgas acquisition, circumvented the problem. Elsewhere, access should continue to improve as Europe's supply base diversifies.

E.ON's Route One – Buy Your Way In

E.ON has bought its way into gas

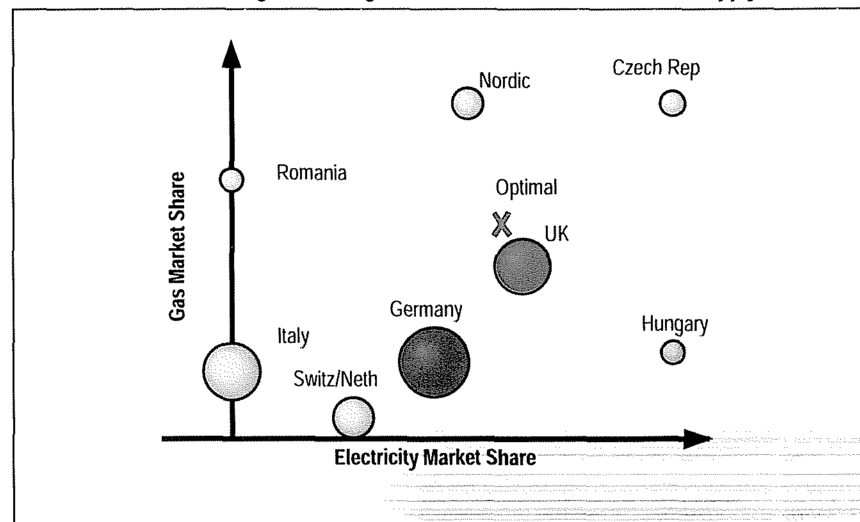
E.ON's overall approach to power/gas convergence appears to have been a) to identify the attractive markets then b) to discern the best mode of entry. Most of its current market positions have been acquired. These include the UK, something of a special case, where the opportunities for Powergen, a leading electricity franchise to become a new entrant in gas have been pretty much unconstrained. The other material market positions established through acquisitions are Ruhrgas itself, in Germany; Slovakia, the Czech Republic, Hungary, and Romania.

Refer to important disclosures on pages 38 to 40.

We have shown a schematic of E.ON's supply market positions in electricity and gas and the 'optimal' of 20% in each (Chart 6). Markets where E.ON has a strong position or potential to make progress in our view are:

- **UK:** Powergen has 7.9m accounts (3.3m electricity, 0.4m gas and 2.1m dual fuel); an overall balanced electricity position; and with 27% of generation capacity is CCGT. The obvious gap in the UK portfolio is gas procurement, which will in the future be in the hands of Ruhrgas.
- **German Distribution/Supply**: Six out of seven RECs are integrated and offering power (7.5m customers) and gas (1.1m); but another 1.4m customers are indirect and served by municipalities, which might not allows for full retail market synergies. Lack of CCGT is another weakness.
- **German Transmission:** E.ON Energie/Ruhrgas transmission networks have good geographical overlap; though the power network is 4x the size of gas.
- **Hungary:** E.ON serves almost half (46%) domestic electricity customers and is 'close to integration'. Gas market share is small (9%) but the offering, and convergence opportunity should be enhanced with the acquisition of MOL.
- **USA:** LG&E may not be greatly in the public eye, and it is regulated, but it does have a combined electric/gas business. There are 0.9m electric customers, 0.31m gas, and 1.1MW of CCGT. E.ON may be considering exiting the US market over the next two years.

Chart 6: E.ON and Power/gas Convergence Relative Market Shares in Supply



Source: Merrill Lynch estimates

Route Two – Organic Growth

But organic growth is the next option

Ruhrgas is the likely key to E.ON's organic growth in power/gas convergence. Access to gas and the opportunity to leverage its long established relationships upstream, which until recently have been largely confined to supplying Germany, will be rolled out progressively across the Pan-European operations. This will take time, given the existing contractual relationships of E.ON's acquisitions.

Italy is one country where E.ON will use Ruhrgas as the entry point. The Italian power market has among the highest wholesale prices in Europe at present. Ruhrgas has a modest wholesale gas business giving it a small gas market position in Italy, but will also supply gas to two new 800MW CCGTs being built in a JV with Buzzi Unichem. E.ON has the platform to replicate this model across much of Europe.

Ruhrgas is also involved in two infrastructure projects, which will increase E.ON's scope to deliver gas to its main markets. The BBL pipeline is due onstream in 2007/8, linking the Netherlands and UK. Further out, the NEGP pipeline will bisect the Baltic, as well as deliver to the major European target markets.

At this stage, however, the gaps in E.ON's the portfolio are more obvious frankly than the strengths. There seems to us to be two central weaknesses in the model:

- **Equity Gas:** Ruhrgas currently meets a minimal proportion of its needs from equity production in the UK. The plan is to increase equity production to 15%. Assuming that Ruhrgas eventually meets all E.ON's gas requirements – and to get the most out of convergence, this should be a pre-requisite – the investment upstream could be substantial. For example, Ruhrgas sells around 106bn kWh of gas annually in Germany. After including recent acquisitions, E.ON and its subsidiaries supply another 200bn kWh to customers around Europe. EUR2bn of capital has been allocated for 2005-07 to start building the 15% equity position. The JV with Gazprom is expected to contribute a significant part of this. LNG, the boom segment of international gas trade, is likely to be part of the equation.
- **Continental CCGT's**: A major growth opportunity for Ruhrgas, and arguably the 'glue' in the power/gas convergence story for the industry as a whole in Central Europe. The proportion of gas-fired power stations in E.ON's portfolio across Europe is 11%, less than half that of Powergen's 28%. There is no quick-fix, though it is clear that CCGTs will be one of the likely fuels of choice for new build across the continent at the turn of the decade.

E.ON – A Work In Progress

Our overall assessment of E.ON's as a power/gas convergence play is that the backbone is in place as indeed are key geographic platforms. E.ON has established critical mass positions in gas or power in several individual markets.

Still a long way short of convergence

However, most of the operations though are still 'not joined up', or anything like fully converged. It will likely be well into next decade when E.ON manages to combine all of the potential elements - the potential of Ruhrgas' buying power, a European wide CCGT portfolio and dual fuel customer bases to capture the real benefits of an integrated business.

The shift into upstream gas has not been well timed in terms of the commodity cycle or indeed competition. The big North Sea asset sale late in 2004, BP's stake on the Norwegian Orman Lange field, sold well above expectations. E.ON's EUR2bn allocated for upstream won't go far at current prices, ands it may prove sensible to wait for asset markets to cool down.

CCGT build will surely happen in Central Europe – but it will be some years. The need for capacity rebuild is early next decade, and spark spreads will have to improve from current mediocre levels to justify the economics.

Refer to important disclosures on pages 38 to 40.

4. E.ON and GazProm

Russia is the great opportunity for European energy companies. Development of Russian oil and gas reserves, and the power industry, needs capital, technology and know-how. Europeans, geographically close at hand, culturally akin in many ways, seem well placed to be the providers. However, Russia is also a frontier province with the political and financial risks to match. The natural instinct of utilities management should be risk aversion, so Russia will present a new challenge.

Scale of Opportunity Weighed Against Risk

Others have learnt tough lessons in Russia

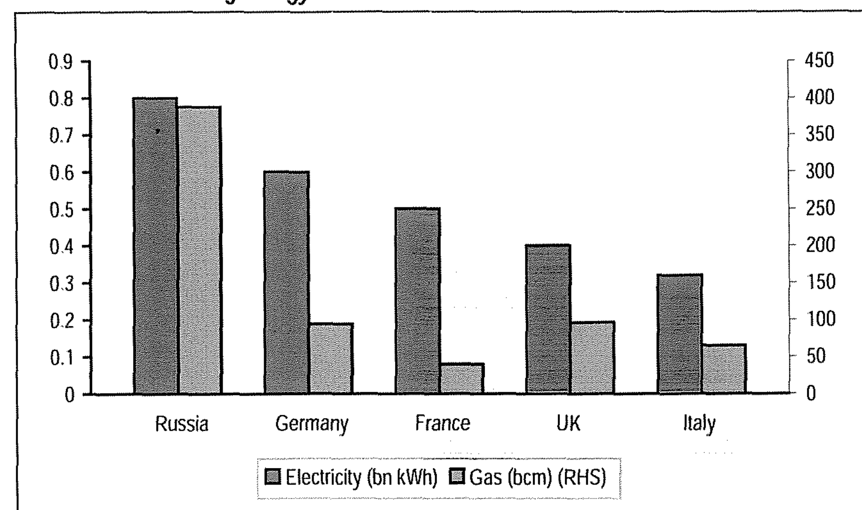
E.ON has taken an imaginative step in forging its prospective Joint Venture with GazProm. Russia offers great attractions for utilities, but with the exception of Finland's Fortum which has had long term links to the country, none has yet bitten the bullet. The risks associated with Russia are (mostly) apparent.

But forearmed is forewarned. The trials and errors of companies in other industries (mainly oil) which have tread the Russian Steppes suggest already there are three basic rules to follow:

- **Choose Your Partner Carefully:** There are a lot of fast talkers in Moscow; the only ones that matter are those closest to the government.
- **Know What You Are Buying:** Due diligence pays off. It must be galling to find your flagship acquisition is just a holding company, and that previously unknown parties have rights over the assets. BP wrote off its £0.5bn investment in Sidanko for this very reason.
- **Make Sure You Get the Cash Out:** It's not turned out to be a big issue so far, but it's the one that keeps all the CFOs awake at night.

The opportunity for E.ON in Russia could, over time, be transforming for the company, given the scale of upstream reserves and the power market.

Chart 7: Russia A Big Energy Market



Source: E.ON

A clearer idea of the capital at risk should emerge later this year

What is not clear is how much capital E.ON wants to commit, though management's cautious approach in these early stages is encouraging. E.ON is a big utility in Global terms, but realistically lacks the scale and resources of Big Oil, the other industry committing serious capital to the country. Nor is it clear how much equity Gazprom or the Russian power industry might be prepared to let E.ON have. Or for that matter how much, if any, of its core downstream gas

markets in Europe E.ON might want to share with Gazprom. These and other details will be thrashed out during 2005 and a vision may appear by year end. For the time being we offer this assessment the four main areas of the proposed JV.

Upstream Gas

E.ON's primary focus in the near term is upstream gas. The beauty of Russia is the scale and long productive life of its reserves. The MOU with Gazprom envisages E.ON participating in the development of Yushno Russkoje, a gas field in Western Siberia. Production is due to start in 2008, and output should be 25BCM p.a. – roughly equivalent to 25% of total German annual demand! It's a big gas field.

Giant reserves to fulfil Ruhrgas' dream

E.ON's desire for upstream gas reflects Ruhrgas' strategy of increasing flexibility in its procurement in anticipation of changing market conditions as markets liberalise. Ruhrgas has been itching for years to move upstream for this very reason.

E.ON's enthusiasm, spurred by the higher returns typically available from upstream (even from Russian projects), is underlined by the relationship being forged with Gazprom. The basis of the partnership is mutual dependence, which historically has been important between upstream producers and downstream gas partners – it is fairly common for the buyer to take an equity stake in a big gas project. Europe as a whole, and Germany in particular, are Gazprom's biggest external markets.

Russian Power

Industry restructuring may start soon

The Russian power sector is at the start of a major restructuring, initiated by the state, the majority shareholder in UES, the state-wide vertically integrated power behemoth. After a brief pause following the elections in 2003, the process is expected to move forward in 2005. The first step is expected to be the separation of upstream power segment into a series of 'Gencos' which will either be floated or auctioned. The Russian electricity market is slightly bigger than that of Germany.

Gazprom has already built up stake of c10% in UES, and also has 25% in Mosenergo, the Moscow distribution company. These stakes have a combined market value of about EUR 1.7bn.

E.ON's stated interest in Russian power is in generation, trading and retail. There seems to be a variety of options. First, Gazprom could sell all or part of its stakes in UES/Mosenergo for cash. Secondly, E.ON could swap European gas assets for these stakes to satisfy Gazprom's interest in downstream markets – though it is difficult to see what assets E.ON would want to sell or dilute. Thirdly, E.ON and Gazprom may together build new capacity in Russia. New plants are needed to replace old, inefficient stations; and market growth is expected to be c6% p.a., indicating future requirement for new build capacity. These projects could be attractive on the basis of PPAs, guaranteed offtake.

NEGP (North European Gas Pipeline)

Up to a point, an equity share in this Baltic infrastructure project is a staple business for Ruhrgas, a major pipeline operator. Outside Germany, Ruhrgas has UK Interconnector, and 17% in the second UK interconnector (BBL) under construction; though NEGP is potentially bigger and more speculative.

Essentially a strategic asset, i.e. a means of getting gas to the market, gas pipelines can be very long life and very good long term investments. The main target markets are the UK and continental Europe, but returns will partly depend on developing offtake along the route to Finland, Sweden and other low gas usage Baltic states.

Refer to important disclosures on pages 38 to 40.

European Downstream

And what does Gazprom get out of all this?

Gazprom wants downstream access, certainly to large customers either distribution companies or Industrial companies. CCGTs will no doubt form part of any arrangement. Sharing some growth opportunities in certain of its own target markets may be the price E.ON pays to be Gazprom's preferred partner.

At this early stage, it is difficult to visualise quite where the tie up with Gazprom will take E.ON, either in Russia or Europe. Besides the risks outlined above, there is Gazprom's balance sheet, which has limited flexibility. There is also uncertainty over state-owned Rosneft, which after buying assets from in the Yukos auction late in 2004, the government wants to merge with Gazprom.

E.ON will be wary of 'carrying' Gazprom if it were to come to it, and certainly wary of putting more than its fair share of capital into projects.

Conclusions

Choosing your partner was one of the risks identified, and no company is closer to the Russian government than Gazprom – indeed, the state could end up with a majority stake in 2005. If it can be made to work, the relationship could in the long term be E.ON's real opportunity to leverage off its Ruhrgas acquisition.

Ruhrgas has always been a big player in gas terms, but essentially just another domestic gas utility reselling someone else's gas in Germany. Direct equity in large scale Russian production, the infrastructure accessing other markets via NEGP could be the springboard for Ruhrgas to break the mould and move into the big league as a Pan-European gas player.

The risks are dimensionally different to those utilities typically take

The flip side, of course is the risk of operating in Russia. How much risk E.ON faces will be difficult to judge until the projects are more clearly identified and capital commitment quantified. However, the potential for upside to returns and valuation will need to be balanced against a very different investment profile to those E.ON, and its investors are used to.

5. Regulation: Ex-Ante - Positive in Concept?

Investors have proved to be relatively phlegmatic in anticipation of the introduction of formal regulation for German power and gas companies – share prices for both RWE and E.ON were robust through the course of 2004 as the proposals came more into the public domain. The regulator, RegTP, is expected finally to be provided with the legal powers and regulatory framework to set network fees by mid-2005, a year late. We assume that the first of a series of progressive tariff cuts begins from start 2006.

Painstaking Progress Towards Painful Outcome?

Progress to formal regulation has been grindingly slow, and may remain so during the early months of 2005. The government is attempting to push through parliament five separate bills, or mini-bills, which make up the overall proposed framework. These are:

- **The Energy Law**, providing the legal framework, defining the powers of the regulator and outlining the method of tariff calculation and access conditions to power and gas networks
- Four **ordinance provisions**, which will detail the tariff calculations and network access terms for gas and power networks.

Political process the wrong way round

The usual procedure elsewhere in Europe has been for the government to frame the law and empower the regulator to thrash out the nitty gritty. In Germany's case, all political parties have been able to advance views on the detail of each part of the new legislation. The fragmentation and complexity of the German industry are other reasons why the parliamentary debate has been so protracted. The framework will affect 900 electricity and 700 gas network companies. There are also five different gas qualities used in different pipeline networks in Germany.

Once approval is given by the lower House, or Bundestag (possibly in Q1 2005), the Energy Law will proceed to the Upper House (Bundesrat). If, as some believe, the Bundesrat (controlled by the CDU/CSU opposition) rejects the proposals, the Government will seek arbitration. Thus there is no clear deadline for all this to conclude, although the general industry expectation is that RegTP will be empowered by the end of the first half of 2005.

Ex-Ante – Carrot and Stick Regulation

Pain before gain, the ex-ante way

Exactly what regulation will mean for the companies is difficult to assess. The proposed ex-ante, or UK style, regulation is more radical than the industry originally expected. In principal, we believe that as a concept, formal, ex-ante regulation as a concept is positive for the industry and investors. Clear tariffs, allowed returns and incentives all help provide transparency for investment and visibility for earnings.

The transition from a to b, though, can be painful, especially if current returns are excessive. RWE fanned the fears with its widely quoted statement in November 2004 *"We expect the new regulatory framework will definitely cause the earnings situation of our German Grid business to deteriorate significantly"*.

We suspect that the core issue, both for the companies and the government/regulator will be the allowed return on investment – current *and* future. The network companies are currently allowed a notional real return of 6.5% on new investment. Actual overall returns are thought to be in double digits based on historic cost assets and depreciation. The industry wants this base 6.5% level of return to be maintained for new investment.

The proposed incentive mechanism should help offset the revenue impact of tariff cuts. A typical revenue cap mechanism, or X-factor, would enable the companies to focus on cost cuts as a means of raising returns above the base level. Certainly

Refer to important disclosures on pages 38 to 40.

RWE, and indeed E.ON, expect to respond with fresh cost cuts, if required. However, it seems unlikely that the regulator can expect German network operators to deliver the scale of redundancies achieved in the UK in the 1990s given German employment laws. Moreover, the fragmentation of the industry implies higher costs than other, more concentrated networks, such as the UK.

Assessing which companies are exposed is difficult for the outsider. Tariffs, and returns, vary widely, a significant factor in the motivation behind the changes to the framework. Though how much is related to overcharging or a function of population/supply density is hard to fathom. The tariffs for a rural network can be twice that of a city (see Table 6).

Table 6: German Regulatory Tariffs

	Tariff Ct/kWh	Supply Density MWh/kmsq
Urban - Dussledorf (E.ON)	4.6	4300
RWE Energy	6.2	3500
Rural - Avacon, East	8.1	2000

Source: E.ON

Impact on E.ON

E.ON has argued that its exposure to regulatory change is modest and that its tariffs are close to the German average. The company's view in gas, for example, is that only 10% of network revenues are generated by third party use of system. Ruhrgas uses the other 90% and its end user prices (i.e. a bundled price of commodity, network fees and supply margin) need not be affected. It strikes us as unlikely that the Bundestag and Bundesrat will put so much effort into establishing the legislation for such a modest outcome.

E.ON does not present unbundled revenues or EBIT for its German network business, and has been less explicit in its guidance than RWE. We have estimated E.ON's revenue at around EUR6.5bn, based on a comparison of network size with RWE. Assuming a margin of c30%, broadly in line with other network businesses around Europe implies network operating profits for E.ON of EUR2.0bn, approximately 28% of Group EBIT.

An educated guess

We have modelled a cumulative reduction in revenue of EUR668m over the first three years of the new regulator's office from 2006-08, i.e. c10% of 2004E total EBIT. We would consider a reduction of this scale as at the tough end of likely outcomes. However, we have also assumed that E.ON is able to offset 50% of the revenue reduction by renewed cost cuts.

The net EBIT reduction of EUR334m, or 4% of the group, we have modelled needs also to be weighed against the operating gains we envisage elsewhere in the portfolio. We expect E.ON's EBIT for the core Energy business to increase from EUR6.7bn in 2004E to EUR8.1bn by 2008E. Table 7 below summaries our estimates of the impact of regulation on both RWE and E.ON.

Table 7: Regulation Impact on E.ON and RWE

	E.ON			RWE		
	2006E	2007E	2008E	2006E	2007E	2008E
Cumulative Reduction in Grid Revenues	**-226**	**-448**	**-668**	**-155**	**-307**	**-457**
% Group 04E Revenue	-0.5%	-0.9%	-1.4%	*-0.4%*	*-0.7%*	*-1.1%*
% Group 04E EBIT	-3.4%	-6.7%	-9.9%	*-2.6%*	*-5.1%*	*-7.7%*
Cost Reduction	113	224	334	78	154	229
Net Impact on Group s EBIT (EURm)	**-113**	**-224**	**-334**	**-77**	**-153**	**-228**
% of Group's 2004E EBIT	-2%	-3%	-4%	*-1 %*	*-3%*	*-4%*

Source: Merrill Lynch estimates

6. Power Markets

The major driver of E.ON's earnings over the next few years is likely to be higher wholesale power price. We expect rising prices, helped by the ongoing cost-cutting programme to lead to a rise in group operating profits of cEUR1.5bn. The up-cycle for prices partly indicates tightening of power markets across Central Europe, implying re-investment in new capacity. Our pragmatic view is that either prices will continue to rise to attract the capital needed, or political expediency will act to extend productive plant life, notably nuclear. This suggests that we are in the early stages of an upcycle for profitability.

European Wholesale Markets

On the rise, despite mild winter

There has been a sea-change in power markets over the last three years. Prices on the EEX have risen by 50% from EUR24/MWh in early 2003 to around EUR34/MWh in 2005. The forward curve indicates a price of EUR38/MWh by the end of the decade. Prices across in other markets across Northern Europe, including the UK and the Netherlands show a similar trend.

There are three main factors behind the upward trend.

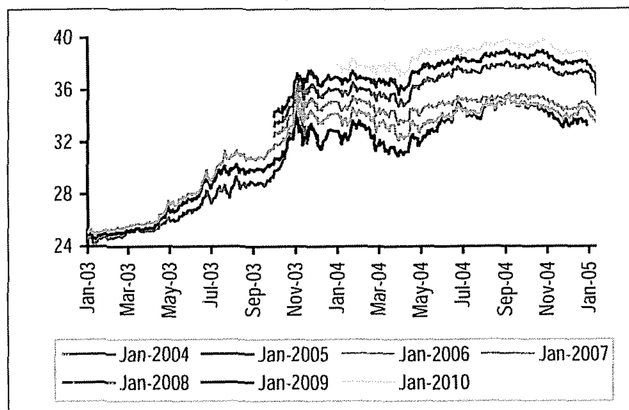
- **Rising Fuel Costs:** the cost of hard coal, natural gas and oil have soared over the last two years. Although oil and gas prices have eased back from the highs of Q3 2004, we expect – as indeed we believe the industry does – prices to settle at a higher level than in recent years. (ML raised its medium term forecast from US$31 to US$33/bbl on January 24th 2005). Coal prices may have been driven by slightly different factors (e.g. China) but are also likely to average higher levels than in the recent past.
- **Cost of Carbon:** The advent of carbon trading in the EU from January 1st 2005 brings with it a transparent 'cost of carbon', currently trading at around EUR7/tonne (cEUR3-4/MWh). We regard this cost as effectively another 'commodity' cost which consumers will have to pay. Just how much is already factored into the forward curve is impossible to discern, but the EUR8/MWh delta in EEX between 2004A and 2007/8 prices suggest some at least is in the price. If, as seems likely, the terms of the second phase beginning in 2008 are tougher, a scarcity of carbon certificates scarcer would drive carbon costs up. In all likelihood power costs would follow.
- **Tightening Reserve Margins:** The closure and mothballing of capacity over the last three years has left the peak reserve margin in Germany at around 7-8%, and lower in the summer maintenance season. Interconnection capacity is less than 3%. As carbon emissions trading and the impending sulphur emissions legislation lead inevitably to the closure of older, uneconomic fossil fuel plant, replacement capacity will be required. Both RWE and E.ON have plans for capacity expansion later in the decade.

High gas prices pushup new entrant costs

The forward curve is still short of where it needs to be to support new investment. We estimate that a wholesale price of EUYR40-42/MWh is needed to justify a new CCGT based on forward gas prices and expected CO2 costs. Either oil prices, and hence gas prices need to fall, or power prices will have to rise to create a spark spread that will give generators an adequate return.

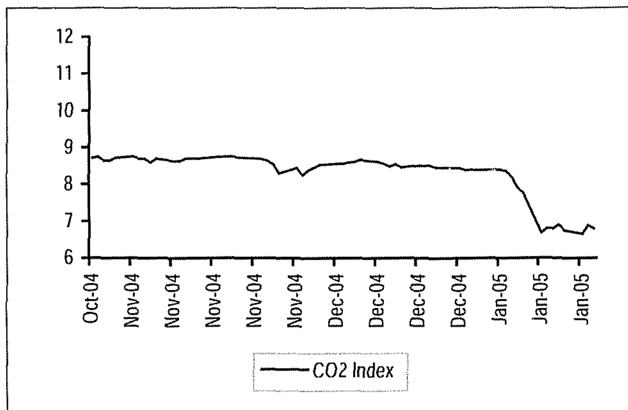
Refer to important disclosures on pages 38 to 40.

Chart 8: EEX Forward Curve (EUR/MWh)



Source: EEX

Chart 9: Carbon Index (EUR/tonne)



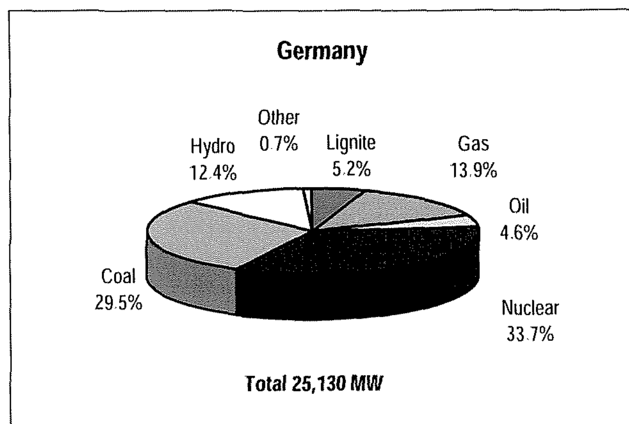
Source: EEX

E.ON's Portfolio

60% of output unaffected by higher fuel costs

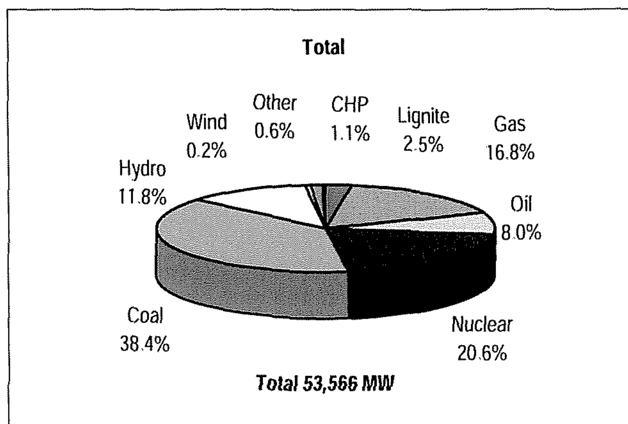
E.ON Energie produces around 137TWh of power (2003A). Over half (73TWh) is supplied by nuclear plant, around 9TWh hydro, and the remaining 55TWh conventional thermal (hard coal, gas, oil and lignite). Thus a little over 60% of E.ON's domestic output is immune from rising oil, gas and coal prices and should contribute higher margins as wholesale prices rise.

Chart 10: E.ONs German Power Portfolio



Source: E.ON

Chart 11: E.ONs Overall Power Portfolio



Source: E.ON

Costs on par with the European average

We estimate E.ON's variable generation costs are marginally above the European average (see Table 8). The comparison shows our estimates for the marginal costs of different fuels both for E.ON and the industry as a whole. Variable costs include fuel costs, carbon costs and other operating expenses such as O&M, but exclude staff costs and D&A. We have not taken into account free CO2 allocations in these calculations. We should note that the high proportion of nuclear in some countries, especially France, influences the European average.

Table 8: Comparison of E.ON s Generation Costs With the European Industry

European Average Generator

	Generation Mix	Var.Costs Excl. CO2 (EUR/MWh)	Carbon Emissions (t per MWh)	Cost of Carbon (EUR/ tCO2)	Cost of Carbon (EUR/MWh)	Var Cost Incl CO2 (EUR/MWh)
Hydro/Wind	18%	7	0.0	8.5	0.0	7
Nuclear	34%	10	0.0	8.5	0.0	10
Coal	28%	25	1.0	8.5	8.5	34
CCGT	14%	30	0.4	8.5	3.1	33
Fuel Oil	6%	35	0.7	8.5	5.9	41
Total Var. Costs (EUR/MWh)		**18.0**				**21.1**

E.ON s Domestic Portfolio

	Generation Mix	Var.Costs Excl. CO2 (EUR/MWh)	Carbon Emissions (t per MWh)	Cost of Carbon (EUR/ tCO2)	Cost of Carbon (EUR/MWh)	Var Cost Incl CO2 (EUR/MWh)
Hydro	12%	7	0.0	8.5	0.0	7.0
Nuclear	34%	10	0.0	8.5	0.0	10.0
Coal	30%	25	1.0	8.5	8.5	33.5
Lignite	5%	25	1.0	8.5	8.5	33.5
Gas	14%	30	0.4	8.5	3.1	33.1
Oil	5%	35	0.7	8.5	5.9	40.9
Other	1%	18.0	0.5	8.5	4.3	22.2
Total cost (EUR/MWh)		**18.8**				**22.5**

Source: Merrill Lynch estimates

The relatively high proportion of non-fossil fuel output means that the burden of carbon costs will be modest in the first phase of carbon emissions trading from 2005-07. E.ON's allocation is based on carbon emissions - 38% below the German average of 580g/kWh. Based on the current traded cost of carbon of around EUR4/MWh, the overall cost will be around EUR15m p.a. or well below 1% of EBIT.

Higher power prices will feed progressively into the P&L

The benefit of higher wholesale prices on the non-fossil fuel output should feed progressively through to profits over the next few years. We have based our forecasts on the EEX forward curve, taking into account forward sales. E.ON typically locks in 100% of sales and procurement on 12-24 month contracts and will have fully hedged for the 12 months ahead at any point.

Our forecasts suggest an increase in EBITDA of around EUR730m from German generation alone over the next four years. This is after taking into account higher fuel costs (mostly coal) and the cost of carbon certificates.

Medium Term Investment Requirements

Politics will determine the scale of new capacity required in Germany. The Nuclear Energy Agreement, which resolves to close nuclear plants before the end of useful station life, lies at the heart of the uncertainty, as well as the German response to carbon emissions. E.ON has assessed capacity build ranges from a modest 4,000MW by 2020, or 4% of total national capacity; to as high as 18,000MW, or 18% if the full environmental option is pursued and nuclear closure remains on track.

Nukes – the big conumdrum

However, most power plants operating in Germany have technical scope for life extension, which would defer the need for investment on this scale. The greatest uncertainty lies over the nuclear plant, scheduled for closure by law after 45-year average asset lives, versus perhaps a 60-70-year practical life.

Refer to important disclosures on pages 38 to 40.

We expect the Law will be subject to great scrutiny after the 2006 elections, when the new government and opposition parties will need to face up again to the trade off between environmental aspirations and the desired level of electricity prices. It has become clear in the last 12 months that UK energy policy has recently become receptive to nuclear again for the same reasons, after decades of disinterest. Perhaps Germany may follow suit.

Closure – high prices; life extensions, moderate prices

We take a pragmatic view of the outcome of this debate. If nuclear extension comes, power prices will likely be more moderate, but producers like E.ON will gain from the extended life of fully depreciated plant as well as the deferral of decommissioning and new build costs. On the other hand, if the legislation stands and a heavier replacement programme is needed, wholesale prices will need to remain higher for longer to justify the investment.

Understandably, given the wide range of possible outcomes in Germany, E.ON is playing it step by step and keeping options open. The company has 2000MW of hard coal and CCGT on the drawing board to start by 2012; and another 3000MW could be made available within a 12-24 months from de-mothballing or tweaking existing plant. Elsewhere in Central Europe there are plans to build additional capacity to support market positions in Italy, Hungary, the Netherlands and the Czech Republic.

The new investment plans for 2005-07 announced by the company in December 2004 underscore the cautious approach. E.ON's plans to spend EUR2.4bn on generation including EUR1.1bn on renewables. This suggests around 1-2GW of conventional capacity across Europe.

7. Financials

E.ON's focus on power and gas should deliver progressively rising profits over the next few years given the rising trend in energy prices. The 'on.top' cost cutting programme and ongoing integration of recently acquired assets should also provide momentum. Key uncertainties are German regulation and further out returns from possible investments in Russia. Cash generation looks set to burgeon, boosted by anticipated major non-core asset sales in 2005E and 2006E. There is therefore considerable flexibility for both growth investment and incremental shareholder returns above the flagged double-digit dividend growth.

Earnings and Dividends

Core EBIT set to increase by 45% over the next four years

Rising power and gas prices, allied to the cost-cutting programme and in the very near term integration of recently acquired assets are the main drivers of earnings in the near term. We expect Group EBIT to increase by 38% from 2003A to 2008E and the core business by 45% (excluding Degussa and Viterra).

Table 9 below summarises our price assumptions.

Table 9: Main Assumptions

	2004E	2005E	2006E	2007E	2008E	2009E
Price Assumption Based on EEX Forward	28.0	34.5	34.5	36.0	38.0	40.0
GBP/EUR (Average)	0.72	0.75	0.76	0.76	0.76	0.76
USD/EUR (Average)	1.29	1.34	1.35	1.35	1.35	1.35

Source: Merrill Lynch estimates

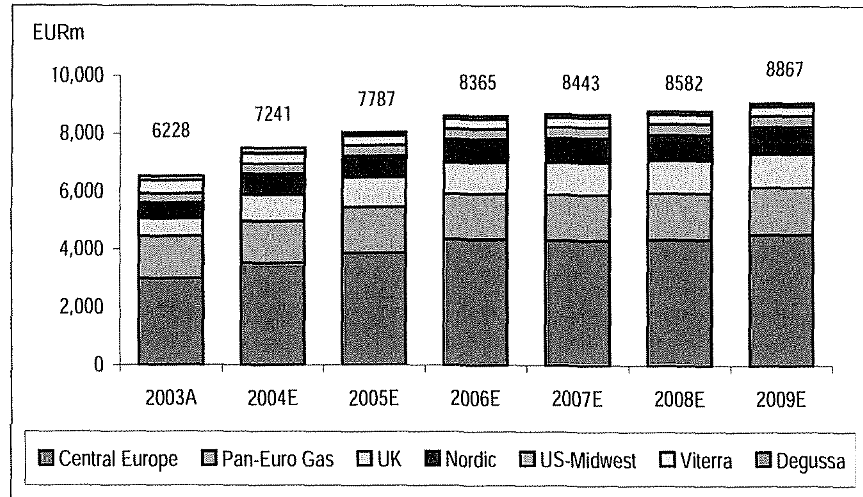
EBIT Growth

The main growth phase should be 2003A-2006E when these three individual factors are at their strongest. During this period we forecast EBIT from **Central Europe** (48% of EBIT) to grow at double digit rates; the **UK** and **Nordic** businesses similarly, though mainly through acquisitions. The rate of growth post 2006E is significantly dampened by the somewhat wary stance view we have taken on regulatory tariff cuts in Germany. The key assumption is that we have used the forward curves for EEX and UK power prices; beyond 24 months volumes are unhedged.

The more pedestrian growth rate post 2006E could be improved by a number of factors. These include a gentler regulatory review in Germany (either zero tariff reductions, or full offset of tariff cuts with cost-cutting would add 4% to our 2008E EBIT forecasts), higher power or gas prices or material new investment such as in Russia. Equally energy prices could soften.

Refer to important disclosures on pages 38 to 40.

Chart 12: EBIT by Division



Source: Merrill Lynch estimates

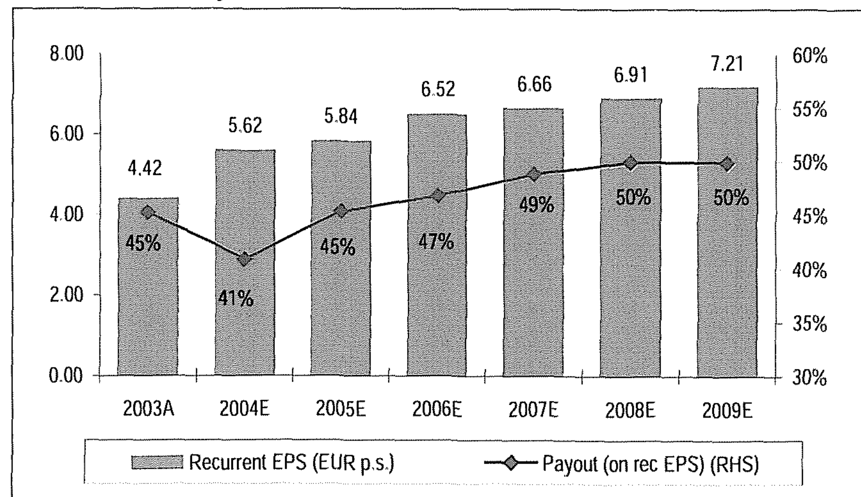
EPS and Dividends

Our cautious assumptions on regulation dampen growth post 2006E

The higher EBIT will translate into strong EPS growth 2004E-06E. Recurrent EPS forecast for 2004E is EUR5.6. The more modest 5% CAGR for 2004E-09E is subdued by the effect of regulation in the latter years which we have assumed cumulatively reduces EBIT by 4% over the three years 2006E-08E. We believe this to be a conservative assumption from the company's point of view. Fresh cost-cutting targets likely await clarity on regulatory tariffs, probably late in 2005E.

E.ON has had a dividend policy at the more aggressive end of the sector compound growth of 14% since 2000A. We have forecast 15% for 2004E, and the following two years. For the subsequent period we have assumed 5-6% growth, broadly in line with earnings on our forecasts. The pay-out ratio on recurrent earnings reaches 50% by 2008E.

Chart 13: EPS and Payout Ratios



Source: Merrill Lynch estimates

Table 10 below shows our estimates versus consensus.

Table 10: Merrill Lynch Forecasts Versus Consensus

EBITDA (EURm)	2004E	2005E	2006E	2007E	04E - 07E CAGR
MLe	10,464	11,093	11,721	11,858	4.3%
IBES Consensus	10,057	10,501	11,003	11,084	3.3%
Mle vs Consensus	*+4.0%*	*+5.6%*	*+6.5%*	*+7.0%*	
EPS (EUR p.s.)	**2004E**	**2005E**	**2006E**	**2007E**	**04E - 07E CAGR**
MLe - Reported	6.8	5.8	6.5	6.7	-0.5%
MLe - Recurrent	5.6	5.8	6.5	6.7	5.8%
IBES Consensus	5.3	5.6	6.0	6.2	5.1%
Mle vs Consensus	*+5.5%*	*+4.2%*	*+8.5%*	*+7.9%*	

Source: Merrill Lynch estimates, IBES

Cash Flow and Balance Sheet

E.ON's cash flow and balance sheet are beginning to settle down after a tumultuous period through the restructuring of the business. Major acquisitions and disposals have distorted the underlying picture for five or six years. Whilst there are still disposals to come, the materiality is diminishing. At the same time, cash generation in the core business is improving.

Our forecasts suggest 44% growth in operating cash flow from EUR6.1bn in 2004E to EUR8.9bn by 2007E. Given around EUR4bn of capex, this leaves E.ON with in excess of EUR4.0bn of free cash p.a. flow within a few years. However, our own capex forecasts are a little lower than E.ON's December 2004 update; and we anticipate that investment will increase, into generation towards the end of the decade and also when the Russian joint venture crystallises.

Two key non-core disposals remain for E.ON to execute.

- **Viterra** (E.ON 100%) is a likely sale in 2005. The strength in German real-estate transactions in recent months has lifted our expectations of the Enterprise Value of Viterra to EUR6bn, though there is debt in the business.
- **Degussa:** E.ON owns 43% of the company worth around EUR2.5bn. Likely to be a 2006 transaction given the current climate in the chemicals industry; and the size of the stake.

Combined, if at sold at our valuations, these two disposals could realise up to EUR12.5/share providing the basis for a return to shareholders. In practice, potential tax on disposal and net debt within Viterra could reduce the available capital to return to around EUR6-8/shares or c10% of market cap. The planned sales of Ruhrgas Industrial and Connect Austria (telco) could add a further EUR0.75bn (cEUR1/share) combined.

A return of capital is possible . . .

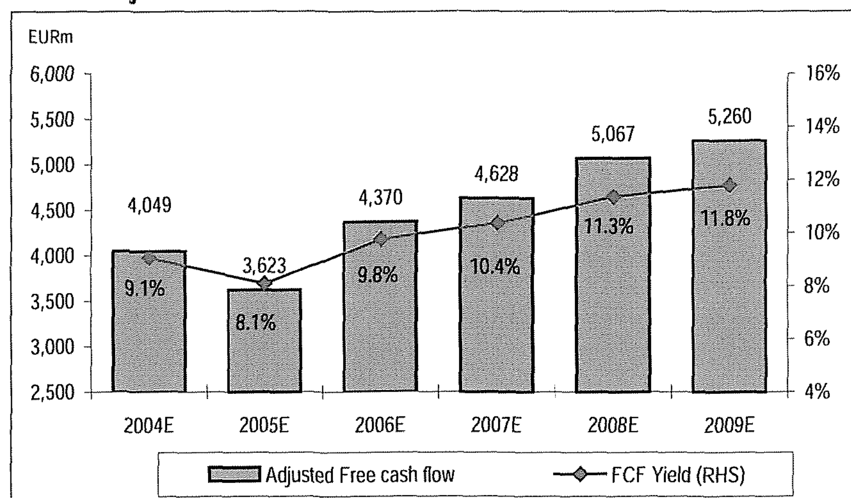
The return of capital from the sale of non-core businesses could serve the dual purposes of satisfying shareholders expectations, which have gradually been on the rise; and maintaining balance sheet flexibility for future investment.

. . . and funding options for acquisitions are substantial

Irrespective of the disposals, the balance sheet is one of the stronger in the sector. Net debt has fallen from EUR12.5bn at end 2002A to EUR6.4bn on our forecasts by end 2004E. EBITDA/Net Interest (on financial debt) cover is set to rise from 18.7x to 23.5x, giving balance sheet flexibility for new investments. There is also the 'option' of selling LG&E in the USA if there are greater investment opportunities identified in Europe. The Gazprom stake, currently worth around EUR3.8bn could also be used as currency in any Russian investment.

Refer to important disclosures on pages 38 to 40.

Chart 14: Adjusted Free Cash Flow and FCF Yield



Source: Merrill Lynch estimates. FCF adjusted for change in long term provisions

Assessment of Financial Targets

E.ON set out a number of operating and financial targets for 2006E. Here is our assessment of the progress made so far.

- **ROCE**: The aim is to lift from 9.2% in 2002 to 10.5%. Our forecasts suggest E.ON will beat the target by around 100bp, even on a higher Capital Employed estimate.
- **Free Cash Flow**: The target is to realise at least EUR2.4bn of FCF p.a. Our forecasts suggest E.ON will breach the target in 2004E, and both subsequent years by a margin, depending on capex.
- **Adjusted EBIT**: The EUR6.7bn target excludes Degussa and Viterra; even so could be reached in 2004E.
- **Dividends**: The modest target of double digit growth to 2006E and a 50% pay-out ratio should be easily achieved.
- **Cost-cutting**: on.top targets a total of EUR1.0bn cost cuts by 2006E. EUR270m were achieved in 2003A; around EUR490m cumulative had been delivered by Q3 2004, indicating a similar run rate and on track for the 2006E target.

The eclipsing of the majority of the targets in 2004E is likely to prompt some fresh aspirations, perhaps with the 2004E Finals on March 10th. There may be some reluctance to refresh on.top cost cutting targets until some clarity emerges on German regulation, which is not likely to emerge for another year or so.

Credit Profile (Aa3 Stable/AA- Stable) –

Shokat Khan, European Utilities Fixed Income Research (+44 20 7995 1393)

Fundamentals in electricity and gas continue to remain supportive of E.ON's credit quality and as discussed earlier we expect limited impact from the upcoming network tariff regulation. The company has ruled out any sizeable acquisitions and continues to seek opportunities in the Eastern European market as was evident with its recent announcement to purchase a major stake in Hungary's Ruhrgas-look alike, MOL. Given E.ON's cash generation abilities, we believe the company can with stand negative ratings pressure in 2005 if it continues with its current acquisition strategy and/or announces a large share buy-back or special dividend. We believe recent management comments on target ratings of high single-A demonstrate that E.ON will eventually take advantage of its balance sheet flexibility over time.

Table 11: E.ON s Balance Sheet Ratios

Balance Sheet Ratios	2003A	2004E	2005E	2006E	2007E	2008E	2009E
Net Debt	7,855	6,391	5,186	3,627	1,689	-1,258	-4,277
Net Debt/(Net Debt +Shareholders Equity)	21%	17%	13%	9%	4%	-3%	-11%
ROCE	10%	11%	12%	12%	12%	12%	13%
EBITDA/Total net Interest Expenses	5.7x	8.7x	7.5x	8.2x	8.7x	9.6x	9.8x
EBITDA/Net Interest on Financial Debt	14.3x	23.5x	28.3x	37.5x	56.2x	173.3x	345.4x

Source: Merrill Lynch estimates

Refer to important disclosures on pages 38 to 40.

Table 12: Profit & Loss Projections

EURm	2003A	2004E	2005E	2006E	2007E	2008E	2009E	04A -09E CAGR
Total Sales	**46,364**	**48,665**	**52,728**	**53,463**	**54,147**	**55,207**	**56,354**	*3.0%*
Growth	*27%*	*5%*	*8%*	*1%*	*1%*	*2%*	*2%*	
Total EBITDA (incl associates)	**9,458**	**10,464**	**11,093**	**11,721**	**11,858**	**12,024**	**12,340**	*3.4%*
Growth	*25%*	*11%*	*6%*	*6%*	*1%*	*1%*	*3%*	
Margin	*20%*	*22%*	*21%*	*22%*	*22%*	*22%*	*22%*	
Core Business Energy	8,580	9,762	10,477	11,102	11,237	11,400	11,713	
Central Europe	*4,471*	*5,016*	*5,417*	*5,894*	*5,880*	*5,923*	*6,105*	
Pan-European Gas	*1,889*	*1,893*	*2,038*	*2,054*	*2,072*	*2,094*	*2,127*	
UK	*1,036*	*1,369*	*1,487*	*1,539*	*1,589*	*1,609*	*1,629*	
Nordic	*933*	*1,160*	*1,215*	*1,270*	*1,321*	*1,373*	*1,426*	
US-Midwest	*517*	*537*	*547*	*557*	*572*	*587*	*602*	
Corporate Center/Consolidation	*-266*	*-213*	*-226*	*-212*	*-198*	*-186*	*-175*	
Viterra	643	530	508	510	513	515	518	
Degussa	235	171	109	109	109	109	109	
Total EBIT	**6,228**	**7,241**	**7,787**	**8,365**	**8,443**	**8,582**	**8,867**	*4.1%*
Growth	*34%*	*16%*	*8%*	*7%*	*1%*	*2%*	*3%*	
Margin	*13%*	*15%*	*15%*	*16%*	*16%*	*16%*	*16%*	
Core Business Energy	5,621	6,698	7,336	7,919	8,002	8,146	8,437	
Central Europe	2,979	3,511	3,880	4,346	4,321	4,354	4,526	
Pan-Euro Gas	1,463	1,454	1,580	1,578	1,578	1,609	1,642	
UK	610	901	1,033	1,084	1,123	1,138	1,159	
Nordic	546	724	741	793	842	891	940	
US-Midwest	317	349	356	358	363	368	373	
Corporate Center/Consolidation	-294	-241	-254	-240	-225	-214	-203	
Viterra	456	372	342	337	332	327	322	
Degussa	151	171	109	109	109	109	109	
Financial Expenses	-1,663	-1,208	-1,487	-1,436	-1,365	-1,255	-1,254	
PBET	**4,565**	**6,033**	**6,300**	**6,929**	**7,078**	**7,327**	**7,613**	
Extraordinary Items and Non Operating Income	973	752	-60	0	0	0	0	
PBT	5,538	6,785	6,240	6,929	7,078	7,327	7,613	*2.3%*
Income Tax	-1,124	-1,815	-1,919	-2,086	-2,126	-2,192	-2,267	
Minority Interests	-464	-524	-529	-546	-563	-579	-595	
Net income, Continuing	**3,950**	**4,447**	**3,791**	**4,296**	**4,390**	**4,556**	**4,750**	
Discontinuing Items / Other	697	0	0	0	0	0	0	
Group Net Income	**4,647**	**4,447**	**3,791**	**4,296**	**4,390**	**4,556**	**4,750**	*1.3%*
Growth	*67%*	*-4%*	*-15%*	*13%*	*2%*	*4%*	*4%*	
Recurrent Group Net Income	**2,891**	**3,695**	**3,851**	**4,296**	**4,390**	**4,556**	**4,750**	*5.2%*
Growth	*29%*	*28%*	*4%*	*12%*	*2%*	*4%*	*4%*	
Reported EPS (EUR p.s.)	*7.11*	*6.76*	*5.75*	*6.52*	*6.66*	*6.91*	*7.21*	*1.3%*
Recurrent EPS (EUR p.s.)	*4.42*	*5.62*	*5.84*	*6.52*	*6.66*	*6.91*	*7.21*	*5.1%*
DPS (EUR p.s.)	*2.0*	*2.3*	*2.7*	*3.1*	*3.3*	*3.5*	*3.6*	*9.4%*
Payout Ratio (on reported earnings)	*28%*	*34%*	*46%*	*47%*	*49%*	*50%*	*50%*	*728%*
Payout Ratio (on recurrent earnings)	*45%*	*41%*	*45%*	*47%*	*49%*	*50%*	*50%*	*183%*

Source: Merrill Lynch estimates

Table 13: Free Cash Flow Analysis

	2003A	2004E	2005E	2006E	2007E	2008E	2009E	04E -09E CAGR
Adjusted Free Cash Flow	1,292	4,049	3,623	4,370	4,628	5,067	5,260	9.1%
FCF P.S.	2.0	6.2	5.5	6.6	7.0	7.7	8.0	
FCF Yield	2.9%	9.1%	8.1%	9.8%	10.4%	11.3%	11.8%	

Source: Merrill Lynch estimates. FCF adjusted for change in long term provisions

Table 14: Cash Flow Projections

EURm	2003A	2004E	2005E	2006E	2007E	2008E	2009E	04E -08E CAGR
Net Income	4,647	4,447	3,791	4,296	4,390	4,556	4,750	
Minority Interests	464	524	529	546	563	579	595	
Income from Discontinued Operations	-1,137	0	0	0	0	0	0	
Depreciation, Amortisation, Impairments	3,272	3,222	3,306	3,356	3,415	3,442	3,472	
Gains / Losses on Disposals	-1,815	-792	0	0	0	0	0	
Change in Provisions	1,586	-244	512	536	561	588	616	
Change in Deferred Taxes	-132	0	0	0	0	0	0	
Change in Working Capital	-1,191	-1,010	-311	-133	-78	-116	-140	
Other non-cash Items	-156	0	0	0	0	0	0	
Cash Flow from Operations	**5,538**	**6,147**	**7,827**	**8,601**	**8,851**	**9,049**	**9,294**	*8.6%*
Disposals	7,035	2,537	0	0	0	0	0	
Investments	-9,196	-4,771	-4,757	-4,760	-4,351	-3,394	-3,418	
Change in securities > 3 months and other liquid funds	2,200	967	0	0	0	0	0	
Cash Flow from Investments	**39**	**-1,267**	**-4,757**	**-4,760**	**-4,351**	**-3,394**	**-3,418**	*22.0%*
Free Cash Flow	**2,878**	**3,805**	**4,135**	**4,906**	**5,190**	**5,655**	**5,876**	*9.1%*
Net Change in Treasury Stock	7	-10	0	0	0	0	0	
Payment of Cash Dividends	-1,621	-1,825	-2,035	-2,282	-2,561	-2,709	-2,857	
Net proceeds from Financial Liabilities	-1,931	0	0	0	0	0	0	
Cash flow from Financing	**-3,545**	**-1,835**	**-2,035**	**-2,282**	**-2,561**	**-2,709**	**-2,857**	*9.3%*
Net Cash Income / outgoings	2,032	3,044	1,035	1,559	1,939	2,946	3,019	
Forex Impact on Net Cash	-43	0	0	0	0	0	0	
Cash from Discontinued Operations	-10	0	0	0	0	0	0	
Change Net Cash & Equivalents	**1,979**	**3,044**	**1,035**	**1,559**	**1,939**	**2,946**	**3,019**	*-0.2%*
Cash at y/e	3,321	5,398	6,434	7,993	9,931	12,877	15,897	

Source: Merrill Lynch estimates

Table 15: Balance Sheet Projections

EURm	2003A	2004E	2005E	2006E	2007E	2008E	2009E
Goodwill	13,955	13,564	13,365	13,365	13,365	13,365	13,365
PPE & Intangibles	46,950	46,052	47,503	48,907	49,843	49,795	49,741
Financial Assets	17,725	17,725	17,725	17,725	17,725	17,725	17,725
Fixed Assets	**78,630**	**77,341**	**78,592**	**79,997**	**80,933**	**80,885**	**80,831**
Inventories	2,477	2,867	3,106	3,149	3,190	3,252	3,319
Receivables	18,025	18,778	19,201	19,302	19,395	19,541	19,698
Liquid Funds, Non-Cash	7,474	6,507	6,507	6,507	6,507	6,507	6,507
Cash & Cash Equivalents	3,321	5,398	6,434	7,993	9,931	12,877	15,897
Non-Fixed Assets	**31,297**	**33,550**	**35,248**	**36,951**	**39,023**	**42,177**	**45,421**
Other	1,923	1,937	1,974	1,975	1,981	1,991	2,000
TOTAL ASSETS	**111,850**	**112,828**	**115,814**	**118,923**	**121,937**	**125,052**	**128,252**
Shareholders Equity	29,774	31,580	33,862	36,414	38,799	41,224	43,709
Minority Interests	4,625	4,635	4,646	4,657	4,668	4,680	4,692
Provisions	34,206	33,962	34,473	35,009	35,571	36,159	36,775
Financial Liabilities	21,787	21,434	21,264	21,264	21,264	21,264	21,264
Operating Liabilities	14,113	14,246	14,597	14,608	14,664	14,756	14,841
Other	7,345	6,971	6,971	6,971	6,971	6,971	6,971
TOTAL EQUITY & LIABILITIES	**111,850**	**112,828**	**115,814**	**118,923**	**121,937**	**125,052**	**128,252**
Balance sheet ratios	**2003A**	**2004E**	**2005E**	**2006E**	**2007E**	**2008E**	**2009E**
Net Debt	7,855	6,391	5,186	3,627	1,689	-1,258	-4,277
Net Debt/(Net Debt +Shareholders Equity)	21%	17%	13%	9%	4%	-3%	-11%
ROCE	10%	11%	12%	12%	12%	12%	13%
EBITDA/Total Net Interest Expenses	5.7x	8.7x	7.5x	8.2x	8.7x	9.6x	9.8x
EBITDA/Net Interest on Financial Debt	14.3x	23.5x	28.3x	37.5x	56.2x	173.3x	345.4x

Source: Merrill Lynch estimates

Refer to important disclosures on pages 38 to 40.

8. Valuation

Our sum-of-parts based valuation for E.ON is EUR75/share. The valuation is DCF based, and equates to a 2005E EV/EBITDA multiple of 7.5x, in line with the peer group. The valuation suggests upside of around 10% from the current share price.

DCF-Based Sum of Parts Valuation

We valued each of the constituent parts of E.ON's portfolio using DCF, or market based values where appropriate. These benchmarking metrics, and the implied EV/EBITDA multiples are shown in Table 16.

The valuation of **Central Europe**, E.ON's core power generation, regulated wires and supply business in an around Germany is substantially the biggest part of the valuation at 45% of total EV. Both Central Europe and **Pan European Gas** (Ruhrgas) have incorporated our assumptions for German network regulation.

The **United Kingdom** (PowerGen) business has been adjusted for OFGEM's regulatory review announced in late November 2004. **Nordic** (mainly Sydkraft) and LG&E are both vertically integrated predominantly power businesses.

Listed financial assets have been included at a discount to market value. These include **Gazprom** (6.4%) at EUR3.6bn and **Degussa** (43%) at EUR2.7bn. The value for **Viterra** (EUR6.2bn) is based on recent real estate transactions.

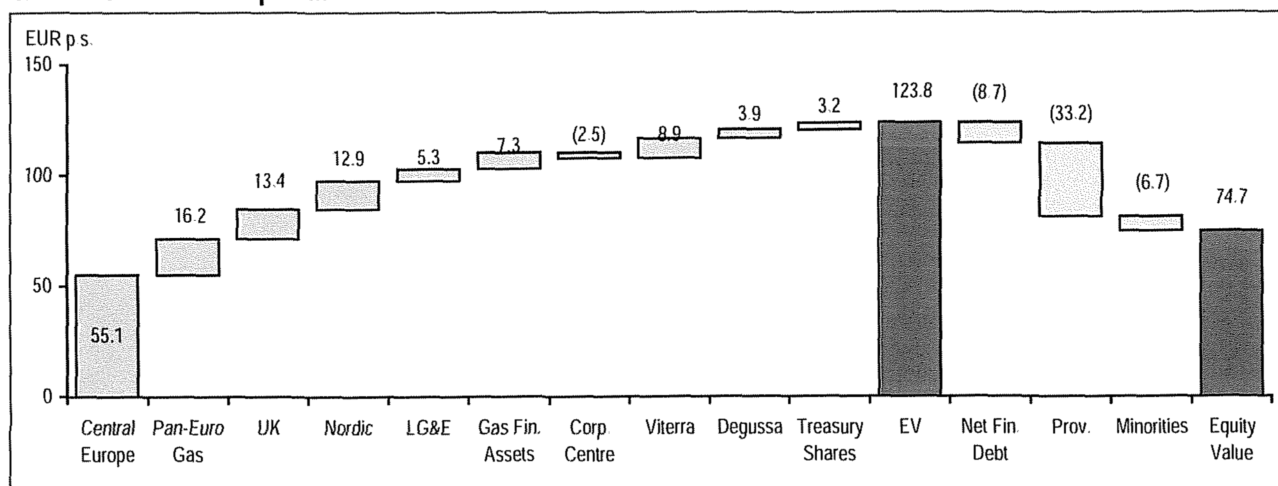
Financial debt is estimated at December 2004E; provisions are in full at estimated book value 2004E.

Table 16: SOTP

Division	EUR m	EUR p.s.	% EV	Method	Implied Multiple	
Central Europe	38,162	55	*45%*	DCF for Germany and International	7.0x	05E EBITDA
Pan-European Gas	11,227	16	*13%*	DCF, 7.5% WACC	6.6x	05E EBITDA
United Kingdom	9,284	13	*11%*	DCF and Premium to RAV	6.2x	05E EBITDA
Nordic	8,924	13	*10%*	DCF, 7.5% WACC	7.3x	05E EBITDA
LG&E	3,649	5	*4%*	DCF, 6% WACC	6.7x	05E EBITDA
Gas Financial Assets	5,069	7	*6%*	PE, Market Value		
Corporate Center	-1,724	-2	*-2%*	DCF, 7.5% WACC	2.7x	05E Cash Costs
Core Energy Business	**74,591**	**108**	***87%***		**7.1x**	**05E EBITDA**
Viterra	6,174	9	*7%*	DCF, 7.5% WACC	12.2x	04E Capital Employed
Degussa	2,701	4	*3%*	Market price based	-5%	Discount to market
Enterprise Value	**83,467**	**121**	***97%***			05E EBITDA
Treasury Shares	2,242	**3**	***3%***	Market price based		
Total Enterprise Value	**85,709**	**124**	***100%***		**7.5x**	05E EBITDA
Net Financial Debt	-6,391	-9	*-8%*			04E Book
Provisions	-22,981	-33	*-28%*			Sum-of-Parts
Nuclear	-14,121	-20				04E Book
Pension	-6,835	-10				04E Book
Mining / Environmental	-2,025	-3				04E Book
Minority Interests	-4,635	-7	*-6%*			04E Adj. Book
Equity Value	**51,701**	**74.7**	***62%***			

Source: Merrill Lynch estimates

Chart 15: SOTP Valuation per Share



Source: Merrill Lynch estimates

Peer Group Valuation

The comparative trading multiples for E.ON and its peer group are shown in Table 17 and Table 18.

Table 17: E.ON Comparative Ratings: PE Multiples and Yield

	P/E			Div Yield		
	2005E	2006E	CAGR	2005E	2006E	CAGR
E.ON @ Trading price	**11.6x**	**10.4x**	**5.2%**	**3.9%**	**4.5%**	**9.4%**
E.ON @ PO	12.8x	11.5x	5.2%	3.5%	4.1%	9.4%
RWE	10.0x	9.1x	9.1%	3.8%	4.4%	10.0%
European Competitive Market	12.2x	11.2x	9.3%	4.3%	4.7%	10.7%
European Utilities	13.2x	12.0x	7.8%	4.4%	4.9%	8.6%

Source: Merrill Lynch estimates

Table 18: E.ON Comparative Ratings: EV/EBITDA Multiples and FCF Yield

	EV/EBITDA			FCF Yield		
	2005E	2006E	CAGR	2005E	2006E	CAGR
E.ON @ Trading price	**7.2x**	**6.8x**	**3.4%**	**8.1%**	**9.8%**	**9.1%**
E.ON @ PO	7.5x	7.1x	3.4%	7.4%	8.9%	9.1%
RWE	6.7x	6.3x	3.9%	13.0%	12.8%	n.m.
European Competitive Market	7.7x	7.3x	5.8%	n.a	n.a	n.a
European Utilities	7.6x	7.1x	4.7%	n.a	n.a	n.a

Source: Merrill Lynch estimates

Refer to important disclosures on pages 38 to 40.

Table 19: Other Companies Mentioned

	ML Symbol	Footnotes	Q-R-Q	Price	
Centrica	CPYYF	qvwLbB	B-2-7	p	235.75
Centrica (ADR)	CPYYY	qvbBL	B-2-7	$	44.36
EdP	ELCPF	qLbBvw	B-2-7	EUR	2.24
EdP (ADR)	EDP	bBLvw	B-2-7	$	29.41
Endesa	ELEZF	qvxL	A-2-7	EUR	17.04
Endesa (ADR)	ELE	bBvxL	A-2-7	$	22.31
Enel	ESOCF	ijpqsvMgLbBx	B-2-8	EUR	7.19
Enel (ADR)	EN	svbMBijpgLx	B-2-8	$	46.93
Fortum	FOJCF	vML	B-1-7	EUR	13.68
Gas Natural	GASNF	qMLv	B-2-7	EUR	21.97
GazProm	OGZRF	ijoqvsgLbB	C-2-8	$	2.73
GazProm (ADR)	OGZRF	ijoqvsgLbB	C-2-8	$	2.73
Iberdrola	IBDRF	joqLv	A-2-7	EUR	18.64
RWE	RWNFF	ijopqsLvM	A-1-7	EUR	43.08
RWE (ADR)	RWEOY	ijopqsLvM	A-1-7	$	56.31

Source: Merrill Lynch Prices as at 26 January 2005

Price Objective Basis and Risk

E.ON: EUR75

The long term nature of E.ON's assets lends itself to DCF Our DCF based valuation for E.ON is EUR75/share. This valuation is based on the forward curve as shown by the EEX (EUR34.5/MWh in 2006) and has been cross checked with implied multiples and compared to peers.

The risks to our valuation are lower wholesale electricity and gas prices. E.ON is also exposed to regulatory risk through its transmission and distribution businesses.

Also, the discount rate used in our DCF calculation is based on the prevailing cost of debt and equity, which may change with market conditions.

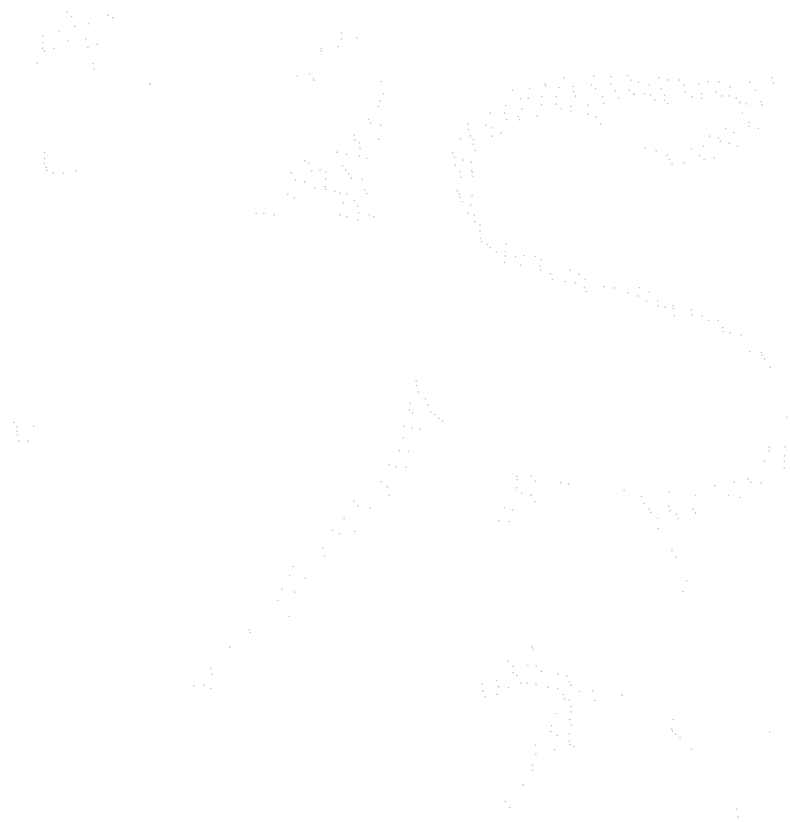
RWE: EUR55

The long term nature of RWE's assets lends itself to DCF Our DCF based valuation for RWE is EUR55/share. This valuation is based on the forward curve as shown by the EEX (EUR34.5/MWh in 2006) and has been cross-checked with implied multiples and compared to peers. The risks to our valuation are lower wholesale electricity, gas and oil prices. RWE is also exposed to regulatory risk through its transmission and distribution businesses.

The discount rate used in our DCF calculation is based on the prevailing cost of debt and equity, which may change with market conditions.

Analyst Certification

I, Simon Flowers, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.



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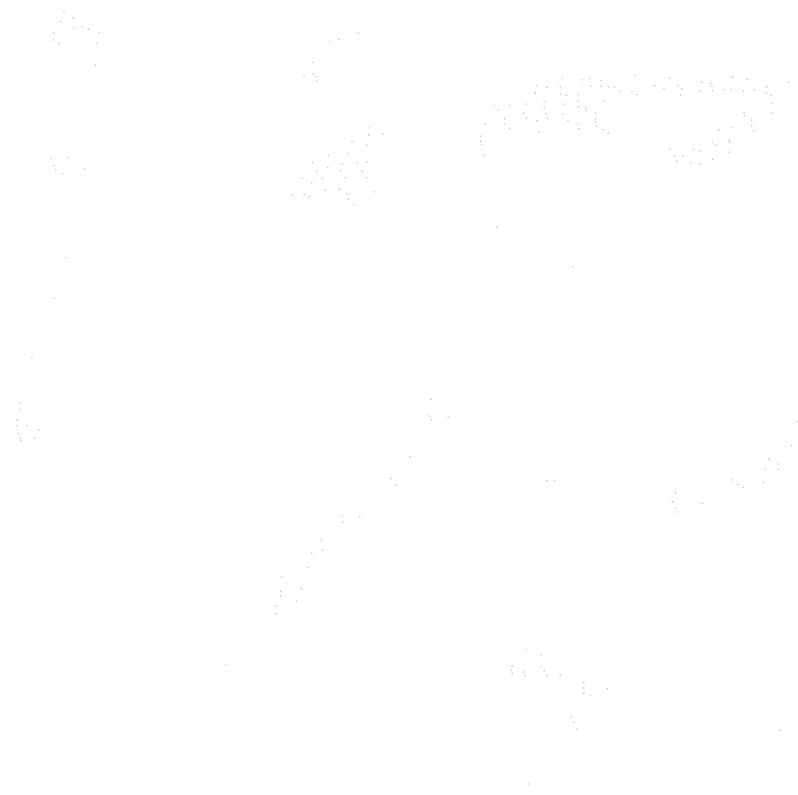
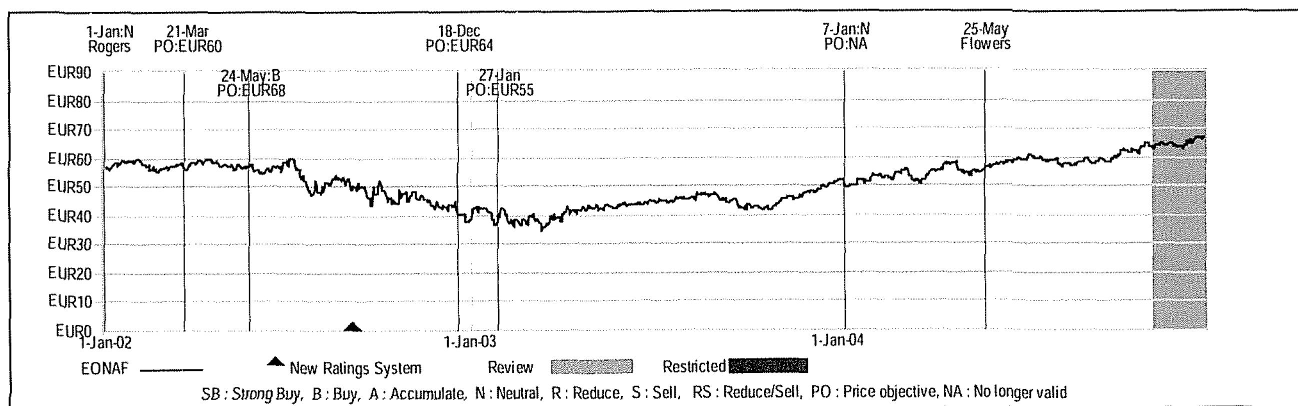


Important Disclosures

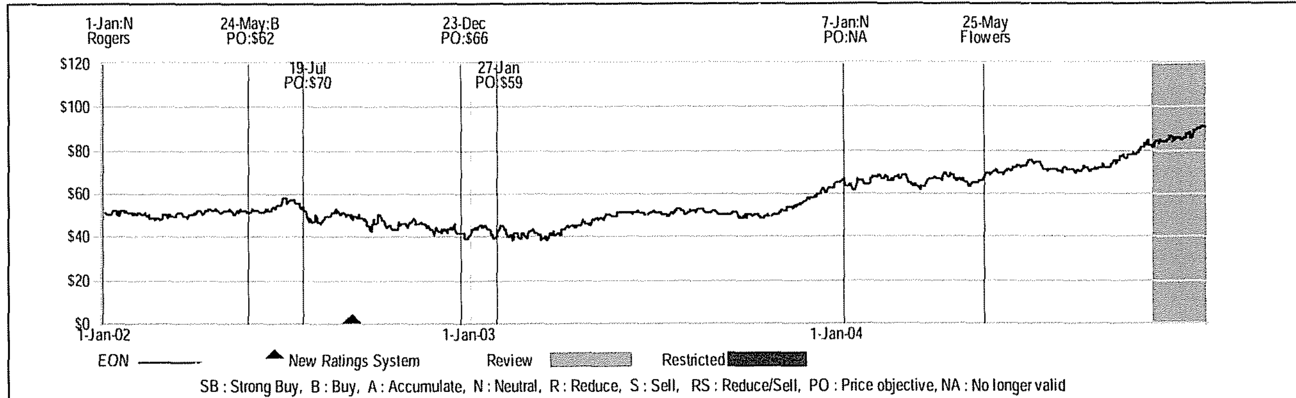
EONAF Price Chart



From 8 Dec. 2001 to 6 Sep. 2002, the Investment Opinion System included: Strong Buy, Buy, Neutral, and Reduce/Sell. On 6 Sep. 2002, Strong Buy and Buy ratings became Buy, and Reduce/Sell became Sell. Any exceptions to these rating revisions are reflected in the chart. All price objectives for Neutral and Sell rated securities established before 6 Sep. 2002 were eliminated as of that date. The current Investment Opinion System is contained at the end of the report under the heading Fundamental Equity Opinion Key. Dark Grey shading indicates the security is restricted with the opinion suspended. Light Grey shading indicates the security is under review with the opinion withdrawn.

Refer to important disclosures on pages 38 to 40.

EON Price Chart



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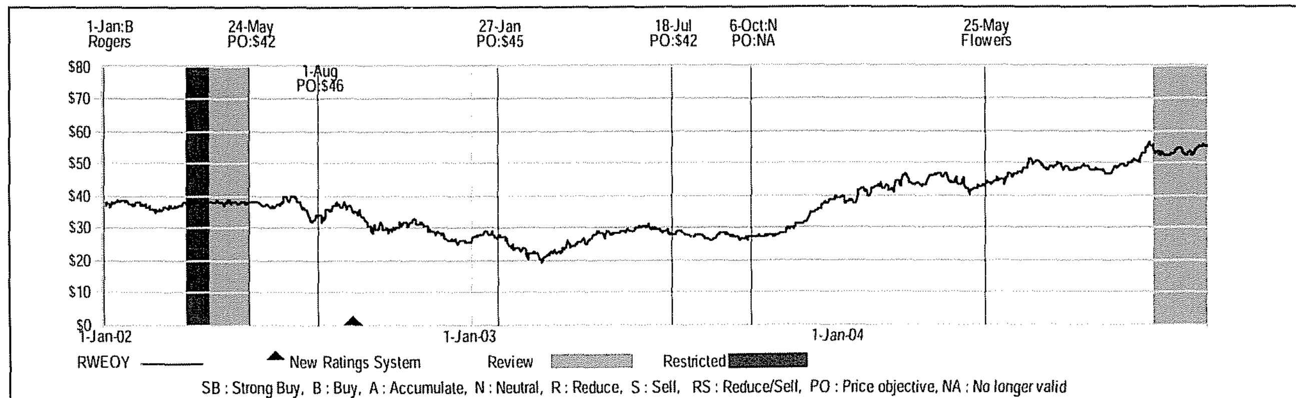
RWEOY Price Chart



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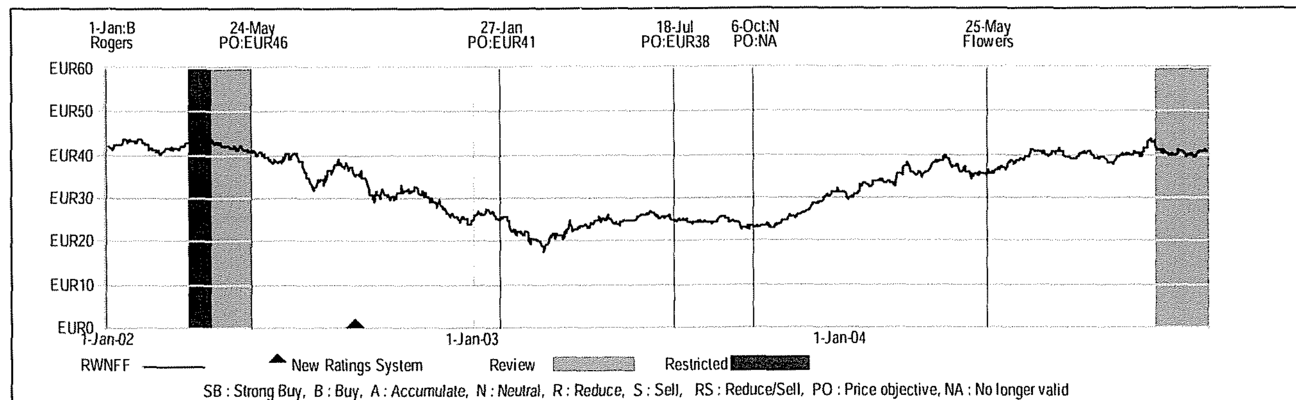
RWNFF Price Chart



From 8 Dec. 2001 to 6 Sep. 2002, the Investment Opinion System included: Strong Buy, Buy, Neutral, and Reduce/Sell. On 6 Sep. 2002, Strong Buy and Buy ratings became Buy, and Reduce/Sell became Sell. Any exceptions to these rating revisions are reflected in the chart. All price objectives for Neutral and Sell rated securities established before 6 Sep. 2002 were eliminated as of that date. The current Investment Opinion System is contained at the end of the report under the heading Fundamental Equity Opinion Key. Dark Grey shading indicates the security is restricted with the opinion suspended. Light Grey shading indicates the security is under review with the opinion withdrawn.

Convertible Alternatives: E.ON (Ergo) 2.25% 06 (Data as of 27-Jan-2005)

Market Value:	EUR 357 Mn	Current Yield:	2.2%	Recent Price:	103.6 EUR	YTM/YTP:	0.0%
Conversion Ratio:	133.333	Yield Gain vs. Stock:	-0.8%	Parity:	90.2 EUR	Breakeven:	Neg
Theoretical Value:	101.1	% Theo Value Disc:	-2.5%	Call Info:	Hurdle->06	Premium:	14.8%

We estimate over one year this issue will return +10.6% and -2.1% in a stock price move of +/- 25%

To calculate theoretical values and return profiles, Merrill Lynch uses a proprietary arbitrage model to value the convertible as a combination of embedded options. The model is sensitive to, amongst other factors, the following inputs: stock volatility, dividend yield, interest rate levels, and credit spread, all of which we hold constant. Further, we assume a similar discount/premium persists over the entire investment horizon. Our theoretical valuation in no way constitutes a fundamental opinion, nor does a theoretical discount necessarily constitute a recommendation.

Investment Rating Distribution: Utilities Group (as of 31 December 2004)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	30	28.85%	Buy	14	46.67%
Neutral	65	62.50%	Neutral	30	46.15%
Sell	9	8.65%	Sell	2	22.22%

Investment Rating Distribution: Global Group (as of 31 December 2004)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1054	40.45%	Buy	383	36.34%
Neutral	1339	51.38%	Neutral	382	28.53%
Sell	213	8.17%	Sell	43	20.19%

* Companies in respect of which MLPF&S or an affiliate has received compensation for investment banking services within the past 12 months.

FUNDAMENTAL EQUITY OPINION KEY: Opinions include a Volatility Risk Rating, an Investment Rating and an Income Rating. VOLATILITY RISK RATINGS, indicators of potential price fluctuation, are: A - Low, B - Medium, and C - High. INVESTMENT RATINGS, indicators of expected total return (price appreciation plus yield) within the 12-month period from the date of the initial rating, are: 1 - Buy (10% or more for Low and Medium Volatility Risk Securities - 20% or more for High Volatility Risk securities); 2 - Neutral (0-10% for Low and Medium Volatility Risk securities - 0-20% for High Volatility Risk securities); 3 - Sell (negative return); and 6 - No Rating. INCOME RATINGS, indicators of potential cash dividends, are: 7 - same/higher (dividend considered to be secure); 8 - same/lower (dividend not considered to be secure); and 9 - pays no cash dividend.

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JPMorgan

E.ON

Play it for value, yield + a free option

Overweight

€67.5

08 April 2005
Price Target: €80.00

We have raised our 12-month DCF-based price target for E.ON to €80 *(19% upside from the current share price) from €72. Our 9% 05E-07E EPS upgrades drive a dividend yield in 06E of 5%. We expect a further 6% from the Degussa disposal capital return. Total return for E.ON in 2006E could reach 30%.*

- The renewed reinvestment risk concerns post the FY04 results are overdone, in our view. **Assuming €3/share for 15% value destruction on a €15bn acquisition, for example, still leaves 14% potential upside, on our estimates.**
- **We see five potential positive catalysts**
  1. May 22: Nordrhein-Westfalen elections
     - Opposition win opens nuclear life extension debate (p15)
  2. June 26: E.ON UK seminar
     - Re-rating possible given discount to peers (p13)
  3. Q1 & Q2 results (May & Aug)
     - Confirmation of growth esp Central & Eastern Europe (p18)
  4. July 05: regulation arbitration concludes:
     - Regulatory relief is in sight (p22)
  5. H105: Viterra sale
     - Per €1bn>book, increases value by €1.5/share, on our ests
- **We reiterate our OW view as we believe E.ON's 30% 06E potential total return offers immunity from rising interest rate fears and a free option to benefit from** nuclear plant life extensions, E. European growth and potential upside from Viterra.

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Comments from Credit Research – page 21

Equity Derivatives overlay - page 9

Ordinary Shares (Reuters: EONG.DE Bloomberg: EOA GR

€		Y/E Dec	EV/EBITDA	P/E	Dividend yield		
Price 08/04/05	€67.5	2004	7.2	11.2	4.2	Eurotop 300	1,100
52-Week Range	€71.9-52.25	2005E	6.9	10.1	5.0	Market Cap (€m)	44,334
Net debt Dec 04 (€m)	5,483	2006E	6.6	9.5	6.0	Shares out	657m

Source: Datastream, Company data, JPMorgan estimates

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Table of Contents

Investment thesis: the positives **3**
Positives 3
Investment thesis: the risks **4**
Risks 4
Valuation upside **5**
DCF-based price target of €80 5
ROCE:WACC analysis supports €80 price target 6
Relative to peers, E.ON's attractiveness is further confirmed 7
A derivative overlay to give outperformance on the upside 9
Group earnings adjustments 10
EBIT unit earnings adjustments 10
Back-out valuation of UK unit **13**
Implied UK valuation illustrates the extent of E.ON's undervaluation 13
Nuclear plant life extensions **15**
The German nuclear plant life debate may reignite this year 15
Impact on E.ON 16
C & E European growth markets **18**
E.ON: exposure to Central & Eastern Europe growth 18
Reinvestment risk **20**
Concerns look overdone 20
Targeted areas: 20
Acquisitions in the US are less likely than those in Europe, in our view 20
E.ON's recent track record in Europe is not a cause for concern, in our view 21
Credit opinion on reinvestment risk 21
Regulation **22**
Calendar 22
Likely regulatory changes after Energy Law is passed 22
Commodity & carbon price volatility **24**
E.ON has better immunity than RWE, in our view 24
Fuel exposure flatters E.ON relative to RWE 25
E.ON – financial data **28**
5 potential positive catalysts: **36**
1. May 22: Nordrhein-Westfalen elections 36
2. June 26: E.ON UK seminar 36
3. Q1 & Q2 results (May & Aug) 36
4. July 05: regulation arbitration concludes: 36
Regulatory relief is in sight 36
5. H1 05 Viterra sale 36

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Investment thesis: the positives

Positives

Valuation upside

Our new price target of €80 indicates 19% potential upside from the current share price. E.ON currently trades at 06E multiples for PE of 9.5 and EV/EBITDA of 6.6 versus the sector at 13.5 and 7.6 respectively. This 20% average discount also highlights the valuation gap indicated by our price target.

Looks 20% undervalued (see page 5)

Earnings upgrade

In this report we are raising our 05E-07E EPS forecasts by an average of 9%. In addition, we believe that consensus is yet to account for any additional growth uplift associated with the growth capex plan yet has asymmetrically factored in its associated costs, thereby artificially depressing the earnings growth by c. 10% on our estimates.

9% earnings upgrade. Consensus may be too low (see page 12)

Potential 06E yield of 11% with a blue sky of more

Based on E.ON's targeted 07E payout ratio of 50-60%, we believe that E.ON will increase its dividend by 20% p.a. over the next three years. We estimate 05 yield at 4.2% and 06 yield at 5%. In addition, the Degussa special dividend may yield a further 6% in 06E. Note also the possibility of additional capital return post 2006E should E.ON not find any large-scale acquisitions which fit its strict financial criteria.

Total yield in 05E may reach 11% (including Degussa capital return) (see page 8)

Backward valuation

In addition to our DCF-based target price, which is in turn backed up by a ROCE analysis, we compute a reversed SOP for E.ON. This currently indicates that the UK division is trading at an EV/EBITDA multiple of 1.1x – versus 05E multiples of 6.9x at SPW and SSE.

Backing out value of UK unit indicates value below UK peers (see page 13)

Nuclear plant life extensions

A win in September 06's general elections in Germany by the current Opposition party (Christian Democrats) would increase the possibility of nuclear plant life extensions. The local Nordrhein-Westfalen elections on May 22nd 2005 are a key indicator for the general election result. Nuclear plant life extensions would allow E.ON to reduce its planned capex spend on new plant and would delay the provision calculations made by E.ON as a result of the nuclear energy agreements in 00/01. It would also reduce E.ON's exposure to rising carbon and commodity prices whilst allowing it to benefit from rising wholesale prices.

Nuclear plant life may be extended from 32 years to 47 years (see page 15). Benefits are fivefold

Tap into the Eastern European growth markets

We estimate that E.ON's current EBIT exposure to the fast growing Eastern European countries is due to increase to 10% (from 5%) by 2006 due to the agreed acquisitions/ put options for expansion in Slovakia, Bulgaria and Hungary within the Central Europe unit and in Hungary and Romania within pan-European gas. The growth rates associated with these countries are forecast by our economists to be 5% p.a. versus the lower rates of 2% in W. Europe. Out of the pan-European utilities, E.ON has the greatest exposure for investors wishing to participate in this theme. However, we currently do not forecast any additional valuation and earnings uplift from the planned investment in spite of an estimated ROCE:WACC premium on our numbers of over 20%.

E.ON's 05E EBIT exposure to the faster growing Eastern European economies is 10% (see page 18)

Investment thesis: the risks

Risks

Reinvestment risk: concerns overdone in our view

E.ON's statement at its full year results in March that it would 'no longer necessarily limit ourselves to small or medium-sized acquisitions in the future' has inevitably reignited reinvestment risk concerns. These concerns stem from E.ON's historical track record (pre 2002) together with its spending capacity of up to €20bn . In our view, E.ON is strongly committed to maintaining its more recent track record of financial discipline whilst ensuring that its strict financial criteria are met. If we assume a worst case scenario of E.ON overpaying by 15% for a €15bn acquisition, for example, the value destruction per share would be €3. On our €80 price target, a €3 reduction would still offer 14% upside from the current share price.

Worst-case €3/ share value destruction still leaves an est. 14% potential upside from current share price. (p18)

Regulation: limited to 10% grid fee impact in 06-08E

In our view, the arbitration process to confirm the Energy Law and its new regulatory impact should complete by June 05 with the Law coming into force by July/ August 2005. We believe at this point, E.ON should benefit from a reduction in regulatory risk concerns. We already factor in a negative EBIT impact of €1bn in total for 2006-2008 due to a 10% cut in margins from electricity grid fees. We note that E.ON believes that regulatory impact should be at least partially offset by its existing 'on-top' cost savings plan. In addition, we believe that E.ON should be able to offset regulatory pressure from the subsequent move to incentive-based regulation via a cost-cutting programme.

10% grid fee margin reduction is already factored into our forecasts and valuation. Regulatory relief is in sight. (p20)

Commodity & carbon price volatility

E.ON's contract strategy of locking in fuel prices as it signs wholesale contracts allows its generating margin to remain protected against volatility in the commodity markets. The upward pressure on German wholesale prices has recently been driven by rising commodity costs. Whilst this relationship continues, E.ON's exposure to commodity volatility is limited. In our view, the same upward pressure will apply to the wholesale price should the recent rise in the price of CO_2 allowances continue. For example the forward electricity wholesale curve for 2007/2008 already indicates a steepening in response to expectations that CO_2 prices will continue to rise. However, relative to RWE, E.ON's fuel positioning (more nuclear relative to coal) offers more exposure to rising wholesale prices whilst limiting its exposure to rising coal and carbon prices.

We believe that E.ON's nuclear portfolio is better placed than RWE to benefit from upward pressure on wholesale prices from rising coal and carbon prices. (p14)

Rising interest rates

In a rising interest rate environment, the debate surrounding the resulting negative impact on utilities is well documented. However, for E.ON in particular, we believe that the current valuation gap, together with the premium of E.ON's dividend yield to bond yields (including the Degussa capital return) should be enough to offset these macro concerns. E.ON's low gearing, together with its low and locked in debt profile, should add further protection.

E.ON's potential total return of 30% should be enough to offset macro interest rate concerns. (p8)

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Valuation upside

Our €80 price target is driven by our DCF-based sum of the parts

DCF-based price target of €80

Our DCF based sum of the parts computes a price target for E.ON of €80. As can be seen in Table 1, for each of the divisions we calculate a 7-year DCF. We use a terminal growth rate averaging at 2% with a WACC of 6.5% (post tax), the components of which are shown in Table 1. The implied EV/EBITDA multiple of our core business valuation is 6.7x (based on 2006E EBITDA). In spite of the upside implied by our €80 price target, the implied EV/EBITDA is still 18% below the 05 sector average of 8.1x.

Table 1: DCF based target price calculation

€ million

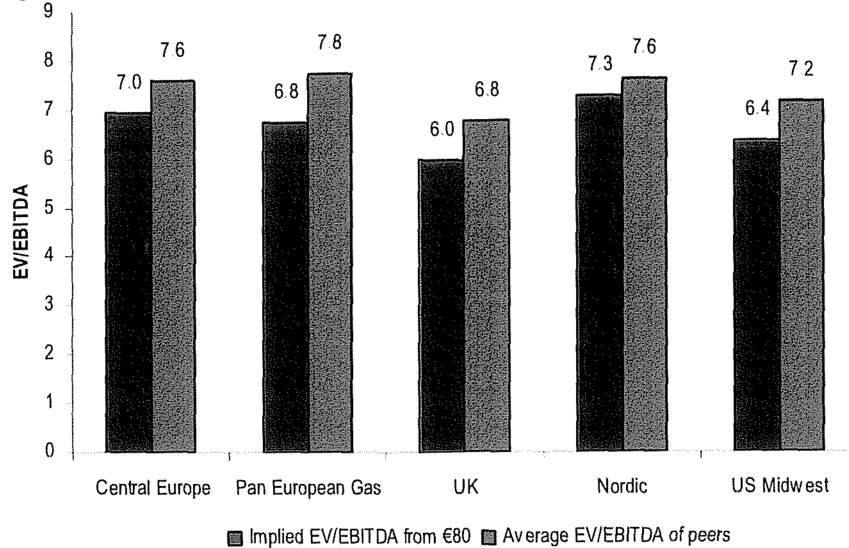
	Method	WACC	EV €m	EV per Share	% of Total EV	EV per 2006E EBITDA
Central Europe	DCF	6.5%	38,245	**58.2**	45.3	7.0
Pan European Gas	DCF	6.5%	14,615	**22.2**	17.3	6.8
UK	DCF	6.5%	10,152	**15.5**	12.0	6.0
Nordic	DCF	6.5%	8,208	**12.5**	9.7	7.3
US Midwest	DCF	6.5%	3,704	**5.6**	4.4	6.4
Other/consolidation	DCF	6.5%	-2,559	**(3.9)**	(3.0)	10.7
Total core businesses			**72,366**	**110.1**	85.7	6.7
Viterra	90% of IC		3,866	5.88	4.6	6.5
Degussa	market value	42.9%	2,849	4.34	3.4	
Non equity consolidated financial holdings	book value		5,318	8.09	6.3	
Total financial and industrial holdings			**12,033**	**18.31**	14.3	
Total Enterprise Value			**84,399**	**128.5**	100.0	7.3
Less:		*% of book value*				
Net debt (cash)	04 balance sheet		5,483	8.3		
Minority interests	04 balance sheet		4,144	6.3		
Pension liabilities	04 balance sheet	100%	8,589	13.1		
Nuclear liabilities	04 balance sheet	100%	13,481	20.5		
Total adjustments to EV			**31,697**	**48.2**		
Total fair value (equity value)			**52,702**	**80.2**		
Current share price				**67.5**		
Upside/(downside) to fair value				19%		

Source: Company reports and JPMorgan estimates.

In addition, we believe the individual units' implied 06E EV/EBITDA multiples, as shown in Figure 1 compare well with their equivalent peer group.

The implied premium of ROCE: WACC adds to our confidence that our target price of €80 is still on the conservative side

Figure 1: Peer EV/EBITDA comps confirm conservative stance of our SOP



Source: JPMorgan estimates.
Note: Central Europe peers: RWE, Endesa, Iberdrola, Enel; Pan European Gas peers: Gas Natural; UK peers: ScottishPower, Scottish & Southern; Nordic peers: Fortum; US Midwest peers: AEP

The EV/ EBITDA multiples implied by our SOP units look conservative compared to each unit's individual peer group

ROCE:WACC analysis supports €80 price target

Our ROCE:WACC calculations shown in Figure 2 below calculate that based on the ROCE-WACC spread 2006, the implied value for E.ON should be €104. The ROCE implied in 2006 is 13% versus the core WACC of 9%. These conclusions are also supported, in our view, by comments from E.ON which indicate that the group ROCE is likely to trend upwards (albeit at a slower rate of improvement than seen historically) from the 11.5% reached in 2004. We believe that the static approach of this analysis is such that it is not an appropriate stand-alone valuation tool. However, the premium of ROCE:WACC implied by this analysis is such that it adds to our confidence that the target price of €80 from our DCF sum of the parts is still on the conservative side. If, for example we were to simply (and conservatively) assume that the ROCE achieved in 2004 was maintained indefinitely and not improved upon, the implied valuation would be €89, again above our €80 price target.

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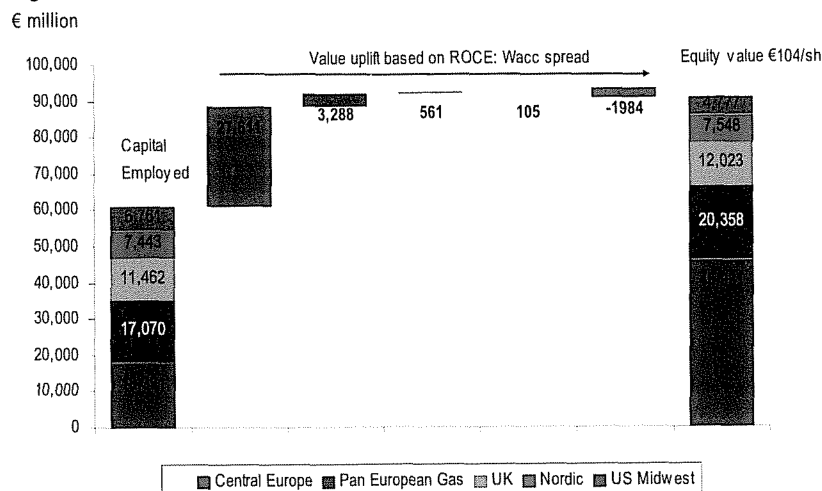
Figure 2: ROCE: WACC indicates €104/share value

€ million



Source: JPMorgan estimates, Company data.

Risk to rating and price target

Electricity price declines combined with rising commodity prices, an overly punitive regulatory policy and overpaying by E.ON for an acquisition appear unlikely in our view, but represent a risk to our rating and price target.

Relative to peers, E.ON's attractiveness is further confirmed

E.ON's discount relative to its peers further widens to 30% on 06E PE multiples

On earnings multiples...

We estimate that E.ON currently trades at a 30% discount to its pan-European peers on 2005E and 2006E PE multiples. Using EV/EBITDA shows E.ON at a 16% and 13% discount for 05E and 06E respectively.

Table 2: Relative earnings multiples

	E.ON	Pan Euro Average Peers	RWE
2005E PE	10.1	15.0	11.0
2006E PE	9.5	13.5	9.6
2007E PE	9.2	12.2	9.5
2005E EV/EBITDA	6.9	8.1	7.7
2006E EV/EBITDA	6.6	7.6	7.1
2007E EV/EBITDA	6.4	7.0	6.9
PEG (04-09E)	1.7	2.4	1.4
EV/EBITDA/EBITDA grth (04-09E)	1.9	3.8	2.6

Source: JPMorgan estimates.

On dividend yield...

E.ON's commitment to a dividend payout ratio of 50-60% by 2007 results in the following dividend policy, in our view:

Table 3: Dividend peer comparison

	E.ON	Pan Euro Average Peers	RWE
DPS growth (2004-2009E)	13.3%	10%	14%
2005 Dividend payout ratio	42.9%	60%	44%
2005E dividend yield	4.2	4.0	3.8
2006E dividend yield	5.0	4.3	4.6
2007E dividend yield	6.0	4.8	4.8

Source: JPMorgan estimates

In 2006, we estimate that E.ON's yield rises further still to 5% versus the sector average at that point of 4.3%. The Degussa disposal could yield an incremental 6%.

The estimated yield of 4.2% by 2005 compares well with the sector average yield of 4% and an average dividend payout ratio of 43%. Note that in 2006, the yield rises further still, on our estimates, to 5% versus the sector average at that point of 4.3%. In addition, this is likely to be further supplemented in 2006 by the return of capital associated with the Degussa stake. We currently value E.ON's 43% holding at €3bn, which would imply a capital return per share of €4.6 i.e. an incremental yield of 6%. We continue to believe that the proceeds will be distributed either as Degussa shares or simply as cash as we understand that E.ON's preference does not lie in the direction of a share buyback.

On total return

The total return potential therefore for E.ON in 2006 would be 30%. As Table 4 below shows, a total return analysis taking into account upside to our target price, plus yield plus potential for special dividend, places E.ON right at the top of the sector.

Table 4: Total return for our sector Overweights

Stock	Curr	Current price	12mth price target	% upside	06E div yield	Total return	
AWG	p	875	880	1%	6%	7%	& estimated 6% spec. div
E.ON	**€**	**67.5**	**80**	**19%**	**5%**	**24%**	**& estimated 6% spec. div**
International Power	p	186	195	5%	3%	8%	
Scottish & Southern	p	930	900	-3%	5%	2%	
Severn Trent	p	943	1000	6%	4%	10%	
Veolia Environnement	€	29	31	7%	3%	10%	

Source: JPMorgan.

This positioning supports our view that in a rising interest rate environment the 30% total return potential from E.ON is strong enough to offset any threat from rising bond yields.

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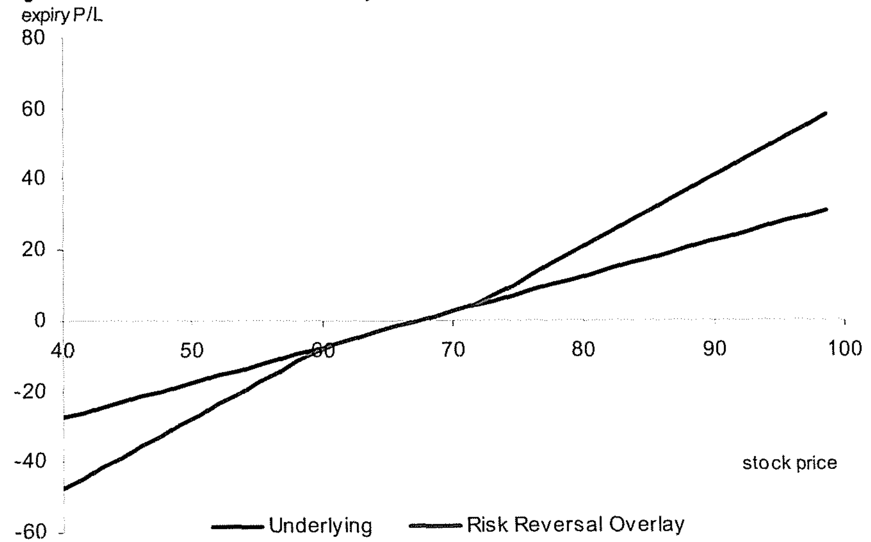
A derivative overlay to give outperformance on the upside

Assuming a commission of about 20 bps and working off Friday April 8th's close of €67.48, an 89/106% risk-reversal overlay (long underlying, short an 89% put, long a 106% call) would be costless. The 89% call equates to a strike of €60.06, and if the stock fell below this level you would suffer double the losses. Above 106% (€71.53) all gains would be doubled.

The reason this trade looks strong (typically a 106% call would cost more than an 89% as its strike is nearer to spot) is due to two factors. Firstly there is the skew: making downside puts slightly richer than comparable upside calls. Secondly, and in this case more importantly, there is a dividend of about 3.5% due at the end of May, causing the forward to trade a little below spot.

Figure 3: Risk-reversal derivative overlay



Source: JPMorgan estimates.

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Earnings upgrade

Group earnings adjustments

EBIT forecasts upgraded by an average of 3% 05-07E

EPS rises by an estimated 9% over the same period

As shown below, we have raised our core EBIT forecasts by an average of 3% for 05-07. We discuss the unit EBIT contribution in more detail below. Within our assumptions, we continue to forecast E.ON's cost saving target at €1bn by 2006. To date, E.ON has achieved €590m of this since 2003. In addition, due to an adjustment in the forecast tax rate between 05-07, we have increased EPS by 9% over the same period. Our tax assumptions have been adjusted in line with the guidance given by E.ON at its full year results presentation. Small adjustments to our net interest charge due to lower than expected year end net debt contribute as well. As a result, we have raised our dividend forecast from 05 onwards in order to fit in with E.ON's statement that the dividend payout ratio by 2007 would be 50-60%. By 2007, on our numbers, the dividend payout ratio will reach 55%.

Table 5: Earnings upgrade analysis - group level

€ million

	2005E			2006E			2007E		
	Previous	New	*% change*	Previous	New	*% change*	Previous	New	*% change*
Core EBIT	7,129	7,301	*2.4%*	7,602	7,691	*1.2%*	7,726	8,046	*4.1%*
Total EBIT	7,609	7,799	*2.5%*	8,153	8,219	*0.8%*	8,288	8,584	*3.6%*
EBITDA	10,869	11,046	*1.6%*	11,380	11,514	*1.2%*	11,541	11,936	*3.4%*
EPS	6.13	6.68	*9.1%*	6.61	7.10	*7.5%*	6.63	7.34	*10.7%*
DPS	2.76	2.82	*2.1%*	3.24	3.38	*4.3%*	3.81	4.06	*6.5%*

Source: Company reports and JPMorgan estimates.

EBIT unit earnings adjustments

Our EBIT adjustments per unit for E.ON are shown in Table 7 below. Within the Central Europe division, we have adjusted our assumptions to take into account E.ON's contracted position within the wholesale market, the likely impact from regulation on grid fees, the growth potential from E.ON's medium term investment plan (excluding financial investments) and the ongoing cost-cutting benefits from the 'on-top' programme. Our detailed assumptions on grid fees and wholesale prices can be seen in Table 6.

Table 6: Base case sensitivity assumptions

	2005E	2006E	2007E	2008E
German baseload wholesale prices (€/ MWh)	34	34.0	34.5	36.0
German peak wholesale prices (€/ MWh)	47	48.0	49.0	50.0
German average wholesale prices (€/MWh)	36	36.8	37.4	38.8
Contracting positions by Q1 05	100%	65%	35%	15%
TWh produced	100	100	100	100
Contracted price forecast (€/MWh)	36.2	36.8	37.4	38.8
Year on year change (€/MWh)	2	0.6	0.6	1.4
P&L uplift yr on yr from contracting (€m)	220	60.0	60.0	140.0
Coal prices (€/ tonne)	62	60	58	58
Impact on EBIT per (€/tonne) shift	4	4	4	4
EBIT impact assumed in model (€m)	(42)	8	8	0
Carbon prices (€/tonne)	13	13	13.5	14.0
UK baseload wholesale prices (£/ MWh)	30	32	33	34
UK peak wholesale prices (£/ MWh)	34	36	36	38
UK average wholesale prices (£/MWh)	31	32.7	33.2	34.9
Nordic wholesale prices (€/ MWh)	23	23.5	24.0	24.4
German grid fee adjustments (%)	0	-3.0%	-6.0%	-10.0%
Revenue associated with German Grid fees (€m)	4,642	4,888	5,083	5,210
% Central Europe division	0	21.0%	21.0%	21.0%
Impact on EBIT (€m)	0	(147)	(305)	(521)

Source: Company reports and JPMorgan estimates.

We conservatively only take into account the additional earnings growth from the fixed asset investments but do not attribute full earnings growth from the planned financial investments...

For Pan-European Gas, we take into account the potential EBIT contribution from E.ON's incremental capex programme (but excluding the financial investments) as well as the likely growth impact from gas delivery expansion. For the UK division, we have taken into account the impact from forward electricity and commodity prices a well as the divestment of the Asian asset management business. For the Nordic unit, we have taken into account the sale of the hydroelectric plants to Statkraft but have also factored in the weakening of the wholesale electricity price into 2005, with recovery from 2006.

... particularly in Central & Eastern Europe

In general, we continue to believe that our forecasts are still likely to be conservative since for all the divisions, we take into account the additional earnings growth from the fixed assets investments but do not attribute full earnings growth from the planned financial investments (€6.2bn in total) as detailed by E.ON in December 2004 in its 05-07 investment plan. The area where this is likely to be most incremental is in Central and Eastern Europe due to the materially higher indigenous growth as discussed on page 18.

Table 7: Earnings upgrade analysis - unit level

€ million

	2005E			2006E			2007E		
EBIT	**Previous**	**New**	**% change**	**Previous**	**New**	**% change**	**Previous**	**New**	**% change**
Central Europe	3,868	3,879	0.3%	4,101	4,134	0.8%	4,206	4,393	4.4%
Pan European Gas	1,520	1,573	3.5%	1,577	1,669	5.9%	1,554	1,724	10.9%
UK	924	1,071	15.9%	1,010	1,106	9.5%	1,027	1,133	10.4%
Nordic	763	699	-8.4%	845	679	-19.6%	862	688	-20.2%
US Midwest	359	359	0.0%	375	382	1.8%	382	388	1.6%
Other/consolidation	(305)	(280)	-8.3%	(305)	(280)	-8.3%	(305)	(280)	-8.3%
Core business	**7,129**	**7,301**	**2.4%**	**7,602**	**7,691**	**1.2%**	**7,726**	**8,046**	**4.1%**

Source: Company reports and JPMorgan estimates.

As shown in Table 8 below, our numbers are higher than consensus by 3% for EBIT and 13-14% for EPS. The gap, in our opinion, is driven principally by the inclusion in consensus estimates of E.ON's investment plan without attributing any additional earnings upside. The German Government's strategy to reduce the basic rate of corporate tax rate from 25% to 19% is also unlikely to have filtered through into consensus forecasts yet. (We note, however, that the percentage of dividend income liable to taxation was also increased to 60% percent from 50%).

Table 8: Consensus vs JPMe

€ million

	EBIT (stated/ reported)			EPS (stated)		
	2005E	**2006E**	**2007E**	**2005E**	**2006E**	**2007E**
Consensus average	7,540	8,057	8,290	5.8	6.3	6.4
JPMe	7,799	8,219	8,584	6.6	7.1	7.3
% difference	3.4%	2.0%	3.5%	13.3%	13.7%	14.3%

Source: JPMorgan estimates.

Back-out valuation of UK unit

Implied UK valuation illustrates the extent of E.ON's undervaluation

We estimate that E.ON's UK unit is currently valued at €1.9bn within the current share price

In the table below we back out the value of the UK business. We use the current market value of E.ON's EV, together with our SOP estimate for E.ON's other units. We select the UK business specifically because we intended to compare the backed out valuation of our selected unit with the purest (and similar) peer trading multiple – the UK vertically integrated utilities. In our view, Scottish & Southern Energy and ScottishPower are the purest plays with the most similar fit to the UK unit. Our SOP valuation for the UK business (as discussed on page 14) is €10.4bn.

Table 9: Back-out valuation of E.ON's UK unit

€ million

Component	Value
Current share price (€)	67.5
No. of shares (m)	657
Market cap	44,334
Total debt & liabilities	31,697
Current EV	76,031
Less:	
Non core	12,193
Central Europe	38,245
Pan European Gas	14,615
Nordic	7,955
US Mid-West	3,704
Corporate Centre	(2,559)
Implied EV for UK	1,878
Implied EV/EBITDA 06	1.1

Source: JPMorgan estimates.

This contrasts with our DCF-based valuation of €10.2bn and sum of the parts valuation of €10.4bn

The UK peers to E.ON currently trade at 6.9x 2005E EV/EBITDA

As the analysis below shows, the backed out valuation of the UK business is valued at €1.9bn and an EV/EBITDA of 1.1. (ScottishPower and Scottish & Southern trade on an average 2005E EV/EBITDA of 6.9). Clearly investors following this approach would have to feel comfortable with our SOP components for E.ON's non UK units. However, this exercise clearly illustrates, in our view, the extent to which E.ON is currently undervalued. Using our old SOP unit analysis based on our previous €72 price target would value the UK business at €5.9bn i.e. an EV/EBITDA multiple of 3.5x. Even this multiple would still be below that of SSE's and SPW's current trading levels.

A separate sum of the parts of the UK unit confirms our €10bn valuation

By way of contrast, we include below a sum of the parts analysis for E.ON's UK unit on a component basis (rather than the DCF analysis we use in computing our share price target).

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Table 10: SOP for E.ON' s UK unit
£ million

	£m
Midlands - 5% premium to 2006 RAB of £1,013m	1,064
East Midlands - 5% premium to 2006 RAB of £989m	1,039
Supply - DCFat £249 per customer for 5.8m elec & 2.8m gas	2,141
SME - 700,000 customer accounts at DCF value of £478/ account	335
Generation - 9,265MW at average of £279/kW	2,585
Total EV	7,163
Total EV (€m)	**10,387**

Source: JPMorgan estimates.

This sum of the parts analysis draws on the assumptions for the UK market that we use for our analysis of ScottishPower and Scottish & Southern Energy. The resulting valuation for E.ON's UK unit is c.€10.4bn which both confirms the current valuation gap implied by E.ON's share price and also confirms the DCF valuation for E.ON's UK unit used in our price target.

Nuclear plant life extensions

The German nuclear plant life debate may reignite this year

The decision to phase out nuclear energy was a political decision by the current government, not an economical one

Opposition party increasing in popularity

The decline in popularity of the current German Government (Social Democrats) in favour of the opposition Christian Democrats, opens up the possibility of nuclear plant life extensions. In 2000 and 2001, the German utilities agreed with the current government as part of the nuclear energy agreement that no further life extensions were to be granted to their German nuclear plants. The decision to phase out nuclear energy was a political decision by the current government, not an economical one driven by the companies i.e. dependent on plant quality. This is based on an agreement of 32 years for plant life. In contrast, French nuclear plants currently have a 60-year life and Scandinavian plants have a 45-year life. The operating effectiveness and quality of the German nuclear plants is considered to be 'best-in-class' and so a 15-year extension, for example, should be easily justifiable in operational terms.

Should the Opposition party win next year's General election, there is a strong possibility of reopening this debate

Next year's general election may be a key pivot

However, should the Opposition party win the September 06 General Election, there is, in our view, a strong possibility of reopening this debate with a view to granting nuclear plant life extensions of up to 15 years. The first key indication of the General Election result is likely to be on May 22 2005 when the Nordrhein-Westfalen region holds a local election.

The pressure is increasing from two sources

The pressure from this debate is likely to originate from the strict environmental legislation imposed across the EU. Germany is currently unable to meet the Kyoto targets of CO_2 reduction and at the same time reduce German base load generation by 30% should nuclear plants close down. The need for extending the life of nuclear plant is heightened further when we consider that age-related reduction in existing power plant capacities between 2010 and 2020 will total 40,000MW. This figure also assumes that nuclear plants are decommissioned after 40 years. If the current government stipulations of 32 years are adhered to, then clearly the replacement requirements will increase further. When this requirement is therefore taken in context with the Kyoto commitment CO_2 reduction targets (initially a 21% reduction for Germany 2008-2012), the conundrum is obvious.

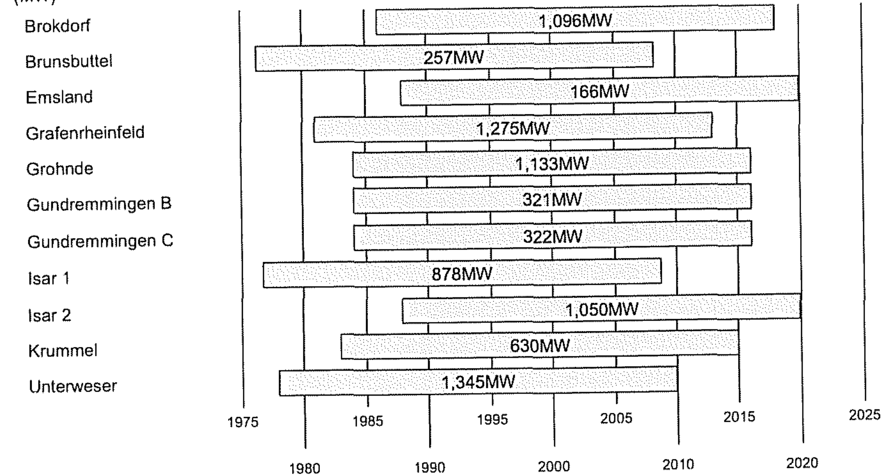
The conundrum of meeting the 2012 Kyoto targets within the current planned reduction in nuclear capacity and other plant age related closures must be solved

Impact on E.ON

E.ON's existing nuclear capacity is 8,473MW (34% of its owned generating capacity). Under the existing agreement, the shut down for E.ON's plants would begin as early as 2008 (as shown in Figure 4 below).

Figure 4: E.ON nuclear plant planned life

(MW)



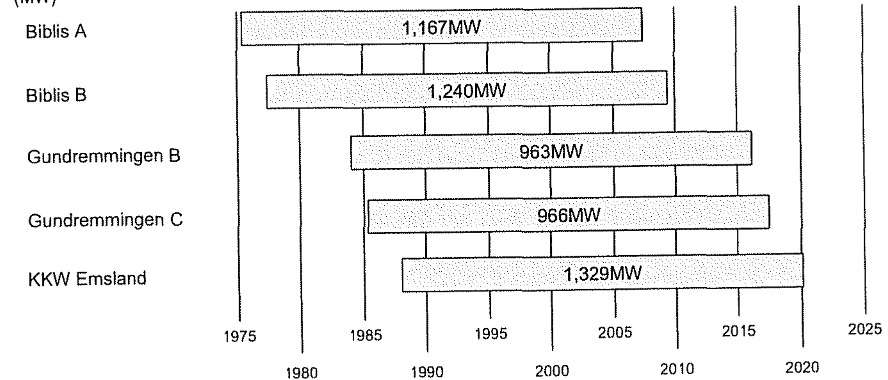
Source: Company reports and JPMorgan estimates.

Note: We assume 32 year life for all plants

Therefore the extent of the potential capacity uplift if plant life was to be extended by a further 15 years is clearly material. In Figure 5 below, we show RWE's current expected nuclear plant life - the first plant shutdown is expected in 2007.

Figure 5: RWE nuclear plant planned life

(MW)



Source: Company reports and JPMorgan estimates.

Note: We assume 32 year life for all plants

At this stage, it is too theoretical to speculate about the likely financial impact to E.ON should its nuclear plant life be extended to the extent discussed above. However the areas of additional upside will be, in our view:

1. Reduction in planned capex to replace/ build non-nuclear capacity
2. Cost benefit from increased proportion of low cost nuclear capacity within generation portfolio
3. Reduction in cost pressure from carbon credit price rises (as nuclear requires no carbon credits) whilst benefiting from wholesale price rises
4. As above but for coal and gas price increases
5. Provision adjustment – both as potential P&L release and an NPV impact on the nuclear liabilities within the balance sheet.

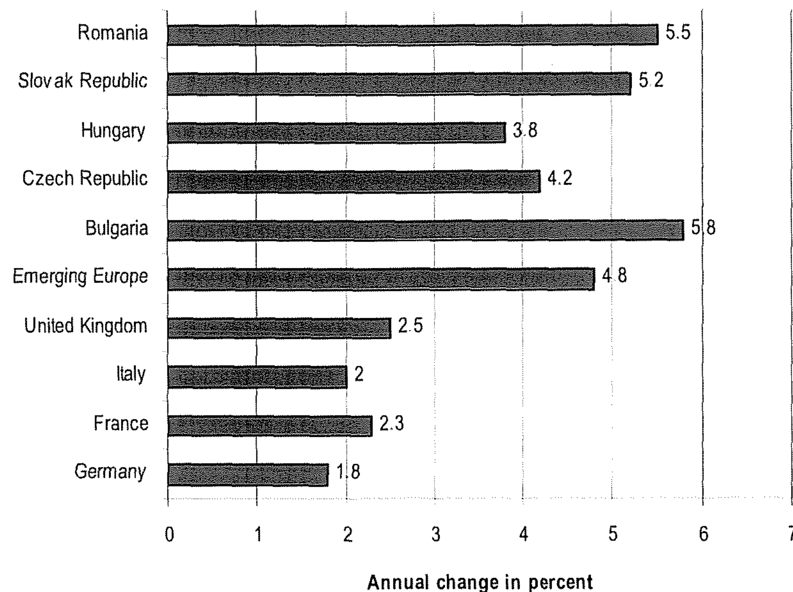
C & E European growth markets

E.ON: exposure to Central & Eastern Europe growth

E.ON has the largest exposure among the large-cap pan-European utilities for investors wishing to benefit from the (almost double) growth rates vs. Western Europe

We estimate 10% of E.ON's EBIT from this market by end 05E.
E.ON's EBIT exposure to Central and Eastern European energy markets is likely to be 10% by end of 2005, on our estimates. In addition, E.ON has earmarked this region as a potential recipient for additional investment opportunities. E.ON's 10% EBIT exposure makes it the largest play among the large-cap pan-European utilities for those investors wishing to benefit from the (almost double) growth rates we forecast into 06, as shown in Figure 6 below. In contrast, we estimate that Electrabel has 5% of 2005 EBIT exposure, Enel will be at 3% in 2006 and RWE at 5%.

Figure 6: Central & Eastern European growth rates outstrip Western Europe
2006E GDP Growth in Real Terms



Source: JPMorgan estimates.
Note: Emerging Europe comprises Romania, Slovak Republic, Hungary, Czech Republic, Bulgaria

E.ON's investment to date earns a ROCE of 20%
To date we calculate that E.ON has invested a total of €1.7bn (since 2000) in Central and Eastern Europe. However, this currently excludes the transactions scheduled to complete in 2005 (Mol: €0.7bn, Bulgarian Northeastern regional distributors €140.7m, the put option in distributor ZSE in Slovakia of €300m, the Distrigaz North shareholding in Romania for €303m and Electric Moldova of approximately €100m). Therefore by the end of 2005, we estimate E.ON's capital employed in Central and Eastern Europe will total €3.3bn (we estimate this will rise to above €4bn once all the options for Mol have closed out by 2008).

Table 11: E.ON in Central and Eastern Europe

	Power			Gas		
	Unit	Power supplied (TWh)	Customers (m)	Unit	Gas supplied (TWh)	Customers (m)
Czech Republic	ECR, ECE, ECD	11.6	1.4	Minority Hdgs	58	1.5
Slovakia (plus 740TWh gas transit)	ZSE	7.3	1.0	SPP	75	1.4
Hungary	EDD, EDE, ETI	15.4	2.4	Kogaz, Ddgaz, Fogaz & MOL	145	0.5
Bulgaria	Gorna, Varna	4.9	1.1			
Romania	Moldova	4.1	1.3	Distrigaz North	46	1.1

Source: Company reports.

Note: Shareholdings >20%. Bulgaria and Romania power expected to close in 2005. Hungary gas (MOL) expected to close in 2005, Slovakia gas: SPP 24.5% held by E.ON-Ruhrgas. Romania gas: Distrigaz North 51%

We estimate (conservatively) that the ROCE within E.ON's Central and Eastern European investments will reach approximately 20% by the end of 2005 vs a likely pre-tax WACC of 9.5%

Therefore on our estimate of a FYE contribution from all of E.ON's investments representing approximately 10% of group EBIT, we believe that the ROCE within E.ON's Central & Eastern European investments will reach approximately 20% by the end of 2005. This compares favourably with a likely pre-tax WACC of 9.5%.

We believe that our assumptions are still conservative

In addition, we note that this analysis is likely to be conservative since we do not include any additional synergies arising from integration of E.ON's power and gas business (where geographic overlap permits). Further upside could come from E.ON's ability to increase the efficiency of its newly acquired assets as stabilizing regulatory frameworks are put in place. We see the value creation potential from these investments as a free opportunity, not currently valued by either the market or in our forecasts. Therefore, if we apply the ROCE: WACC premium to the planned investment by E.ON in this region, we could increase our valuation by close to €1/share (instead of valuing it at capital employed).

Reinvestment risk

Concerns look overdone

We believe that the market's response to reinvestment risk concerns at E.ON is unwarranted. As discussed below, we see no need to include a reinvestment risk discount within our valuation. In our view, a worst case scenario could see value destruction of 15% on a €15bn acquisition. This would reduce our sum of the parts valuation by €3/share yet would still leave 14% potential upside from the current share price.

We believe that Dr. Bernotat is determined to retain his current reputation for financial discipline

Removal of self-restriction is sensible, in our view

E.ON's decision to remove its self-imposed restriction on large-scale acquisitions, was in our view driven by the Supervisory Board's meeting in February 2005, when the growth prospects over the medium term were examined. It should not therefore be taken as an immediate signal for acquisitions but more an opening up to the possibility of larger investments should E.ON's internal growth prospects for reinvestment become less appealing than new external ones (i.e. a medium-term prospect of slowdown in growth within the core Central Europe markets). We believe that Dr. Bernotat guards his current reputation for financial discipline fiercely and would not want to undo the benefit from the two-year past restriction on large-scale acquisitions. In addition, the following financial criteria should add a further layer of reassurance:

1. earnings enhancing in the first full year after acquisition
2. return exceeding cost of capital three years after acquisition, in general
3. not endangering overall group performance targets,

Targeted areas:

Acquisitions in the US are less likely than those in Europe, in our view

Acquisitions in the US are less likely…

We do not expect E.ON to make a large-scale acquisition in the US in the short/ medium term but to seek out organic growth opportunities within the existing LG&E territory. LNG expansion within the US does remain a possibility but we do not see E.ON trying to become a major player (it is possibly too late at this stage, in our view). We believe that E.ON will view any small scale LNG investment as a strategic investment to further strengthen its security of supply arrangements.

...than acquisitions in Europe

Instead we expect E.ON to look for attractive opportunities within core markets that it has already identified as attractive (within Central and Eastern Europe). E.ON's business model of integration of gas and power opens up the possibility for further filling in of these core competencies within already developed Gas or Power markets. E.ON recognizes the importance of making investments that can justify its ability to take part in shaping political negotiations for future regulatory stability.

E.ON's recent track record in Europe is not a cause for concern, in our view

Our analysis indicates too that E.ON's acquisition track record within Europe is stronger than when it has sought to acquire in the UK or US. This is reassuring given that its focus for larger scale acquisitions is likely to be in Europe (although we note that the acquisition in 2004 of Midland Electricity was achieved at a good price). In addition, it is not clear (given E.ON's geographic preferences, as discussed above) where it would even have the opportunity for a large scale acquisition. We believe that E.ON wanted to firstly have the ability to bid for Edison, if appropriate, and secondly to be able to look at any similar opportunities without an investment-size restriction. However, at this stage the timing of an acquisition does not appear near-term. The opinion of JP Morgan's credit research utilities team given below adds further comfort in this debate, in our view.

The credit opinion of JP Morgan's credit research utilities team given below adds further comfort in this debate, in our view.

Credit opinion on reinvestment risk

The strongest credit in European utilities

We believe that E.ON retains its crown as the strongest credit in the European Utilities universe based on its very strong balance sheet and powerful market positions. The five positive catalysts that our equity colleagues have identified are all positive items for credit, although we do not expect them to have a material impact on spreads. Rather, we expect them to further cement E.ON's position as the name offering the most stability to credit investors.

Clearly, the key concern after lifting of the restrictions on the size and nature of acquisitions, is the potential for M&A activity.

M&A risk to credit lower at E.ON than Enel or RWE, in our view

We think it is actually a positive for E.ON against peers that it is prepared to admit that it cannot achieve long-term earnings growth of 10% based solely on cost-cutting. As such, we found the decision of S&P to put the AA- rating on negative outlook rather hard to understand, especially as the agency discussed in the statement that at least one medium-sized acquisition could be absorbed at the AA- level. We think that M&A/event risk is lower at E.ON than at the likes of Enel or RWE because of E.ON's relatively strong record on acquisitions, stronger starting balance sheet and clearer strategic focus.

Single A commitment unlikely to impact E.ON's funding costs

In any case, E.ON is only committed to a strong single-A rating rather than double-A, and we think that E.ON currently has at least €15bn of headroom within that commitment (subject to volatility in the rating process). Given current spread levels, we do not believe that a downgrade to single-A would materially impact E.ON's funding costs (5Y CDS is 1bp tighter than A1/A+ rated RWE).

Regulation

As discussed on page 11, within our earnings forecasts we factor in a 10% electricity grid fee reduction in 06-08 and assume ongoing incentive-based regulation thereafter.

Calendar

15th April: Bundestag (Government & the Green Party) will pass the Energy Law which will then go to the Bundesrat (controlled by the opposition Christian Democrats) for approval. There is normally a three-week process from this point but the Bundestag would like the Bundesrat to be able to deal with the law at its regular meeting on April 27th and so it is applying for a fast track decision.

27th April: Bundesrat will debate and (most likely) reject the Energy Law.

Arbitration then commences for the following six weeks.

May/ June: Final decision reached by the arbitration committee (50:50 of Bundestag and Bundesrat members).

July/August: Implementation of newly approved Energy Law.

Likely regulatory changes after Energy Law is passed

1) Electricity network fees adjustment:

- The regulator will examine all the network operators which have increased network prices this year (EnBW, Vattenfall and RWE Net) and whether these price increases were justified.
- Note that E.ON did not increase its grid fees this year as the renewal law for Energy which increased the balancing costs for other operators did not impact E.ON. In addition, E.ON had foreseen increased costs for buying energy and had increased grid fees in 2004 instead.

2) Benchmarking analysis on electricity grid fees

- The regulator's analysis of benchmarking network fees of electricity grid operators will commence. Due to E.ON's relatively higher rural coverage, its grid fees are slightly above average. It is possible that the benchmarking analysis will take this into account and look at load density within supply areas too. E.ON's suggestion to introduce a qualitative element has not been successful. Those network operators with above-average network fees are vulnerable to a grid fee cut (we assume a 10% margin reduction commencing January 2006 and fully implemented by 2008).

3) Incentive regulation for electricity network operators

- After a further 12-18 months, the regulator will look to introduce incentive-based regulation. This will inevitably penalize the inefficient operators in favour of the efficient operators (of which E.ON believes it is one - even when comparing similar economies of scale potential). The form of the incentive based regulation will possibly be similar to the current UK schemes with price or revenue caps imposed in the first year of a set regulatory period.

4) Gas: entry-exit & benchmarking

a. Implementation of the new entry-exit model will be expected by the regulator after July/ August. We do not currently estimate a material negative impact on gas network prices.

b. We do not expect E.ON-Ruhrgas to have to reduce its current network fees as a result of a benchmarking analysis here. Its fees are below average and a benchmarking system has been in place for some time already with only relatively minor price discrepancies between players.

5) Household consumer competition

c. Finally we believe that the regulator will look at competition for household customers in order to further develop the extent of liberalization. Due to the gas year starting in October, we believe that the earliest that regulatory changes are likely to be felt here would be October 2006.

(Note that E.ON has told us it believes that inevitably this first time regulatory authority may make mistakes in its calculations which will result in court appeals – this should be seen as a natural initial path for a new regulatory body and not undue cause for concern.)

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Commodity & carbon price volatility

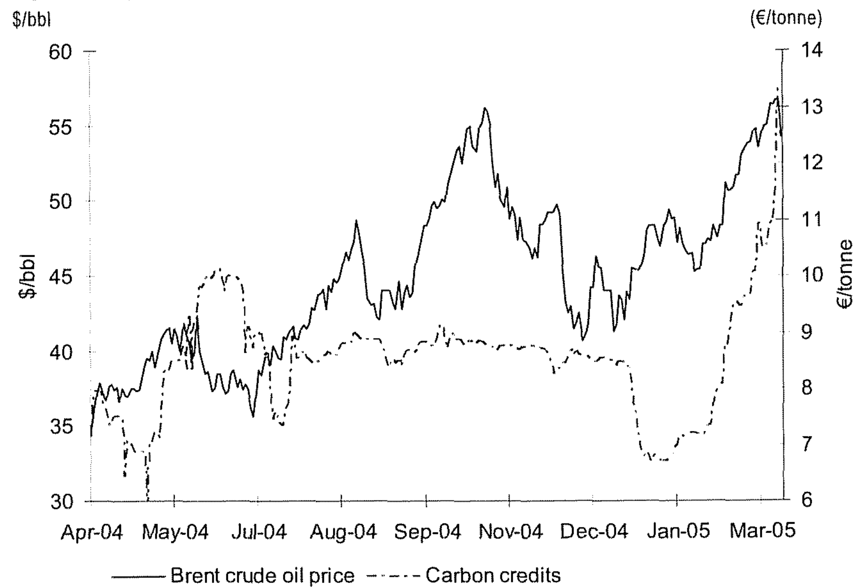
E.ON has better immunity than RWE, in our view

We believe that the relative benefits of E.ON's generating capacity is overlooked by consensus

Volatility and price rises have occurred in both fuel and output prices

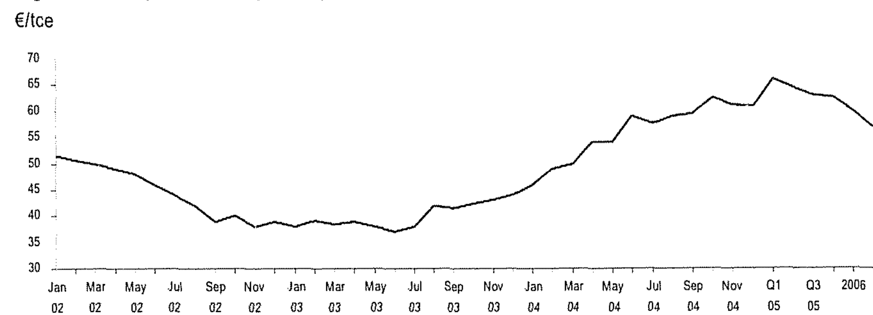
Figure 7 and Figure 8 show the clear volatility and rise in oil, gas and coal costs and also in carbon prices over the course of the last year. E.ON (as with most other utilities) is naturally exposed to these rising costs but in our opinion has more immunity relative to its principal peer, RWE. In market debates over RWE and E.ON's exposure to rising wholesale prices, we believe that consensus overlooks the relative cost benefits of E.ON's generating capacity vs RWE.

Figure 7: Oil price & carbon price spikes



Source: Bloomberg

Figure 8: Coal price development (BAFA)

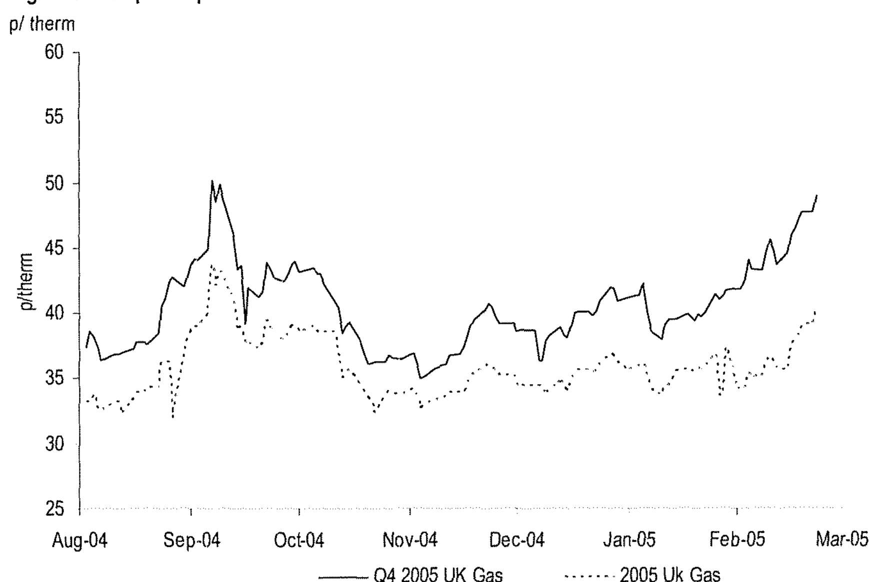


Source: RWE

The oil price jump as seen in Figure 7 caused natural gas prices to climb, albeit less steeply because of a reduction in volatility due to the long-term nature of gas imports vs spot contracts. E.ON Ruhrgas was able to adjust its sales prices in 2004 to reflect higher levels although the long-term nature of these import contracts means it will be impacted less by volatility than spot market transactions.

Figure 9: Gas price spikes

p/ therm



Source: Bloomberg

E.ON's exposure to commodity volatility is limited whilst German wholesale prices respond to rising commodity costs

Contractual protection – even if carbon prices continue upwards

E.ON's contract strategy of locking in fuel prices as it signs wholesale contracts allows its generating margin to remain protected against volatility in the commodity markets. The historical upward pressure on German wholesale prices has been principally driven by rising commodity costs and whilst this relationship continues, E.ON's exposure to commodity volatility is limited. In our view, the same will apply to the wholesale price should the current rise in the price of CO_2 allowances continue. For example the forward electricity wholesale curve for 2007/2008 already indicates a steepening in response to expectations that CO_2 prices will continue to rise (as shown in Figure 7).

Fuel exposure flatters E.ON relative to RWE

For both coal ...

However, relative to RWE, E.ON's fuel positioning (more nuclear relative to coal) offers more exposure to rising wholesale prices whilst limiting its exposure to rising coal prices. We note that E.ON's total coal exposure is limited to 11m tonnes (versus 18m tones for RWE) in Germany, of which costs of 6m are passed straight through to RWE & Deutsche Bahn. The remaining 5m are hedged 1 year ahead, along with the wholesale price which protects E.ON's margin. E.ON has no coal spot exposure at all.

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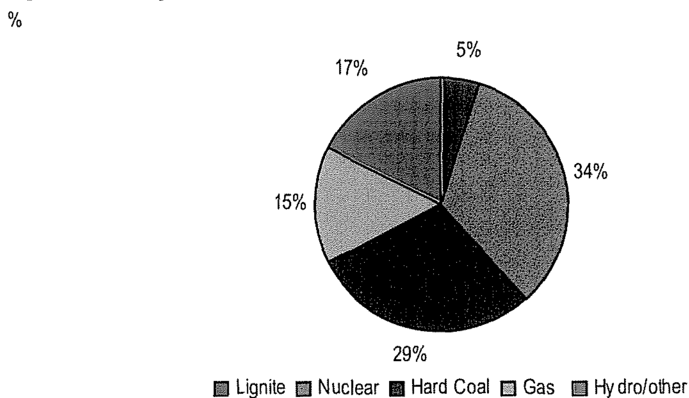
Figure 10: E.ON generation capacity split

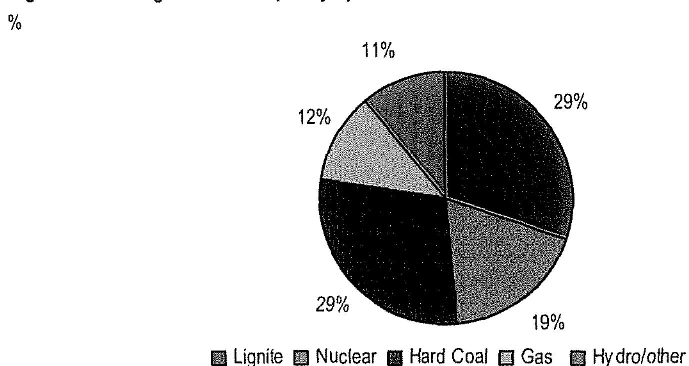
%



Source: Company reports and JPMorgan estimates

Figure 11: RWE generation capacity split

%



Source: Company reports and JPMorgan estimates.

...and nuclear

As shown in Figure 10 above, E.ON's nuclear exposure as a percentage of its generation portfolio is 34% relative to RWE's 19%. This could potentially have a triple benefit for E.ON:

1. via the nuclear plant life extensions as discussed on page 16.
2. in the context of commodity prices, it may allow E.ON's nuclear plant to benefit from the uplift in wholesale prices driven by rising coal and gas prices whilst retaining a relatively lower cost base than RWE due to its higher nuclear capacity.
3. CO_2 emissions for nuclear plant are zero, which also increases E.ON's immunity (relative to that of RWE) to currently rising carbon prices, and simultaneously allows it to benefit as wholesale prices rise to take account of rising carbon prices.

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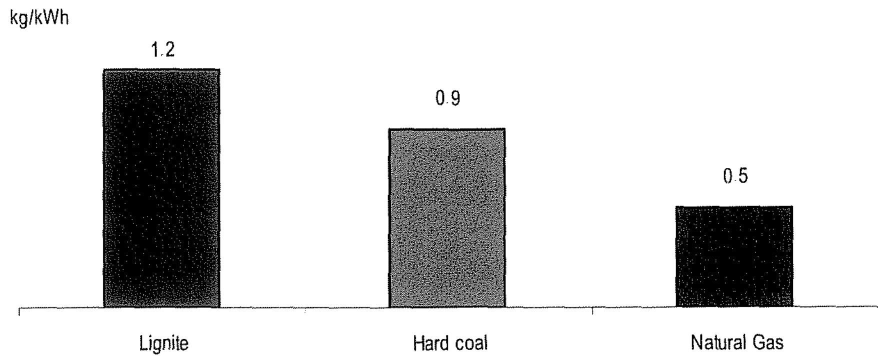
We estimate that with an average 2003 emission rate of roughly 358 grams of CO_2 for every kilowatt-hour (kWh) of electricity produced, E.ON Energie's emissions are nearly 40% below the average for power producers in Germany due to E.ON's plant mix balance being closer to the lower emitting plant types shown in Figure 12.

Figure 12: CO_2 emissions per plant type

kg/kWh



Source: RWE

Note: For a lignite optimized plant, Lignite emissions reduce from 1.2 to 0.9

As well as being Europe's largest investor-owned operator of nuclear power plants, E.ON is also Germany's biggest hydroelectric power generator. In contrast, we estimate that for every kWh of electricity produced, RWE emits 803 gram of CO_2.

E.ON – financial data

Table 12: E.ON - segment forecasts

€ million, year-end 31 December

	2003	2004	2005E	2006E	2007E	2008E	2009E	CAGR (%) 2004-09E
EBITDA								
Central Europe	4,471	4,908	5,215	5,486	5,760	5,887	6,042	4.2
Pan European Gas	1,896	1,900	2,049	2,161	2,231	2,283	2,342	4.3
UK	1,036	1,592	1,643	1,695	1,739	1,782	1,827	2.8
Nordic	933	1,121	1,134	1,127	1,138	1,161	1,189	1.2
US Midwest	517	544	556	583	593	636	651	3.7
Other/consolidation	(273)	(273)	(239)	(239)	(239)	(239)	(239)	(2.6)
Core business	8,580	9,792	10,359	10,813	11,222	11,510	11,813	3.8
Viterra	643	621	579	591	603	615	627	
Degussa	235	107	108	109	110	111	112	
Non core business	878	728	688	700	713	726	740	
Total EBITDA	**9,458**	**10,520**	**11,046**	**11,514**	**11,936**	**12,236**	**12,552**	3.6
EBIT								
Central Europe	2,979	3,602	3,879	4,134	4,393	4,505	4,646	5.2
Pan European Gas	1,463	1,428	1,573	1,669	1,724	1,760	1,804	4.8
UK	610	1,017	1,071	1,106	1,133	1,161	1,191	3.2
Nordic	546	701	699	679	688	709	730	0.8
US Midwest	317	349	359	382	388	427	439	4.7
Other/consolidation	(319)	(314)	(280)	(280)	(280)	(280)	(280)	(2.3)
Core business	5,596	6,783	7,301	7,691	8,046	8,282	8,530	4.7
Viterra	456	471	411	419	428	437	446	
Degussa	176	107	87	109	110	111	112	
Non core business	632	578	498	528	538	548	558	
Total EBIT	**6,228**	**7,361**	**7,799**	**8,219**	**8,584**	**8,830**	**9,088**	4.3

Source: Company reports and JPMorgan estimates.

Table 13: E.ON - P&L forecasts

€ million, year-end 31 December

	2003	2,004	2005E	2006E	2007E	2008E	2009E	CAGR (%) 2004-09E
Total external revenues	46,427	49,103	51,320	52,988	54,453	55,684	57,008	3.0
% growth	26.8	5.8	4.5	3.2	2.8	2.3	2.4	
Total operating costs	(33,399)	(34,686)	(36,150)	(37,187)	(38,097)	(38,930)	(39,834)	2.8
% growth	18.8	3.9	4.2	2.9	2.4	2.2	2.3	
EBITDA - adjusted (excluding equity investments)	8,550	9,823	10,349	10,817	11,239	11,539	11,855	3.8
EBITDA margin (%)	18.4	20.0	20.2	20.4	20.6	20.7	20.8	
EBITDA - reported (inc equity investments)	9,458	10,520	11,046	11,514	11,936	12,236	12,552	3.6
EBITDA margin (%)	20.4	21.4	21.5	21.7	21.9	22.0	22.0	
Depreciation, accruals, writedowns	(3,230)	(3,159)	(3,247)	(3,295)	(3,351)	(3,406)	(3,465)	1.9
of which amortisation of goodwill	0	0	0	0	0	0	0	
EBIT -adjusted (excluding equity investments)	5,320	6,664	7,102	7,522	7,887	8,133	8,391	4.7
EBIT margin (%)	11.5	13.6	13.8	14.2	14.5	14.6	14.7	
EBIT - reported (inc equity investments)	6,228	7,361	7,799	8,219	8,584	8,830	9,088	4.3
EBIT margin (%)	13.4	15.0	15.2	15.5	15.8	15.9	15.9	
Internal operating profit	4,565	6,221	6,978	7,465	7,906	8,218	8,516	6.5
Operating margin (%)	9.8	12.7	13.6	14.1	14.5	14.8	14.9	
Net extraordinary gains (losses)	973	578	(100)	0	0	0	0	
Pre-tax profit - pre exceptionals	4,565	6,221	6,978	7,465	7,906	8,218	8,516	6.5
Pre-tax profit - reported (post exceptionals)	5,538	6,799	6,878	7,465	7,906	8,218	8,516	4.6
Total income taxes	(1,124)	(1,947)	(2,055)	(2,294)	(2,580)	(2,677)	(2,769)	
Minority interests	(464)	(504)	(504)	(504)	(504)	(504)	(504)	
Income/loss from cont ops - reported (post excep)	3,950	4,348	4,319	4,667	4,822	5,038	5,243	3.8
Net reported income	4,647	4,339	4,319	4,667	4,822	5,038	5,243	3.9
Key Income Statement Data								
EBITDA - reported (inc equity investments)	9,458	10,520	11,046	11,514	11,936	12,236	12,552	3.6
% growth	25.1	11.2	5.0	4.2	3.7	2.5	2.6	
EBIT - reported (inc equity investments)	6,228	7,361	7,799	8,219	8,584	8,830	9,088	4.3
% growth	34.0	18.2	5.9	5.4	4.4	2.9	2.9	
Avg number of shares (million)	654	657	657	657	657	657	657	
Adjusted earnings	3,189	3,925	4,391	4,667	4,822	5,038	5,243	6.0
Effective tax rate (%)	20.3	28.6	29.9	30.7	32.6	32.6	32.5	
Key Income Statement Ratios								
Reported EPS (from net income)	7.11	6.61	6.57	7.10	7.34	7.67	7.98	3.9
% growth	66.8	(7.0)	(0.5)	8.1	3.3	4.5	4.1	
Ordinary EPS - pre goodwill	4.88	5.97	6.68	7.10	7.34	7.67	7.98	6.0
% growth	12.2	22.5	11.9	6.3	3.3	4.5	4.1	
Gross dividend per share (€)	2.00	2.35	2.82	3.38	4.06	4.22	4.39	13.3
% growth	14.3	17.5	20.0	20.0	20.0	4.0	4.0	
Dividend cover (x)	3.6	2.8	2.3	2.1	1.8	1.8	1.8	
Payout ratio (%)	28.1	35.6	42.9	47.6	55.3	55.1	55.0	
Interest cover (x)	3.2	5.8	8.7	10.0	11.6	13.3	14.7	
EBITDA margin (%)	20.4	21.4	21.5	21.7	21.9	22.0	22.0	
EBIT margin (%)	13.4	15.0	15.2	15.5	15.8	15.9	15.9	
Net reported income margin (%)	10.0	8.8	8.4	8.8	8.9	9.0	9.2	

Source: Company reports and JPMorgan estimates.

Table 14: E.ON - balance sheet forecasts

€ million, as at 31 December

	2003	2004	2005E	2006E	2007E	2008E	2009E	CAGR (%) 2004-09E
Assets								
Intangible assets	4,114	3,788	3,788	3,788	3,788	3,788	3,788	
Tangible assets	42,836	43,563	45,720	47,490	49,119	50,742	52,916	
Financial assets	17,725	17,263	17,263	17,263	17,263	17,263	17,263	
Goodwill	13,955	14,454	14,454	14,454	14,454	14,454	14,454	
Total fixed assets	**78,630**	**79,068**	**81,225**	**82,995**	**84,624**	**86,247**	**88,421**	**2.3**
Non current deferred tax assets	1,403	1,359	1,545	1,594	1,638	1,675	1,715	
Inventories	2,477	2,647	2,728	2,815	2,892	2,957	3,028	
Receivables	15,408	16,170	15,795	16,281	16,711	17,077	17,471	
Total cash and equivalents	13,932	14,818	16,954	18,462	20,064	21,351	22,226	
Total current assets	**31,817**	**33,635**	**35,477**	**37,558**	**39,666**	**41,386**	**42,725**	
Total assets	**111,850**	**114,062**	**118,246**	**122,147**	**125,928**	**129,308**	**132,861**	**3.1**
Liabilities								
Capital Stock	1,799	1,799	1,799	1,799	1,799	1,799	1,799	
Additional paid in capital	11,564	11,746	11,746	11,746	11,746	11,746	11,746	
Accumulated other comprehensive income	(309)	268	268	268	268	268	268	
Retained earnings	16,976	20,003	22,803	25,269	27,713	29,867	32,130	
Treasury Stock	(256)	(256)	(256)	(256)	(256)	(256)	(256)	
Minority interests	4,625	4,144	4,144	4,144	4,144	4,144	4,144	
Total shareholder equity	**34,399**	**37,704**	**40,504**	**42,970**	**45,414**	**47,568**	**49,831**	**5.7**
Pension provisions	7,442	8,589	8,778	8,971	9,168	9,370	9,576	
Nuclear provisions	13,758	13,481	13,778	14,081	14,390	14,707	15,031	
Other provisions	13,006	12,172	12,172	12,172	12,172	12,172	12,172	
Total provisions	34,206	34,242	34,728	35,224	35,731	36,249	36,779	
Non current deferred tax liabilities	6,450	6,687	7,103	7,329	7,530	7,701	7,884	
Total debt	**21,787**	**20,301**	**20,557**	**20,781**	**20,979**	**21,148**	**21,329**	**1.0**
Payables	3,768	3,627	3,830	3,953	4,061	4,153	4,252	
Other operating liabilities	11,240	11,501	11,524	11,890	12,214	12,489	12,786	
Total liabilities	**111,850**	**114,062**	**118,246**	**122,147**	**125,928**	**129,308**	**132,861**	**3.1**
Net debt (cash)	7,855	5,483	3,603	2,319	915	(203)	(897)	**(169.6)**

Source: Company reports and JPMorgan estimates

Table 15: E.ON-cash flow forecasts

€ million, year-end 31 December

	2003	2004	2005E	2006E	2007E	2008E	2009E	CAGR (%) 2004-09E
Group Cash Flow Statement								
Net Reported Income pre minorities	5,111	4,843	4,823	5,171	5,326	5,542	5,747	**3.5**
Increase/(decrease) in provisions	1,586	(482)	1,032	698	686	670	693	
Deprec., amortiz., accruals, writedowns	3,272	3,256	3,247	3,295	3,351	3,406	3,465	
Cash flow	**9,969**	**7,617**	**9,103**	**9,164**	**9,363**	**9,618**	**9,904**	**5.4**
(Increase)/decrease in net working capital	(1,191)	(767)	937	141	125	107	115	
(Investment) in fixed assets	(2,660)	(2,712)	(4,352)	(4,011)	(4,008)	(4,061)	(4,709)	
Disposals / (acquisitions) of fixed assets	7,035	3,457	0	0	0	0	0	
Net investment in financial fixed assets	(6,536)	(2,573)	(1,052)	(1,053)	(972)	(968)	(930)	
Surplus from operations	**6,617**	**5,022**	**4,636**	**4,240**	**4,508**	**4,696**	**4,381**	**(2.7)**
Dividends paid	(1,621)	(1,598)	(2,028)	(2,332)	(2,702)	(3,147)	(3,254)	**15.3**
Free cash flow after dividends	**4,996**	**3,424**	**2,609**	**1,908**	**1,805**	**1,549**	**1,127**	**(19.9)**
Key Cash Flow Ratios								
Cash flow per share (€)	**13.64**	**10.39**	**12.41**	**12.59**	**12.90**	**13.31**	**13.75**	**5.8**
Free cash flow per share (€)	9.05	6.85	6.32	5.82	6.21	6.50	6.08	**(2.3)**

Source: Company reports and JPMorgan estimates

E.ON - Profit and loss statement

€ million, year-end 31 December

	FY03	FY04	FY05E	FY06E	FY07E
Sales	46,427	49,103	51,320	52,988	54,453
EBITDA	**9,458**	**10,520**	**11,046**	**11,514**	**11,936**
Depreciation and amort.	(3,230)	(3,159)	(3,247)	(3,295)	(3,351)
EBIT	**6,228**	**7,361**	**7,799**	**8,219**	**8,584**
Net interest	(1,663)	(1,140)	(821)	(754)	(678)
Pre-tax profit	**4,565**	**6,221**	**6,978**	**7,465**	**7,906**
Tax	(1,124)	(1,947)	(2,055)	(2,294)	(2,580)
Minority interests	(464)	(504)	(504)	(504)	(504)
Amortisation of goodwill	0	0	0	0	0
Pre-g'dwill net ord. inc.	**3,189**	**3,925**	**4,391**	**4,667**	**4,822**
Reported net income	**4,647**	**4,339**	**4,319**	**4,667**	**4,822**

E.ON - Cash flow statement

€ million, year-end 31 December

	FY03	FY04	FY05E	FY06E	FY07E
Net income (incl. mins)	5,111	4,843	4,823	5,171	5,326
Provisions increase (decr)	1,586	(482)	1,032	698	686
D&A	3,272	3,256	3,247	3,295	3,351
Cash flow from ops	**9,969**	**7,617**	**9,103**	**9,164**	**9,363**
Working capital (increase)	(1,191)	(767)	937	141	125
Capex	(9,196)	(5,285)	(5,404)	(5,065)	(4,980)
Disposals (acquisitions)	7,035	3,457	0	0	0
Free cash flow	**6,617**	**5,022**	**4,636**	**4,240**	**4,508**
Dividends paid	(1,621)	(1,598)	(2,028)	(2,332)	(2,702)
Free cash flow after div	**4,996**	**3,424**	**2,609**	**1,908**	**1,805**

E.ON - Balance sheet

€ million, as at 31 December

	FY03	FY04	FY05E	FY06E	FY07E
Fixed assets	78,630	79,068	81,225	82,995	84,624
Current assets	33,220	34,994	37,022	39,152	41,304
Total assets	**111,850**	**114,062**	**118,246**	**122,147**	**125,928**
Total debt	21,787	20,301	20,557	20,781	20,979
Total equity	34,399	37,704	40,504	42,970	45,414
Other liabilities	55,664	56,057	57,185	58,396	59,535
Total liabilities	**111,850**	**114,062**	**118,246**	**122,147**	**125,928**
Net debt	7,855	5,483	3,603	2,319	915
Capital employed	63,454	65,257	66,662	68,341	69,888

E.ON - Market valuation

€ million

	FY03	FY04	FY05E	FY06E	FY07E
Share price (YE / current)	51.9	67.2	67.5	67.5	67.5
Number of shares (mill)	654	657	657	657	657
Market capitalisation	33,962	44,137	44,334	44,334	44,334
EV adjustment	33,680	31,697	31,697	31,697	31,697
Enterprise value	67,642	75,834	76,031	76,031	76,031

Source: Company data, JPMorgan estimates

Note 1: Historical multiples use net debt and share price at financial year-end

Note 2: Forward multiples use last reported net debt and current share price

E.ON - Valuation ratios

x

	FY03	FY04	FY05E	FY06E	FY07E
P/E (pre-goodwill ordinary)	10.6	11.2	10.1	9.5	9.2
P/E (reported)	8.6	10.2	10.3	9.5	9.2
Price to book value	1.1	1.3	1.2	1.1	1.1
EV / EBITDA	7.2	7.2	6.9	6.6	6.4
EV / EBIT	10.9	10.3	9.7	9.3	8.9
EV / capital employed %	106.6	116.2	114.1	111.3	108.8
FCF yield (pre divs, post mins) %	17.4	10.2	9.4	8.6	9.2
Dividend yield %	3.9	3.5	4.2	5.0	6.0
Local long bond yield (current) %			3.7		

E.ON - Per share

€

	FY03	FY04	FY05E	FY06E	FY07E
Pre-goodwill net ordinary income	4.9	6.0	6.7	7.1	7.3
Reported income	7.1	6.6	6.6	7.1	7.3
FCF (pre divs, post mins)	9.1	6.9	6.3	5.8	6.2

E.ON - Performance and return ratios

%

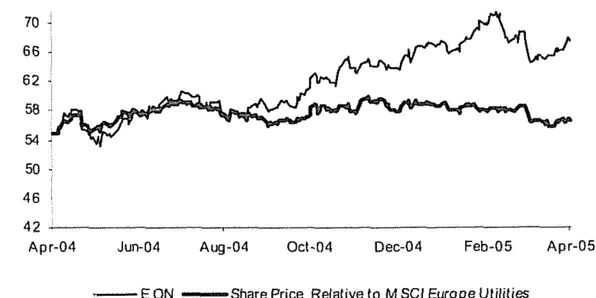
	FY03	FY04	FY05E	FY06E	FY07E
EBITDA margin	20.4	21.4	21.5	21.7	21.9
EBIT margin	13.4	15.0	15.2	15.5	15.8
Net margin (reported income)	10.0	8.8	8.4	8.8	8.9
ROE (pre-goodwill ordinary)	10.0	11.3	12.2	12.0	11.7
ROCE (EBIT)	9.8	11.3	11.7	12.0	12.3
ROA (EBIT)	6.4	7.4	7.7	7.9	8.1

E.ON – Leverage / Debt cover

x

	FY03	FY04	FY05E	FY06E	FY07E
Net debt / (equity+minorities) %	22.8	14.5	8.9	5.4	2.0
Net debt / EBITDA	0.8	0.5	0.3	0.2	0.1
EBITDA / net interest	5.7	9.2	13.5	15.3	17.6
Reported net income / dividends	2.9	2.7	2.1	2.0	1.8

E.ON - 12-month share price performance



Source: Datastream, JPMorgan estimates

Companies Recommended in This Report
AWG (AWG.L/876p/Overweight), E.ON (EONG.DE/€67.48/Overweight), International Power (IPR.L/187p/Overweight), RWE (RWEG.F/€47.37/Neutral), RWE (RWEG_p.F/€41.45/Neutral), Scottish & Southern Energy (SSE.L/929p/Overweight), Severn Trent (SVT.L/938p/Overweight), Veolia Environnement (VIE.PA/€28.91/Overweight)

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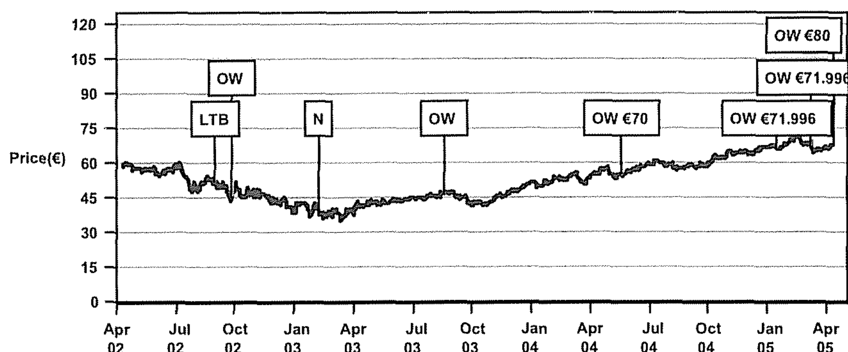
E.ON (EONG.DE) Price Chart



Source: Reuters and JPMorgan; price data adjusted for stock splits and dividends.
This chart shows JPMorgan's continuing coverage of this stock; the current analyst may or may not have covered it over the entire period. As of Aug. 30, 2002, the firm discontinued price targets in all markets where they were used. They were reinstated at JPMSI as of May 19th, 2003, for Focus List (FL) and selected Latin stocks. For non-JPMSI covered stocks, price targets are required for regional FL stocks and may be set for other stocks at analysts' discretion.
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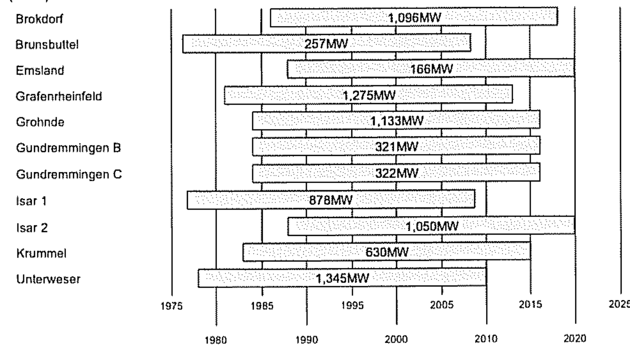
5 potential positive catalysts:

1. May 22: Nordrhein-Westfalen elections

Opposition win may open nuclear life extension debate

E.ON nuclear plant planned life

(MW)



Source: Company reports and JPMorgan estimates

Note: We assume 32 year life for all plants

2. June 26: E.ON UK seminar

Re-rating possible given discount to peers

Table 16: Back-out valuation of E.ON's UK unit

€ million

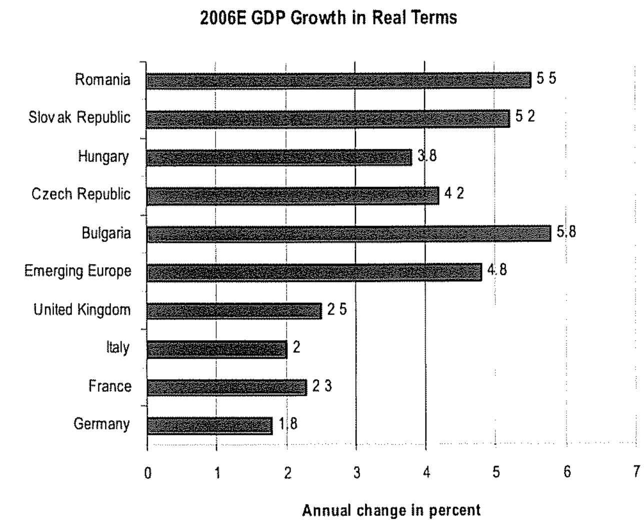
Component	Value
Current share price (€)	67.5
No. of shares (m)	657
Market cap	44,334
Total debt & liabilities	31,697
Current EV	76,031
Less:	
Non core	12,193
Central Europe	38,245
Pan European Gas	14,615
Nordic	7,955
US Mid-West	3,704
Corporate Centre	(2,559)
Implied EV for UK	1,878
Implied EV/EBITDA 06	1.1

Source: JPMorgan estimates

3. Q1 & Q2 results (May & Aug)

Confirmation of C.E. Europe growth

Central & Eastern European growth rates outstrip Western Europe



Source: JPMorgan estimates.

Note: Emerging Europe comprises Romania, Slovak Republic, Hungary, Czech Republic, Bulgaria

4. July 05: regulation arbitration concludes:

Regulatory relief is in sight

Calendar

15th April: Energy Law due to go to Bundesrat for approval.

27th April: Bundesrat will debate and reject Energy Law. Arbitration then commences for the following six weeks.

May/ June: Final decision expected to be reached by arbitration committee

July/August: Implementation of new Energy Law

5. H1 05 Viterra sale

Per €1bn>book, increase E.ON value by €1.5/sh on our ests

citigroup
Smith Barney

See page 37 for Analyst Certification and Important Disclosures

Industry Report

EQUITY
RESEARCH:
EUROPE

Utilities

28 July 2005

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Europe

German Utilities

More To Go For

- **E.ON target price raised from €75 to €86 per share, Buy/ Medium Risk rating retained**
- **RWE target price raised from €55 to €65 per share, Buy/ Medium Risk rating retained**
- **Achieved power price assumptions modestly boosted but we remain well below the forward curve...**
- **...because we think forward prices will soften**
- **Regulatory timetable now known – initial decisions unlikely until November/ December at the earliest**
- **Nuclear life extension now factored in to our sum-of-parts valuations**
- **Biggest political risk: some form of windfall tax or new tax on nuclear power production**
- **Near-term share price triggers: 1H05 results in August and federal election in September**

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Citigroup Global Markets

Table of Contents

Investment overview **5**

Wholesale power prices **11**

Time to revisit our assumptions 11

What really drives the German power price? 12

Revising power price assumptions 14

Threats to higher wholesale power prices 16

Regulation and politics **18**

Regulation: impact delayed to 2006 18

Politics: any sting in the tail? 21

E.ON: balance sheet concerns **25**

Investment thesis 25

Valuation and financial forecasts 28

RWE: driven by earnings growth **32**

Investment thesis 32

Valuation and financial forecasts 34

Figure 1. E.ON Statistical Abstract at €76.55 Share Price (Closing Price on 27 July 2005)

Year to Dec	Sales (EURm)	EBITDA (EURm)	EPS (EUR)	EPS (Old) (EUR)	P/E	P/E Relative	FV/ EBITDA	Net DPS (EUR)	Div Yield (%)
2003A	42,541	8,550	4.24	4.24	18.1	0.9	7.5	2.00	2.6
2004A	44,745	9,823	5.52	5.52	13.9	0.9	6.5	2.35	3.1
2005E	49,383	10,042	6.08	6.01	12.6	1.0	6.4	2.76	3.6
2006E	48,363	10,539	6.78	6.39	11.3	0.9	6.1	3.24	4.2
2007E	47,962	10,677	6.80	6.40	11.3	1.0	6.0	3.81	5.0

52W Price Range: EUR76.84 to 56.85				Price Performance (%)	Ytd	-1m	-3m	-12m
Expected Share Price Return	12.3%	Shares Outstanding	691.0m	Absolute	18.00	5.30	18.10	34.30
Expected Dividend Yield	3.6%	Market Cap.	EUR52,896.8m	Relative to Local	3.44	-1.89	1.89	5.50
Expected Total Return	16.0%	ROE (Curr Yr)	11.8%	Relative to DJ STOXX	2.38	1.46	5.53	7.27

Sources: Company reports and Smith Barney estimates

Figure 2. RWE Statistical Abstract at €55.30 Share Price (Closing Price on 27 July 2005)

Year to Dec	Sales (EURm)	EBITDA (EURm)	EPS (EUR)	EPS (Old) (EUR)	P/E	P/E Relative	FV/ EBITDA	Net DPS (EUR)	Div Yield (%)
2003A	43,875	8,476	2.28	2.28	24.3	1.2	6.1	1.25	2.3
2004A	42,137	8,400	3.19	3.19	17.3	1.1	6.2	1.50	2.7
2005E	41,035	8,250	3.97	3.97	13.9	1.1	6.3	1.95	3.5
2006E	43,251	9,630	5.48	5.36	10.1	0.8	5.4	2.74	5.0
2007E	44,646	9,908	5.93	5.91	9.3	0.8	5.2	3.15	5.7

52W Price Range: EUR55.67 to 37.82				Price Performance (%)	Ytd	-1m	-3m	-12m
Expected Share Price Return	17.5%	Shares Outstanding	559.1m	Absolute	40.80	7.50	21.10	43.60
Expected Dividend Yield	3.5%	Market Cap.	EUR30,919.3m	Relative to Local	23.42	0.16	4.48	12.80
Expected Total Return	21.1%	ROE (Curr Yr)	23.1%	Relative to DJ STOXX	22.17	3.58	8.21	14.70

Sources: Company reports and Smith Barney estimates

We expect both German utilities to perform well over the coming months, with the 1H05 results in August and the federal election in September as likely positive triggers. We are raising our price targets by €10 for RWE and €11 for E.ON to €65 and €86 per share. Amongst other factors, we have decided to build in the extension of nuclear plant lives. We have also adopted slightly higher power price assumptions, although we are wary of the current forward curve. We expect no material impact from regulation until 2006.

Modestly higher power prices assumptions

E.ON and RWE have already locked in the price for nearly all of their planned production until the end of 2006, but we are modestly raising our expectations for 2007 and beyond. Our 2007 assumption rises from €36.5/MWh to €37/MWh. This is €4/MWh below the current forward price, but we just do not trust the forward curve that far out. Forward prices appear to have been driven up by higher carbon prices, which have substantially beaten our expectations. But we think this is simply a case of one illiquid market driving another.

Modestly higher new entrant price estimate

The long-run outlook for prices is more important and here the key anchor remains the new entrant price. In Germany, new entrants get the bulk of their carbon permits for free, so although we now take carbon explicitly into account the impact is only small. We are lifting our estimate of the German new entrant price by €1/MWh to €43/MWh. We are also bringing forward the date at which we expect achieved power prices to match this level by two years to 2010.

Nuclear life extension now factored in

Extending nuclear power station lives is a manifesto commitment by the CDU, which looks highly likely to be the dominant party in the next government. Based on a 45-year life, we estimate the positive impact on value to be some €4 per share for both companies. The CDU has linked the life extension to an expectation of lower power prices, but this appears to be more a vague hope than a clearly thought through policy. We think intervention in the wholesale power market is very unlikely, although we would not rule out some form of tax levied on nuclear power production or on carbon permits.

Regulatory timetable now known

More likely, we think the CDU will look to the newly established network regulator to offset high wholesale prices by cutting transmission and distribution prices. This is a risk we think the stock market has already taken on board. Now that the Energy Industry Act has been passed, we know the timetable for the initial regulatory review of current charges. We do not expect to hear any significant regulatory decisions until November or December at the earliest. We still think a 30% fall in network charges may eventually materialise and we continue to factor this reduction into our forecasts by 2010. But our forecasts now assume the squeeze does not begin until 2006.