RWE's earnings growth the main driver

Despite being the third best performing utility stock year to date, RWE still looks undervalued on most measures. In fact, it is one of the cheapest stocks in the sector on the FY06E P/E multiple (10.1x against the sector on 12.7x). The stock market does not yet seem to have faith in our FY06E estimates, which appear to be some 14% ahead of consensus. As a result, we think earnings delivery is likely to be a key driver for the share price.

E.ON's balance sheet conundrum

The main obstacle to the E.ON investment case arises from its soon-to-be completely unleveraged balance sheet. As a result of this situation, E.ON's earnings growth is more pedestrian than that of RWE, and its P/E ratio is less compelling. In this report we model the impact of special dividends and acquisitions on the earnings multiple. Either route would help make the shares look as cheap as we believe they are, although in practice we suspect E.ON will run with an inefficient balance sheet for some time to come.

Investment Overview

- **We are raising our target prices and reiterating our Buy/ Medium Risk (1M) ratings on both German utility stocks**
- **But we have not marked our forecast to market and our achieved power price assumptions remain well below the current forward curve**
- **We have raised our estimate of the German new entrant price to €43/MWh from €42/MWh...**
- **...and we are assuming this level is reached in 2010 against 2012 previously**
- **In addition, we are factoring into our sum-of-parts valuations an extension of nuclear power station lives to 45 years**

Raising target prices once again

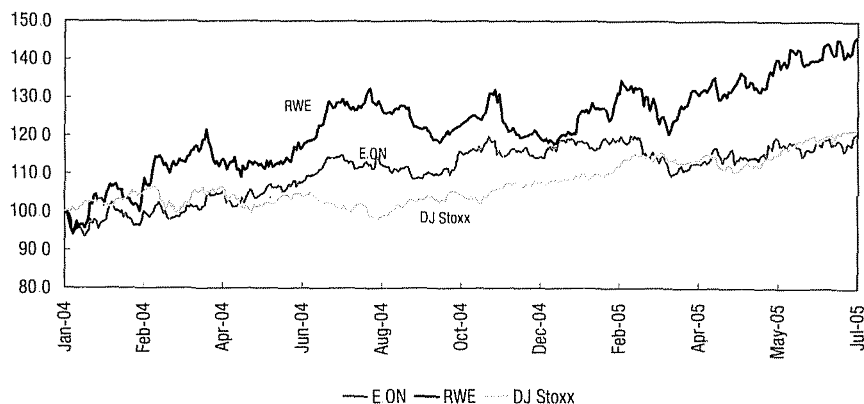
We are raising our target prices, forecasts and valuations once more for both German utilities. This move takes into account a slightly more optimistic assumption on wholesale power prices and we are also building in upfront the potential extension to nuclear power station lives that we believe a CDU-led government would deliver.

- For E.ON our target price rises from €75 to €86 per share, while our FY06E EPS estimate goes up by 6% to €6.78.
- For RWE our target price rises from €55 to €65 per share, while our FY06E EPS forecast increases 2% to €5.48.

On both stocks we retain a Buy/ Medium Risk (1M) rating.

We think there is still more to go for

Figure 3. Share Price Performance (Indexed to 1 Jan 04=100)



Source: Reuters

Our detailed arguments on power prices are set out in the section beginning on page 11, while we review the political and regulatory situation in Germany starting on page 18. Several key points are worth emphasising upfront.

Forecasts not marked to market

Treat the forward curve with caution

We have resisted the temptation simply to mark our forecast assumptions on power prices to the current forward curve. Forward prices are volatile and liquidity is thin for 2007 and beyond. In addition, we believe prices are at least partly being driven by the overheated UK gas market. The price E.ON and RWE will actually achieve in 2007 will chiefly reflect forward prices in the first six months of 2006, and we see scope for prices to soften between now and then.

For 2005 and 2006, forward prices are more liquid. But these prices by now are irrelevant to the price that RWE and E.ON will realise for the bulk of their power in those years as both companies have sold forward almost all of their production until 2007.

The new entrant price is what matters in the long run

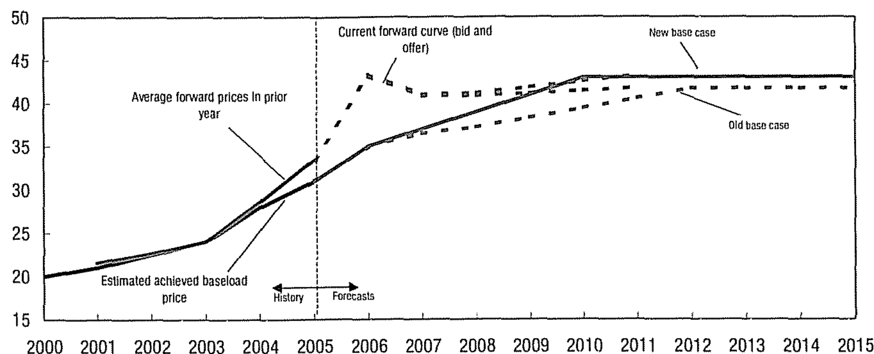
In the long run, we still believe the key anchor for the wholesale power prices is the likely new entrant price, and we are raising our estimate today for the German new entrant price from €42/MWh to €43/MWh. This is because we have tweaked our new entrant model to take CO2 explicitly into account in year 15 and beyond, although we still assume new entrants get for free the permits they require for their first 14 years of operation.

We are also bringing forward the date at which we expect achieved prices to converge with new entrant levels from 2012 to 2010. As set out on page 12, we are sceptical about CO2 as a direct driver of achieved power prices, but we do think it will enable new entrant prices to be achieved rather earlier than we had previously supposed.

Figure 4 shows how our assumptions have changed and how our achieved price assumptions compare with the current forward curve. Figure 5 sets out a sensitivity analysis based on different levels of the new entrant price. For the range in scenarios covered by the table, all of which are defensible in our view, the implied range in SoP for E.ON would be from €87 to €98 per share, while for RWE the range would be from €58 to €75 per share.

We are well below the forward curve for the next couple of years

Figure 4. Achieved Power Price Assumptions (€/MWh)



Source: Platts and Smith Barney estimates

Figure 5. Impact of Power Scenarios on SoP Valuation

Date of convergence	New entrant price (€/MWh)	RWE SoP impact (€ per share) Base case SoP €64 per share	E.ON SoP impact (€ per share) Base case SoP €91 per share
2008 convergence	40	-3.4	-2.4
	43	+2.1	+1.0
	48	+11.3	+6.8
2010 convergence	40	-4.7	-3.1
	43	0	0
	48	+7.9	+5.1
2012 convergence	40	-5.9	-3.6
	43	-1.8	-0.9
	48	+4.9	+3.6

Source: Smith Barney analysis

Nuclear life extension highly likely

We have decided to take at face value the CDU manifesto commitment to allow nuclear power stations to operate for as long as it is safe to do so. Current opinion polls suggest the CDU has enough of a lead to make it highly likely that it will form the next government (in coalition with the Free Democrats). However, even if the CDU is forced into some form of grand coalition with the SPD, we think a nuclear life extension is still highly likely. We estimate the impact would be an additional c.€4 per share of value for both stocks.

But at what cost?

On the negative side, the CDU has called for the life extension to be linked to lower power prices. However, we suspect this will be achieved by allowing the newly established network regulator to attack transmission and distribution revenues rather than by some form of intervention in the wholesale market.

Our chief concern would be if the CDU opted to levy a supplementary tax on nuclear power generation with the idea of using this to pay for renewable generation projects which are currently subsidised by a levy on electricity tariffs. So far, this has not cropped up as a possibility, as far as we are aware.

Regulatory impact deferred to 2006

Network regulation becoming more predictable

Although RegTP (now the *Bundesnetzagentur* or BNA) assumed responsibility for regulating German electricity and gas networks on 13 July, we do not believe the regulator will begin the task of scrutinising current electricity network prices in earnest until October (and three months later for gas). The upshot is that we no longer see any need to build in a negative impact from regulation in 2005 and we have therefore deferred the impact of regulation to 2006. We now assume a 6% annual decline in prices over five years to achieve a 30% fall by 2010. Our previous assumption was a 5% decline over six years. This should erode revenues for RWE by around €300m in 2006 and for E.ON by some €400m. We suspect these assumptions may prove too harsh.

Newsflow

In terms of newsflow, the next event is the 1H results for E.ON on 10 August and for RWE on 11 August. As usual, both companies are likely to be fairly cautious in any outlook statements but we do see a chance that RWE in particular could up its guidance for FY05.

The election in September is a key trigger

After that, the federal election is expected to be held on September 18th. We believe the run up to the election should be a positive trigger for both companies, although any sign that the CDU might be edging toward a possible supplementary tax on nuclear generation (or on carbon permits for that matter) could prompt a rethink.

We think it is unlikely that we will see any significant pronouncements from the BNA on grid fees until the closing stages of 2005.

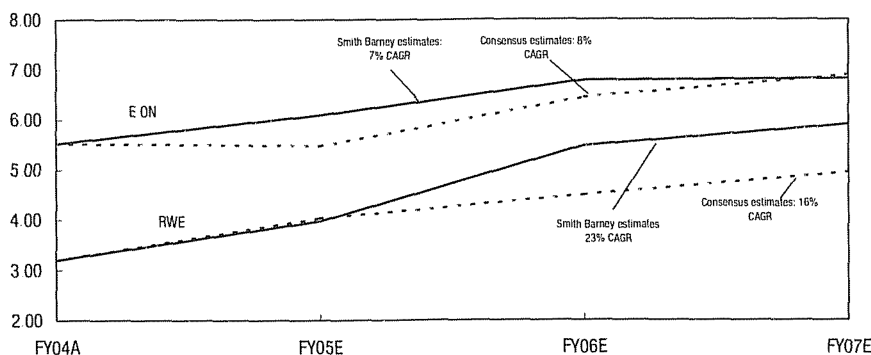
Valuation and financial forecasts

Our sum-of-parts estimate for E.ON now stands at €91 per share (as set out on page 29) while that for RWE is now €64 per share (see page 34). These have both risen by some €10-11 per share since our last published estimates. Increasingly, however, we believe earnings are the real drivers of the share price, particularly as far as RWE is concerned.

Figure 6 sets out how our earnings estimates for both companies compare with consensus. We still believe the analytical community as a whole has not been bold enough, particularly as far as the RWE estimates are concerned.

We are above consensus, particularly for RWE

Figure 6. Pre-exceptional Earning Estimates (€ Per Share)

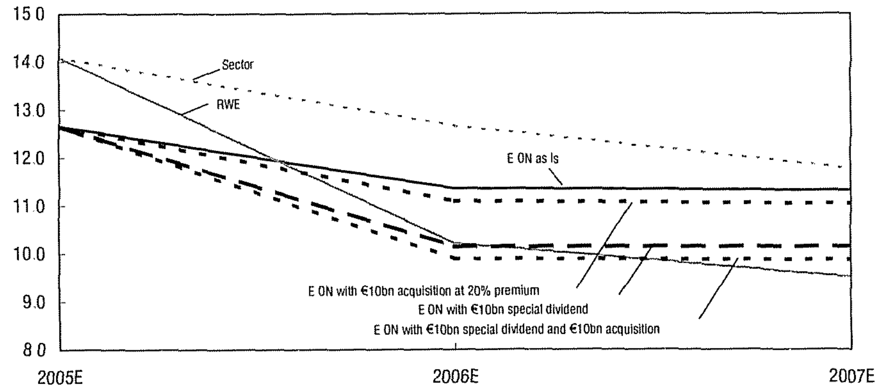


Source: Smith Barney and *Reuters*

E.ON's earnings progression is hampered by its ungeared balance sheet. This is a situation which we do not expect to be resolved quickly. However, it is worth noting that E.ON could look rather more attractive on a P/E basis if it had a more optimal balance sheet. For example, Figure 7 shows the results of some simple modelling of the effect of an acquisition and a special dividend on E.ON's P/E multiples according to our forecasts. Both would boost the P/E multiple, and make E.ON look rather more attractive. In practice, however, E.ON has ruled out making any further commitment on dividends until Spring next year, while a major acquisition also does not seem to be imminent. Our hunch is that share price weakness caused by such an acquisition could be a buying opportunity.

If only E.ON had the right balance sheet...

Figure 7. Impact of Special Dividend and Acquisitions on E.ON's Earnings (€ per Share)



Source: Smith Barney Assumes acquisitions and special dividends are made on 1 January 2006 with the acquisition at a 20% P/E premium to the current sector FY06E P/E multiple.

Figure 8 provides main valuation multiples for both companies on our revised forecasts. Based on sector average FY06E P/E and EV/EBITDA multiples, a share price of €80-92 can be justified for E.ON and €68-72 for RWE.

FY06E sector multiples support €80-92 for E.ON and €68-72 for RWE

Figure 8. Valuation Multiples

	FY05E	FY06E	FY07E
PE (pre-exceptional, pre-goodwill)			
E ON	12 6	11 3	11 2
RWE	13 9	10 1	9 3
Sector average	14 1	12 7	11 8
E ON share price at sector average	**86**	**86**	**80**
RWE share price at sector average	**56**	**70**	**70**
EV/EBITDA (adjusted)			
E ON	7.2	6.8	6.7
RWE	7 2	6 1	5.8
Sector average	7 5	7 0	6 6
E ON share price at sector average	**81**	**80**	**76**
RWE share price at sector average	**60**	**72**	**70**
EV/EBITDA (adjusted, pre associates)			
E ON	6.4	6 0	5.9
RWE	6 9	5 9	5 5
Sector average	7 0	6 5	6 2
E ON share price at sector average	**92**	**92**	**88**
RWE share price at sector average	**57**	**68**	**66**
Dividend yield			
E ON	3 6%	4.2%	5 0%
RWE	3 5%	4 9%	5 7%
Sector average	4 5%	4 6%	5 0%
E ON share price at sector average	**62**	**71**	**77**
RWE share price at sector average	**44**	**60**	**63**

Source: Smith Barney based on share prices at close on 27 July 2005

Our target prices are intended to reflect a compromise between the sum-of-parts approach to valuation and one based on the standard multiples. Overall, we think a reasonable case can still be made for both companies on valuation grounds, but whereas concerns over acquisitions are likely to be an ongoing issue for E.ON's share price, we believe RWE's shares will simply be driven higher by the delivery of earnings growth.

Wholesale Power Prices

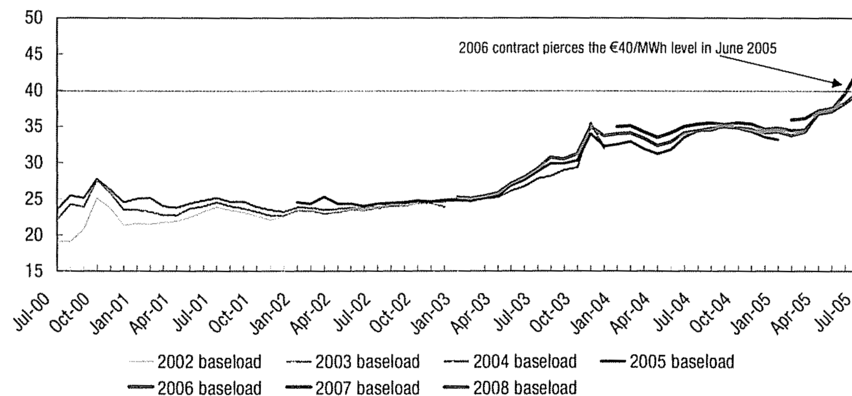
- Our achieved power price assumption of €35/MWh in 2006 now looks secure
- We are raising our estimate for achieved prices in 2007 from €36.5/MWh to €37/MWh...
- ...this is €4/MWh below the current forward curve but we suspect current forward prices are misleading
- We advise investors not to get carried away by CO2 and illiquid forward energy markets
- Instead focus on the fundamentals: the new entrant price is still the long-run constraint on German power price
- We now assume a €43/MWh new entrant price achieved in 2010, instead of €42/MWh in 2012 previously

Time to revisit our assumptions

Back in March, we set out a base case for German wholesale power prices involving a steady rise towards a €42/MWh new entrant level by 2012[1]. Already we have been overtaken by events: the forward 2006 baseload contract breached the €40/MWh level last month, peaked at €45/MWh and now trades at around €43/MWh.

Forward prices have risen more strongly than we supposed

Figure 9. Forward Baseload Power Prices in Germany (€/MWh)



Source: Platts and Smith Barney analysis

Most people seem to agree that the key factor pushing forward prices higher has been the carbon market, while the carbon market in turn appears to have been driven by a number of factors, including high UK gas prices and downward revisions to the allocations of carbon permits in some countries.

[1] See *German Utilities – Power Prices A Scenario Analysis* 22 March 2005

These high power prices have led to a steady stream of upgrades for the German utility stocks as analysts shift their power price assumptions closer to the current forward curve.

We too are shifting to a more optimistic set of assumptions today, but we are also trying to sound something of a note of caution. At the outset, two key facts are worth stressing.

We are sounding a small note of caution

- First, both E.ON and RWE have sold forward nearly all of their expected production for 2006 as well as 2005. We are not changing our achieved power price assumptions for either of those years and we think the strength of the 2006 contract price is now pretty much an irrelevance. What we are really arguing about is the outlook for 2007 and beyond.
- Second, we suspect that forward power prices, carbon prices and gas prices for 2007 are not really very meaningful as the liquidity of these markets is likely to be very limited. We want to avoid being duped into a sharp power price upgrade on the back of forward prices that are of dubious significance.

€35/MWh should be in the bag for 2006

On the plus side, we are now more confident that our assumptions and forecasts for 2006 are reasonable. An achieved power price in the region of €35/MWh at baseload should be pretty much in the bag for both companies, which means that RWE really should deliver nearly 40% growth in recurrent EPS next year on top of 25% growth in FY05E.

However, despite all the noise that rising carbon prices and gas prices have generated over the last few months, we think the long-run constraint on German power prices is still the new entrant price – i.e. the level at which a new competitor would be tempted to enter the market. Our view on this price has not really changed a great deal and, although we are raising our base case estimate today, it only rises by €1MWh to €43/MWh.

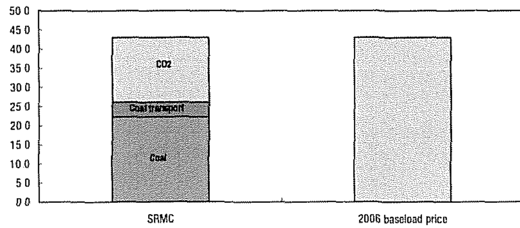
We are, however, assuming this price is reached two years earlier than we had previously assumed. The justification for these changes in view is set out below on page 14. Some readers may prefer to jump straight to these pages and skip out the following section, where we explore recent trends in forward prices in more detail and set out our own theories on the real drivers of German power prices.

What really drives the German power price?

We think most analysis of the impact of carbon trading on the German market starts from the wrong assumption. Encouraged by the companies themselves, many seem to believe that the key determinant of the German power price is short-run marginal cost (SRMC). Given that this must now include the opportunity cost of carbon as well as the cost of the fuel consumed, the explanation for the sharp rise in German power prices since the start of carbon trading seems clear.

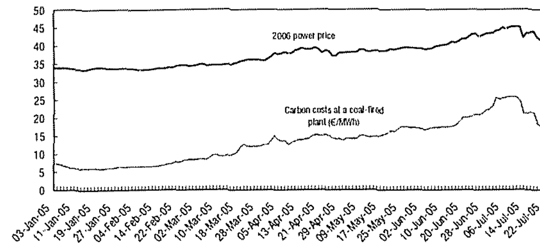
Further, the numbers also seem to add up more or less, at least as far as the 2006 contract is concerned. At €43/MWh, the 2006 baseload price is close to the carbon-inclusive SRMC, while the correlation of the forward price to the carbon price is also fairly clear (Figure 11).

Figure 10. German Power Price vs SRMC (€/MWh)



Source: Platts and Smith Barney estimates

Figure 11. Power Price and Carbon Costs (€/MWh)



Source: Platts and Smith Barney estimates

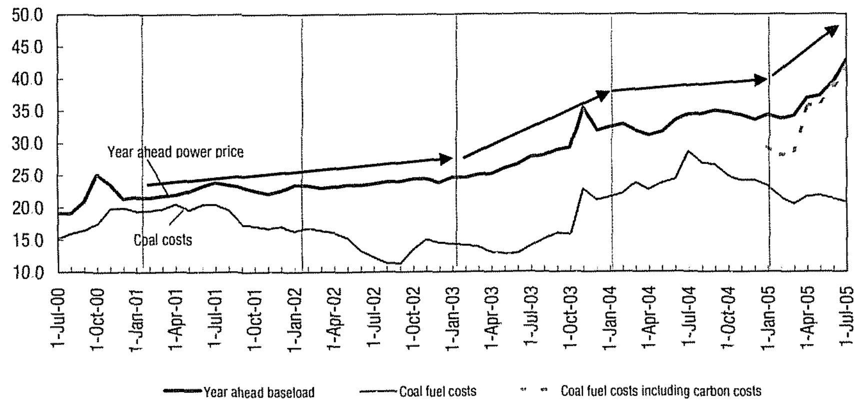
But the idea that SRMC sets German power prices is not consistent with the way the German power price has behaved. For example, forward power prices in 2007 are slightly lower than 2006 prices, even though 2007 CO2 prices are a shade higher than those in 2006. Some people argue that this is because the 2007 power prices are not yet "properly factoring in" carbon, and that 2007 power prices must therefore rise still further. This would mean achieved prices in 2007 would probably be even higher than the current forward curve suggests.

However, we think this is way too optimistic a view. Power prices have never been purely driven by SRMC in the past, so it seems odd to believe that this will be the case going forward.

For example, Figure 12 shows how the price of the year-ahead baseload contract in Germany has changed over the last five years. The chart also shows our estimate of short-run marginal cost based on the fuel cost for a typical coal-fired plant with 34% efficiency. There does not seem to be an automatic link between changes in fuel prices (i.e. SRMC) and changes in power prices. In fact, when coal prices have fallen, power prices have tended not to change so that margins have expanded instead. On the other hand, power prices tend to rise when fuel prices rise, so that margins are preserved.

Short-run marginal cost has not really driven the German power price in the past

Figure 12. Year-ahead Baseload Power Prices in Germany and Fuel Costs (€/MWh)



Source: Platts and Smith Barney estimates

citigroup
Smith Barney

Instead we think the fact that there are just four players is significant

This pattern is consistent with our view that it is the behaviour of the dominant four generators in the German market which is the overwhelming factor controlling the German power price. This ruling quartet was established in 2000 as a result of various mergers (e.g. RWE-VEW, VEBA-VIAG). Since then, we believe, the link between short-run marginal cost and German power prices has been an indirect one. Rising fuel prices have basically been used to ratchet the German power price closer to the new entrant price. In our view the launch of carbon trading should be seen in the same light.

This, in our view, is the significance of carbon in the German market: it has allowed new entrant level pricing to be achieved much earlier than we had supposed. However, as discussed below, it has not really changed the level of the new entrant price, at least under the current rules for allocating carbon permits in Germany.

Two key predictions follow from our view that the oligopolistic nature of the German market is the key determinant of power prices.

So we would not get too carried away by carbon

- First, German power prices should not carry on rising indefinitely, even if carbon prices do. If the new entrant level is breached, we would expect the oligopoly to allow prices to soften to stave off new entry.
- Second, if carbon prices do tumble, there is not necessarily going to be an equivalent negative impact on power prices. This is just as well, as the evidence suggests that the overheated UK gas market has been the dominant influence on the carbon price.

We do believe, however, that it is in the interests of the incumbent German generators that forward power prices drift a little bit lower in future months.

Revising power price assumptions

If we set aside the evidence from the current forward curve for 2007 and beyond as potentially misleading, we think there are still two key anchors on the power prices that RWE and E.ON can be expected to achieve in coming years.

1. We think it is fairly clear that the 2006 achieved price will be around €35/MWh, based on the average level of the 2006 forward price when the two companies renewed their power sales contracts (i.e. chiefly 1H06).

The new entrant price is still the key long-run anchor

2. We think the long-run power price will tend to hover at just below the level at which it makes economic sense to build a new power station – any higher and the incumbent generators will risk sacrificing market share to new entrants, any lower and the incumbents will needlessly be sacrificing margin.

As noted above, we have changed slightly our estimate for the German new entrant price and we have also brought forward the date by which we expect the achieved power price to converge on this level.

New entrant price

When we last calculated a new entrant price for the German market, we decided not to take carbon costs into account because, under the current rules, new entrants in the German market receive for free sufficient permits to cover their first 14 years of operation.

We think carbon is not very important for new entrants in Germany

It is of course possible that the rules for allocations to new entrants will change and that ultimately new entrants will need to buy carbon permits to cover their carbon requirements. However, we suspect this rule will apply at least for the first two phases of carbon trading (i.e. up to 2012).

The change we are making reflects our adoption of a slightly more sophisticated new entrant model, which now takes into account the fact that carbon costs will have an impact in year 15 and beyond instead of ignoring carbon completely. The result is a modest increase in our calculated new entrant price (by about €1/MWh) depending on the assumed carbon price.

We are at this stage not changing our fuel price assumptions. Under our base case and high case fuel assumption, we assume the current contractual link between gas prices and oil price remains intact in Germany. Our base case adopts a long-run oil price assumption of US$32/bbl, consistent with the Smith Barney house view. Our high case assumes US$40/bbl, which is arguably closer to consensus expectations. The low case, on the other hand, represents a perhaps unlikely scenario of intense competition in the German gas market leading to a decoupling of gas prices from oil prices.

The range is from €37/MWh-48/MWh

Figure 13. New Entrant Model Assumptions

Fuel scenario description	High	Base case	Low
Long run gas price	€13/MWh (or 26p/therm, or US$5 1/mmBTU) plus €2/MWh transport costs	€11/MWh or 22p/therm, or US$4.4/mmBTU) plus €2/MWh transport costs	€8/MWh or 16p/therm, or US$3.2/mmBTU) plus €2/MWh transport costs
Other assumptions	Construction costs of €0.5m per MW, 80% load factor, 25 year operational life, 2 year lead time, 35% tax rate, 54% efficiency, €40/kW annual fixed costs growing by inflation rate of 2% a year. 10% post-tax nominal discount rate		
New entrant price (excluding carbon costs)	€46/MWh	€42/MWh	€37/MWh
New entrant price (€15/tonne carbon)	€47/MWh	**€43/MWh**	€38/MWh
New entrant price (€30/tonne carbon)	€48/MWh	€44/MWh	€39/MWh

Source: Smith Barney

Assuming €15/tonne carbon, the end result is a central case new entrant assumption of €43/MWh, compared with €42/MWh previously.

Convergence

Predicting the date at which achieved power prices converge to the new entrant level is not easy. From a fundamental perspective, we still believe that new capacity is not really needed in the German market until beyond 2010, especially if nuclear power station lives are extended as now seems likely.

However, the oligopolistic nature of the market suggests this price may be achieved rather sooner, especially under the smokescreen provided by the introduction of carbon trading.

We have therefore brought forward our assumption for the date of convergence by two years, from 2012 to 2010 and we have decided to assume a linear increase in prices between 2006 and 2010. This is of course a fairly arbitrary assumption, but we feel it is preferable to simply marking our forecasts to the current forward curve.

Threats to higher wholesale power prices

Rising electricity prices are controversial in any country and this is clearly the case in Germany. Energy intensive consumers have been complaining about high prices for the last couple of years and the decision by Norsk Hydro to close its aluminium smelter in Hamburg last month has provoked a further chorus of disapproval.

See the next section for more on political risks

In practice, there is no obvious mechanism for the direct political intervention in the wholesale power market. Regulating the market, or imposing a price cap or similar, would require new legislation and runs contrary to European moves to liberalise the market. In our view, only if wholesale power prices soar to levels well above the new entrant price is the German government likely to contemplate such direct intervention.

We discuss below the CDU's desire to link its proposal to extend the lives of German nuclear power stations to an expectation of lower prices, but in short we think this will either result in greater pressure on the network prices, or in some form of windfall tax, rather than an undermining of the wholesale power price.

We would not completely rule out the possibility of some modification to the European emissions trading scheme. However, we suspect this would need to come at an EU level, and that Germany is unlikely to act unilaterally in this regard.

As a result, we are reasonably comfortable that direct action by politicians to curb wholesale power prices will not materialise. However, we do suspect nevertheless that forward prices will soften further over the rest of the Summer. We think the incumbent generators will decide in the run up to the federal election that it is more politically expedient to adopt a less rigid policy towards adding carbon costs to power prices than has so far been the case.

We would be reassured by slightly lower forward prices

In fact, power prices have already been weakening over the last few weeks, with the 2006 contract off €2/MWh from its high of around €45/MWh. In our view, a further decline in the forward curve to the high €30s would be helpful politically and would not undermine our forecast assumptions. Equally, we would be rather concerned were the forward curve to rise back toward the €45-50/MWh level. This in our view would be a sign that the level of control that the incumbents have over power prices is much less than we currently suppose.

As well as risking some form of political backlash, such high wholesale power prices would increase the risk that E.ON and RWE could lose market share to new entrants. Figure 14 shows the current list of major new power station projects currently underway in German excluding those planned by the four major incumbent generators. Most of these projects have been under consideration for several years and there does not so far seem to be a wave of new projects that have been provoked by the recent wholesale power price rise. Given current gas prices this is hardly surprising – our €43/MWh new entrant price assume a long-run gas price of €11/MWh. The current year-ahead gas contract at the German/Dutch border is trading at over €20/MWh.

So far there is no major dash by new entrants

Figure 14. Major New Power Station Projects (Excludes Projects Planned by Main Incumbents)

Name	Capacity	Status	Target on-line date	Comment
Saarbrücken	400MW CCGT	Feasibility study	2007	Backed by Electrabel
Lubmin (Concord Power)	1200MW CCGT	Construction to begin shortly	2007	50% Saalfeld Group/ 50% EnBW.
Hürth Knapsack (Statkraft)	800MW CCGT	Statkraft recently bought the project from Intergen. Decision recently taken to proceed.	2007	Essent is to take 33% of the output
Hamm Ütnrop (Trianel)	800MW CCGT	Final go-ahead recently given.	2007	Backed by 26 municipal utilities.
Herdecke Cuno	400MW CCGT	Final go-ahead recently given.	2007	Backed by Statkraft and two municipal utilities
Ingelheimer Aue	400MW CCGT	Appears to be at an early stage	2007	Backed by three municipal utilities
Dettelbach	800MW CCGT	Appears to be at an early stage	2007/8	Backed by the Nurnberg municipal utility

Source: Power in Europe

Conclusion

Although we are raising our assumptions of achieved power prices, we are not marking our forecasts to the current forward curve. This would be substantially too optimistic in our view. We think forward prices are more likely to soften than to rise further. In any case, both E.ON and RWE have already sold forward the bulk of their power until 2007. Our assumption for the achieved power price in 2007 now stands at €37/MWh – i.e. some €4/MWh below the current forward price for that year.

Regulation and Politics

- **Network regulation now up and running by unlikely to have any impact at all in 2005...**
- **...but we still assume a 30% price cut by 2010**
- **An extension of nuclear power station lives now looks very likely – we still estimate this is worth around €4 per share to both companies**
- **The nuclear life extension has been linked by the CDU to an expectation of lower prices...**
- **...but we see no way that the two issues can directly be linked**
- **Some form of extra taxation could be a possibility, but does not currently form part of the CDU's plans**

Introduction

On the political and regulatory front, the two key issues remain:

- the likely impact of regulation on network profits; and
- the consequences of a probable new CDU-led government in Germany from September 2005.

Regulation: impact delayed to 2006

The Energy Industry Act completed its passage through Parliament on 17 June with the telecoms and post regulator finally assuming the additional responsibility of overseeing gas and electricity networks on 13 July 2005 under the new name of the *Bundesnetzagentur* (BNA, or Federal Network Agency).

Getting the legislation through parliament was a tortuous process and the Government was forced to compromise in several areas. We identified the areas where some form of compromise was likely in our report of 22 March[2]. These are reviewed in Figure 15 which also sets out the final decisions reached.

There is nothing particularly alarming on the list, in our view. Perhaps the most important compromise was the decision to allow local regulation of smaller networks. This allows the BNA to focus its energies more on the larger operators such as E.ON and RWE. Indeed, BNA head Matthias Kurth has already indicated that he will initially target both the largest operators as well as those with the highest prices. However, he has also played down his ability to have an immediate impact on energy prices.

[2] See *German Utilities – Power Prices A Scenario Analysis* 22 March 2005

Figure 15. Main Areas of Compromise

No devil in the final detail of the Energy Industry Act

Issue	Compromise Agreed	Our view
Involve local government in the regulatory process	Utilities serving above 100k customers will have their network fees overseen by the BNA, but those falling below that threshold may be overseen by the economics ministry in their local federal state. Alternatively, the state may delegate this responsibility to the BNA	This was not a major surprise, but does simplify the BNA's task and potentially could allow network prices to be cut more rapidly
Nature of accounting used for regulation	Prices for existing assets are to continue to be set using current cost accounting, but historic cost accounting is to be used for new assets	This should be neutral over the life of the assets
Allowed rate of return	Prices are to be set on the are basis of real returns on equity of 6 5% for electricity and 7 8% for gas. These rates of return are fixed until the start of incentive-based regulation	In line with the draft proposals
Incentive-based regulation	The BNA has been tasked with designing incentives for cost cutting after 1 year. It must do so in consultation with the utility industry, however.	An incentive-based regime will probably not become effective until 2007

Source: Smith Barney

Timetable now clearer

The next step in the process is that the utilities have three months to notify the BNA of their existing network charges for electricity, and six months to do the same for gas. The BNA then has a further six months to object to the existing charges. If no objection is made, then the existing fees are deemed approved.

In practice, we expect the utilities will take their time to submit the required data, so that the BNA will not begin to review the bulk of current network charges until mid-October for electricity and January 2006 for gas. This means that we are unlikely to see any reduction in network fees during 2005. It also means there should not be too much to worry about by way of share-price sensitive newspaper headlines emerging from the BNA until November/December.

As a result, we have decided to change our assumptions on network prices.
We previously assumed prices fall 5% a year from 2005 (inclusive) to reach a 30% decline by 2010. We are sticking with our expectation of a 30% decline, which we think should bring German network fees down to UK levels, but we now assume a 6% annual decline starting in 2006. As before, we are not factoring in any additional cost cutting into our numbers beyond that the companies have already announced. This, of course, is likely to be a conservative assumption.

Figure 16 sets out the negative impact from regulation in Germany factored into our forecasts for both RWE and E.ON taking into account both electricity and gas network operations as well our expectations for cost cutting in the business area concerned based on current published cost cutting plans.

We think our forecasts are likely to prove a worst case scenario

Figure 16. Forecast Change in Network Profits (€m)

E.ON	2005E	2006E	2007E	2008E	2009E	2010E	Total
Regulation	0	-409	-392	-375	-359	-250	-1785
Cost cutting	50	50	0	0	0	0	100
Volume growth/other	105	101	97	94	90	89	576
Net impact	155	-258	-294	-281	-269	-162	-1109

RWE	2005E	2006E	2007E	2008E	2009E	2010E	Total
Regulation	0	-298	-281	-264	-248	-233	-1324
Cost cutting	150	150					300
Volume growth/other	19	18	17	15	13	11	101
Net impact							-922

Source: Smith Barney.

We are still forecasting EBIT from network operations to fall by some €1bn for both companies over the next six years. We regard this as very much an upper estimate of the likely impact, and we would expect additional cost cutting to offset the decline in revenues at least in part.

Valuation assumptions

As before, to value the German network operations we rely on a benchmarking exercise using the published regulatory asset bases of similar businesses in other markets (chiefly the UK and Italy). For example, we estimate the average RAB for distribution equates to €623 per customer in the UK and €621 per customers for ENEL in Italy, and we use data such as this to generate implied RABs for E.ON and RWE in Germany.

Figure 17 shows the valuation of the electricity network businesses, for example, and we adopt a similar valuation approach for gas.

Figure 17. Electricity Network Valuations (€m)

		Value based on length			Value based on volumes			Value based on load			Value based on customers		
	Average value	*Circuit length (km)*	Value per km	Value (€m)	GWh	Value per GWh	Value	GW	Value per GW	Value	Custom-ers (m)	Value per customer	Value
E.ON													
Transmission	**3,355**	10,829	0.38	4,063				21,000	0.13	2,646			
Distribution	**6,902**	417,407	0.020	8,483	106,731	0.069	7,341				7.7	634	4,880
RWE													
Transmission	**4,123**	11,903	0.38	4,466				30,000	0.13	3,780			
Distribution	**5,904**	331,157	0.020	6,730	93,300	0.069	6,417				7.2	634	4,563

Source: Smith Barney analysis

These valuations should be conservative for two reasons.

- First, we suspect German networks are more robust than those in Italy and in the UK and we think this is likely at least in part to be reflected in higher regulatory asset valuations.
- Second, we are implicitly assuming that the profitability of German networks is in line with that allowed by regulators in other markets. If E.ON and RWE are currently making excess profits in their network businesses, our valuations do not take these into account.

Finally, it is also worth noting that our valuations are consistent with implied FY05E EV/EBITDA multiples of between 6.0x and 7.0x for the businesses of which the network assets form a part (i.e. E.ON's Central Europe and Pan European Gas business units and RWE's Energy division). This compares with the sector average FY05E EV/EBITDA of 7.5x, to which infrastructure stocks tend to trade at a premium.

Politics: any sting in the tail?

We believe the stockmarket has already begun to factor in the potential nuclear power station life extension that should materialise if the CDU wins the forthcoming federal election expected on 18 September.

Nuclear life extensions now seem highly likely

Given that the CDU is some 17 points ahead in the opinion polls, and that the CDU's manifesto explicitly calls for nuclear power stations to be allowed to generate for as long as their safety can be guaranteed, it seems entirely reasonable to us for the shares to begin to reflect this potential upside. At this stage, the most likely future government looks set to be a coalition of the CDU with the business-friendly Free Democratic Party. However, it is possible that the recently formed Left Party will win enough votes to force the CDU into some form of grand coalition with the SPD. Either way, we suspect the nuclear power station life extension will be on the cards.

But will there be any offsetting negative?

But we also suspect the utilities will not have it all their own way under a CDU-led government. Already, for example, the CDU manifesto states that the extension of nuclear power station lives must also lead to lower electricity tariffs. So before we quantify the impact of the nuclear life extension on value, it is worth reviewing the possible offsetting negatives that could also crop up under a new government.

Our view of the areas of risk are set out in Figure 18. In short, we do not see any way a CDU-led government could mandate lower power prices other than by increasing pressure on the BNA to cut network prices. This is a risk which we think the stock market has already taken on board.

Figure 18. Possible Political Threats to the German Utilities

Issue	Possible mechanism	Comment	Verdict
Achieve lower electricity prices			
	Force generators to enter into power sales agreements at prices below the current forward curve.	There is no legal mechanism that would enable the government to do this and we doubt the utilities would enter into such agreements voluntarily	Very unlikely
	Introduce a cap to wholesale power prices	There is a precedent in the UK in the early 1990s when the UK electricity regulator capped prices in the power pool, but the UK pool was a fairly artificial market that was much easier to regulate that the German wholesale power market (and indeed the revised UK power market) which is based chiefly on bilateral OTC contracts between generators and resellers. Moreover, there is no legal mechanism for such intervention in the German wholesale power market.	Very unlikely
	Reduce the concentration of ownership of generation by forced divestments of power stations.	We believe this is not legally possible in the German market. The state is only able to mandate a disposal of assets in the event of a merger or acquisition.	Very unlikely
	Cut network prices	This is already underway as a result of the Energy Industry Act of June 2005	This is in the hands of the BNA as discussed above
	Withdraw or modify emissions trading scheme	The German government is unlikely to act unilaterally in this regard and so far there appears to be no sign of a EU move to change the emissions trading regime.	Unlikely
Windfall tax			
	Tax on carbon permits	We would not rule out some move by the government to claw back some of the value that was given for free to the utility companies when the carbon permits were allocated.	A possibility
	Tax on nuclear power stations	A new government could seek to couple the extension of nuclear power station lives with some form of tax on nuclear power	A possibility

Source: Smith Barney

Rather than mandating price cuts, it is far easier, in our view, for an incoming government to impose some form of additional tax on the utilities. The revenue raised could not be used to subsidise power customers directly without prompting some form of protest from Brussels. But it could be used to help fund the existing subsidies for renewable energy, for example. Under the current system, these are paid for by a levy on grid fees and therefore contribute to Germany's high electricity prices.

We see two possibilities here.

We are a little worried about new tax possibilities

- **A tax on carbon permits.** At current market prices, the permits granted for free by the German government for the 2005-2007 period have a value of €6.9bn for RWE and €2.7bn for E.ON. Retrospectively taxing this grant would be highly controversial, but is something we would not rule out.
- **A tax on nuclear power stations.** This is perhaps more likely as a direct payback for the extension of nuclear power station lives. We could see, for example, a levy per TWh on nuclear energy sold. This would of course be strongly resisted by the companies, who would claim that the nuclear life "extension" simply restores the conditions on which the original investment decisions were made.

Aside from taxing nuclear production per TWh, we could also see some move to bring German nuclear provisions more into line with those in other countries. There is of course a precedent for German governments to force the release of nuclear provisions: the incoming Red-Green government did just such a thing in the tax reforms of 1999.

Our valuations take no account of any future tax a new government might introduce on nuclear power production or on carbon permits. We do, however, take into account the impact of tax on the portion of the nuclear provisions which we believe to be overstated (resulting in a tax cost of €1.6bn for E.ON and €1.2bn for RWE).

Valuing nuclear power stations

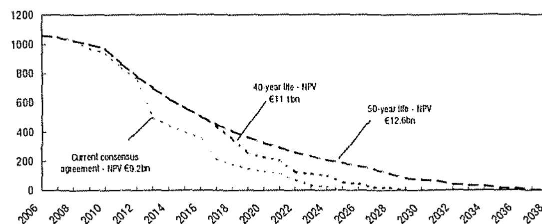
Because of the strong likelihood of an extension to nuclear power station lives, we have decided to factor this into the updated valuations we are publishing today. As we pointed out in our report in March2, There are two main benefits to the extension of nuclear power station lives.

- First, the direct impact on operating cash flow – the companies generate extra cash flow for longer at next to zero cost in terms of capital expenditure.
- Second, the delay to decommissioning liabilities and hence a reduction in terms of net present value.

Nuclear life extensions have a modest impact in NPV terms

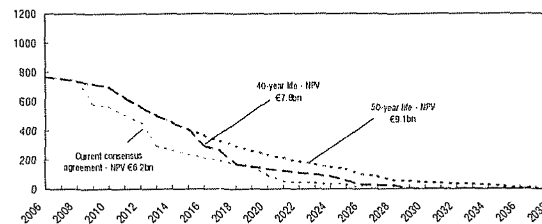
Figure 19 and Figure 20 shows the impact on operating cash flow (pre-interest and pre-tax) we predict under various scenarios for nuclear station lives. The impact on value is perhaps not as large as might be supposed because the extra cash flows occur some way into the future and so their net present value is smaller than would otherwise be the case.

Figure 19. NPV of Nuclear Cash Flows for E.ON (€m)



Source: Smith Barney.

Figure 20. NPV of Nuclear Cash Flows for RWE (€m)



Source: Smith Barney

Under a central scenario of a 45 year life, we estimate the additional operating cash flows to be worth:

- €2.8bn for E.ON or €4.1 per share; and
- €2.4bn for RWE or €4.3 per share

over and above the cash flows under the current consensus agreement which is based on a 32-year average life.

The impact on the back-end liabilities is fairly marginal according to our estimates. On the one hand, the decommissioning liability shrinks, but this is offset by an increase in the back-end costs of dealing with spent nuclear fuel (as more spent fuel is produced). Figure 21 sets out our estimates of the net impact.

Decommissioning liabilities fall too

Figure 21. Estimated Value of Nuclear Liabilities (€m Unless Stated)

	Consensus agreement	40 year life	50 year life
E.ON (2004 book value: €13.5bn)			
Decommissioning liability	2291	2094	1708
Spent fuel liability	3653	4260	5036
Taxation impact on provision release	1765	1669	1578
Total liability	7709	8023	8323
per share	11.1	11.6	12.0
RWE (2004 book value €9.0bn)			
Decommissioning liability	1705	1535	1268
Spent fuel liability	1743	1984	2632
Taxation impact on provision release	1180	1165	1142
Total liability	4628	4683	4771
per share	8.2	8.3	8.4

Source: Smith Barney

Based on a 45-year life, the combined impact of the extra operating cash flows plus the associated changes to the nuclear liabilities is worth €3.9 per share for E.ON and €4.2 per share for RWE.

Conclusion

Regulatory risk has, if anything, receded slightly in the German market over the last few months. There were no nasty surprises in the final version of the Energy Industry Act of last month and Matthias Kurth of the new regulatory agency has so far played down his ability to have an immediate impact on power prices. We still anticipate a substantial cut in network prices over the next few years, but this is unlikely to begin until 2006.

Meanwhile, we think it is reasonable to begin to factor into the share prices of E.ON and RWE the potential extension of nuclear power station lives and we suspect the forthcoming federal election will continue to support a strong share price performance from both German utilities.

E.ON: Balance Sheet Concerns

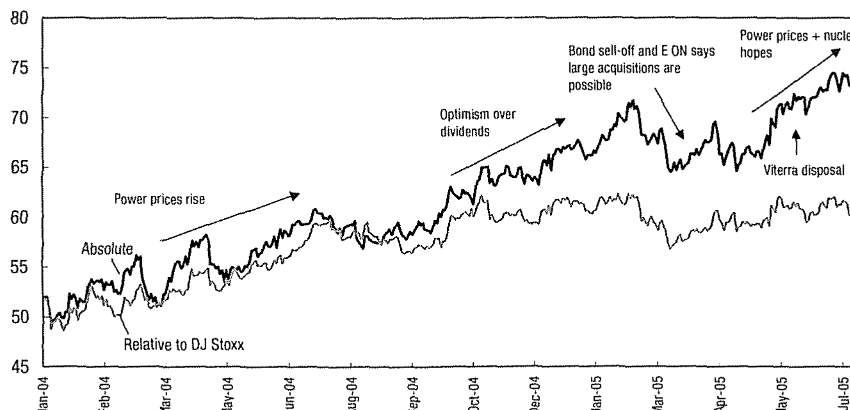
- **E.ON's unleveraged balance sheet remains the major obstacle for the investment case**
- **We expect no imminent move to address this issue, either by way of major acquisition or special dividend**
- **But we think the value on offer in the shares on a sum-of-parts basis is too great to ignore...**
- **...while the valuation ratios also look reasonably attractive even making no adjustment for the balance sheet situation**

Investment thesis

E.ON's share price has done well over the last few months, chiefly on the back of the rising electricity price in the German market and the potential for nuclear power station lives to be extended. As discussed elsewhere in this report, we expect these factors to continue to support the shares over the coming months.

E.ON has exceeded expectations with its disposals

Figure 22. Share Price and Price Relative to DJ Stoxx



Source: Reuters and Smith Barney analysis

Aside from these issues, the other key driver for E.ON concerns its balance sheet strength. As a result of the successful disposals of Viterra and Ruhrgas Industries E.ON is set to end 2005 with a net cash position of some €3.5bn according to our estimates.

But its balance sheet problem is now more obvious than ever

The fact that both disposals surprised on the upside in terms of achieved price contributed to the strong share price performance in part, but chiefly served to rekindle speculation about what E.ON will do with its balance sheet strength.

There are three basic options.

- First, E.ON could use its balance sheet to make acquisitions.
- Second, the company could gear up its balance sheet by returning value to shareholders.
- Third, E.ON may end up operating indefinitely with an inefficient balance sheet.

In practice, we suspect E.ON will end up pursuing a blend of all three options.

Acquisitions

On acquisitions, E.ON continues to search for opportunities in various markets (see Figure 23), but none of these looks set to provide the major €10-20bn investment opportunity that would seriously improve the efficiency of E.ON's balance sheet.

Figure 23. E.ON's Target Markets

Market	Opportunity sought	*Our view*
Central Europe	Invest in generation and continue to make selective acquisitions in Eastern Europe	Acquisitions and investments are likely to be relatively small
Gas	Equity gas in North Sea and Russia	Up to €2bn has been earmarked over the next three years in securing upstream gas.
	Selective acquisitions in Eastern Europe and Italy. Build infrastructure in UK and Nordic market.	Acquisitions and investments are likely to be relatively small
	Enter international LNG business	Again, investments are likely to be fairly small
UK	Optimise existing position	Most likely by incremental investments in new power stations or other assets as opportunities present themselves.
Nordic	Acquire or build new generation capacity and act as a consolidator downstream	This is proving a slow process in the Nordic market and major opportunities are not at all obvious
US	Focus is on organic growth with "long term external growth opportunities"	This has to be a possibility for a major acquisition eventually.
Russia	Potential to invest in power generation jointly with Gazprom	We doubt this will involve a major capital commitment.
Italy	Build power stations	Likely to be value-enhancing at current power prices but difficult to execute

Source: Smith Barney

We believe E.ON is unlikely to attempt to add to its UK position by launching a major acquisition in that market. However, we would not rule out a move in Spain or in the US utility market in due course (i.e. 2006 or beyond). Nor would we completely rule out a major investment in upstream gas. Overall, we expect the share price to continue to be dogged from time to time by speculation that a major acquisition is imminent, but we doubt one will materialise during 2005.

Special dividends

On the possible return of value, E.ON CEO Wulf Bernotat has repeated indicated that share buy-backs are not on the agenda. E.ON has already committed, however, to paying a special dividend with the proceeds of its planned disposal of Degussa (around €3bn at current market value expected some time in 2006). Of course, this falls well short of what would be needed to make a serious dent in the balance sheet. An additional special dividend is possible in due course, but Bernotat has made clear that no such announcement will be made before March 2006.

We suspect the balance sheet will remain inefficient for some time

Status quo

This leaves the third option: running with an inefficient balance sheet. In practice, this has been the default approach of E.ON since its creation in 2000 and of its predecessor company Veba for many years. We have seen major acquisitions and share buy backs since 2000, of course, but these have not been enough to offset the rate at which E.ON has generated cash flow both from operations and from disposals. We suspect E.ON will continue to operate with a less than ideally leveraged balance sheet for the foreseeable future.

Impact of leverage

On our revised forecasts, E.ON looks reasonably attractive on a P/E basis and even at our revised €86 target price, the stock would be on a modest discount to the sector as far as the FY06E ratio is concerned.

However, were E.ON to leverage up, either by special dividend or by acquisition, the valuation would look rather more compelling.

We believe E.ON could comfortably run with a net debt/EBITDA ratio of around 2.0, suggesting the group has around €22bn of net debt capacity based on our FY06. Figure 24 shows the implied P/E ratio at our target price based on various special dividend payments, assuming the share price falls by the exact amount of the special dividend. A €10bn special dividend would leave the shares looking just about as cheap as RWE on the FY06E P/E at the current share price.

A special dividend would clearly help

Figure 24. Impact of Special Dividend

Special dividend paid on 1 January 2006 (€m)	0	5,000	10,000	15,000	20,000
Special dividend per share (€)	0	7.2	14.4	21.6	28.8
Price target ex special dividend (€)	86	78.8	71.6	64.4	57.2
FY06E EPS (€)	6.78	6.48	6.17	5.87	5.57
FY06 P/E at our target price	12.7x	12.2x	11.6x	11.0x	10.3x

Source: Smith Barney estimates

An acquisition would probably be less earnings enhancing because E.ON would probably be buying earnings at a higher multiple. Figure 25 sets out a similar analysis assuming E.ON pays a 10% and a 20% premium to the current sector FY06E P/E of 12.8x. Of course, any speculation that E.ON might be about to spend €10-20bn at a 20% P/E premium to the sector would likely do the E.ON share price no good in the short run. We suspect this would ultimately prove to be an ideal buying opportunity in the long-run however.

But so would an acquisition

Figure 25. Impact of Acquisition

Size of acquisition made on 1 January 2006 (€bn)	0	5	10	15	20
10% premium					
FY06E EPS (€)	6.78	6.90	7.02	7.14	7.27
FY06 P/E	12.7x	12.5x	12.3x	12.1x	11.9x
20% premium					
FY06E EPS (€)	6.78	6.86	6.93	7.01	7.09
FY06 P/E	12.7x	12.6x	12.5x	12.3x	12.2x

Source: Smith Barney estimates

Valuation and financial forecasts

We have updated our valuation and financial forecasts to take account of several issues, the most important of which are as follows.

Viterra and Ruhrgas disposals now factored in

- We have taken into account the disposal of Vittera and Ruhrgas Industries. These should be completed in 3Q05 with a combined profit on disposal of €3.0bn reported under discontinued operations together with the operating net profit of both businesses for the period up to the disposal. The €7bn price tag for Viterra beat our estimate by some €1.5bn, while Ruhrgas Industries went for €1.5bn, or roughly double the amount we had factored into our E.ON SoP.
- We have raised our achieved wholesale power price expectations for 2007 and beyond and deferred the erosion of network prices by regulation into 2006 from 2005 as discussed elsewhere in this report. We have also assumed E.ON's nuclear power stations now have an operational life of 45 years.
- We are also delaying the first time consolidation of the Hungarian gas businesses from mid 2005 to the end of 2005. In addition, we are now adopting a US$/€ exchange rate assumption of 1.25 against 1.35 previously as the average rate for FY05 and beyond. We retain a €/UK£ assumption of 0.70.

Figure 26 summarises the main changes which flow through as a result of these changes, while our revised SoP valuation is presented in Figure 27. Chiefly because of the disposals of Viterra and Ruhrgas Industries (€3 per share) and the assumed nuclear life extension (€4 per share), our SoP has risen by €10 per share since our last published version.

Figure 26. Main Forecast Revisions

Item	Old forecast	New forecast	E.ON guidance	Comment
2005 adjusted EBIT	8040 (+9%)	7661 (+11%)	"Slight rise year on year"	Forecast cut reflects deconsolidation of Viterra etc
2005 headline EPS	5 97 (-10%)	10.86 (+64%)	"Substantially above last year"	Consensus on *Reuters* is €10 3
2005 adjusted EPS	6.01 (+9%)	6.08 (+10%)	-	
2006 adjusted EPS	6.39 (+6%)	6 78 (+6%)	-	
2005 DPS	2.70 (+15%)	2.76 (+17.5%)	Double digit growth with 50-60% payout ratio in FY07	Consensus on *Reuters* is €2.71
2006 DPS	3.11 (+15%)	3.24 (+17.5%)		

Source: Smith Barney

Figure 27. E.ON Sum of Parts

	Value (€m)	Value per share (€m)	Method	FY05E EBITDA (€m)	Reality check
Central Europe	37,826	55	Chiefly based on DCF of component parts	5,396	7.0x FV/EBITDA multiple in 2005E
Pan-European gas	9,677	14	DCF/RAB benchmarking	1,574	6.1x FV/EBITDA multiple in 2005E
UK	10,511	15	£0.3m per MW, £160 per customer and RABs	1,564	6.7x FV/EBITDA multiple in 2005E
Nordic	8,519	12	Assumed EBITDA multiple	1,136	7.5x FV/EBITDA multiple in 2005E
US-Midwest	4,024	6	Assumed EBITDA multiple	536	7.5x FV/EBITDA multiple in 2005E
Corporate centre	-1,153	-2	Assumed EBITDA multiple	-165	7.0x FV/EBITDA multiple in 2005E
Total core businesses (ex associates)	69,404	100		10,042	6.9x FV/EBITDA multiple in 2005E
Financial assets	16,770	24	Estimated book value at 31/12/05	682	
Total	86,174	125		10,724	8.0x FV/EBITDA multiple in 2005E
Net cash	3,461	5	Forecast book value at 31/12/05		
Pension liabilities	-8,637	-12	Forecast book value at 31/12/05		
Nuclear liabilities	-8,184	-12	Based on Smith Barney model - current book value is €12.3bn		
Other liabilities	-5,844	-8	Based on Smith Barney model - current book value is €13.0bn		
Minorities	-4,197	-6	Forecast book value at 31/12/05		
Net equity value	62,774	91			

Source: Smith Barney

In view of the increase in our SoP estimate, we have raised our target price from €75 to €86. This represents a €5 per share (or €3.5bn) discount to our sum of parts which we think is sufficient to account for the potential risks arising from future acquisitions. The €86 target price is also supported by the main valuation ratios (see Figure 8) which suggest that E.ON would trade between €80 and €92 at a sector average rating in terms of FY06E EV/EBITDA or P/E.

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 P&L 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.

Figure 28. Breakdown of Adjusted EBIT (€m)

	2003A	2004A	2005E	2006E	2007E	2008E	2009E	2010E
Central Europe	2,979	3,602	4,194	4,440	4,514	4,569	4,632	4,704
Pan-European Gas	1,463	1,428	1,538	1,541	1,449	1,335	1,221	1,203
UK	610	1,017	1,028	1,060	1,093	1,125	1,157	1,190
Nordic	546	701	671	728	789	853	916	982
US-Midwest	317	349	374	374	381	388	396	403
Corporate centre/consolidation	-319	-314	-248	-148	-148	-148	-148	-148
Core businesses	5,596	6,783	7,557	7,995	8,078	8,122	8,174	8,333
Viterra	456	471	0	0	0	0	0	0
Degussa	176	107	107	107	107	107	107	107
Total continuing operations	6,228	7,361	7,664	8,102	8,185	8,229	8,281	8,440

Source: Company accounts and Smith Barney estimates

Figure 29. Key Financial Figures

	2003 A	2004 A	2005 F	2006 F	2007 F	2008 F	2009 F	2010 F
EPS from ongoing operations (€)	6.04	6.62	6.04	6.78	6.80	6.83	6.80	6.89
EPS from discontinued operations/other (€)	1.07	-0.01	4.82	0.00	0.00	0.00	0.00	0.00
Total reported group EPS (€)	7.11	6.61	10.86	6.78	6.80	6.83	6.80	6.89
Adjusted EPS (€)	4.24	5.52	6.08	6.78	6.80	6.83	6.80	6.89
DPS (€)	2.00	2.35	2.76	3.24	3.81	3.93	4.04	4.17
Cashflow/share (€)	9.6	9.8	10.8	11.3	11.5	11.7	11.8	12.0
Free cash flow (€m)	2,878	3,260	3,278	3,524	3,320	3,467	3,577	3,757
Net cash (debt) (E.ON definition) (€m)	-7,855	-5,483	3,461	4,689	5,371	5,800	6,238	6,750
Gearing	26%	17%	-6%	-9%	-10%	-10%	-11%	-11%
Payout ratio based on clean earnings	47%	43%	45%	48%	56%	58%	60%	61%
EBITDA/net interest expense	8.5	9.2	28.1	34.0	36.5	37.1	37.6	39.0

Source: Company accounts and Smith Barney estimates

Figure 30. Group Financial Forecasts (€m)

Profit and Loss	2003 A	2004 A	2005 F	2006 F	2007 F	2008 F	2009 F	2010 F
Sales	42,541	44,745	49,383	48,363	47,962	48,145	48,339	48,645
Operating costs	33,991	34,922	39,341	37,824	37,284	37,372	37,466	37,567
Adjusted EBITDA before associates	8,550	9,823	10,042	10,539	10,677	10,773	10,873	11,077
Adjusted EBITDA including associates	9,458	10,520	10,724	11,216	11,349	11,440	11,535	11,733
Depreciation	-3,230	-3,159	-3,060	-2,926	-2,999	-3,069	-3,137	-3,191
Adjusted EBIT	6,228	7,361	7,664	8,290	8,351	8,371	8,398	8,542
of which associates & income from investments	908	697	682	677	672	667	662	656
Adjusted interest income	-1,663	-1,140	-854	-805	-800	-812	-824	-834
Net book gains	1,257	589	94	0	0	0	0	0
Restructuring costs and non-operating earnings	-479	-108	-185	0	0	0	0	0
Other non-operating earnings	195	97	0	0	0	0	0	0
Pre-tax profit	5,538	6,799	6,719	7,485	7,551	7,560	7,574	7,709
Tax	-1,124	-1,947	-2,206	-2,460	-2,482	-2,446	-2,451	-2,495
Minorities	-464	-504	-529	-556	-583	-613	-643	-675
Discontinued items/other	697	-9	3,175	0	0	0	0	0
Net attributable profit	4,647	4,339	7,159	4,469	4,485	4,501	4,480	4,538
Adjusted net attributable profit	2,772	3,621	4,010	4,469	4,485	4,501	4,480	4,538

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

Cash flow	2003 A	2004 A	2005 F	2006 F	2007 F	2008 F	2009 F	2010 F
Gross cash flow	5,538	5,972	6,828	7,324	7,470	7,617	7,727	7,907
Capex	-2,660	-2,712	-3,550	-3,800	-4,150	-4,150	-4,150	-4,150
Acquisitions	-6,536	-2,958	-1,271	0	0	0	0	0
Disposal proceeds	7,463	1,825	8,772	0	0	0	0	0
Dividends	-1,621	-1,598	-1,835	-2,296	-2,639	-3,038	-3,140	-3,245
Issue/(redemption) of group equity	-7	0	0	0	0	0	0	0
Other/change in scope of consolidation	2,966	1,990	0	0	0	0	0	0
Change in net debt	5,143	2,519	8,944	1,227	682	429	438	512

Balance Sheet	2003 A	2004 A	2005 F	2006 F	2007 F	2008 F	2009 F	2010 F
Intangible assets	4,153	3,788	3,440	3,125	2,838	2,578	2,341	2,127
Property plant and equipment	42,797	43,563	40,346	41,536	42,974	44,816	46,065	47,739
Financial assets	17,725	17,263	17,604	17,943	18,279	18,612	18,943	19,271
Stocks	2,477	2,647	2,687	2,727	2,768	2,809	2,852	2,894
Receivables	18,025	18,436	18,567	18,700	18,836	18,975	19,116	19,260
Cash and equivalents	10,795	12,016	5,000	5,000	5,537	5,966	6,404	6,916
Other assets	1,923	1,895	1,895	1,895	1,895	1,895	1,895	1,895
Total assets	97,895	99,608	89,539	90,926	93,126	95,650	97,616	100,101
Debt	-19,631	-18,333	-2,373	-1,145	-1,000	-1,000	-1,000	-1,000
Provisions	-34,328	-34,242	-34,429	-35,240	-36,080	-36,950	-37,853	-38,789
Trade creditors	-3,778	-3,662	-3,735	-3,810	-3,886	-3,964	-4,043	-4,124
Other liabilities	-13,449	-13,516	-13,477	-13,320	-13,219	-12,821	-12,426	-12,035
Minorities	-4,625	-4,144	-4,197	-4,252	-4,311	-4,372	-4,436	-4,504
Shareholders Funds	29,774	33,560	39,177	41,008	42,480	44,392	45,706	47,499

Source: Company accounts and Smith Barney estimates

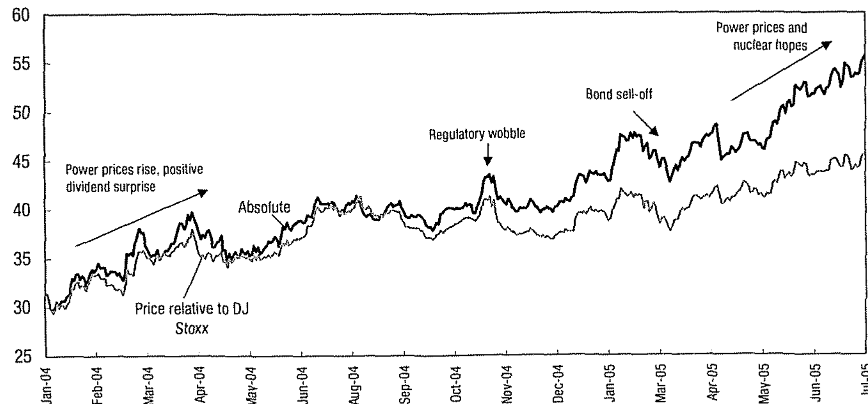
RWE: Driven By Earnings Growth

- **RWE has performed well but the main valuation multiples are still compelling**
- **We think consensus EPS and DPS estimates are still too low...**
- **...and we look to the high earnings growth we are forecasting on the back of rising power prices to drive the share price yet higher**
- **We do not anticipate any major new strategic developments**

Investment thesis

RWE has been the third best performing utility stock under our coverage year to date, outperforming its rival E.ON by 20%. The key to this outperformance is simply RWE's operational and financial leverage into the German wholesale power price. Each additional €1/MWh on the achieved power price boosts our FY06E EPS estimate by 3.5% (compared with 2.0% for E.ON).

Figure 31. Share Price and Price Relative to DJ Stoxx



Source: Reuters and Smith Barney analysis

Even though RWE has performed very strongly, we think there is still more to go for. In particular, we think consensus estimates of RWE's earnings are substantially too low. For E.ON, our forecasts appear to be closer to consensus expectations. With RWE's new policy to link dividends directly to earnings, we suspect future dividends are also likely to be substantially higher than consensus estimates.

We think consensus estimates are still too low

Figure 32. Comparison of our Forecasts with Consensus Estimates

Item	Our forecast	Consensus estimate (as compiled by RWE	RWE guidance	Comment
2005 operating result (€m)	6049 (+1%)	7661 (+11%)	"Single digit growth"	
2005 EPS according to IAS (€)	4.25 (+12%)	4.03 (+6%)	"Single digit growth"	We think RWE's guidance is too low
2006 EPS according to IAS (€)	5.11 (+20%)	4.50 (+12%)	-	
2005 recurrent EPS (€)	3.97 (+25%)	-	Below the 29% growth reported at the 1Q stage	
2006 recurrent EPS (€)	5.48 (+38%)	-	-	
2005 DPS	1.95 (+30%)	1.75 (+17.5%)	At least 15% annual growth with 50% payout ratio in FY06	
2006 DPS	2.75 (+41%)	2.09 (+17.5%)		

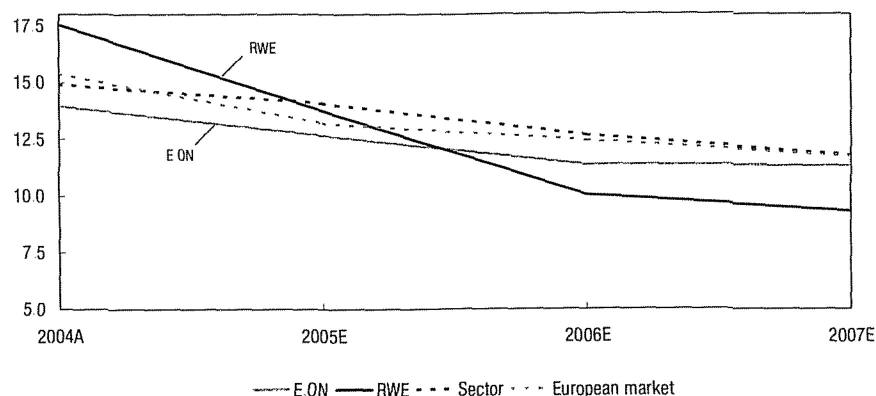
Source: Smith Barney

We think the key reason consensus estimates are low is simply that RWE has been fairly downbeat in its guidance year to date. We expect RWE will continue this policy given the political and regulatory situation in the German market. However, there is a chance that it will slightly raise its guidance at the 1H05 results on 11 August in view of the fact that there is not likely to be any significant impact on network revenues from regulation during FY05.

If we are right with our forecasts, then RWE's share price should continue to perform well. Quite simply, the stock will be derated too quickly in terms of prospective P/E if the share price does not continue to rise.

RWE gets derated rapidly unless its share price rises

Figure 33. Forecast P/E Ratios at Current Share Price



Source: Company accounts and Smith Barney estimates

We do not expect any major strategic developments at the company, other than a continued focus on its existing operations and some minor ongoing disposals (chiefly the rest of the waste business and the water operations in Chile, Spain and Thailand).

Valuation and financial forecasts

We have adjusted our forecasts and valuations to take account of the new power price scenario set out in this report and to build in the expected extension of nuclear power station lives. We have also delayed the onset of the negative impact from regulation until 2006, although we are maintaining our expectation of a 30% fall in network prices by 2010.

The other changes we are making to our forecasts are as follows.

- We now assume a US$/€ exchange rate of 1.25 against 1.35 previously for 2005 and beyond.
- We have revised downwards once again our forecasts for the UK electricity business npower on the back of higher carbon prices which the business is temporarily unable to pass on as a result of its 9TWh of fixed-price power sales contracts which do not fully expire until the end of next year. We now expect a 33% decline in the operating result for this business.
- We have factored in the profit warning at the small renewable energy subsidiary Harpen, which is now foreseeing a net loss of around €30m against a €32m profit last year on the back of write-downs and delays to major projects.

We may be too cautious on DEA

Despite the high oil price, we have chosen not to revise upwards our expectation for RWE DEA, the small upstream oil business that forms part of RWE Power. DEA has so far failed to benefit from the oil price boom as a result of hedging arrangements. However, we hope to learn more about this business at the 1H05 results.

The net impact of these changes is negligible on our FY05 EPS and DPS estimates. However, our FY06E recurrent EPS forecast rises by 2% to €5.48, and, based on a 50% payout ratio, we are now forecasting a FY06E DPS of €2.74 per share, up from €2.50 previously.

Our SoP has risen by €11 since we last published our valuation. This chiefly reflects the more optimistic achieved power price assumptions and the assumed extension to nuclear power station lives.

Figure 34. RWE Sum of Parts

	Value (€m)	Value per share (€m)	Method	FY05E EBITDA (€m)	Reality check
Power	28,048	49	Chiefly based on DCF of component parts	2,521	11.1x FV/EBITDA multiple in 2005E
Energy	18,078	32	RABs and multiples of component parts	3,016	6.0x FV/EBITDA multiple in 2005E
npower	4,497	8	Per MW and per customer benchmarks	497	9.0x FV/EBITDA multiple in 2005E
Water	16,934	30	Regulatory asset bases	2,166	7.8x FV/EBITDA multiple in 2005E
Total core businesses	67,557	120		8,311	8.1x FV/EBITDA multiple in 2005E
Other/corporate overhead	-287	-1	7x EV/EBITDA multiple		
Financial assets	3,497	6	Forecast book value at 31/12/05		
Total	70,767	126		8,812	8.0x FV/EBITDA multiple in 2005E
Net debt	-11,284	-20	Forecast book value at 31/12/05		
Pension liabilities	-11,942	-21	Forecast book value at 31/12/05		
Nuclear liabilities	-4,731	-8	Based on Smith Barney model - current book value is €9.0bn		
Other liabilities	-5,606	-10	Based on Smith Barney model - current book value is €11.9bn		
Minorities	-1,471	-3	Forecast book value at 31/12/05		
Net equity value	35,733	64			

Source: Smith Barney estimates

In view of the increase in our SoP estimate, we have raised our target price from €55 to €65. Our €65 target price is intended to be a compromise between the €64 per share sum of parts, and the evidence from the main valuation ratios (see Figure 8) which suggest that RWE would trade between €68 and €72 at a sector average rating in terms of FY06E EV/EBITDA or P/E.

Risks

We rate RWE 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. After taking into account all factors, we think a Medium Risk rating is appropriate. RWE's high level of provisions and debt mean that the value of its equity is sensitive to the assumptions made. Other risks include regulatory risks in both the gas and the electricity markets in Germany and in the water markets in the UK and in the US as well as the risk that RWE may pay too much for future acquisitions. In addition, the group's financials are complex and provision movements complicate the reconciliation of profit and loss account to cash flow. Risks that could impede the share price from reaching our target price include the possibility that equity markets might fall. Also, our investment thesis could be undermined by renewed competition in German generation, or by regulatory change proving more severe than we currently anticipate leading to lower network profits. In addition, were RWE to recover its appetite for acquisitions, we would be concerned about the possibility of value destruction. Finally, if competition erupts in the German gas market, then the value of RWE's upstream assets might suffer.

Figure 35. Operating Result Breakdown

Operating result	2003A	2004A	2005E	2006E	2007E	2008E	2009E	2010E
Power	1,739	1,846	1,907	3,029	3,403	3,779	4,156	4,535
Energy	2,046	2,192	2,332	2,254	2,044	1,829	1,628	1,440
Npower	714	604	403	580	625	642	659	676
Water	1,374	1,389	1,448	1,535	1,579	1,624	1,677	1,711
Waste	76	76	0	0	0	0	0	0
Financial investments	-109	34	0	0	0	0	0	0
Discontinuing operations	-7	0	0	0	0	0	0	0
Other/group centre/consolidation	-282	-165	-61	-41	-41	-41	-41	-41
Total	5,551	5,976	6,030	7,358	7,611	7,833	8,080	8,322

Source: Company reports and Smith Barney estimates

Figure 36. Key Financial Forecasts

Key financial figures for RWE	2003 A	2004 A	2005 E	2006 E	2007 E	2008 E	2009 E	2010 E
Recurrent net income (€m)	1282	1794	2234	3082	3334	3484	3647	3807
Pre-exceptional before goodwill EPS (€)	2.28	3.19	3.97	5.48	5.93	6.19	6.49	6.77
Reported EPS after goodwill (€)	1.69	3.80	4.25	5.11	5.56	5.83	6.12	6.40
Reported EPS before goodwill (€)	3.45	3.80	4.25	5.11	5.56	5.83	6.12	6.40
DPS (€)	1.25	1.50	1.95	2.74	3.15	3.47	3.81	4.19
Free cash flow (€m)	927	1499	1707	2703	2782	2884	3100	3315
Cashflow/share (€)	9.0	9.5	9.9	11.9	12.2	12.5	12.9	13.3
Net cash/(debt) (€m)	-17,838	-12,385	-11,284	-9,828	-8,744	-7,798	-6,821	-5,832
Gearing	221%	133%	112%	91%	76%	64%	54%	45%
Payout ratio based on clean earnings	55%	47%	49%	50%	53%	56%	59%	62%
EBITDA/net interest (x)	7.5	7.4	10.9	14.3	16.1	18.0	20.4	23.4

Source: Company reports and Smith Barney estimates

Figure 37. Group Financial Forecasts (€m)

Profit and Loss	2003 A	2004 A	2005 E	2006 E	2007 E	2008 E	2009 E	2010 E
Sales	43,875	42,137	41,035	43,251	44,646	46,099	47,616	49,172
Operating costs	34,912	32,905	32,535	33,621	34,738	35,944	37,193	38,486
Depreciation and amortisation (excluding goodwill)	3,277	3,166	3,055	3,156	3,048	3,063	3,077	3,091
Goodwill amortisation/impairment charges	985	492	0	0	0	0	0	0
Operating profit	4,701	5,574	5,445	6,474	6,860	7,092	7,346	7,595
Result from investments	300	846	728	528	534	540	546	552
Operating profit after result from investments	5,001	6,420	6,173	7,002	7,394	7,632	7,892	8,147
Revalorisation of provisions	-1,558	-1,327	-1,254	-1,266	-1,290	-1,316	-1,343	-1,371
Net interest expense	-1,131	-1,130	-756	-676	-616	-564	-510	-456
Other net financial income	-189	-28	0	0	0	0	0	0
Pre-tax profit	2,123	3,935	4,164	5,061	5,487	5,751	6,039	6,320
Tax	-1,187	-1,521	-1,500	-1,898	-2,058	-2,157	-2,265	-2,370
Post-tax profit	936	2,414	2,664	3,163	3,430	3,595	3,774	3,950
Minorities	17	-277	-275	-289	-303	-318	-334	-351
Net attributable profit before goodwill	1,938	2,137	2,389	2,874	3,126	3,276	3,440	3,599
Net attributable profit (pre exceptional)	1,282	1,794	2,234	3,082	3,334	3,484	3,647	3,807
Profit from operating activities	4,701	5,574	5,445	6,474	6,860	7,092	7,346	7,595
+ Result of investments	300	846	728	528	534	540	546	552
- Non-operating result	-550	444	124	-332	-332	-332	-332	-333
Operating result	5,551	5,976	6,049	7,334	7,726	7,964	8,224	8,480
EBITDA including operating income from investments	8,681	8,812	8,772	10,158	10,442	10,695	10,970	11,239
EBITDA excluding operating income from investments	8,476	8,400	8,250	9,630	9,908	10,155	10,423	10,687

Cash flow	2003 A	2004 A	2005 E	2006 E	2007 E	2008 E	2009 E	2010 E
Gross cash flow	5,289	4,928	5,690	6,757	6,936	7,138	7,354	7,569
Capital expenditure	-4,362	-3,429	-3,983	-4,054	-4,154	-4,254	-4,254	-4,254
Acquisitions	-5,373	-308	-63	0	0	0	0	0
Proceeds of disposals	1,872	3,320	500	0	0	0	0	0
Dividends	-895	-939	-1,044	-1,247	-1,698	-1,938	-2,123	-2,327
Issue/(redemption) of group equity	0	0	0	0	0	0	0	0
Other	2,754	1,578	0	0	0	-0	0	0
Change in net debt	-715	5,150	1,101	1,456	1,084	946	977	989

Balance sheet	2003 A	2004 A	2005 E	2006 E	2007 E	2008 E	2009 E	2010 E
Intangible assets	19,418	17,718	17,244	16,912	16,580	16,248	15,916	15,584
Property, plant and equipment	36,210	35,025	35,652	36,550	37,656	38,847	40,024	41,187
Financial assets	6,778	5,887	5,956	5,956	5,956	5,956	5,956	5,956
Stocks	3,285	2,043	2,074	2,105	2,136	2,168	2,201	2,235
Debtors	16,947	16,606	16,712	16,820	16,929	17,040	17,153	17,268
Cash and equivalents	11,796	12,539	12,000	12,000	12,000	12,000	12,000	12,000
Deferred tax assets and prepaid expenses	4,708	3,552	3,552	3,552	3,552	3,552	3,552	3,552
Total assets	99,142	93,370	93,190	93,895	94,810	95,812	96,802	97,782
Provisions	-37,671	-34,754	-34,997	-35,501	-36,027	-36,576	-37,148	-37,748
Debt	-31,790	-27,383	-25,743	-24,287	-23,203	-22,257	-21,280	-20,291
Other liabilities	-12,271	-11,736	-12,010	-12,534	-12,847	-13,107	-13,386	-13,686
Deferred tax liabilities and deferred income	-8,345	-8,304	-8,204	-8,104	-8,004	-7,904	-7,804	-7,704
Minority interests	-2,052	-1,537	-1,471	-1,602	-1,740	-1,884	-2,036	-2,196
Shareholders Funds	7,013	9,656	10,766	11,867	12,989	14,084	15,148	16,157

Source: Company reports and Smith Barney estimates

ANALYST CERTIFICATION

Appendix A-1

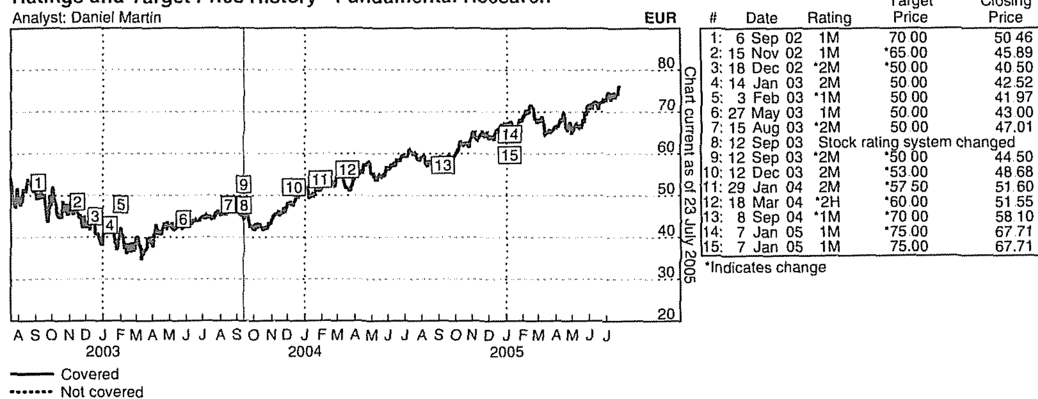
We, Daniel Martin and Elisenne Verdoja, hereby certify that all of the views expressed in this research report accurately reflect our personal views about any and all of the subject issuer(s) or securities. We also certify that no part of our compensation was, is, or will be directly or indirectly related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

IMPORTANT DISCLOSURES

E.ON (EONG.DE)

Ratings and Target Price History - Fundamental Research

Analyst: Daniel Martin



#	Date	Rating	Target Price	Closing Price
1:	6 Sep 02	1M	70 00	50 46
2:	15 Nov 02	1M	*65.00	45.89
3:	18 Dec 02	*2M	*50.00	40.50
4:	14 Jan 03	2M	50.00	42.52
5:	3 Feb 03	*1M	50.00	41.97
6:	27 May 03	1M	50.00	43.00
7:	15 Aug 03	*2M	50.00	47.01
8:	12 Sep 03	Stock rating system changed		
9:	12 Sep 03	*2M	*50 00	44.50
10:	12 Dec 03	2M	*53.00	48.68
11:	29 Jan 04	2M	*57 50	51.60
12:	18 Mar 04	*2H	*60.00	51.55
13:	8 Sep 04	*1M	*70 00	58.10
14:	7 Jan 05	1M	*75.00	67.71
15:	7 Jan 05	1M	75.00	67.71

*Indicates change

—— Covered
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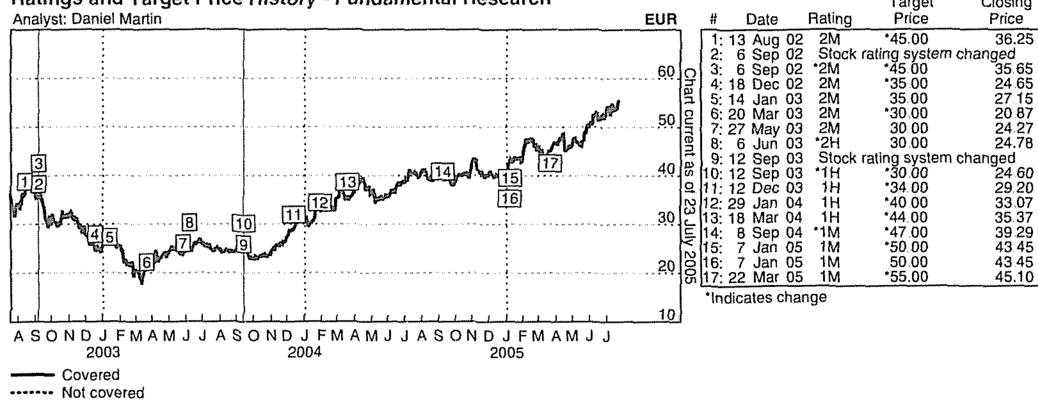
RWE (RWEG.DE)

Ratings and Target Price History - Fundamental Research

Analyst: Daniel Martin



#	Date	Rating	Target Price	Closing Price
1:	13 Aug 02	2M	*45.00	36.25
2:	6 Sep 02	Stock rating system changed		
3:	6 Sep 02	*2M	*45 00	35.65
4:	18 Dec 02	2M	*35.00	24.65
5:	14 Jan 03	2M	35.00	27.15
6:	20 Mar 03	2M	*30.00	20.87
7:	27 May 03	2M	30.00	24.27
8:	6 Jun 03	*2H	30.00	24.78
9:	12 Sep 03	Stock rating system changed		
10:	12 Sep 03	*1H	*30.00	24.60
11:	12 Dec 03	1H	*34.00	29.20
12:	29 Jan 04	1H	*40.00	33.07
13:	18 Mar 04	1H	*44.00	35.37
14:	8 Sep 04	*1M	*47.00	39.29
15:	7 Jan 05	1M	*50.00	43.45
16:	7 Jan 05	1M	50.00	43.45
17:	22 Mar 05	1M	*55.00	45.10

*Indicates change

—— Covered
······· Not covered

Customers of the Firm 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 http://www.smithbarney.com (for retail clients) or http://www.citigroupgeo.com (for institutional clients) or can call (866) 836-9542 to request a copy of this research.

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Data current as of 30 June 2005	Buy	Hold	Sell
Smith Barney Global Fundamental Equity Research Coverage (2617)	42%	42%	17%
% of companies in each rating category that are investment banking clients	48%	49%	28%
Utilities -- Europe (31)	29%	61%	10%
% of companies in each rating category that are investment banking clients	56%	58%	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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See page 61 for Analyst Certification and Important Disclosures

Industry Report

EQUITY RESEARCH: EUROPE

Utilities

2 September 2005

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Utilities 2005: Autumn Edition

Focus Shifts To Balance Sheet Strength

- **We review power prices, bond yields and the sector's increasingly inefficient balance sheet**
- **We highlight the potential for value creation by releveraging**
- **We estimate each 10 percentage point rise in leverage boosts fair value EV/EBITDA by 0.2-0.3**
- **Even expensive acquisitions can enhance value when the impact on leverage is taken into account**
- **E.ON rejoins our top-five list and replaces Veolia; the remaining four stocks are unchanged**

Top Five Stocks

Stock	Country	Rating	Current Price*	Target Price	Upside	Total return	EV/ EBITDA (06E)	PE (pre-goodwill) (06E)	Ordinary dividend yield (06E)
AWG	UK	1M	927p	995p	7%	13%	8.7x	16.2x	5.5%
E.ON	Germany	1M	€78.30	€90.00	15%	18%	6.8x	11.3x	4.1%
Enel	Italy	1M	€7.21	€7.80	8%	13%	7.7x	16.7x	5.2%
International Power	UK	1M	232p	250p	8%	9%	7.3x	13.4x	2.6%
RWE	Germany	1M	€54.8	€65.0	19%	22%	6.0x	9.8x	5.1%
European utilities sector					-2%	2%	7.1x	12.8x	4.5%
European stock market							7.8x	13.2x	3.4%

Source: Reuters and Citigroup Investment Research estimates *At 1 September 2005

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Investment Summary

We review current trends in power prices and bond yields. We also explore the impact of leverage on value, a theme which we believe will increasingly drive utility share prices in future. We think even an expensive acquisition could enhance value once the impact on leverage is taken into account. E.ON is the obvious way to play this theme and we are upgrading our target price today from €86 to €90. Centrica, RWE, Snam Rete Gas, Fortum, ENEL and Scottish & Southern all could also benefit from higher leverage in our view.

Value from leverage
Steadily, the sector balance sheet is becoming more and more underleveraged. Net debt has fallen over €50bn since 2002, while EBITDA has risen 17%. As a result, pressure on management teams to boost balance sheet efficiency is likely to grow. We show how a 10 percentage point increase in leverage should lift the fair value EV/EBITDA multiple by 0.2-0.3. For E.ON in particular, the value boost from higher leverage could be very large. Were E.ON to target a 2.0x net debt/EBITDA ratio, we think some €13bn of value would be created.

Acquisitions no longer a probable negative
Special dividends or share buy-backs are still the best ways to leverage up a balance sheet in our view. But in the real world, most managements will prefer to make acquisitions. We now believe that the value creation from higher leverage will probably be more than enough to offset the negative impact on value from a modestly expensive acquisition. This means that acquisitions may prove a positive trigger for the buyer as well as for the company being bought.

Wholesale power price outlook not fully factored in
Forward power prices may soften in the last few months of 2005 as the risk premium in the UK gas price shrinks. Even so, we think there is still more to go for in the share prices of certain generators (e.g. RWE and International Power). RWE is now pretty much fully hedged to the end of 2006 so there should be little downside risk if forward prices do weaken. International Power, on the other hand, has more exposure to the US market than to Europe.

Bond yields not a major driver for next 12 months
Citigroup economists expect the 10-year Bund yield to hover around 3.2% for the next 12m. If so, the bond market is unlikely to drive share prices one way or the other. Falling bond yields over the last year have driven the sector to a 10% FY05E P/E premium to the market (over two standard deviations above the mean). As long as bond yields stay where they are, this looks sustainable to us.

E.ON replaces Veolia on our top-five list
E.ON is the obvious way to play the balance sheet story. Veolia, on the other hand, could suffer in October/November given the €12-13bn of French utility equity likely to hit the market over the next few months. Apart from E.ON, our top five now comprises RWE, International Power, ENEL and AWG. ENEL has been a poor performer year to date and yet the company should actually be a beneficiary of high oil prices. We also look to a new dividend policy to drive the shares higher.

Figure 1. European Utilities Basic Data

Country	Company	Recommendation	Target Price	Upside to Target Price	Total Return	Share Price Value	Share Price Curr	Shareprice Movement % 1w	1m	12m	Market Value US$ bn	Market Value Euro bn	Firm Value 2005E US$ bn	Firm Value 2005E Euro bn	Year End	Free Float	Debt/Debt +Mkt Cap 2005E
Belgium	Electrabel	Hold/ Medium Risk (2M)	418	1%	5%	414	EUR	0%	10%	49%	28.3	22.6	27.6	22.1	December	50%	-7%
Belgium	Elia	Hold/Low Risk (2L)	31	-2%	2%	31.5	EUR	0%	11%	0%	1.7	1.3	4.5	3.6	December	50%	61%
Finland	Fortum	Buy/ Medium Risk (1M)	15.5	-2%	2%	15.8	EUR	3%	7%	85%	16.8	13.5	20.3	16.3	December	39%	20%
France	Suez	Hold/ High Risk (2H)	24	0%	4%	23.9	EUR	1%	6%	50%	29.7	23.7	13.5	10.8	December	100%	33%
France	Veolia Environnement	Buy/ Medium Risk (1M)	37	12%	14%	33.1	EUR	1%	4%	56%	16.8	13.5	33.7	27.0	December	80%	50%
Germany	E.ON	Buy/ Medium Risk (1M)	90	15%	18%	78.3	EUR	0%	3%	34%	67.7	54.2	74.6	59.8	December	86%	-5%
Germany	RWE	Buy/ Medium Risk (1M)	65	19%	22%	54.8	EUR	1%	0%	36%	38.5	30.8	70.9	56.7	December	67%	27%
Greece	PPC	Hold/ High Risk (2H)	20.0	0%	3%	19.9	EUR	2%	-2%	0%	5.8	4.6	10.4	8.3	December	49%	44%
Italy	AEM Torino	Sell/ Medium Risk (3M)	1.78	-10%	-8%	1.98	EUR	-3%	-2%	11%	1.1	0.9	2.1	1.7	December	40%	43%
Italy	AEM Milano	Hold/ Medium Risk (2M)	1.72	-1%	7%	1.73	EUR	0%	-1%	14%	3.9	3.1	5.6	4.5	December	49%	29%
Italy	Enel	Buy/ Medium Risk (1M)	7.8	8%	13%	7.21	EUR	2%	3%	18%	55.0	44.0	66.6	53.3	December	70%	20%
Italy	Terna	Hold/Medium risk (2M)	2.1	-2%	3%	2.15	EUR	1%	NA	NA	5.4	4.3	8.0	6.4	December	65%	32%
Italy	SNAM Rete Gas	Hold/Medium Risk (2M)	4.40	-3%	2%	4.52	EUR	1%	1%	22%	11.0	8.8	14.2	11.4	December	53%	22%
Portugal	EDP	Hold/ Medium Risk (2M)	2.45	7%	12%	2.28	EUR	2%	5%	5%	10.4	8.3	19.1	15.3	December	80%	52%
Spain	Enagas	Hold/ Medium Risk (2M)	12.8	-10%	-8%	14.30	EUR	1%	-1%	54%	4.3	3.4	6.3	5.0	December	70%	32%
Spain	Endesa	Hold/ Medium Risk (2M)	16.75	-9%	-5%	18.5	EUR	1%	0%	20%	24.4	19.5	48.3	38.7	December	100%	48%
Spain	Gas Natural	Hold/ Medium Risk (2M)	21.5	-12%	-8%	24.4	EUR	1%	-1%	24%	13.6	10.9	18.2	14.5	December	40%	27%
Spain	Iberdrola	Hold/ Medium Risk (2M)	19.0	-10%	-6%	21.0	EUR	1%	1%	24%	23.7	19.0	38.4	30.7	December	100%	36%
Spain	Red Electrica	Hold/ Medium Risk (2M)	18.5	-16%	-13%	22.1	EUR	0%	-2%	56%	3.7	3.0	6.2	4.9	December	57%	40%
Spain	Union Fenosa	Hold/ High Risk (2H)	19.0	-20%	-17%	23.7	EUR	0%	-2%	29%	9.0	7.2	14.7	11.8	December	100%	44%
UK	AWG	Buy/ Medium Risk (1M)	995	7%	13%	927	GBP	0%	-5%	44%	2.4	1.9	8.4	6.8	March	100%	71%
UK	British Energy	Sell/ High Risk (3H)	360	-24%	-20%	476	GBP	2%	7%	0%	4.9	3.9	5.3	4.2	March	100%	8%
UK	Centrica	Buy/ Medium Risk (1M)	260	5%	10%	249	GBP	-1%	6%	1%	17.2	13.8	18.9	15.1	December	100%	10%
UK	International Power	Buy/ Medium Risk (1M)	250	8%	9%	232	GBP	0%	10%	72%	6.3	5.1	10.0	8.0	December	100%	48%
UK	Kelda	Hold/ Low Risk (2L)	610	-11%	-6%	684	GBP	1%	-5%	29%	4.7	3.8	7.8	6.3	March	100%	40%
UK	National Grid	Hold/ Medium Risk (2M)	510	-3%	2%	527	GBP	0%	1%	0%	29.9	23.9	52.7	42.2	March	100%	44%
UK	Pennon	Hold/ Low Risk (2L)	1030	0%	4%	1034	GBP	2%	-1%	26%	2.3	1.9	4.4	3.6	March	100%	47%
UK	Scottish & Southern Energy	Hold/ Low Risk (2L)	935	-5%	-1%	986	GBP	0%	1%	32%	15.5	12.4	17.8	14.2	March	100%	15%
UK	Scottish Power	Sell/ Medium Risk (3M)	415	-19%	-14%	512	GBP	3%	2%	26%	17.2	13.8	24.6	19.7	March	100%	31%
UK	Severn Trent	Hold/ Low Risk (2L)	960	-2%	3%	980	GBP	2%	1%	13%	6.1	4.9	11.4	9.2	March	100%	46%
UK	United Utilities	Hold/ Low Risk (2L)	595	-7%	0%	642	GBP	1%	1%	16%	10.2	8.2	15.8	12.7	March	100%	43%
Continental Europe weighted average (by mkt.cap.)				4%	11%			1%	3%	33%	371	297	503	403			
UK weighted average (by mkt.cap.)				-2%	2%			1%	2%	17%	117	94	177	142			
TOTAL/WEIGHTED AVERAGE (by mkt.cap.)				3%	7%			1%	3%	29%	487	390	680	545			

Share prices at close on 1 September 2005
Sources: Company reports and Citigroup Investment Research.

Figure 2. European Utilities Valuation Data (Year-ends Adjusted to December)

Country	Company	PE (Pre-Exceptional)				Adjusted EV/EBITDA (Pre-Exceptional)*				Adjusted EV/EBITDA (Pre-Exceptional, Pre-Associates)*				P/CF				Dividend yield				Free cash flow yield**			
		2004A	2005E	2006E	2007E	2004A	2005E	2006E	2007E	2004A	2005E	2006E	2007E	2004A	2005E	2006E	2007E	2004A	2005E	2006E	2007E	2004A	2005E	2006E	2007E
Belgium	Electrabel	20.9	20.9	20.5	18.5	13.0	12.4	11.8	10.9	12.5	12.4	11.7	10.7	11.7	11.3	10.8	10.2	3.8%	3.9%	4.1%	4.2%	5.4%	5.4%	6.7%	7.6%
Belgium	Elia	22.2	23.3	21.7	23.7	13.9	13.1	12.5	12.7	14.0	13.2	12.6	12.7	4.3	16.4	15.0	14.9	4.0%	4.0%	4.2%	3.8%	11.3%	-6.8%	-5.2%	-4.4%
Finland	Fortum	20.1	16.4	13.7	12.7	12.2	9.9	8.8	8.1	11.7	9.5	8.4	7.8	7.7	11.6	9.6	9.1	3.7%	3.7%	4.3%	4.7%	13.2%	6.6%	7.6%	8.2%
France	Suez	17.5	13.8	11.9	11.0	8.9	8.5	7.7	7.2	8.4	7.6	6.9	6.4	5.8	6.3	5.5	5.2	3.3%	3.5%	3.7%	3.9%	6.3%	6.1%	8.0%	8.7%
France	Veolia Environnement	20.9	20.3	16.3	14.2	10.1	9.3	8.2	7.4	9.0	8.3	7.3	6.6	5.0	5.3	4.7	4.2	2.1%	2.5%	3.1%	3.5%	1.9%	2.3%	-0.9%	4.6%
Germany	E.ON	14.3	13.1	11.3	11.2	8.3	7.3	6.8	6.6	7.1	6.0	5.5	5.3	9.1	8.0	7.3	7.1	3.0%	3.5%	4.1%	4.9%	6.0%	5.9%	6.7%	6.3%
Germany	RWE	17.2	13.3	9.8	9.3	7.2	7.1	6.0	5.8	6.9	6.9	5.8	5.5	6.2	5.5	4.6	4.4	2.7%	3.6%	5.1%	5.9%	4.9%	5.1%	8.7%	9.1%
Greece	PPC	15.9	22.7	12.8	9.3	7.0	9.1	7.0	5.9	6.9	8.9	6.9	5.8	14.7	5.4	4.8	4.4	3.5%	3.1%	5.5%	7.5%	-10.0%	-0.4%	2.5%	5.0%
Italy	AEM Torino	22.0	17.2	12.6	9.4	11.6	9.3	8.0	6.3	11.6	9.3	8.0	6.3	13.1	6.7	8.2	6.3	1.8%	2.3%	2.9%	4.0%	-10.3%	0.9%	-13.7%	10.1%
Italy	AEM Milano	22.2	15.3	13.4	14.1	10.9	9.5	8.4	8.4	10.9	9.5	8.4	8.4	13.4	6.4	8.5	8.7	2.9%	3.0%	3.1%	3.2%	0.7%	10.7%	9.1%	8.9%
Italy	Enel	12.4	16.2	16.7	16.6	6.3	6.6	7.7	7.5	6.3	6.3	7.3	7.1	10.2	9.8	8.7	7.8	5.0%	7.5%	5.2%	5.2%	1.0%	3.3%	3.3%	6.0%
Italy	Terna	18.2	17.7	17.3	16.3	9.1	9.2	8.8	8.4	9.1	9.2	8.8	8.4	13.4	13.7	8.3	8.0	5.5%	5.7%	5.8%	6.1%	7.5%	1.7%	4.0%	4.3%
Italy	SNAM Rete Gas	16.8	15.7	15.4	14.8	8.1	7.7	7.4	7.0	8.1	7.7	7.4	7.0	7.7	6.9	6.7	6.4	4.6%	4.6%	4.7%	4.9%	6.1%	8.6%	9.1%	9.7%
Portugal	EDP	11.8	12.0	10.9	10.2	9.2	8.2	7.6	7.2	7.7	7.0	6.5	6.1	5.5	5.3	4.8	4.5	4.1%	4.4%	4.7%	5.0%	7.3%	-0.4%	3.2%	6.3%
Spain	Enagas	21.7	18.6	15.3	13.3	11.5	10.2	9.1	8.4	11.5	10.2	9.1	8.4	13.2	9.6	8.8	8.7	2.4%	2.7%	3.3%	3.8%	-6.2%	-4.8%	-6.3%	-6.1%
Spain	Endesa	11.6	11.2	10.9	10.4	9.0	8.5	8.0	7.6	7.7	7.4	7.0	6.7	5.7	5.7	5.4	5.2	4.0%	4.2%	4.5%	4.7%	1.9%	1.0%	4.0%	4.8%
Spain	Gas Natural	19.6	16.6	14.1	13.3	10.3	9.0	8.3	7.7	9.8	8.9	8.2	7.5	10.9	8.9	7.9	7.1	3.0%	3.4%	3.8%	4.3%	0.5%	-2.7%	-4.0%	3.3%
Spain	Iberdrola	16.4	13.6	12.3	11.3	10.7	9.3	8.5	7.9	10.7	9.3	8.5	7.9	9.1	8.2	7.5	7.0	3.7%	4.0%	4.4%	4.8%	-3.4%	1.8%	5.1%	7.6%
Spain	Red Electrica	23.0	18.6	16.4	13.9	10.3	9.6	8.8	7.9	10.2	9.5	8.7	7.9	8.6	8.2	7.5	6.9	2.8%	3.1%	3.5%	4.0%	3.0%	3.5%	4.6%	5.9%
Spain	Union Fenosa	16.6	13.6	11.6	9.7	11.3	8.5	7.5	6.5	9.2	7.3	6.5	5.5	7.0	6.5	6.0	5.4	2.6%	2.8%	3.1%	3.4%	3.8%	6.2%	10.3%	14.2%
UK	AWG	17.0	16.2	16.2	14.0	8.8	8.7	8.7	8.5	9.0	8.8	8.8	8.6	4.4	4.3	4.3	4.0	5.2%	5.4%	5.5%	5.6%	2.4%	0.9%	-3.9%	-5.9%
UK	British Energy	472.9	7.1	7.6	9.7	22.8	2.5	1.7	1.4	22.8	2.5	1.7	1.4	25.4	3.6	4.7	4.8	0.0%	0.0%	6.5%	10.3%	4.0%	28.1%	21.2%	20.8%
UK	Centrica	13.7	14.2	11.9	9.5	5.5	5.1	4.9	4.8	5.7	5.2	5.1	4.9	8.6	7.4	6.6	5.7	3.5%	4.5%	5.2%	6.0%	10.0%	10.3%	11.3%	13.2%
UK	International Power	28.0	17.7	13.4	10.6	17.2	8.6	7.3	6.2	26.4	11.3	8.9	7.1	25.2	9.2	8.4	7.8	1.1%	1.7%	2.6%	3.8%	-4.7%	2.6%	6.5%	9.4%
UK	Kelda	13.2	13.6	13.2	12.6	9.0	8.6	8.3	8.0	9.1	8.7	8.4	8.1	6.5	6.6	6.6	6.3	4.2%	4.4%	4.5%	4.7%	1.6%	-0.2%	0.3%	1.2%
UK	National Grid	14.9	14.1	12.9	12.1	8.9	8.0	7.7	6.9	8.9	8.0	7.7	6.9	8.0	6.9	6.3	5.2	4.3%	4.7%	5.1%	5.4%	4.7%	3.7%	3.2%	1.5%
UK	Pennon	16.1	16.3	14.3	11.8	10.0	9.7	9.0	8.1	10.0	9.7	9.0	8.1	6.8	6.8	6.5	5.7	4.1%	4.3%	4.5%	4.7%	1.1%	-3.3%	-1.7%	1.5%
UK	Scottish & Southern Energy	16.4	14.2	12.8	12.1	9.6	8.5	7.6	7.2	9.9	8.9	8.3	7.8	9.9	9.4	9.4	9.3	4.2%	4.6%	4.9%	5.3%	6.6%	4.7%	3.3%	3.7%
UK	Scottish Power	13.0	12.4	12.0	11.7	8.1	7.8	7.4	7.1	8.0	7.7	7.3	7.0	9.0	7.1	6.4	6.1	4.3%	4.6%	4.9%	5.1%	1.8%	-1.2%	0.9%	2.2%
UK	Severn Trent	14.9	13.8	12.0	11.2	8.3	7.6	7.0	6.8	8.4	7.6	7.1	6.9	6.4	5.7	5.3	5.0	4.9%	5.1%	5.3%	5.6%	1.3%	2.4%	1.4%	1.0%
UK	United Utilities	10.8	11.6	11.2	10.9	8.2	8.2	8.0	7.7	8.3	8.3	8.1	7.7	8.3	7.0	6.3	6.0	7.1%	6.9%	7.0%	7.2%	-6.8%	-2.1%	-0.4%	1.5%
Continental Europe weighted average (by mkt		15.6	14.8	12.9	12.2	7.9	7.5	7.0	6.6	7.3	6.8	6.4	6.0	8.5	8.0	7.2	6.7	3.6%	4.2%	4.4%	4.8%	3.7%	4.0%	5.2%	6.8%
UK weighted average (by mkt.cap.)		14.4	13.8	12.5	11.3	8.4	7.7	7.2	6.9	8.5	7.9	7.4	7.0	9.2	7.3	6.8	6.2	4.3%	4.7%	5.1%	5.5%	3.3%	3.1%	3.5%	4.0%
TOTAL/WEIGHTED AVERAGE (by mkt.cap.)		15.3	14.5	12.8	12.0	8.0	7.6	7.1	6.7	7.6	7.1	6.6	6.2	8.7	7.8	7.1	6.6	3.7%	4.3%	4.5%	4.9%	3.6%	3.8%	4.8%	6.2%

* Adjusted EV is conventional EV (market cap + net debt + minorities + other securities + pension provisions) plus our estimate of the NPV of other liabilities (e.g. nuclear liabilities). For Suez, we include the Electrabel minority at market value. For British Energy, we gross up the market cap by 1/0.35. **Free cash flow yield is operating cash flow less total capex divided by market capitalisation. For Suez we have grossed up the market capitalisation to include 100% of Electrabel Weighted averages exclude British Energy

Source: Citigroup Investment Research

Sector Overview and Stock Selection

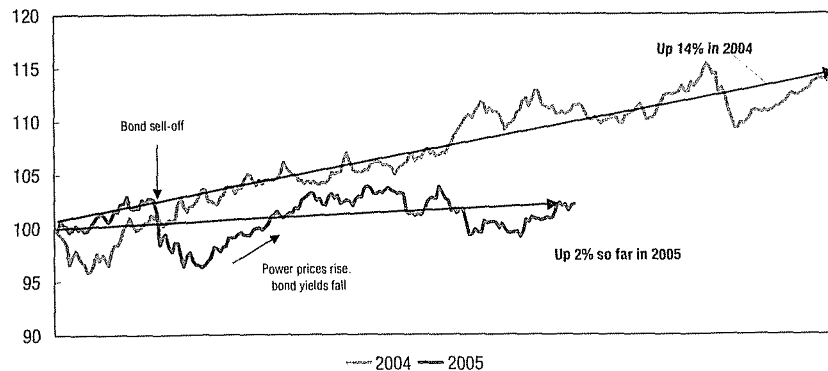
- Sector has moved broadly sideways in recent months – we think this trend will continue
- But the rise in wholesale power prices is still not fully factored in for certain stocks in our view
- Meanwhile, the sector balance sheet is becoming increasingly underleveraged and inefficient
- Shareholder pressure on managements to tackle this problem is likely to grow
- We now believe releveraging could unlock value even if it takes place by mean of an expensive acquisition
- E.ON replaces Veolia as a top-five stock
- RWE, ENEL, International Power and AWG remain on our top-five list

Recent performance

After a strong showing in 2Q05 on the back of a benign bond market environment and rising wholesale power prices, the sector has so far largely marked time during the third quarter. The sector slightly lagged the market in June and July, but recovered during August and is now up 2% on the start of the year in relative terms.

Save for a few wobbles, the sector has been moving sideways since the start of 2005

Figure 3. DJ Utilities Index Relative to DJ Stoxx (1 Jan = 100)



Source: Datastream and Citigroup Investment Research analysis

Bond yields, power prices and balance sheets

Bond yields and power prices have been the major drivers for the sector over the last 12 months. We discuss both issues in detail in this report. In short, we do not expect the bond market to drive the shares significantly one way or the other over the next 12 months. However, we still believe the earnings upside from higher power prices has not yet been fully priced in to certain stocks (most notably RWE and International Power). Overall, we suspect the sector is likely to continue to move broadly sideways in relative terms.

Balance sheets likely to be the focus for debate

But on top of power prices and bond yields, there is a third theme which we expect to increasingly play a role over the next few months. This is the issue of company balance sheets. The sector as a whole is now looking increasingly underleveraged, to an extreme extent in the case of certain stocks (e.g. E.ON). Shareholder pressure on managements to leverage up and take advantage of low interest rates is likely steadily to grow.

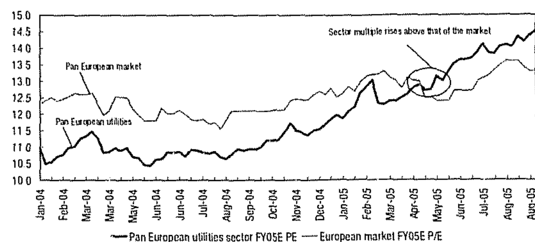
We are less nervous over acquisitions

As a result, balance sheet releveraging, by acquisition, special dividend or share buy-back, is likely to be an increasingly common occurrence going forward. We argue in this report that the value impact from higher leverage could be more than enough to offset the value destruction even from an expensive acquisition. This marks a significant change in our thinking. We now believe large acquisitions could be a positive trigger even for the share prices of the company doing the acquiring.

Sector valuation

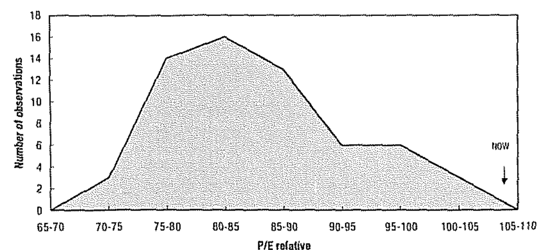
However, for the sector as a whole current valuations do not appear very attractive. The sector has been trading on a P/E premium to the market since April. At first sight, this looks a clear sign that the sector is overvalued – the current P/E relative of 110 is more than two standard deviations above the mean of 86 based on monthly observations over the last 15 years, for example.

Figure 4. FY05E P/E Multiples



Source: Datastream and Citigroup Investment Research

Figure 5. Histogram of Monthly European Utility Sector P/E Relative to European Market



Source: Datastream and Citigroup Investment Research

But our view is that as long as bond yields remain close to their current low levels, there is little danger of an imminent reversion to the mean. In addition, the earnings growth rates we are predicting should mean the sector at least matches the market in this regard. Overall, our view is that a neutral sector weighting is probably correct. Citigroup European Strategists, on the other hand, are currently recommending an Underweight position.

Figure 6. Valuation Ratios

	European Market	European Utilities	Comment
FY05E PE (pre-goodwill, pre-exceptional)	13.2x	14.5x	Utilities are on a 10% premium
FY06E PE (pre-goodwill, pre-exceptional)	12.2x	12.8x	Utilities are on a 4% premium
FY06E EPS growth	8% bottom up	12% bottom up	Utilities beat the market
FY07E EPS growth	8% bottom up	8% bottom up	
FY06E EV/EBITDA (pre-associates)	8.0x	7.1x	Utilities look cheaper
FY06E EV/EBITDA (including associates)	7.8x	7.6x	Utilities look cheaper
FY05E Dividend yield	3.4%	4.3%	Still pretty attractive
FY06E Dividend yield	3.8%	4.5%	
FY05E Free cash flow yield	5.8%	3.1%	But the FCF yield is not that great - some utilities
FY06E Free cash flow yield	6.8%	3.5%	are investing AND paying high dividends

Source: Citigroup Investment Research estimates at 1 September 2005

Stock selection

Veolia exits our top five...

The only change we are making to our list of top-five stocks in our last sector overview[1] is to replace Veolia with E.ON. We suspect the 1H05 results due on 16 September could yet be a positive trigger for the Veolia share price. But during 4Q05, the likely equity offerings from both Electricité de France and Suez (probably €12-13bn combined) could act as a significant drag on the shares.

...E.ON returns

E.ON is the obvious way to play the balance sheet theme that we are highlighting in this report. The stock also benefits from its exposure to the German power price, while the valuation is compelling even with an inefficient balance sheet. Were E.ON to leverage up, even by making a relatively costly acquisition, we think the valuation ratios would look even more attractive.

RWE and International Power remain

RWE and International Power are still undervalued, in our view, even though they are amongst the best performing stocks year to date. We suspect European forward prices may soften over the next few months, but RWE is by now pretty much fully hedged to the end of 2006 and should deliver compound recurrent earnings growth of 32% until then, according to our estimates. International Power, on the other hand, has substantially more exposure outside Europe.

ENEL should make up some lost ground over the next few months

ENEL remains on our favoured list although it has been a disappointing performer so far in 2005. Fundamentally, we think the investment case is robust and we attribute the underperformance chiefly to the fact that the Italian government has offloaded some 20% of the shares in issue within the last 12 months. In fact, our view is that the fundamentals for ENEL have strengthened in view of the rising oil price. Unlike most of Northern Europe, in Italy there is no easily accessible forward power price so the impact of high oil prices on ENEL is less visible to the stock market. A further trigger could come from the unveiling of more clarity on future dividend policy and we think this will be a positive trigger for the shares.

[1] *Utilities 2005. Spring Edition – Bond Yields versus Power Prices* 5 April 2005

AWG remains cheap in our view

AWG remains on our list almost by default as it offers a higher total return than our remaining buy recommendations (Fortum and Centrica).

For each stock a more detailed statement of the investment case is provided starting on page 30.

Figure 7. Top Five Stocks

Stock	Country	Rating	Current Price*	Target Price	Upside	Exp total return	EV/ EBITDA (05E)**	PE (pre-goodwill) (05E)	Dividend yield (05E)	Comment
AWG	UK	Buy/ Medium Risk (1M)	927p	995p	7%	13%	8 7x	16 2x	5.5%	Potential special dividend Non-core valuation cautious
E ON	Germany	Buy/ Medium Risk (1M)	€78 30	€90 00	15%	18%	6 8x	11 3x	4 1%	Even if E.ON arrives at a more efficient balance sheet structure by making a major acquisition we think the net impact will be positive
Enel	Italy	Buy/ Medium Risk (1M)	€7 21	€7 80	8%	13%	7 7x	16 7x	5 2%	Impact of higher oil prices on power prices not factored in New dividend policy awaited
International Power	UK	Buy/ Medium Risk (1M)	232p	250p	8%	9%	7 3x	13 4x	2 6%	FY04 nadir of earnings cycle, recovering spark spread to drive strong growth
RWE	Germany	Buy/ Medium Risk (1M)	€54 8	€65 0	19%	22%	6 0x	9 8x	5 1%	RWE still trades on one of the lowest FY06E P/E multiple in the sector
European utilities sector					-2%	2%	7 1x	12 8x	4.5%	
European stock market							7 8x	13 2x	3 4%	

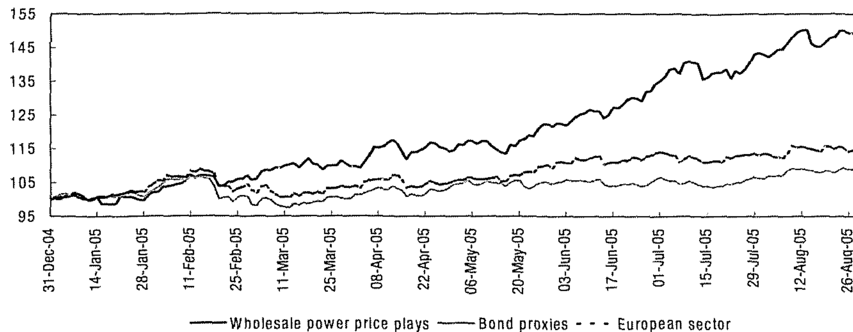
Source: Citigroup Investment Research *Prices at close on 1 September 2005

2005 so far

Of the top-five stocks we highlighted back in April, the best performance has come from International Power (up 30% in absolute terms since 1 April), RWE (up 18%) and Veolia (up 20%). AWG has risen more modestly (up 12%), but ENEL has been a disappointment (down 2%).

Overall for the year to date, stocks with leverage into rising wholesale power prices have strongly outperformed the sector.

Figure 8. Wholesale Power Price Plays vs Bond Proxies Indexed to 1 Jan 05=100



Source: Reuters and Citigroup Investment Research analysis Wholesale power price plays index comprises International Power, British Energy, Fortum and RWE Bond proxies index comprises UK Water, Snam Rete Gas, Terna and Electrabel

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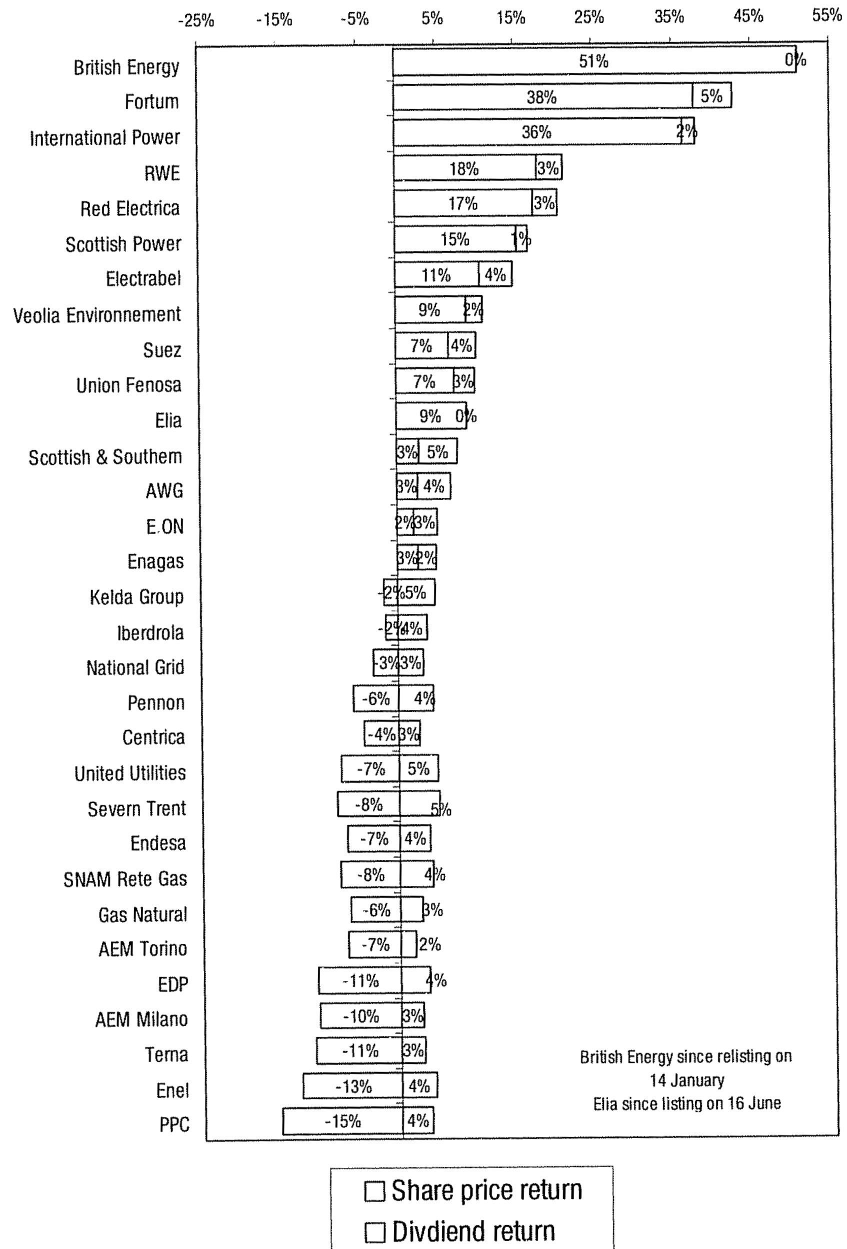
Northern European commodity price plays have performed best

Figure 9. Stock Performance Relative to DJ Stoxx Since 1 January 2005



Sources: Datastream

Focus on balance sheet strength

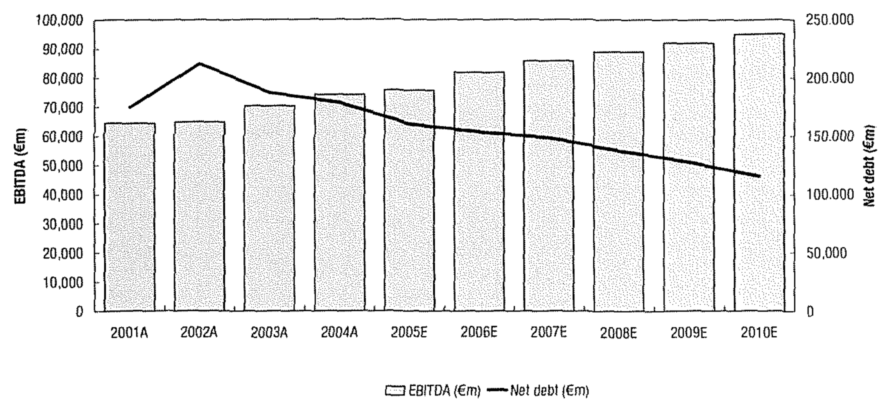
- **We think pressure on management teams to deal with underleveraged balance sheets will steadily build**
- **Achieving the right level of leverage could be seriously value-enhancing for shareholders**
- **Especially so if it is achieved by a special dividend or share buy-back**
- **But even a value-destructive acquisition could have a net positive impact once the benefits of higher leverage are taken into account**
- **So we think acquisitive management teams need no longer be so afraid of a negative share price reaction**
- **Sitting on an inefficient balance sheet and doing nothing is the worst option of all**
- **E.ON is the obvious way to play this theme, but Centrica, RWE, Fortum, Snam Rete Gas, ENEL and Scottish & Southern could all benefit from higher leverage in our view**

Increasingly inefficient

Our hunch is that company balance sheets are likely to be a major investment issue in the sector over the next few months. Because the companies by and large have steered clear of acquisitions, debt levels have steadily shrunk over the last few years. By the end of 2006, we estimate that the aggregate sector net debt will have fallen by more than €50bn from the 2002A peak of €212bn.

Debt capacity has risen, but actual debt levels are still falling

Figure 10. Sector Aggregate Net Debt and EBITDA (€m)



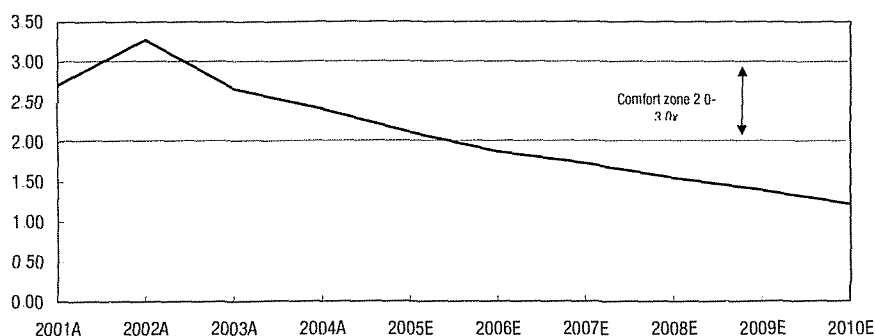
Sources: Company reports and Citigroup Investment Research

Over the same period, the capacity of the sector to take on debt has actually risen. This is because operating cash flows have grown (driven in part for several companies by higher wholesale power prices) with the result that the companies can now cope with higher debt service payments than they could back in 2002.

The upshot is that the sector balance sheet as a whole is becoming steadily more and more inefficiently leveraged. For example, Figure 11 shows the sector aggregate net debt/EBITDA ratio. By the end of 2006 we project a ratio of just 1.9x.

Figure 11. Sector Aggregate Net Debt/EBITDA

The sector balance sheet looks increasingly inefficient



Source: Company reports and Citigroup Investment Research

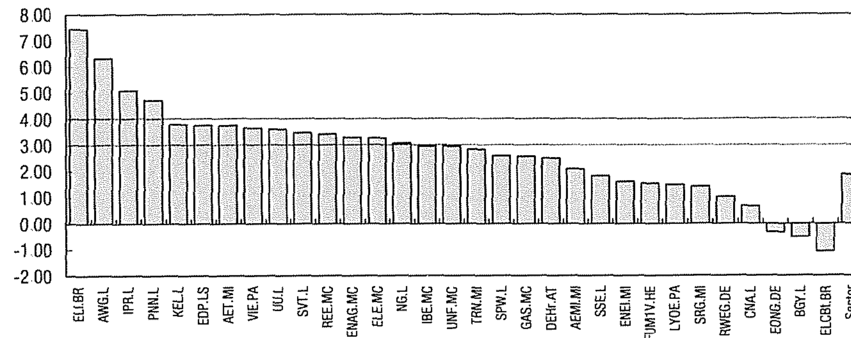
The "right" level of net debt/EBITDA is of course debatable. Some companies run with ratios as high as 5x. For example, the UK water stocks, which have very stable and predictable streams of profit, have FY06E ratios ranging from 3.4x to 6.3x according to our estimates. On the other hand, companies with more unregulated activities and which also have unfunded pension and other liabilities are likely to require lower levels of net debt to protect their credit ratings. For example, E.ON has suggested that it needs to keep net debt/EBITDA in the range of 1.0-2.0x (although we suspect the company is being conservative).

Based on discussions with Citigroup's debt analysts, we think the "comfort zone" for the sector as a whole is likely to be in the region of 2.0x to 3.0x. Based on our forecasts, the sector as a whole is poised to fall below this range over the next few months.

Shareholder pressure on managements is likely to grow

This is a problem which we think company management teams will come under increasing pressure to confront. Some companies will face more immediate pressure than others. From Figure 12, the five companies which stand out (excluding British Energy and Electrabel which are special cases) are E.ON, Centrica, RWE, Snam Rete Gas and Suez. Suez has already of course dealt with this issue by announcing its plans to buy out the Electrabel minorities. This deal should lift the Suez FY06E ratio from our current forecast of 1.5x to 2.3x.

Figure 12. FY06E Net Debt/EBITDA (x)



Source: Citigroup Investment Research

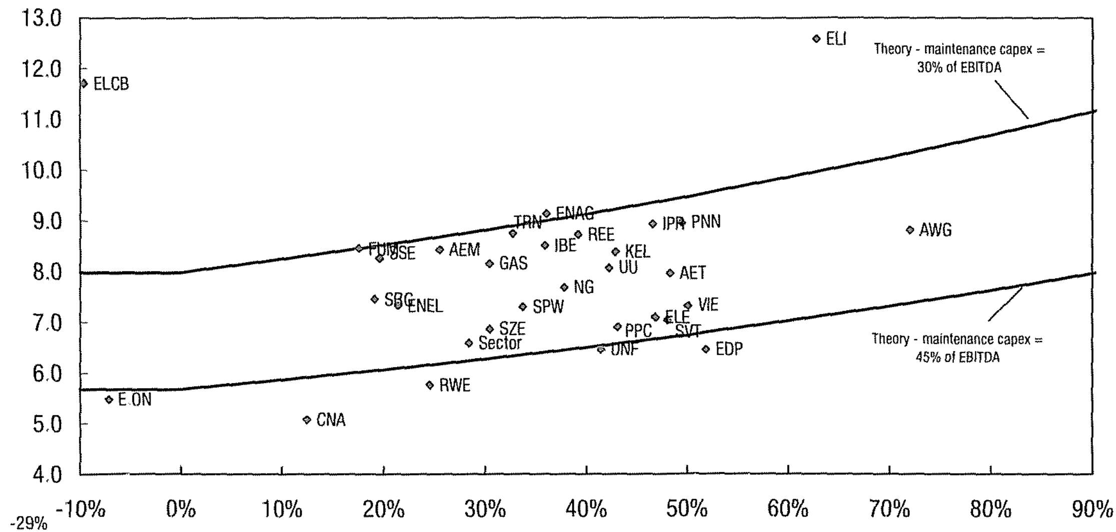
We believe the Suez-Electrabel deal was a powerful demonstration of the impact of leveraging up the balance sheet on shareholder value. Even though the buyout involved Suez paying a significant premium to fair value on our analysis, the share price rose 13% in the 48 hours after the deal was announced. The market appeared to decide that the benefits of higher leverage was enough to offset the premium (of course the extra cost cutting Suez announced also played a role).

In our view, companies operating with permanently underleveraged balance sheets are not simply being "prudent", but instead are doing their shareholders a disservice, especially with interest rates at current low levels. By leveraging up, companies can amplify the returns on equity that they generate, with a knock on impact on their share price.

One way of illustrating the potential is to look at the relationship between leverage and EV/EBITDA. Figure 13 sets out the core[2] FY06E EV/EBITDA for the companies under our coverage plotted against each company's FY06E leverage (net debt/(net debt + equity at market value)).

[2] By "core" we mean EV/EBITDA calculated on the basis of EV=Market value of equity + net debt + minorities + NPV of other liabilities – associates and financial investments at book value, and EBITDA excluding income from associates and financial investments

Figure 13. FY06E Core EV/EBITDA vs Leverage



Source: Citigroup Investment Research

The chart also shows the theoretical relationship between EV/EBITDA and leverage based on a simplified model[3]. As theory suggests, there seems to be a positive relationship between EV/EBITDA and leverage. Roughly speaking, the simplified theoretical lines on Figure 13 suggest that a 10 percentage point increase in leverage equates to an increase in the EV/EBITDA multiple of 0.2-0.3 (concentrating on the 10-50% leverage range).

Applying this relationship to Suez, the extra leverage resulting from the Electrabel deal equates to 4 percentage points, according to our numbers, suggesting an increase in EV/EBITDA of around 0.1x. This in turn equates to an additional €0.7bn of value based on our FY06E EBITDA forecast.

Figure 14 shows a similar calculation for the more underleveraged utilities, assuming they all leveraged up to a net debt/EBITDA ratio of a still modest 2.0x and that each 10 percentage point increase in leverage leads to a 0.25 rise in the FY06E EV/EBITDA multiple.

[3] We assume EV=NOPAT/(WACC-growth rate) WACC is calculated on a post-tax basis assuming a fixed cost of debt of 5.0% which is taken to be independent of leverage We use a cost of equity of calculated on the basis of a 4.0% risk-free rate, with a 5.0% equity risk premium and an unlevered beta of 0.6 Our calculation takes into account the impact of capital structure on the cost of equity by calculating a levered beta We also take into account a 35% tax rate We assume an EBIT growth rate of 2% (i.e. zero in real terms with 2% inflation)

Figure 14. Potential Impact of Leverage on Value

Company	FY06E net debt/EBITDA	FY06E leverage	Additional debt required to achieve 2.0x Net debt/EBITDA	Implied leverage	Increase in leverage	Actual core EV/EBITDA (06E)	Increase in EV/ EBITDA	Implied core EV/EBITDA (06E) based on additional leverage	Implied increase in value	Increase in value per share	Increase in value as % of current share price
E.ON	-0.3	-7%	€24,960m	42%	49%	5.5	1.2	6.7	€13,159m	€19.0	24%
Centrica	0.7	12%	£2,685m	37%	25%	5.1	0.6	5.7	£1,258m	33p	13%
RWE	1.0	24%	€9,305m	47%	23%	5.8	0.6	6.3	€5,503m	€9.8	18%
Snam Rete Gas	1.4	19%	€859m	27%	8%	7.4	0.2	7.6	€290m	€0.1	3%
Fortum	1.5	18%	€878m	23%	5%	8.4	0.1	8.6	€252m	€0.3	2%
ENEL	1.6	21%	€2,830m	26%	5%	7.3	0.1	7.5	€935m	€0.2	2%
Scottish & Southern	1.8	20%	£188m	21%	2%	8.3	0.0	8.3	£50m	6p	1%
Sector	**1.9**	**28%**	**€43,057m**	**36%**	**8%**	**6.6**	**0.2**	**6.8**	**€16,190m**		**4%**

Source: Citigroup Investment Research

This is of course a simplistic calculation. For example, Scottish & Southern and Snam Rete Gas could probably cope with a much higher net debt/EBITDA ratio than just 2.0x. In addition, we are assuming the extra capital raised is either distributed to shareholders or else invested by the company in a value-neutral fashion. Some companies will probably end up making value-destructive acquisitions instead.

However, the table does illustrate, for example, the degree to which such an investment would have to be value destructive to offset the positive impact of the higher leverage. In the case of the German utilities, value destruction of more than 50% would be needed (all else being equal).

P/E impact of releveraging

An alternative approach would be to look at the earnings impact of releveraging. We have done this for the same set of companies in two different ways. Figure 15 sets out the impact on P/E of a special dividend approach, while Figure 16 explores the impact of releveraging by making an acquisition. In both cases we assume a 35% tax rate and a 5.5% interest rate on the additional debt. We also assume the following.

- For the special dividend calculations, we assume the market capitalisation falls by the amount of the special dividend distributed and then calculate the implied FY06 P/E.
- For the acquisition calculations, we assume the company buys additional earnings at a 10% P/E premium to the sector (i.e. at a FY06E P/E of 14.0x).

Figure 15. Impact of Special Dividend on FY06E P/E

Company	Additional debt required to achieve 2.0x Net debt/EBITDA	Additional interest payment at 5.5%	Post-tax impact on earnings assuming 35% tax rate	FY06E net profit	Market value after paying special dividend	FY06E net profit after paying special dividend	FY06E P/E as is	FY06E P/E after special dividend	Impact
E.ON	€24,960m	€1,373m	-€892m	€4,555m	€29,223m	€3,663m	11.9	8.0	-33%
Centrica	£2,685m	£148m	-£96m	£735m	£6,697m	£639m	12.8	10.5	-18%
RWE	€9,305m	€512m	-€333m	€3,148m	€21,487m	€2,815m	9.8	7.6	-22%
Snam Rete Gas	€859m	€47m	-€31m	€573m	€7,977m	€542m	15.4	14.7	-5%
Fortum	€878m	€48m	-€31m	€983m	€12,585m	€951m	13.7	13.2	-3%
ENEL	€2,830m	€156m	-€101m	€2,640m	€41,180m	€2,539m	16.7	16.2	-3%
Scottish & Southern	£188m	£10m	-£7m	£616m	£8,235m	£609m	13.7	13.5	-1%
Sector	€43,057m	€2,368m	-€1,539m	€30,118m	€347,240m	€28,579m	13.0	12.2	-6%

Source: Citigroup Investment Research

Figure 16. Impact of Acquisition on FY6E P/E

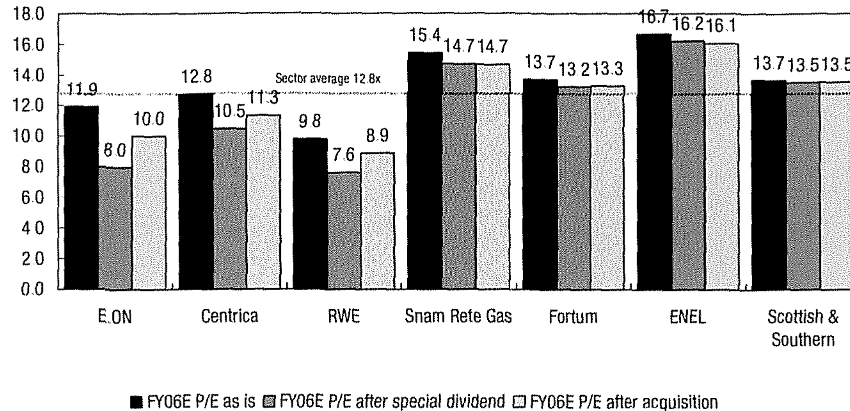
Company	Additional debt required to achieve 2.0x Net debt/EBITDA	Additional interest payment at 5.5%	Post-tax impact on earnings assuming 35% tax rate	FY06E net profit	Additional net profit bought at 14.0x P/E	FY06E net profit after acquisition	FY06E P/E as is	FY06E P/E after acquisition	Impact
E ON	€24,960m	€1,373m	-€892m	€4,555m	€1,751m	€5,414m	11 9	10 0	-16%
Centrica	£2,685m	£148m	-£96m	£735m	£188m	£827m	12 8	11 3	-11%
RWE	€9,305m	€512m	-€333m	€3,148m	€653m	€3,468m	9 8	8 9	-9%
Snam Rete Gas	€859m	€47m	-€31m	€573m	€60m	€602m	15 4	14 7	-5%
Fortum	€878m	€48m	-€31m	€983m	€62m	€1,013m	13 7	13 3	-3%
ENEL	€2,830m	€156m	-€101m	€2,640m	€199m	€2,737m	16 7	16 1	-4%
Scottish & Southern	£188m	£10m	-£7m	£616m	£13m	£622m	13 7	13 5	-1%
Sector	€43,057m	€2,368m	-€1,539m	€30,118m	€3,021m	€31,600m	13.0	12.4	-5%

Source: Citigroup Investment Research

Under both examples, the companies would look significantly cheaper than they currently do in the eyes of the stock market. Of course, the humble P/E ratio has its limitations when it comes to valuation and a company with higher leverage can be expected to trade on a lower P/E than one with low leverage.

Even so, a P/E ratio of less than 10x is likely to prove unsustainably low in our view given the still comfortable levels of leverage we are contemplating. E.ON, RWE and Centrica could all fall into this category depending on how their balance sheets are put to use.

Figure 17. FY06E P/E Ratios



Source: Citigroup Investment Research

Conclusion

We think underleveraged balance sheets are increasingly preventing utility share prices from achieving their true potential. As balance sheets strengthen yet further, we expect shareholder pressure on management teams to sort out their balance sheets will grow, and rightly so in our view.

Some management teams are likely to resort to special dividends and or share buy backs to achieve higher leverage, and this is probably the safest route for most investors and the surest way to achieve a share price rerating.

We think even a modestly value-destructive acquisition is preferable to doing nothing with a grossly underleveraged balance sheet

Most management teams will probably prefer to make acquisitions, either in Europe or potentially in the US. We still think it is wise to assume most utility acquisitions are likely to be value destructive. However, we now suspect the positive impact of such an acquisition on balance sheet efficiency is likely to be more than enough to offset this value destruction.

The worst approach is for a management team simply to do nothing and sit on an underleveraged balance sheet indefinitely. However, with private equity buyers looking to invest ever larger sums of capital, management teams that ignore their strengthening balance sheets will increasingly risk attracting the attentions of such a predator.

Power Prices: Short Term vs Long Term

- **Over the next few months we suspect European forward power prices will tend to soften as the risk premium in the UK gas market declines**
- **But most generators are now either hedged, or else our forecasts assume achieved prices below the current forward curve**
- **The long-term outlook is still intact – power prices should eventually converge towards new entrant levels...**
- **...and our estimates of new entrant prices at least in Continental Europe are looking pretty conservative in view of rising long-run oil price expectations**
- **In the UK, our long-run power price forecasts are more optimistic, but British Energy nevertheless still looks expensive to us**
- **We remain positive on the other main power price plays: E.ON, ENEL, Fortum, International Power and RWE**

Overview

We think current forward prices still look a bit overheated

Although we still think there is more to go for in the share prices of most European power generation stocks, current forward prices could be painting too bright a picture as far as the short-term outlook is concerned. As set out below, UK gas prices appear to have been at least partly responsible for driving pan-European power prices higher and we see scope for these prices to soften over the next few months.

The good news is that, where companies are unhedged, our forecasts mostly assume they achieve power prices that are below the current forward curves. This means that some weakness in forward prices would not undermine the investment case for stocks such as RWE and E.ON. In fact, lower forward prices could arguably ease the political risks in Germany.

But our long-run assumptions may yet prove too low

Beside, the long run outlook is more important. We believe power prices will eventually converge towards new entrant levels, and we think our estimates for new entrant prices (at least in Continental Europe) are looking increasingly conservative as long-run oil price expectations rise.

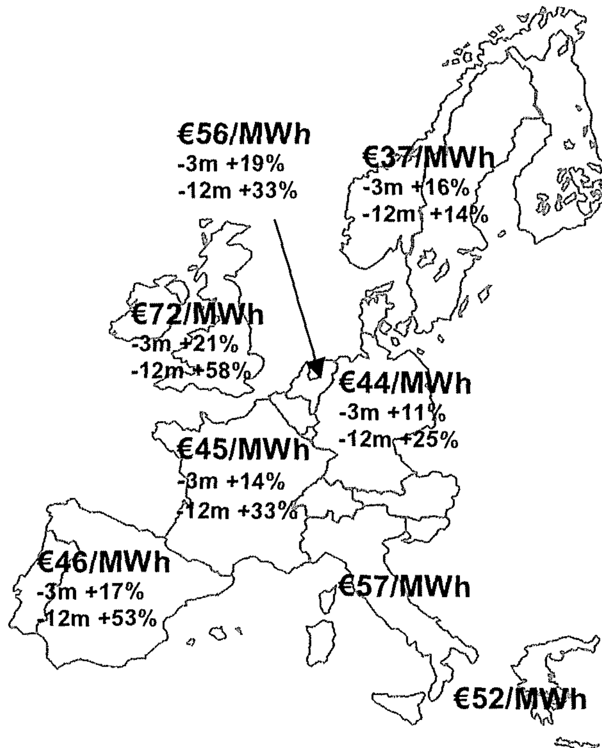
Overall, we think a good case can still be made for investing in E.ON, ENEL, Fortum, International Power and RWE on the back of the power price outlook (amongst other factors). We think British Energy, on the other hand is overvalued.

Recent wholesale power price trends

European power prices now appear more interlinked as a result of the introduction of carbon emissions trading at the start of this year. Generators now need a permit for each tonne of carbon dioxide they produce, and these permits are traded in a pan-European market. The price of the permits has risen much faster than we expected and this appears at first sight to be the chief reason behind the rise in European power prices this year.

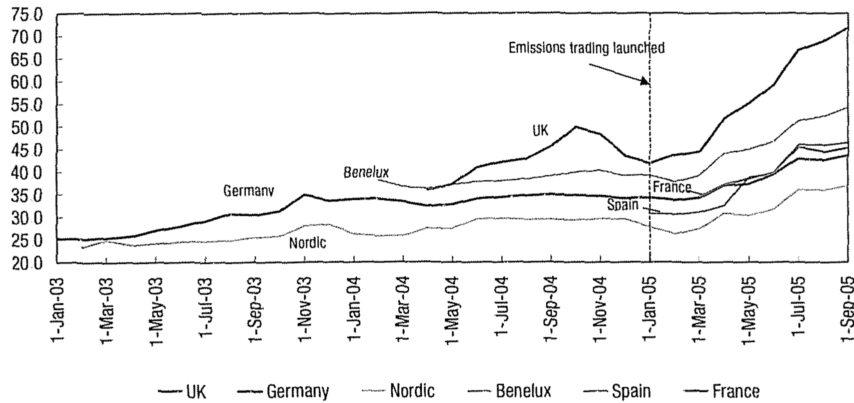
Year-ahead prices have risen well above our expectations at the start of 2005

Figure 18. European Wholesale Power Prices at 1 September 2005



Source: Year Ahead Baseload Prices from Platt's except Italy and Greece where we show Citigroup Investment Research forecasts for 2006 achieved prices

Figure 19. Times Series of 2006 Contract Price (€/MWh)

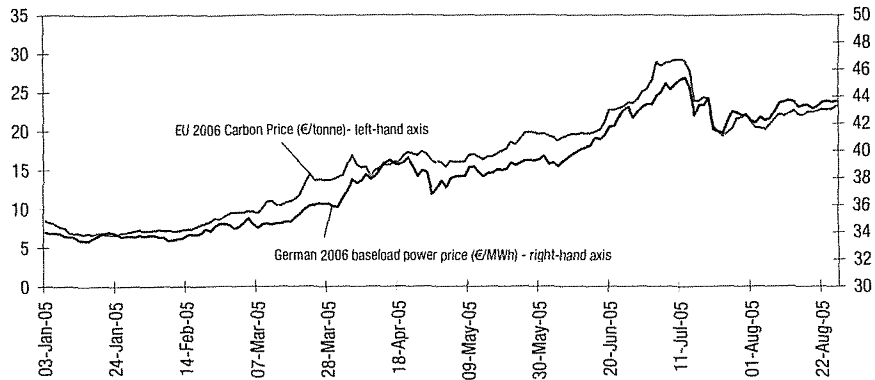


Source: Platt's sampled on 1st trading day of each month

For example, Figure 20 shows how the German 2006 power price is tightly correlated with the price for carbon permits. It also shows how the fall in the carbon price in mid-July translated into a fall in the German power price. (There was a similar impact on power prices in other markets). Although both prices have recovered since then to some extent, there is clearly a risk of such events in future.

Figure 20. German 2006 Power Prices and European 2006 Carbon Price (€/tonne)

Carbon prices appear to have been the main driver



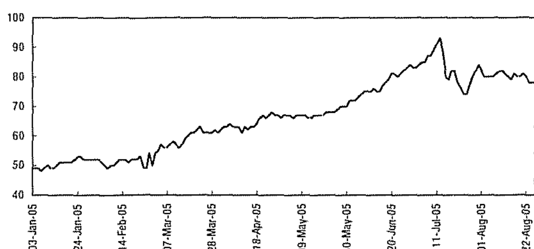
Source: Bloomberg and Citigroup Investment Research analysis

This chart suggests the outlook for European forward power prices depends to a large extent on the outlook for European carbon prices. This in turn appears to depend largely on the outlook for UK gas prices.

The peculiar UK gas market appears to be driving the carbon market

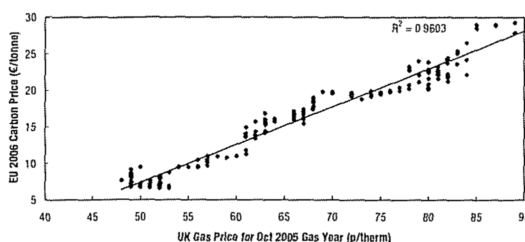
In the UK, there is substantial capacity of both gas-fired and coal-fired plant, with the result that generators can switch between the two types of production depending on the fuel price. The upshot is that the sharp rise in forward gas prices (Figure 21) we have seen this year has resulted in an increase in electricity production at coal-fired plant and hence an increased demand for carbon permits. This factor seems to be the dominant one driving carbon prices on a pan European basis. As Figure 22 shows, the correlation between the two is very strong.

Figure 21. 2006 UK Gas Year Ahead (p/therm)



Source: Bloomberg

Figure 22. 2006 Carbon Price vs UK Gas Year Ahead



Source: Bloomberg and Citigroup Investment Research analysis

This whole situation makes us rather uneasy. Forward UK gas prices are volatile and not necessarily that liquid. In turn, we think the liquidity of the pan European carbon market is also pretty questionable. So it seems we have one illiquid market, driving another illiquid market which in turn is driving power prices on a pan European basis.

For this reason, we tend to be sceptical about current forward prices for power, gas and carbon. As far as UK gas prices are concerned, prices have been driven up by a temporary situation of potential shortage should the coming winter prove exceptionally harsh. Gas buyers have had to pay a hefty risk premium to ensure security of supply over the winter months.

We think UK gas, carbon and year-ahead power prices will all trend lower

As a result, unless the winter does prove to be exceptionally harsh, we think there is a good chance that UK gas prices will soften as autumn turns into winter. In addition, new import pipeline capacity is set to be available by the end of 2006, and this should also lead to lower prices.

If UK gas prices do soften, then there is a good chance that carbon prices and power prices on a pan European basis will follow suit, at least to some extent.

What does this mean as far as the prices that companies actually achieve for their power are concerned? We think it is best to consider the short-term outlook separately from the long-term outlook.

Short run outlook for achieved prices

In the short run (i.e. the next year or two), the power prices that companies actually achieve for their power will typically reflect:

Forward prices are not necessarily a good guide to the prices companies will actually achieve

- existing power sales contracts that are already in place; and
- the level of forward prices *when those contracts are renewed.*

In some countries there may also be regulatory arrangements in place which prevent vertically integrated producers from achieve market prices for their power. For example, some countries still essentially have a cost-plus arrangement under which power producers get paid their actual costs plus an allowance for profit rather than a market based price for power. This applies to some extent in France, Belgium and throughout most of Southern Europe.

Taking such considerations into account, we have restricted our discussion to the most obvious wholesale power price plays: British Energy, E.ON, ENEL, International Power and RWE.

Figure 23 sets out some key figures for each of these companies, including an assessment of the extent to which future power sales have been hedged for future years.

Figure 23. Key Valuation Data For Major European Power Generation Stocks

	Hedging arrangements			Pre-exceptional EPS			Price earnings ratio on *current forecasts*			Mark to market EPS impact			Mark to market P/E		
Company	FY05E	FY06E	FY07E	FY05E	FY06E	FY07E	FY05E	FY06E	FY07E	FY05E	FY06E	FY07E	FY05E	FY06E	FY07E
British Energy	Hedged	Slightly hedged	Unhedged	10.7p	86.0p	54.8p	44.5x	5.5x	8.7x	0%	1%	36%	44.5x	5.5x	6.4x
E.ON	Hedged	Hedged	Half hedged	€5.96	€6.91	€6.99	13.1x	11.3x	11.2x	0%	0%	11%	13.1x	11.3x	10.1x
ENEL	Mostly hedged	Moderately hedged	Unhedged	€0.44	€0.43	€0.43	16.2x	16.7x	16.6x	0%	8%	27%	16.2x	15.4x	13.1x
Fortum	Hedged	Slightly hedged	Unhedged	€0.97	€1.15	€1.24	16.4x	13.7x	12.7x	0%	11%	0%	16.4x	12.3x	12.7x
International Power	Hedged	Half hedged	Unhedged	13.1p	17.4p	21.9p	17.7x	13.4x	10.6x	0%	0%	0%	17.7x	13.4x	10.6x
RWE	Hedged	Hedged	Unhedged	€4.11	€5.60	€5.89	13.3x	9.8x	9.3x	0%	0%	17%	13.3x	9.8x	7.9x
European sector							14.5x	12.8x	12.0x						

Source: Citigroup Investment Research with share prices at 1 September 2005

We think several aspects of the table are worth highlighting.

First, for **British Energy** we think current earnings are peak cycle and are inflated because the company's assets, which it is not replacing, are largely depreciated. Our long run DCF valuation produces a value of 370p per share and this in turn is based on fairly optimistic assumptions compared with those we use elsewhere in Europe.

E.ON and RWE are now largely hedged until 2007

Second, both **German utilities** are now pretty much fully hedged until 2007. This means the FY06E profit outlook should be largely locked in so movements in the 2006 forward price are now largely irrelevant. Our 2007 forecasts are based on an estimated achieved price of €37/MWh – some 10% below the current forward curve. This provides some room for comfort if forward prices weaken, as we suspect they will.

Third, there is substantial uncertainty over the prices that Fortum and International Power will achieve in 2006. For **Fortum**, we see scope for 11% FY06E EPS upside if the forward price for 2006 remains close to current levels as contracts are renewed over the next 2-3 months, our 2007 price assumptions are in line with the current forward curve on the other hand. For **International Power**, on the other hand, our forecasts are close to current forward prices, but for this company it is US prices that are most important and we think these are less vulnerable to a downward correction than those in the UK.

Fourth, for **ENEL** there is as yet no forward market for power in Italy, so our calculations are based on the impact of raising the oil price assumptions which feed into our Italian power price model to those more in line with consensus expectations. Our published estimates for ENEL are in fact based on the Citigroup oil team's forecasts before the recent upgrade, while the mark-to-market impact is based on the team's current oil price scenario. We think ENEL's status as a power price play has yet to be fully appreciated by the stock market.

Figure 24. Oil Price Assumptions Used to Estimate Italian Power Prices (US$/bbl)

	FY06E	FY07E
Oil price in published ENEL estimates (U$/bbl)	39 0	32 0
Published Italian pool price estimate (€/MWh)	57 1	48 5
Oil price in "Mark-to-market" estimates (US$/bbl)	48 5	45 5
"Mark-to-market" Italian pool price estimate (€/MWh)	69.4	66.3

Source: Citigroup Investment Research

Long run outlook

On a 5-10 year view, we expect wholesale power prices in most markets to trend towards the new entrant price. Figure 25 sets out the long run power price assumption built into our current models and valuations by country. In Germany, Italy and in the Nordic market, there appears to be some scope for us to move to a more optimistic assumption which would further support our positive recommendations on RWE, E.ON, ENEL and Fortum.

Figure 25. Citigroup Long-run Power Price Assumptions in Major European Markets

	Long run power price assumption	Comment
Germany	€43/MWh in 2010 and beyond	This is the new entrant price for a CCGT under current carbon permit allocation rules, whereby a new entrant gets carbon for free for the first 14 years of life. We assumed €15/tonne carbon and €11/MWh gas (excluding transport costs) The €11/MWh gas price assumption reflected a long run oil price assumption of US$32/bbl. Were we to raise this to the current long-run forecast of the Citigroup oils team (i e. US$37 5/bbl), the gas price would rise to €13/MWh, leading to a new entrant price of €47/MWh
UK	£32/MWh (i e. €47/MWh) in 2008 and beyond	This is a CCGT new entrant price with a 32p/therm (i e €16/MWh) gas price (based on US$45/bbl oil) and €20/tonne for carbon
Italy	€50/MWh in 2010 and beyond	We estimate a the new entrant price of €46/MWh based on long-run oil of US$32 per barrel However we assume power prices settle at €50/MWh for ENEL in view of its capacity mix which allows ENEL to control most segments of the load factor curve, from baseload to peak-shaving units, whilst the vast majority of ENEL's competitors are present just in the baseload segment.
Nordic	€42/MWh for 2012 and beyond	This is the new entrant price for a CCGT combined heat and power plant. We assumed €15/tonne carbon and €11/MWh gas (excluding transport costs). The €11/MWh gas price assumption reflected a long run oil price assumption of US$32/bbl. Were we to raise this to the current long-run forecast of the Citigroup oils team (i.e US$37 5/bbl), the gas price would rise to €13/MWh, leading to a new entrant price of €45/MWh.

Source: Citigroup Investment Research

In the UK, on the other hand, our estimates are already based on fairly optimistic assumptions, which in turn means our sell stance on British Energy should be more robust.

Conclusion

We suspect forward power prices will soften over the next few months as the risk premium that is currently factored into the UK gas forward curve reduces. This should not undermine our forecasts for most companies because of hedging arrangements that are already in place, or because our forecasts assume prices well below the current forward curve. In the long run, our forecasts and valuations are based on power price assumptions that we think are more likely to prove too low than too high, at least as far as Continental Europe is concerned.

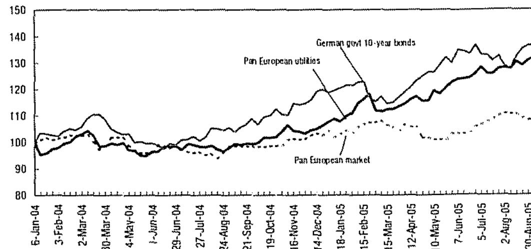
Bond Yields: Lower Regulatory Returns In Prospect

- **Citigroup economists expect 10-year Bund yields to remain in the 3.10-3.35% range for the next 12 months**
- **So in contrast to the last 18 months, the bond market is unlikely to drive share prices much one way or the other going forward**
- **As bond yields fell, the infrastructure stocks were driven up to trade at substantial premiums to their regulatory asset bases**
- **But regulators should ultimately take lower bond yields into account and the current premiums may eventually prove unjustified**
- **So we would tend to avoid the infrastructure stocks by and large**

Bond markets to remain benign

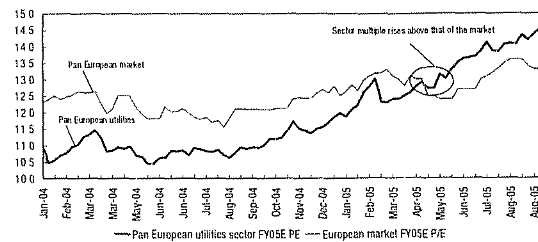
Falling bond yields have been one of the main reasons behind the strong performance of the sector over the last 12-18 months. Figure 26 shows this effect clearly, with the sector P/E being dragged up relative by the rising P/E (i.e. the inverse of the yield) on bonds.

Figure 26. FY05E P/E Multiples (Indexed)



Source: Citigroup Investment Research

Figure 27. FY05E P/E Multiples (Absolute)



Source: Citigroup Investment Research

Our view is that this story is pretty much done and dusted. Bond yields may fluctuate up and down by 10-20 basis points or so in response to varying economic newsflow. But the bond market as a whole seems well underpinned at current levels.

For example, Citigroup Investment Research economists do not expect major changes in bond yields for the next 12m – Figure 28 sets out their latest forecasts. If they are right, then the bond market is likely only to be a weak driver of utility share prices over the coming months.

Citigroup foresees little change in bond yields

Figure 28. Bond Yield Forecasts

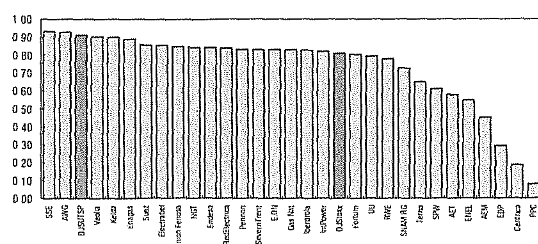
	Current	3Q05	4Q05	1Q06	2Q06	3Q06
10-year Bund Yield	3.10%	3.30%	3.35%	3.30%	3.20%	3.20%

Source: Citigroup Investment Research

From a theoretical standpoint, we think the bond-sensitivity of utilities arises because of their low beta nature[4]. And it is no surprise, therefore, that the heavily regulated stocks with the least exposure to commodity prices display the strongest correlation to bonds.

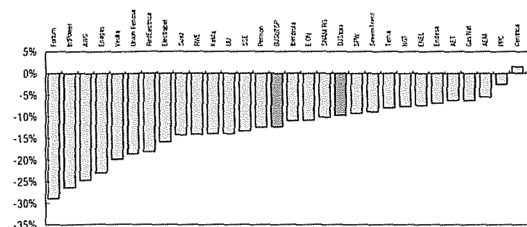
Figure 29 provides an update of the correlation of individual stocks to bond prices, while Figure 30 sets out the change in the share price that the statistical correlation would imply should bond yields rise by 50 basis points. These are only statistical correlations and we are sceptical in several instances that they are really very meaningful.

Figure 29. R-squared vs 10-Year Bund Since 1 July 2004



Source: Datastream and Citigroup Investment Research analysis

Figure 30. Share Price Decline Implied by 50 b.p. Bond Yield Rise



Source: Datastream and Citigroup Investment Research analysis

If the past is any guide to the future, then changes in bond yields are likely to have most impact on AWG and Scottish & Southern and least impact on Centrica and PPC.

But is the market behaving irrationally?

For more value-added analysis, we recommend investors take a look at a report published in July 2005[5] in which Alberto Ponti analysed the share price behaviour of infrastructure stocks on a Pan European basis.

We assessed the history of valuations relative to RAB

For these companies, the regulators set prices to allow a fair return on a regulatory asset base (or RAB). The infrastructure stocks tend to trade at a premium or a discount to RAB depending on whether the stock market expects them to earn a return above or below their true cost of capital.

Some companies, for example, might trade at a premium to their value based on RAB if they are expected to beat the regulator's assumptions on efficiency and hence earn a return above their cost of capital. Similarly, if a regulator has set prices based on a rate of return that is below what the market regards as a fair cost of capital, then a discount to RAB can be expected.

What our research showed is that the premium or discount to RAB for the infrastructure stocks as a whole changes almost exactly in line with the change in bond yields.

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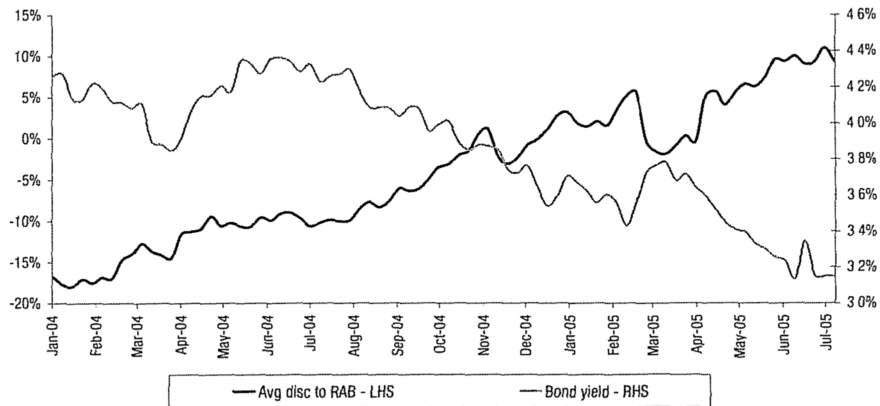
[4] The lower the beta, the stronger the relationship between the cost of equity and the risk-free rate (i e the local government bond yield) For high beta stocks, variations in the equity risk premium play more of a role

[5] See Alberto Ponti's report *Premium/Discount to RAB An Integrated European Approach* 19 July 2005

Figure 31. Premium to RAB and 10-Year Bond Yield

Bond yields appear to control the premium (or discount)



Source: Datastream and Citigroup Investment Research analysis

Some relationship between the two is to be expected because the regulators do not change their targeted rates of return very often. In an extended period of falling bond yields, most companies will be operating under price controls which reflect target rates of return that are above the actual cost of capital. The opposite should be true if bond yields rise.

But regulators should eventually ratchet returns down to reflect lower bond yields

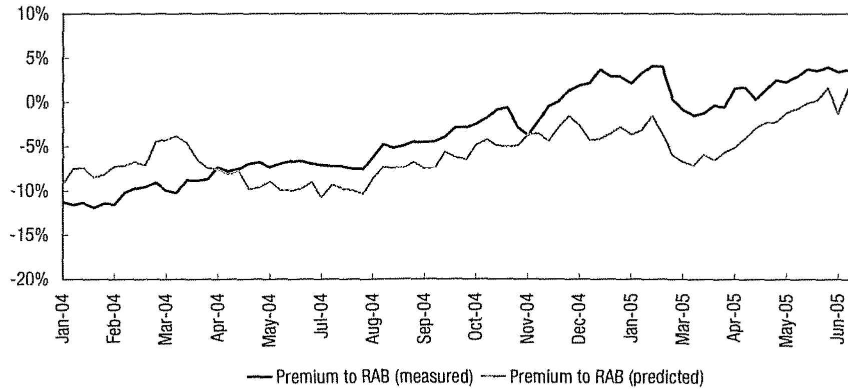
However, when the regulators do reset price controls, they can in general be expected to ratchet down the allowed rates of return to reflect the prevailing bond yield. This means that the companies should only earn a higher return for a few years at most.

This is not what the share price behaviour of the infrastructure stocks appears to discount. Our analysis suggests that the share price movements we have actually seen assume the utilities get to earn the excess returns into perpetuity – i.e. that the regulator never trims the return back to reflect lower bond yields.

For example, in Figure 32 we show the theoretical change in the premium to discount to RAB that we would expect as bond yields have changed, under the assumption that the rate of return is constant into perpetuity. This is fairly close to the observed data, which suggest to us that this is indeed the assumption the stock market is making.

The stock market seems to assume this will never happen

Figure 32. Comparison of Observation with Theory if Lower Bond Yield Benefits Last into Perpetuity



Source: Citigroup Investment Research

So the next regulatory reviews could produce lower returns than share prices are discounting

This analysis argues for a cautious stance on the infrastructure stocks, even assuming bond yields do not rise. If bond yields stay where they are, we suspect the stock market will be disappointed by the low rates of return the regulators adopt when prices are next reset. For some stocks, of course, this disappointment may be several years in coming. For others, it appears closer to hand. Figure 33 sets out the timetable of next reviews for the infrastructure stocks as we see it.

Amongst the more mainstream stocks, it appears to be National Grid in the UK that may have most to worry about, although this is more likely to be an issue for Summer 2006 than Autumn 2005.

Figure 33 Regulatory Timetable

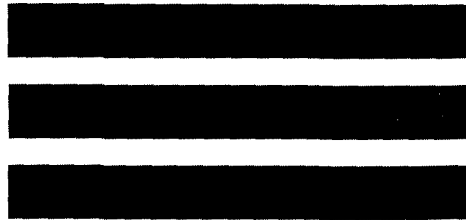
Country and business	Companies affected	Date of next review	Bond yield assumption at previous review	Current bond yield	Current premium to RAB
Belgium electricity transmission	Elia	Annual	4 13% used for 2006 tariffs	3 42% likely to be used for 2007 tariffs	+27%
UK electricity transmission	National Grid	2006 to be in force 1 April 2007	2 75% (index-linked gilt)	1 33% (index-linked gilt)	+19%
UK gas transmission	National Grid	2006 to be in force 1 April 2007	2 75% (index-linked gilt)	1 33% (index-linked gilt)	+19%
UK gas distribution	National Grid, Scottish and Southern, United Utilities	2007 to be in force 1 April 2008	2 75% (index-linked gilt)	1 33% (index-linked gilt)	+19% (NG), +30% (SSE), +5% (UU)
Italy electricity distribution	ENEL	End of 2007	4 25%	3 36%	-2%
Italy electricity transmission	Terna	End of 2007	4 25%	3 36%	+5%
Italy gas transmission	Snam Rete Gas	End of 2009	4 25%	3 36%	+1%
UK water	AWG, Kelda, Pennon, Severn Trent, United Utilities, RWE	2009 to be in force 1 April 2010	2 75% (index-linked gilt)	1 33% (index-linked gilt)	-1 to +8%
UK electricity distribution	Scottish and Southern, United Utilities, ScottishPower, E ON	2009 to be in force 1 April 2010	2.25-3 00% (index-linked gilt)	1 33% (index-linked gilt)	+30% (SSE), +5% (UU0, +29% (SPW)

Source: Citigroup Investment Research

Elia appears to be driven by yield hungry local Belgian investors, keen to find an alternative home for their cash in anticipation of the Suez buyout of Electrabel. However, we suspect the market has not yet fully realised that the dividend is likely to fall in future as lower bond yields are factored into the tariffs.

Conclusion

Although we do not expect the bond market to be a major driver of share prices over the next few months, we do think there could be a sting in the tail of the apparently benign current bond market environment. This is because lower bond yields should ultimately lead to lower returns for regulated utilities. We suspect some stocks are being priced as though regulators will allow returns to remain at current levels indefinitely. For this reason, we would tend to avoid the infrastructure stocks as a whole, and particularly those which are closest to the next regulatory review of prices.



Top Five Stocks

AWG

- AWG has enough bottom-up drivers to deliver superior performance, even if the UK water sector continue to underperform
- AWG should generate surplus cash of £260m over the next five years — at least half could be returned in 12-24 months
- The potential for refinancing AWS's expensive debt is already beginning to realise benefits — ultimately earnings could be enhanced by 16%
- Morrison is now 18 months into a two-year plan — disposal plans may be announced at the end of this period...
- ...but even a re-rating in line with peer group multiples could generate 40p/share upside
- We rate AWG Buy/ Medium Risk (1M) with a 995p price target

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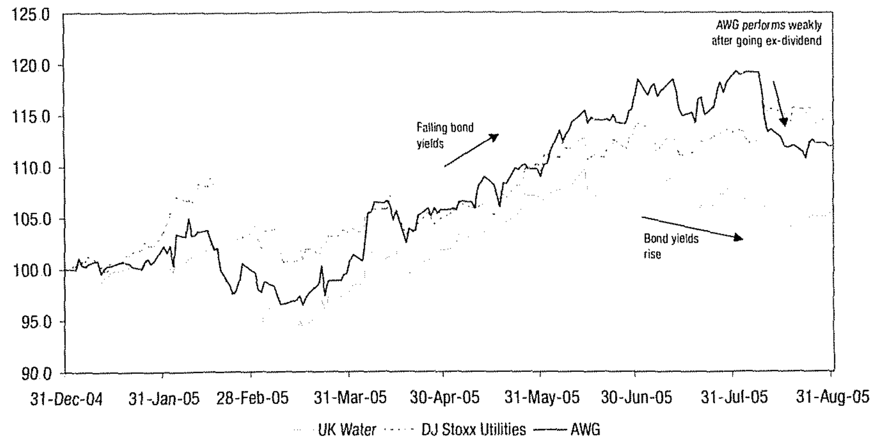
Investment thesis

AWG has been the strongest performing water stock in 2005. However, the water sector as a whole has underperformed the wider European utilities sector and so AWG's performance has been unspectacular compared to some of the more commodity-orientated plays.

Figure 34. AWG — Share Price vs. UK Water Sector and DJ Stoxx Utilities



Sources: Datastream.

AWG has bottom-up potential and plays neatly into the leverage theme

While we believe that the water sector could continue to underperform if bond yields remain flat, AWG has enough bottom-up drivers to distinguish it from the pack. In addition, AWG plays neatly into the leverage theme. It has a highly geared balance sheet and is likely to maintain this high level of gearing by returning surplus cash to shareholders.

We highlight three of AWG's characteristics that support our positive stance:

1. Potential for further returns of value

AWG could return an additional £260m of value over time

AWG announced an 8-9 month £75m share buyback programme at its full-year results in June. In our view, this is just the beginning and AWG has potential to return even more value.

- AWG has £150m free cash at group level. It is not returning all of this immediately, in order to retain some financial headroom in the early stages of the new price control period. However, once AWG is more confident about meeting (or beating) Ofwat's targets, we believe it could return the remaining £75m — probably in a 12-24 month time frame.
- We expect Morrison to generate an additional c£120m FCF (see Figure 35) over the next five years.

Figure 35. Morrison — Free Cash Flow, 2006E-2010E

	2006E	2007E	2008E	2009E	2010E
EBITDA	37.1	39.5	44.1	47.2	50.5
Interest + Tax	(10.1)	(10.8)	(12.1)	(13.1)	(14.0)
Capex	(7.5)	(7.8)	(8.1)	(8.5)	(8.8)
FCF	19.5	20.9	23.8	25.7	27.6

Source: Citigroup Investment Research estimates

- AWG has around £100m of restricted cash at group level (e.g. committed for working capital, redeemable shares, solvency ratio requirements, debt guarantees), of which we believe around £20-25m could be freed up over the next two years (principally elimination of debt guarantees as property assets are sold).
- AWG has nearly £90m of net operating assets in its property division, of which around £60m is non-core. AWG has set out a two-year time frame over which it intends to harvest cash from these non-core assets.

So, in total, we see potential for up to £260m of further returns of value over the next five years, over half of which could materialise in the next 12-24 months — AWG's interim results on 1 December 2005 should provide some clues as to timing.

2. Refinancing potential

Refinancing should enhance EPS by up to 16%

The longer interest rates stay low, the better, as far as AWG is concerned. Analysts often punish AWG for having large levels of expensive embedded debt in its water business, AWS, but we believe the market is yet to fully appreciate the benefits that AWS can gain through refinancing.

We believe that AWS has around £1.2bn of debt that is either callable (at zero premium) or matures in the next five years. The cost of this debt ranges up to 8.25%. Our latest calculations suggest that as long as AWG can secure refinancing rates of between 5.5-6.0% on the debt, the NPV of the WACC outperformance between 2006-2010 is worth nearly 30p/share. Also, the interest saving is substantially EPS enhancing versus a flat interest cost — up to 16% enhancement by 2010.

The process of refinancing this debt is already underway. In June, AWG announced that it had redeemed £410m of its outstanding bonds at par. These bonds had an average coupon of 6.1%, which would have stepped up over time. The redemption was being funded from the £800m of debt that AWG raised in 1Q05 at an average rate of 5.1%. Overall, we calculate that AWG has already reduced the average debt cost on AWS's £3.5bn net debt by 30bps to 6.5%. This benefit should flow through to 2H05/06 earnings.

3. Outlook for Morrison

We see 40p/share upside if Morrison is valued in line with its peer group

AWG's FY04/05 results in June showed firm evidence that the new management at Morrison is gradually delivering promised improvements: the order book grew to £2.8bn and 85% of it is now concentrated on lower-risk long-term framework contracts; operating margins their positive trend, rising from 2.0% to 2.4%.

Although it is still early days, we have faith that management can continue to deliver over the next 12-months. We believe that his should feed through into increased expectations of the potential value that could be realised, should the business be sold in 12-18 months time.

We value this business at £160m using a conservative 4.9x EV/EBITDA multiple, which represents a 20% discount to its comparative peer group (e.g. McAlpine, Carillion etc.). With comparatives now trading at an average 6.2x EBITDA, there is scope for our valuation to rise by £54m or 40p/share if AWG can demonstrate that the performance improvements are sustainable and the business becomes rated in line with its peer group.

By the time of the interim results, AWG will be 18 months into a two-year recovery plan for Morrison. It is possible that the business will be but up for sale at the end of this two-year period. This could crystallise additional value, and generate further returns of cash to shareholders.

Valuation

We have a target price of 995p

We value AWG at 995p. We use an adjusted RCV valuation for the regulated water business, and a combination of DCF and market multiples for the unregulated operations. Based on our sum-of-parts, AWG would trade at a FY05/06E dividend yield of 5.0% and an EV/EBITDA of 8.8x compared to a current UK water sector average of 5.3% and 8.4x respectively. We believe this is justified given AWG's leverage and potential for earnings growth.

Figure 36. AWG — Sum-of-Parts Valuation

	£mm	p/share	Comment
Regulated UK Water			
Anglian Water Services RCV	4,507	3,351	Estimated RCV as at 31 March 2006
Logging Up/(Down)	0	0	-
AMP4 Capex Clawback	(108)	(81)	Clawback of outperformance during AMP3
Capex Outperformance	17	13	*up to 5% outperformance during AMP4*
Opex Outperformance	30	23	up to 2 5% outperformance during AMP4
WACC Outperformance	146	108	Ave. nom. cost of equity = 14.1% / ave nom. cost of debt = 6 4% / ave debt/RCV = 79 7%
Financeability Uplift / OPA Incentive	37	27	0.1% OPA incentive adjustment / Financeability uplift in 08-10
Regulated UK Water Total	4,629	3,442	Equates to a 2.7% premium/(discount) to RCV as at 31 March 2006
Other Operations			
Support Services	131	97	4 9x 2006E EV/EBITDA multiple - 25% discount to UK comps e.g. McAlpine, Carillion
Project Investments	51	38	4 9x 2006E EV/EBITDA multiple - 25% discount to UK comps e.g. McAlpine, Carillion
Construction Services	17	13	4 9x 2006E EV/EBITDA multiple - 25% discount to UK comps e.g. McAlpine, Carillion
AWG Property	91	68	100% of NPV of net operating assets (assuming recoverable over 2 years)
International Services	0	0	-
Morrison Central	(40)	(30)	10x 2006E EV/EBIT multiple
Total Other Operations	250	186	-
Non-Operating Items			
Corporate Costs/Intersegment Trading	(129)	(96)	10.0x 2006E corporate costs/intersegment trading
Provisions	(58)	(43)	Book value forecast as at 31 March 2006
ACT Recoverable	48	36	100% of NPV of ACT asset (assuming recoverable after 9 years over a period of 5 years)
Total Non-Operating Items	(139)	(103)	-
Enterprise Value	4,740	3,525	-
Net Debt	(3,404)	(2,531)	Book value forecast as at 31 March 2006
Equity Value	1,336	**994**	-

Source: Citigroup Investment Research estimates

Risks

We rate AWG 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 Citigroup Investment Research quantitative research team, as a possible indicator of future stock-specific risk. With regard to AWG, risks to the achievement of our target price include:

- AWG has a highly geared structure. Although our estimates suggest that AWG has comfortable levels of headroom above its debt covenant levels, this type of structure is inherently more risky for equity investors. The thin equity slice is highly sensitive to small changes in assumptions, which means that AWG's equity valuation is considerably more volatile than for a normally geared company.
- AWG has a number of unregulated activities which contain underperforming contracts and have a history of write-downs. There is no guarantee that these contracts will improve and there is always a risk of further write-downs, although none are expected.

Figure 37. AWG — Summary Financials, 2001-2010E (£mm)

Year ending 31 March	2001	2002	2003	2004	2005	2006E	2007E	2008E	2009E	2010E
Normalised P&L										
Turnover	1,231	1,705	1,740	1,760	1,690	1,801	1,850	1,926	2,006	2,089
EBITDA	480	524	517	523	524	548	557	595	636	667
EBITA (pre-exceptionals)	313	332	326	342	346	358	361	390	421	445
Interest	(159)	(195)	(220)	(264)	(262)	(261)	(267)	(276)	(284)	(287)
EBTA (pre-exceptionals)	154	137	106	78	83	97	94	114	138	158
Current Tax	(31)	25	12	0	3	(17)	(16)	(20)	(25)	(29)
EPS - Basic	24.9p	(16.3p)	(26.4p)	(52.0p)	35.2p	41.8p	42.0p	52.4p	64.8p	75.3p
EPS - Adjusted (pre-exceptionals)	31.1p	36.1p	19.1p	41.6p	38.9p	41.8p	42.0p	52.4p	64.8p	75.3p
EPS - Adjusted (pre-exceptionals & goodwill)	31.4p	42.0p	25.0p	50.6p	47.3p	50.8p	51.3p	61.7p	74.1p	84.5p
EPS - Adjusted (pre-goodwill, exceptionals & FRS19)	40.7p	43.9p	33.6p	43.9p	58.1p	56.9p	57.3p	69.1p	83.4p	95.3p
DPS	44.0p	44.6p	46.0p	47.2p	48.7p	49.9p	51.2p	52.4p	53.8p	55.1p
Divisional P&L										
Anglian Water Services	283	305	287	319	339	341	342	367	396	416
Support Services	13	12	21	12	16	19	21	24	26	29
Project Investments	-	-	-	13	10	10	11	11	11	12
Construction Services	-	-	-	(8)	2	3	3	5	5	5
Less: Morrison Centre/Intersegment Trading	-	-	-	0	(7)	(4)	(4)	(4)	(4)	(4)
Morrison - Total	13	12	21	17	22	29	31	36	39	42
AWG Property	14	13	2	5	1	1	1	0	0	0
International Services	6	15	26	13	0	0	0	0	0	0
Head Office/Other	(3)	(11)	(9)	(11)	(16)	(12)	(12)	(12)	(13)	(13)
Less: Intersegment Trading	(1)	(2)	(2)	(1)	(1)	(1)	(1)	(1)	(1)	(1)
Group EBITA	313	332	326	342	346	358	361	390	421	445
BS & CF										
Fixed Assets	4,322	4,371	4,398	4,057	4,128	4,242	4,409	4,607	4,753	4,862
Net Assets	1,867	1,698	1,030	610	545	458	445	446	463	491
Operational Cash Flow	345	421	465	515	512	538	549	588	630	662
Free Cash Flow	(101)	(68)	(24)	31	32	5	(70)	(81)	(8)	43
Net Cash Flow	(602)	(161)	(632)	(76)	(22)	(65)	(140)	(151)	(78)	(29)
Net Debt	(2,389)	(2,612)	(3,221)	(3,191)	(3,248)	(3,404)	(3,561)	(3,728)	(3,822)	(3,867)
Regulated Business										
RCV	3,650	3,827	4,033	4,252	4,429	4,507	4,696	4,928	5,129	5,305
Net Debt	(1,571)	(1,971)	(3,289)	(3,451)	(3,499)	(3,605)	(3,772)	(3,958)	(4,078)	(4,155)
Net Debt/RCV	43.0%	51.5%	81.6%	81.2%	79.8%	80.0%	80.3%	80.3%	79.5%	78.3%
FFO/Interest	3.1x	4.5x	3.5x	10.2x	1.9x	2.0x	2.0x	2.0x	2.1x	2.1x
EBIT/Interest	2.2x	2.7x	2.5x	6.4x	1.3x	1.4x	1.3x	1.4x	1.4x	1.5x
k-factor	-10.0%	1.0%	2.2%	2.5%	2.5%	3.8%	0.0%	2.8%	2.7%	2.7%
Group Statistics										
Average Number of Shares	278.1	282.7	234.4	149.7	143.3	139.1	135.0	135.0	135.0	135.0
Average Interest Cost	6.5%	7.7%	9.7%	7.9%	7.8%	7.6%	7.5%	7.4%	7.4%	7.3%
Effective Current Tax Rate	22.2%	-29.9%	-11.7%	2.5%	-2.2%	20.0%	20.0%	20.0%	20.0%	20.0%
Dividend Cover	0.9x	1.0x	0.7x	0.9x	1.2x	1.1x	1.1x	1.3x	1.6x	1.7x
EBIT/Interest	2.0x	1.7x	1.5x	1.3x	1.3x	1.4x	1.4x	1.4x	1.5x	1.5x
Net Debt/(Net Debt + Equity)	56.1%	60.6%	75.8%	84.0%	85.6%	88.1%	88.9%	89.3%	89.2%	88.7%
ROE	6.1%	7.0%	5.8%	8.0%	14.4%	15.8%	17.1%	20.9%	24.8%	27.0%
Post-Tax ROIC	5.0%	5.3%	5.1%	5.7%	6.0%	6.2%	6.1%	6.3%	6.6%	6.8%
Valuation at 995p										
P/E	24.5x	22.7x	29.6x	22.7x	17.1x	17.5x	17.4x	14.4x	11.9x	10.4x
EV/EBITDA	7.9x	7.7x	9.0x	8.8x	8.9x	8.8x	8.9x	8.7x	8.2x	7.9x
Dividend Yield	4.4%	4.5%	4.6%	4.7%	4.9%	5.0%	5.1%	5.3%	5.4%	5.5%

Source: Company reports and Citigroup Investment Research estimates

E.ON

- **The healthy German electricity market should continue to support E.ON's share price**
- **But the real story for the next few months is likely to concern the balance sheet**
- **With higher leverage, we think E.ON's shares would look significantly cheaper...**
- **...and we suspect this will more than offset the possible value destruction that a significant acquisition might entail**
- **We maintain a Buy/ Medium Risk rating but we are raising our target price from €86 to €90 per share providing an expected total return of 18%**

Investment thesis

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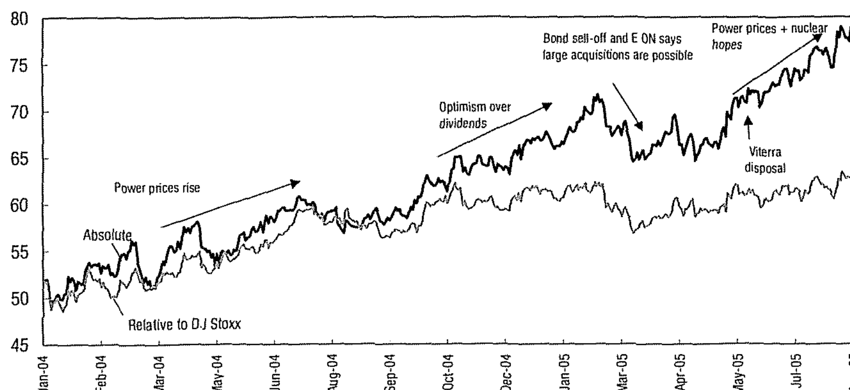
E.ON's share price has done well over the last few months, chiefly on the back of the rising electricity price in the German market and the potential for nuclear power station lives to be extended.

Figure 38. Share Price and Price Relative to DJ Stoxx



Source: Reuters and Citigroup analysis

RWE remains the better play on the German power market

Although these factors are clearly beneficial to E.ON, we have tended to view RWE as the best way to play the German electricity market because of its greater operational and financial leverage to wholesale power prices. As with RWE, our forecasts for E.ON assume a €35/MWh achieved power price in FY06, and we are now factoring in a 45-year nuclear power station life into our valuations. We also continue to assume a 30% decline in transmission and distribution prices in Germany by 2010, with no additional cost cutting. (For more on these issues see the RWE section on page 53).

The investment thesis for E.ON goes beyond the dynamics of the German electricity market, however. In particular, we think the balance sheet will be a key driver for the shares over the next few months.

E.ON's balance sheet

But E.ON has its balance sheet as a key driver for the shares

After the successful disposals of Viterra and Ruhrgas Industries, E.ON is set to end 2005 with a net cash position of some €3.2bn according to our estimates. The recent decision to set up a contractual trust arrangement to fund the bulk of its pension liability should consume €5.4bn of its excess liquidity by the end of 2006. But a much more radical step is needed to really have an impact on the balance sheet.

As we see it, E.ON has three basic (not mutually exclusive) options.

- First, E.ON could use its balance sheet to make acquisitions.
- Second, the company could gear up its balance sheet by returning value to shareholders.
- Third, E.ON may end up operating indefinitely with an inefficient balance sheet.

Acquisitions

Figure 39 summarises E.ON's current target markets, most of which are likely to see only small incremental investments in the foreseeable future of €1bn or below.

Figure 39. E.ON's Target Markets

Market	Opportunity sought	Our view
Central Europe	Invest in generation and continue to make selective acquisitions in Eastern Europe	Acquisitions and investments are likely to be relatively small
Gas	Equity gas in North Sea and Russia	Up to €2bn has been earmarked over the next three years in securing upstream gas.
	Selective acquisitions in Eastern Europe and Italy. Build infrastructure in UK and Nordic market	Acquisitions and investments are likely to be relatively small
	Enter international LNG business	Again, investments are likely to be fairly small
UK	Optimise existing position	So far this has seemed most likely to take place by incremental investments in new power stations or other assets as opportunities present themselves.
Nordic	Acquire or build new generation capacity and act as a consolidator downstream	This is proving a slow process in the Nordic market and major opportunities are not at all obvious
US	Focus is on organic growth with "long term external growth opportunities"	This has to be a possibility for a major acquisition eventually.
Russia	Potential to invest in power generation jointly with Gazprom	We doubt this will involve a major capital commitment.
Italy	Build power stations	Likely to be value-enhancing at current power prices but difficult to execute

Source: Citigroup Investment Research

Of these areas, the ones we think E.ON is currently most actively working on are the potential for E.ON to enter the LNG market and to expand the upstream equity gas position.

LNG

E.ON appears to be working hard on LNG

E.ON identified the LNG business as an area for further investment in February this year. LNG is increasingly being used to import gas to the European markets and E.ON want to develop expertise in this area to support its Pan European gas business. LNG has not so far been used in the German market, but E.ON does have permission to build a terminal at Wilhelmshaven and it is reviewing whether to reactivate this project. The company may also invest in a similar project in Croatia.

But the big leap forward in LNG for E.ON could come in the form of a stake in an existing major LNG project. For example, ExxonMobil and ConocoPhilipps have several projects on the drawing board for LNG trains in Qatar with an aggregate capacity in the region of 60bcm per year. There could be scope for E.ON to secure a position in one of these. We envisage this could involve total investment in the region of €3-5bn.

Equity gas

E.ON has a long-term goal to secure 15-20% of its gas needs from its own production and has a 52-strong team reviewing potential investments in the North Sea. In addition, it is still working to secure a position alongside BASF in the Gazprom's Yushno-Rosskoye field in Western Siberia. E.ON has said it aims to invest €2bn in equity gas by the end of 2007.

What else?

But a more major deal would be needed to really have an impact on the balance sheet

Even if these gas investments come to fruition, E.ON will clearly still have ample balance sheet firepower left. We see two main possibilities for future investment over and above the company's current stated plans.

- **ScottishPower** – we would not rule out a bid by E.ON for ScottishPower. We suspect there would be significant synergies between the two businesses, although there would be regulatory and political constraints to take into account. In terms of size, buying ScottishPower would make a serious dent on the balance sheet. The company currently has a market capitalisation of €13bn, with net debt in the region of €4bn (excluding Pacificorp).
- **US market** – with M&A activity in the US set to rise following the repeal of the Public Utilities Holding Companies Act, E.ON may decide to adopt a more aggressive stance in the US market. Currently E.ON's US strategy calls for organic growth only, but we suspect this could change in due course.

Figure 40. Combining E.ON UK with ScottishPower

		E.ON UK	SPW	Com-bined	Share of UK	Comment
Supply customers (m)	Electricity	5.9	3.4	9.3	32%	The next biggest player would be Centrica with 20%
	Gas	2.8	1.8	4.6	22%	Number 2 behind Centrica which has 56%
	Combined	8.7	5.2	13.9	28%	Number 2 behind Centrica which has 35%
Generation capacity (MW)		8,807	4,734	13,541	20%	The next biggest would be British Energy with 18%
Distribution customers (m)		4.8	3.4	8.2	28%	The next biggest player would be EDF with 27%

Source: Company reports and Citigroup Investment Research analysis

Both of these possibilities would involve substantial risks for shareholders and we have previously been sceptical about E.ON's ability to create value from such deals.

Lately, however, we have slightly softened our stance. This is for two chief reasons.

- First, as set out in this report, we think the benefits of leveraging up the balance sheet could be enough to outweigh the premium that E.ON could pay.

Bernotat would be staking his reputation

- Second, having accompanied Bernotat on E.ON's recent US roadshow, we now have a greater sense of the extent to which he feels he would be putting his own personal reputation on the line if he did go ahead with any major deal. It would be the first large acquisition E.ON has made under Bernotat's stewardship and we think he will only go ahead if he feels confident that the deal can be made to add up in the eyes of shareholders.

Special dividends

On the possible return of value, Bernotat has repeated indicated that share buy-backs are not on the agenda. E.ON has already committed, however, to paying a special dividend with the proceeds of its planned disposal of Degussa (around €3bn at current market value expected some time in 2006). Of course, this falls well short of what would be needed to make a serious dent in the balance sheet. An additional special dividend is possible in due course, but Bernotat has made clear that no such announcement will be made before March 2006.

Status quo

The worst option would be to do nothing

This leaves the third option: running with an inefficient balance sheet. In practice, this has been the default approach of E.ON since its creation in 2000. We have seen major acquisitions and share buy backs since 2000, of course, but these have not been enough to offset the rate at which E.ON has generated cash flow both from operations and from disposals. E.ON could continue to operate with a less than ideally leveraged balance sheet, however shareholder pressure on the company to resolve this issue is likely to grow.

Impact of leverage

As set out on page 15, E.ON with a leveraged balance sheet could look significantly cheaper than it does currently. On a simple P/E basis, even if E.ON makes an acquisition at a 10% premium to the sector multiple, the earnings enhancement from the deal could drag the FY06E P/E down below 10x. We suspect this would wake the stock market up to the value on offer in E.ON shares, even though such an acquisition may have been value-destructive.

Valuation and financial forecasts

Our latest sum of parts for E.ON is set out in Figure 41, while Figure 42 provides the major valuation multiples based on our current forecasts.

Figure 41. E.ON Sum of Parts

	Value (€m)	Value per share (€m)	Method	FY05E EBITDA (€m)	Reality check
Central Europe	37,826	55	Chiefly based on DCF of component parts	5,396	7.0x FV/EBITDA multiple in 2005E
Pan-European gas	9,677	14	DCF/RAB benchmarking	1,439	6.7x FV/EBITDA multiple in 2005E
UK	10,511	15	£0.3m per MW, £160 per customer and RABs	1,564	6.7x FV/EBITDA multiple in 2005E
Nordic	8,859	13	Assumed EBITDA multiple	1,181	7.5x FV/EBITDA multiple in 2005E
US-Midwest	4,024	6	Assumed EBITDA multiple	536	7.5x FV/EBITDA multiple in 2005E
Corporate centre	-1,153	-2	Assumed EBITDA multiple	-165	7.0x FV/EBITDA multiple in 2005E
Total core businesses (ex associates)	**69,744**	**101**		**9,952**	**7.0x FV/EBITDA multiple in 2005E**
Financial assets	17,511	25	Estimated book value at 31/12/05	682	
Total	**87,255**	**126**		**10,634**	**8.2x FV/EBITDA multiple in 2005E**
Net cash	3,171	5	Forecast book value at 31/12/05		
Pension liabilities	-8,037	-12	Forecast book value at 31/12/05		
Nuclear liabilities	-8,184	-12	Based on Citigroup Investment Research model - current book value is €12.3bn		
Other liabilities	-5,844	-8	Based on Citigroup Investment Research model - current book value is €13.0bn		
Minorities	-4,197	-6	Forecast book value at 31/12/05		
Net equity value	**64,164**	**93**			

Source: Citigroup Investment Research

Our SoP estimate now stands at €93 per share, having risen modestly in the wake of the 1H05E results. We have raised our target price from €86 to €90 in view of our growing optimism that if E.ON does opt to make a major acquisition, this will not prove strongly value-destructive. The main valuation ratios suggest that E.ON would trade between €83 and €95 at a sector average rating in terms of FY06E EV/EBITDA or P/E.

Sector average FY06E P/E and EV/EBITDA multiples suggest €88-95 per share for E.ON

Figure 42. Valuation Multiples

	FY05E	FY06E	FY07E
PE (pre-exceptional, pre-goodwill)			
E.ON	13.1	11.3	11.2
Sector average	14.5	12.8	12.0
E.ON share price at sector average	**86**	**89**	**84**
EV/EBITDA (adjusted)			
E.ON	7.3	6.8	6.6
Sector average	7.6	7.1	6.7
E.ON share price at sector average	**82**	**83**	**79**
EV/EBITDA (adjusted, pre associates)			
E.ON	6.0	5.5	5.3
Sector average	7.1	6.6	6.2
E.ON share price at sector average	**94**	**95**	**93**
Dividend yield			
E.ON	3.5%	4.1%	4.9%
Sector average	3.6%	5.1%	5.9%
E.ON share price at sector average	**64**	**72**	**77**

Source: Citigroup Investment Research

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 Citigroup Investment Research 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 P&L 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.

Figure 43 . Breakdown of Adjusted EBIT (€m)

	2003A	2004A	2005E	2006E	2007E	2008E	2009E	2010E
Central Europe	2,979	3,602	4,194	4,440	4,514	4,569	4,632	4,704
Pan-European Gas	1,463	1,428	1,403	1,539	1,447	1,332	1,219	1,201
UK	610	1,017	1,028	1,060	1,093	1,125	1,157	1,190
Nordic	546	701	716	849	959	1,076	1,199	1,330
US-Midwest	317	349	374	374	381	388	396	403
Corporate centre/consolidation	-319	-314	-248	-148	-148	-148	-148	-148
Core businesses	**5,596**	**6,783**	**7,467**	**8,114**	**8,246**	**8,342**	**8,455**	**8,679**
Viterra	456	471	0	0	0	0	0	0
Degussa	176	107	107	107	107	107	107	107
Total continuing operations	**6,228**	**7,361**	**7,574**	**8,221**	**8,353**	**8,449**	**8,562**	**8,786**

Source: Company accounts and Citigroup Investment Research estimates

Figure 44. Key Financial Figures

	2003 A	2004 A	2005 F	2006 F	2007 F	2008 F	2009 F	2010 F
EPS from ongoing operations (€)	6.04	6.62	6.96	6.91	6.99	7.08	7.13	7.30
EPS from discontinued operations/other (€)	1.07	-0.01	4.82	0.00	0.00	0.00	0.00	0.00
Total reported group EPS (€)	7.11	6.61	11.78	6.91	6.99	7.08	7.13	7.30
Adjusted EPS (€)	4.24	5.52	5.96	6.91	6.99	7.08	7.13	7.30
DPS (€)	2.00	2.35	2.76	3.24	3.81	3.93	4.04	4.17
Cashflow/share (€)	9.6	9.8	10.7	11.4	11.7	11.9	12.1	12.4
Free cash flow (€m)	2,878	3,260	3,188	3,604	3,438	3,627	3,786	4,019
Net cash (debt) (E.ON definition) (€m)	-7,855	-5,483	3,171	4,479	5,278	5,867	6,514	7,288
Gearing	26%	17%	-5%	-8%	-9%	-10%	-11%	-12%
Payout ratio based on clean earnings	47%	43%	46%	47%	55%	55%	57%	57%
EBITDA/net interest expense	8.5	9.2	26.7	33.1	36.4	38.3	40.7	44.9

Source: Company accounts and Citigroup Investment Research estimates

Figure 45 . Group Financial Forecasts (€m)

Profit and Loss	2003 A	2004 A	2005 F	2006 F	2007 F	2008 F	2009 F	2010 F
Sales	42,541	44,745	49,427	48,481	48,128	48,363	48,618	48,987
Operating costs	33,991	34,922	39,475	37,823	37,283	37,370	37,464	37,563
Adjusted EBITDA before associates	8,550	9,823	9,952	10,658	10,845	10,993	11,154	11,423
Adjusted EBITDA including associates	9,458	10,520	10,634	11,335	11,517	11,660	11,816	12,079
Depreciation	-3,230	-3,159	-3,060	-2,938	-3,010	-3,079	-3,146	-3,200
Adjusted EBIT	6,228	7,361	7,574	8,397	8,508	8,581	8,669	8,879
of which associates & income from investments	908	697	682	677	672	667	662	656
Adjusted interest income	-1,663	-1,140	-871	-784	-771	-773	-772	-764
Net book gains	1,257	589	188	0	0	0	0	0
Restructuring costs and non-operating earnings	-479	-108	-13	0	0	0	0	0
Other non-operating earnings	195	97	741	0	0	0	0	0
Pre-tax profit	5,538	6,799	7,619	7,613	7,736	7,809	7,898	8,115
Tax	-1,124	-1,947	-2,502	-2,502	-2,544	-2,527	-2,557	-2,628
Minorities	-464	-504	-529	-556	-583	-613	-643	-675
Discontinued items/other	697	-9	3,175	0	0	0	0	0
Net attributable profit	4,647	4,339	7,762	4,555	4,609	4,669	4,698	4,812
Adjusted net attributable profit	2,772	3,621	3,926	4,555	4,609	4,669	4,698	4,812

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

Cash flow	2003 A	2004 A	2005 F	2006 F	2007 F	2008 F	2009 F	2010 F
Gross cash flow	5,538	5,972	6,738	7,404	7,588	7,777	7,936	8,169
Capex	-2,660	-2,712	-3,550	-3,800	-4,150	-4,150	-4,150	-4,150
Acquisitions	-6,536	-2,958	-1,451	0	0	0	0	0
Disposal proceeds	7,463	1,825	8,752	0	0	0	0	0
Dividends	-1,621	-1,598	-1,835	-2,296	-2,639	-3,038	-3,140	-3,245
Issue/(redemption) of group equity	-7	0	0	0	0	0	0	0
Other/change in scope of consolidation	2,966	1,990	0	0	0	0	0	0
Change in net debt	5,143	2,519	8,654	1,308	799	589	647	775

Balance Sheet	2003 A	2004 A	2005 F	2006 F	2007 F	2008 F	2009 F	2010 F
Intangible assets	4,153	3,788	3,440	3,125	2,838	2,578	2,341	2,127
Property plant and equipment	42,797	43,563	40,526	41,704	43,132	44,963	46,203	47,867
Financial assets	17,725	17,263	18,345	18,684	19,020	19,353	19,684	20,012
Stocks	2,477	2,647	2,687	2,727	2,768	2,809	2,852	2,894
Receivables	18,025	18,436	18,567	18,700	18,836	18,975	19,116	19,260
Cash and equivalents	10,795	12,016	5,000	5,000	5,444	6,033	6,680	7,454
Other assets	1,923	1,895	1,895	1,895	1,895	1,895	1,895	1,895
Total assets	97,895	99,608	90,460	91,835	93,932	96,606	98,770	101,510
Debt	-19,631	-18,333	-2,663	-1,355	-1,000	-1,000	-1,000	-1,000
Provisions	-34,328	-34,242	-33,829	-34,622	-35,445	-36,297	-37,181	-38,097
Trade creditors	-3,778	-3,662	-3,735	-3,810	-3,886	-3,964	-4,043	-4,124
Other liabilities	-13,449	-13,516	-13,477	-13,320	-13,219	-12,821	-12,426	-12,035
Minorities	-4,625	-4,144	-4,197	-4,252	-4,311	-4,372	-4,436	-4,504
Shareholders Funds	29,774	33,560	40,407	42,324	43,921	46,001	47,533	49,599

Source: Company accounts and Citigroup Investment Research estimates

ENEL

- **Since the start of the year ENEL underperformed the rest of the sector quite substantially**
- **A large placement in July and lack of newsflow after the sale of WIND are the reasons in our view**
- **But presentation of 1H results is likely to revive investors' interests – we expect more clarity in dividends and guidance for future growth of earnings...**
- **... and possibly more clarity on acquisitions – acquisitions remain a risk with ENEL but perhaps risks are overstated**
- **Solidity of the core business and attractive dividend yield underpin our Buy / Medium Risk (1M) rating on the stock and the target price €7.8 per share**

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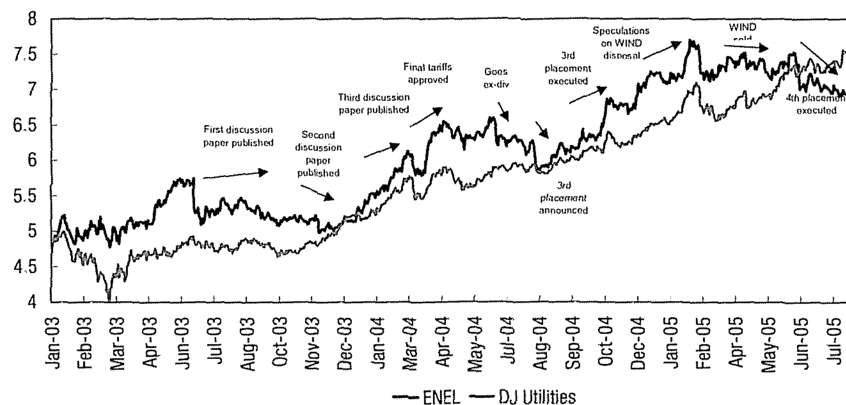
Investment thesis

Since the start of this year, ENEL clearly underperformed the sector, falling by c3% vs the sector that rose by 15%. However, ENEL share price started to rose during the last week of August as investors refocused on the stock and the possible news that could be released at the 1H results presentation to be held on September 8th.

A poor performer in 2005 so far

Figure 46. ENEL's share price, 1 Jan 2003 – 1 Sept 2005



Source: Datastream, Citigroup Investment Research analysis

Bond yields not a major factor for the share price

Unlike most of the utilities within the sector, bond yields didn't play a major role in determining ENEL's share price in our view, whilst stock specific events were probably more important.

It should be borne in mind that ENEL was one of the best performing stocks in 2004, within a sector that outperformed the equity market by c14%. However, performance so far in 2005 has been poor perhaps chiefly as a result of the placement of 10% of ENEL's outstanding shares by the government in July, i.e. after a similar large placement that took place in October 2004.

Repeated stock placings sent the shares lower

ENEL's share price peaked at around €7.5 per share in May when the sale of WIND was announced at a declared price of c€12.0 billion, towards the top of the range of consensus estimates. However, the placement in July and the fact that ENEL failed to communicate promptly its new dividend policy (as largely expected) after the WIND's deal meant the share price drifted downward until it reached €6.9 towards the end of August.

1H05 results – what catalysts?

We don't think the 1H05 figures by themselves will provide much of a catalyst for ENEL's share price. However, we suspect the shares could be driven higher by ENEL providing more clarity on acquisitions, by the announcement of the new dividend policy, and by renewed guidance for ENEL's earnings going forward.

Acquisitions – a threat or a foe?

Conti has yet to set out his store

Former CFO Fulvio Conti took the helm at ENEL in July after the departure of Paolo Scaroni to ENI. We think the market is now eager to know in what direction ENEL will go. Over the past five years ENEL was forced to sell core assets to pave the way for the liberalisation of the electricity market in Italy. It also sold non-core assets to focus on its core business of gas and electricity. As the stream of disposals is drying up, investors wonder what is going to be the source of earnings growth in the future.

As ENEL's balance sheet appears undergeared, one of the most relevant concerns investors have relates to acquisitions. We acknowledge that this risk exists and in fact we set our target price of €7.8 per share at a discount to our SoP to account for possible value destruction. But it is also possible the market is exaggerating this risk. Here is why.

ENEL is targeting acquisitions in Eastern Europe, possibly including Russia, where local governments are privatising the local utilities. France is also a market of interest and ENEL could build a new nuclear reactor together with EdF or buy some distribution assets there. At the presentation we doubt ENEL will give a lot more clarity on this issue and investors will have to learn to live with some uncertainty.

The important thing to bear in mind though is that, although acquisitions are a risk, ENEL's track record is not that bad and the acquisitions done so far have performed fairly well in terms of profits and the prices paid were not ludicrously high. On top of this we should also bear in mind that the average size of the assets up for sale in Europe is not very big relative to ENEL's market cap so that announcements of further acquisitions may have an impact on momentum but are unlikely to have a material impact on the numbers.

That acquisitions should not have a strong impact, either positive or negative, is supported by the analysis we have shown earlier in this report. In fact, if acquisitions are likely to be small in the context of ENEL's market cap thus limiting the negative impact, we also expect the potential upside from the releveraging of the balance sheet to be smaller than in the cases of EON or RWE for example.

More clarity on dividends

Our dividend forecast could be too low

We expect the 1H results presentation to finally bring more clarity on the dividend policy. The recent disposal of WIND allowed ENEL to cash in €3.0 billion and deconsolidate c€7.0 billion of debt so that today ENEL with a gearing of just 22% has room to raise its dividend. At present we forecast a dividend of €0.37 per share for the next four years but we think ENEL could distribute up to €0.45 thanks to the proceeds from the sale of WIND and/or with the adoption of a more aggressive pay our ratio, the latter being 70% at present. The way we calculate €0.45 is by simply taking our current forecast for the dividend and add on top of it the cash inflow from the sale of WIND (€3.0 billion) spread over five years. With a dividend of €0.45 per share ENEL's dividend yield would stand at 6.3%, one of the most attractive within the sector.

Another issue of course, is what is the sustainable long-run dividend yield once the proceeds of WIND are entirely distributed. But we think ENEL should have the ability of distributing an attractive dividend all the same. Investors should bear in mind that ENEL's new CEO Fulvio Conti, is the one who opted for a 100% pay out policy as chairman of Terna and were he to do the same at ENEL, net profits alone should guarantee a dividend of €0.43-€0.44 per share over the period 2006-2009E according to our forecasts, with no need therefore to tap on WIND's proceeds. In other words, we think ENEL's investors should expect the ongoing dividend yield to stay at an attractive 6% over the coming years.

Since the start of the year, ENEL clearly didn't benefit from the constant fall in bond yields. As mentioned, despite the disposal of WIND, it is possible the placement by the government had a prominent role in explaining ENEL's performance although we would point out the lack of a clear dividend policy as another element that weighed on the stock. As we expect ENEL to clarify this issue, it is possible its share price could reflect the current benign bond yield environment, admittedly with some delay compared to the rest of the sector.

Providing the market with a better guidance

Over the past year and a half ENEL has so far failed to communicate a clear set of targets to the market, both in terms of cost cutting and EBITDA growth. Actually, as to the latter, ENEL gave up commenting on expected growth but promised to come back to the market with clearer guidance once WIND was sold, which happened back in May this year.

The market needs help with the numbers

So ENEL could now provide us with this guidance, which would help the market to make a more informed judgement as to the future profitability of this company. Alternatively, ENEL could leave this subject until March 2006 when FY results will be announced. Our forecasts assume a compound annual growth rate for EBITDA over the period 2005-2009E for ENEL to be at 2.9% (see Figure 47 where for 2005E we have stripped out exceptional components and the businesses that will be deconsolidated, mainly WIND and Terna).

Figure 47. EBITDA evolution (Euro millions)

	2005E	2006E	2007E	2008E	2009E	CAGR
EBITDA	7,079	7,398	7,538	7,693	7,931	
Growth	n/a	4.5%	1.9%	2.1%	3.1%	2.9%

Source: Citigroup Investment Research estimates

ENEL may also give some broad indication as to what the management expects in terms of performance for the divisions although we would not expect ENEL to give a full breakdown.

Valuation

In Figure 48 we summarise ENEL's trading multiples vs the sector whereas our sum of the parts valuation is in Figure 49.

Dividend yield provides the key support

Figure 48. Trading multiples

	2005E	2006E	2007E
EV/EBITDA			
@ current price	6.3x	7.4x	7.2x
@ target price	7.1x	8.3x	8.1x
Sector average	7.5x	7.0x	6.7x
Dividend yield			
@ current price	7.5%	5.2%	5.2%
@ target price	6.9%	4.8%	4.8%
Sector average	4.4%	4.6%	5.0%
Adj. Price / earnings			
@ current price	16.1x	16.6x	16.5x
@ target price	17.4x	17.9x	17.9x
Sector average	14.4x	12.7x	11.9x
Free cash flow yield			
@ current price	3.3%	3.3%	6.0%
@ target price	3.1%	3.1%	5.6%
Sector average	3.8%	4.9%	6.2%

Source: Citigroup Investment Research estimates

In terms of trading multiples, ENEL appears to be trading somewhat at a premium to the rest of the sector. Part of the reason for this is that we value generation with a DCF model which implies a premium in terms of EV/EBITDA. For example, we value ENEL Produzione (domestic generation, 40% of our fair enterprise value) at 9.2x EV/EBITDA, or €571 per kW, although we think that such a premium is justified given ENEL's market power in the Italian electricity wholesale market that should allow it to keep power prices at c8% premium to the new entrant level in the long-run. This for example compares with 10.7x EV/EBITDA 2005E that our DCF valuation for RWE's generation assets equates to, or 10.6x for those of Fortum.

Also, as mentioned earlier in this report, our numbers still reflect the old Citigroup's oil scenario that allows for long-term oil prices to reach $32 per barrel in the long run. For a more detailed discussion on the upside on our earnings using the new oil price scenario, see the discussion on page 23 in this report.

But it is on the dividend yield side where ENEL seems more attractive and, we argue, the potential upside has not been reflected yet in full in the share price. As mentioned earlier, at present ENEL offers a dividend yield higher than the rest of the sector (5.2% in 2006E) although we think a more generous policy could bring this to at least 6% if ENEL distributes the proceeds from the disposal of WIND and/or adopts a more generous pay out ratio. We believe a dividend yield in excess of 6% supports our target price of €7.8 per share and our rating Buy / Medium Risk (1M).

SoP now at €7.8 per share

Figure 49. Sum of the parts valuation

	Euro m	Euro per share	Comment
Generation & Energy Management	28,913	4 7	DCF for ENEL Produzione – 9 5x EV/EBITDA 05E
Network & Sales	27,258	4 5	RAB based DCF - 7 9x EV/EBITDA 05E
Telecoms	2,000	0 3	Agreed price
Services	1,239	0 2	valuation with multiples and book value for real estate
Enel S p A (Import Contracts)	23	0 0	DCF of existing contracts
Terna	215	0 0	Market value - E2 15 per share
Stranded Costs	899	0 1	NPV of expected reimbursement over three years
TOT FIRM VALUE	60,546	9 9	
ENEL's Consolidated Net Debt (end 2005E)	(11,158)	(1 8)	Expected book value at the end of '05
Pension provisions (TFR)	(1,024)	(0 2)	Expected book value at the end of '05
Reinvestment Risk	(750)	(0 1)	Assuming E5bn spent in acquisitions and 15% value destruction
ENEL' Equity Value	47,613	7.8	

Source: Citigroup Investment Research estimates

Risks

We rate ENEL Medium Risk. The risk rating on the stock is derived after the 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 Citigroup Investment Research quantitative research team.

With regards to ENEL we would highlight in particular regulatory risk and further speculation of imminent acquisitions could increase stock price volatility, in our view. Finally, ENEL has a strong presence in the market for generation of electricity for which prices are expected to fall in the future although the magnitude of such decline is not known as we write. Were power prices to fall faster and deeper than we expect, this could hit the profitability of the company. Among the risks highlighted above, we see the risks of acquisitions as the most immediate threat to ENEL's performance. As these could possibly be executed over the next few months, it could potentially prevent ENEL's share price from reaching our target price.

Figure 50. Profit and loss – balance sheet (Euro millions)

	2001A	2002A	2003A	2004A	2005E	2006E	2007E
PROFIT AND LOSS							
Revenues	29,796	31,219	31,317	36,489	28,661	24,564	24,482
EBITDA	8,522	7,859	9,841	11,010	8,482	7,398	7,538
Depr, Amort, Prov	(5,044)	(4,979)	(5,139)	(4,689)	(3,255)	(2,556)	(2,674)
EBIT	3,478	2,880	4,702	6,321	5,227	4,841	4,864
Financial charges & Writedowns	(1,195)	(1,237)	(1,130)	(1,142)	(800)	(543)	(554)
Extraordinaries	2,318	736	(136)	(818)	900	0	0
PBT	4,601	2,379	3,436	4,361	5,327	4,298	4,310
Taxes	(649)	(608)	(966)	(1,533)	(1,712)	(1,658)	(1,663)
Minorities	274	237	82	(126)	0	0	0
Net Profit	4,226	2,008	2,552	2,702	3,615	2,640	2,647
BALANCE SHEET							
Long term assets	50,316	51,162	51,260	48,524	34,901	36,179	36,770
Current Assets	13,789	16,775	18,576	20,870	16,486	13,675	13,273
TOT ASSETS	64,105	67,937	69,836	69,394	51,388	49,854	50,043
S/holder funds	21,109	20,842	21,315	20,978	20,165	20,542	20,918
Long term liabilities	5,513	6,282	5,758	6,027	5,473	4,989	4,505
Current liabilities	13,748	14,737	15,605	15,187	14,591	12,358	13,026
Gross debt	23,735	26,076	27,161	27,202	11,159	11,966	11,594
TOT LIABILITIES	64,105	67,937	69,839	69,394	51,388	49,854	50,043

Source: Citigroup Investment Research estimates

Figure 51. Cash flow statement

	2001A	2002A	2003A	2004A	2005E	2006E	2007E
Net Profit	4,226	2,008	2,479	2,702	3,615	2,640	2,647
Depr. Amort.	4,445	4,475	4,546	4,177	2,955	2,256	2,374
Capex	(3,095)	(6,120)	(4,715)	(3,834)	(3,024)	(3,607)	(3,017)
Disposals	666	(92)	0	3,530	15,065	0	0
Change in L.t. liabilities	(533)	769	(524)	269	(554)	(484)	(484)
Change in Current Assets	(5,842)	(3,158)	(438)	(2,463)	1,567	2,811	402
Change in Current Liabilities	2,109	989	868	(418)	(596)	(2,233)	668
Dividends	(1,578)	(2,183)	(2,209)	(4,183)	(3,296)	(2,264)	(2,270)
Opening Net Debt	(21,634)	(21,940)	(24,453)	(24,172)	(24,385)	(11,159)	(11,966)
Variation	(306)	(2,513)	78	(213)	13,227	(807)	371
Closing Net Debt	(21,940)	(24,453)	(24,375)	(24,385)	(11,158)	(11,966)	(11,594)

Source: Citigroup Investment Research estimates

International Power

- IPR can look forward to sharply improved earnings
- The key US market is showing clear signs of recovery
- The UK and rest of the world are also improving steadily
- Risks do remain – could US spark spreads retreat again? Could one of the recently acquired IPP projects get into difficulty?
- We maintain a Buy/ Medium Risk rating and a 250p price target

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Investment Thesis

We rate IPR Buy/ Medium Risk (1M) with a 250p price target. The fundamental investment case for IPR is that its profits will rise strongly as the power markets in the US and the UK recover from depressed levels seen over the last few years. This recovery appears to be underway and should feed through into strong earnings growth in the 2005-07 period. Particularly in the US, IPR is highly leveraged to improving spark spreads, which drive margins and also allow for higher load factors. Following some plant closures, consolidation of ownership, and sustained load growth, the crucial Texas generation market appears to have moved from over-supply.

Earnings guidance upgraded to 12.0-13.0p/share

In August IPR raised and tightened its earnings guidance for 2005 from 11.0p-12.5p to 12.0p-13.0p. This reflects a combination of strong performance in 1H05, a lower tax rate of 31%, a five-month contribution from Saltend and the fact that IPR is highly contracted for FY05 in its US (75% of output is hedged) and UK (over 80% of output hedged) merchant markets. We continue to believe that 13.1p is achievable for FY05.

Outlook for US spark spreads looks brighter

The earnings momentum within IPR's US merchant markets is gathering pace. Spark spreads on the forward curve for the summer months of 2006 have risen sharply over the last 3-4 months. For example, the summer spread in Texas has jumped from around US$19/MWh to US$34/MWh. Average annual spreads on the curve for 2006 in Texas have risen from US$11/MWh to US$16/MWh. Importantly, load factors also seem to be on the rise: IPR are now forecasting an FY05 load factor of 45% in Texas (versus 35% previously) and 35% in New England (versus 25% recently). Our analysis shows that, at an average spark spread of US$15/MWh, each 10% increase in load factor from the US merchant fleet adds 1.2p/share to EPS.

Valuation

In our view, a 250p share price is justifiable based on the earnings momentum within the business and the improved underlying fundamentals.

1 **DCF Valuation.** We have increased our DCF valuation to 246p from 208p take account of the following changes:

- Our more generous forecasts for average captured spark spreads and load factors in Texas and New England.
- A stronger US$ exchange rate (US$1.75 versus US$1.90 previously).
- Stronger FY05 cash flow that we previously forecast, including the benefit of £68m of TXU compensation payments received so far this year.
- An increased valuation for the EME assets to reflect especially strong performance at First Hydro, EcoElectrica and Paiton.

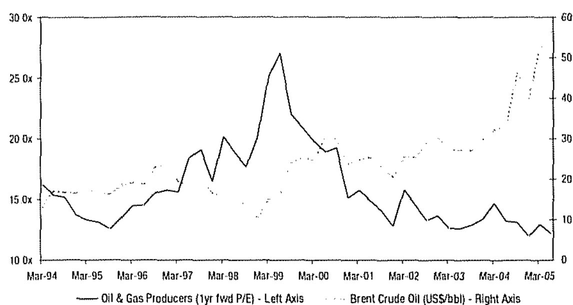
Figure 52. IPR — Summary Sum-of-Parts Valuation

	£mm	p/share
Equity Value		
US Merchant inc. Tax losses	1,016	68
UK Merchant	466	31
Australia Merchant	573	39
Other Consolidated Plant	369	25
Mitsui JV	249	17
Unlisted JV & Associates	287	19
Listed JV & Associates	418	28
Development	107	7
Net Cash - Exc. Debt Held Above	172	12
Equity Value	3,657	**246**

Source: Citigroup Investment Research estimates

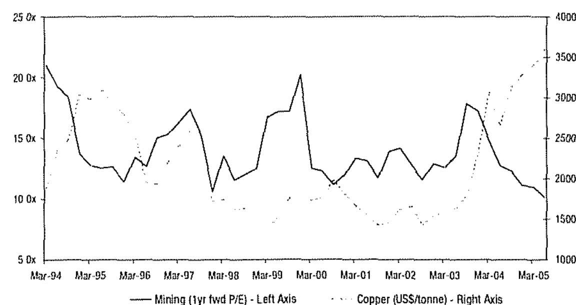
2 **P/E Analysis.** Reading across from other commodity sectors (see Figure 53 and Figure 54), an appropriate bottom-of-cycle P/E multiple for IPR would be in the 18-20x range, an appropriate mid-cycle multiple would be in the 14-16x range, while an appropriate top-of-cycle P/E would be in the 10-12x range. At our 250p target, IPR would be trading at 19.7x FY05E EPS, which is within the range of appropriate bottom-of-cycle multiples. If the earnings recovery comes through, as we expect, over the next 2-3 years, a 250p valuation would equate to 11.7x FY07 earnings — again consistent with the range of top-of-cycle multiples. It is worth pointing out that the US merchant generators are currently trading at a much higher P/E multiples, for example, NRG is trading at25.8x FY05E EPS, while Reliant is trading at 62.3xFY05E EPS.

Figure 53. Oil Producers — P/E vs. Commodity, Mar 94-Jun 05



Source: Datastream

Figure 54. Mining — P/E vs. Commodity, Mar 94-Jun 05



Source: Datastream

Risks

We rate IPR as 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 Citigroup quantitative research team, as a possible indicator of future stock-specific risk. These risks, as well as the company specific risks we detail below, may prevent the share price from reaching our target: IPR's recent US$5bn acquisition of power plants in several countries carries risks that returns will not match company expectations. IPR's overall risk may have increased following this acquisition as IPR paid a full price for several PPA contracts, which may be abrogated. Should this happen, IPR will be left with a stranded investment. IPR still faces many serious challenges, especially in the US, where the recent improvements in spreads could be undermined by rising gas prices. However, the business has established a degree of stability that was not in evidence in FY04.

Financial Forecasts

Figure 55. IPR — Income Statement, 2002-2008E (Pounds in Millions)

	2002	2003	2004	2005E	2006E	2007E	2008E
Total Revenue	717	852	768	1,824	2,270	2,401	2,514
Cost of Sales	(558)	(729)	(583)	(1,401)	(1,745)	(1,804)	(1,870)
Operating Costs (exc Depreciation & Amortisation)	161	111	10	62	66	66	63
JV & Associate Operating Profit	149	127	177	319	343	372	390
Income from Investments	31	33	0	0	0	0	0
EBITDA	**500**	**394**	**372**	**804**	**933**	**1,035**	**1,097**
Depreciation	(111)	(109)	(85)	(128)	(133)	(135)	(133)
Amortisation	(1)	0	0	0	0	0	0
Exceptional Items	(61)	(342)	15	0	0	0	0
EBIT	327	(57)	302	676	800	900	964
EBIT (Pre-Exceptionals)	**388**	**285**	**287**	**676**	**800**	**900**	**964**
Net Interest	(132)	(111)	(123)	(319)	(345)	(336)	(322)
Exceptional Items	0	(16)	(31)	0	0	0	0
PBT	195	(184)	148	357	455	564	642
PBT (Pre-Exceptionals)	**256**	**174**	**164**	**357**	**455**	**564**	**642**
Tax	(77)	(54)	(47)	(111)	(146)	(186)	(212)
Exceptional Items	1	26	2	0	0	0	0
PAT	119	(212)	103	246	309	378	430
PAT (Pre-Exceptionals)	**179**	**120**	**117**	**246**	**309**	**378**	**430**
Minority Interest	(6)	(7)	(9)	(52)	(53)	(53)	(54)
PAT and Minorities	113	(219)	94	194	257	324	376
PAT and Minorities (Pre-Exceptionals)	**173**	**113**	**108**	**194**	**257**	**324**	**376**
Dividends	0	0	(37)	(58)	(90)	(130)	(150)
Retained Earnings	113	(219)	57	136	167	195	226
Basic EPS	9 0p	(17 6p)	7.2p	13 1p	17.4p	21.9p	25.4p
Adjusted EPS	**13.9p**	**9.1p**	**8.3p**	**13.1p**	**17.4p**	**21.9p**	**25.4p**
Diluted EPS	9.0p	(17.6p)	7 1p	13 1p	17 4p	21 9p	25 4p
Adjusted Diluted EPS	13 9p	9 2p	8.2p	13 1p	17.4p	21.9p	25.4p
DPS	-	-	2.5p	3.9p	6.1p	8.8p	10.2p

Source: Company reports and Citigroup Investment Research estimates

Figure 56. IPR — Divisional EBIT, 2002-2008E (Pounds in Millions)

	2002	2003	2004	2005E	2006E	2007E	2008E
North America	99	2	(13)	10	40	58	101
Europe	100	103	113	203	250	279	275
Middle East	9	23	29	37	64	98	111
Australia	101	101	104	93	97	101	105
Asia	108	84	87	99	110	121	124
Mitsui JV	0	0	0	268	273	279	284
Corporate costs	(29)	(28)	(33)	(34)	(35)	(36)	(36)
Group EBIT (Pre-Exceptionals)	**388**	**285**	**287**	**676**	**800**	**900**	**964**

Source: Company reports and Citigroup Investment Research estimates

Figure 57. IPR — Balance Sheet, 2002-2008E (Pounds in Millions)

	2002	2003	2004	2005E	2006E	2007E	2008E
Fixed Assets	2,981	2,587	4,907	5,224	5,381	5,447	5,579
Current Assets	1,031	968	1,514	1,407	1,520	1,789	2,019
Current Liabilities	(1,405)	(846)	(571)	(594)	(644)	(707)	(763)
Long-Term Liabilities	(583)	(909)	(3,384)	(3,383)	(3,383)	(3,407)	(3,434)
Provisions	(255)	(238)	(404)	(404)	(404)	(404)	(404)
Net Assets	**1,769**	**1,562**	**2,062**	**2,250**	**2,470**	**2,718**	**2,997**
Shareholder's Funds	1,740	1,523	1,825	1,961	2,128	2,322	2,548
Minority Interest	29	39	237	289	342	395	449
Equity	**1,769**	**1,562**	**2,062**	**2,250**	**2,470**	**2,718**	**2,997**
Net Debt	(812)	(692)	(2,739)	(3,164)	(3,011)	(2,742)	(2,512)

Source: Company reports and Citigroup Investment Research estimates

Figure 58. IPR — Cash Flow, 2002-2008E (Pounds in Millions)

	2002	2003	2004	2005E	2006E	2007E	2008E
Group operating profit	105	(279)	121	357	457	528	573
Add back:							
Depreciation	111	109	85	128	133	135	133
Amortisation of goodwill	1	0	0	0	0	0	0
(Profit)/loss on sale of fixed assets	0	0	(11)	0	0	0	0
Other non-cash movements	103	404	0	0	0	0	0
Movement in other provisions	3	(7)	0	0	0	0	0
(Increase)/decrease in stocks	(29)	(5)	3	0	0	0	0
(Increase)/decrease in debtors	19	(25)	0	59	19	0	0
Increase/(decrease) in creditors	(37)	(13)	0	0	0	0	0
Cash Flow from Operations	**276**	**184**	**198**	**544**	**609**	**663**	**707**
Dividends received from joint ventures	157	101	69	127	137	149	156
Returns on Investment & Servicing of Finance	(113)	(88)	(135)	(210)	(224)	(205)	(183)
Tax	(20)	(14)	(20)	(89)	(116)	(149)	(169)
Free Cash Flow	**300**	**183**	**112**	**373**	**406**	**458**	**510**
Capital Expenditure	(159)	(63)	(273)	(282)	(183)	(85)	(143)
Acquisitions & Disposals	(144)	24	(1,126)	(61)	0	0	0
Equity Dividends Paid	0	0	0	(57)	(69)	(104)	(137)
Cash Flow Before Financing	**(3)**	**144**	**(1,287)**	**(27)**	**153**	**269**	**230**
Management of Liquid Resources	0	(20)	(32)	21	21	0	0
Financing	210	(247)	782	(21)	(21)	0	0
Share Buy Back	0	(13)	286	0	0	0	0
Net Change in Cash	**207**	**(136)**	**(251)**	**(27)**	**153**	**269**	**230**

Source: Company reports and Citigroup Investment Research estimates

RWE

- RWE has performed well but we think the main valuation multiples are still compelling
- We think consensus EPS and DPS estimates are still too low...
- ...and we look to the high earnings growth we are forecasting on the back of rising power prices to drive the share price yet higher
- We do not anticipate any major new strategic developments
- We maintain a Buy/ Medium Risk rating and a €65 target price

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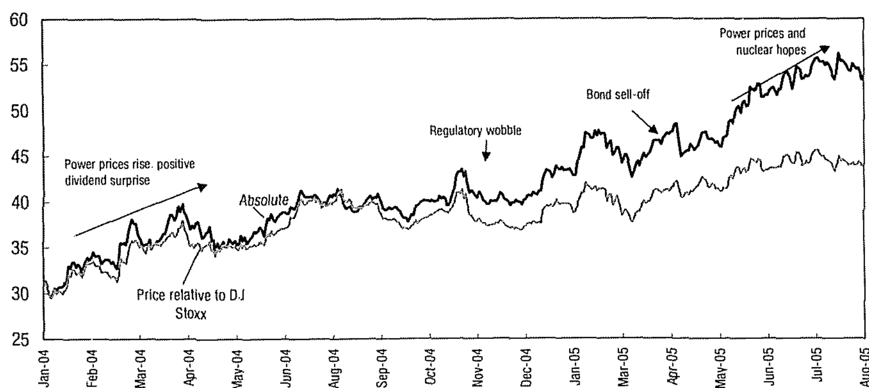
Investment thesis

RWE has been the fourth best performing utility stock under our coverage year-to-date, outperforming its rival E.ON by 16%. The main reason for this outperformance is simply RWE's operational and financial leverage into the German wholesale power price. Each additional €1/MWh on the achieved power price boosts our FY06E EPS estimate by 3.5% (compared with 2.0% for E.ON).

Figure 59. Share Price and Price Relative to DJ Stoxx



Source: Reuters and Citigroup Investment Research analysis

As set out above (see page 22), we base our financial forecasts on an achieved power price assumption of €35/MWh in 2006 and €37/MWh in 2007. We are some €4/MWh below the current forward curve for FY07E, but this is because we suspect forward prices may soften over the next few months. Even so, our forecasts suggest RWE is set to deliver very strong earnings growth over the next couple of years.

Politics and regulation

Aside from wholesale power price developments, the forthcoming newsflow is likely to be concerned chiefly with regulatory and political developments in the German market.

Federal election due 18 September

The forthcoming election on September 18th is likely to see the CDU emerge as the dominant partner in any new governing coalition. As a result, it is highly likely that nuclear power station lives will be extended beyond the 32-year average under the current agreement with the SPD-Green coalition. Our valuations already take into account the benefit of an extension up to 45 years (worth €3.9 per E.ON share and €4.2 for RWE share).

However, we do not take into account any quid pro quo that the CDU may extract in return. As set out in Figure 60 (taken from a recent report on the German utilities[6]), we think it is unlikely that we will see any direct intervention in the electricity market. However, we do think there is a danger of some form of new taxation levied on the utilities, which could recoup part of the benefit of extended nuclear plant lives.

Figure 60. Possible Political Threats to the German Utilities

Issue	Possible mechanism	Comment	Verdict
Achieve lower electricity prices			
	Force generators to enter into power sales agreements at prices below the current forward curve.	There is no legal mechanism that would enable the government to do this and we doubt the utilities would enter into such agreements voluntarily	Very unlikely
	Introduce a cap to wholesale power prices	There is a precedent in the UK in the early 1990s when the UK electricity regulator capped prices in the power pool, but the UK pool was a fairly artificial market that was much easier to regulate that the German wholesale power market (and indeed the revised UK power market) which is based chiefly on bilateral OTC contracts between generators and resellers. Moreover, there is no legal mechanism for such intervention in the German wholesale power market.	Very unlikely
	Reduce the concentration of ownership of generation by forced divestments of power stations.	We believe this is not legally possible in the German market. The state is only able to mandate a disposal of assets in the event of a merger or acquisition.	Very unlikely
	Cut network prices	This is already underway as a result of the Energy Industry Act of June 2005.	This is now in the hands of the BNA
	Withdraw or modify emissions trading scheme	The German government is unlikely to act unilaterally in this regard and so far there appears to be no sign of a EU move to change the emissions trading regime.	Unlikely
Windfall tax			
	Tax on carbon permits	We would not rule out some move by the government to claw back some of the value that was given for free to the utility companies when the carbon permits were allocated.	A possibility
	Tax on nuclear power stations	A new government could seek to couple the extension of nuclear power station lives with some form of tax on nuclear power	A possibility

Source: Citigroup Investment Research

As a result, although we suspect the shares will perform relatively well in the run up to the election, there could be scope for some weakness in the aftermath as more details emerge about the new government's plans.

[6] See *German Utilities: More to Go For* 28 July 2005

On the regulatory front, the Federal Network Agency (*Bundesnetzagentur* or BNA) assumed responsibility of overseeing gas and electricity networks on 13 July 2005. The next step in the process is that the utilities have three months to notify the BNA of their existing network charges for electricity, and six months to do the same for gas. The BNA then has a further six months to object to the existing charges. If no objection is made, then the existing fees are deemed approved.

Regulatory newsflow should increase towards the end of the year

In practice, we expect the utilities will take their time to submit the required data, so that the BNA will not begin to review the bulk of current network charges until mid-October for electricity and January 2006 for gas. This means that we are unlikely to see any reduction in network fees during 2005. It also means there should not be too much to worry about by way of share-price sensitive newspaper headlines emerging from the BNA until November/December.

RWE's recent public comments on regulation suggest it is becoming more confident about being able to contain the negative impact. With the 1H05A results announcement, RWE stated it expected to be able to offset "for the most part" the negative impact from regulation in 2006 by additional cost cutting in the RWE Energy division.

We think this is significantly more upbeat that the company's previous statements on regulation. For example, in November 2004, RWE warned that regulation "will definitely cause the earnings situation of our German grid business to deteriorate significantly". Nevertheless, we continue to factor in a 30% fall in network fees for both companies by 2010 and we make no additional cost cutting assumption.

Financial forecasts

Although we think the post-election newsflow could be mixed on the political and regulatory side, we think the earnings that RWE should report will continue to drive the shares higher.

In particular, we think consensus estimates of RWE's earnings are substantially too low. (For E.ON, our forecasts appear to be closer to consensus expectations.) With RWE's new policy to link dividends directly to earnings, we suspect future dividends are also likely to be substantially higher than consensus estimates.

We think consensus estimates are still too low

Figure 61. Comparison of our Forecasts with Consensus Estimates

Item	Our forecast	Consensus estimate (as compiled by RWE	RWE guidance
FY05E results			
Operating result (€m)	+3%	+3%	"Single digit growth"
Recurrent net income (€m)	+29%	-	"Growth in the tow teens"
EPS according to IAS (€)	+10%	+8%	"Single digit growth"
DPS according to IAS (€)	+30%	+20%	"At least 15%"
FY06E results			
Operating result (€m)	+21%	+11%	
Recurrent net income (€m)	+36%	-	
EPS according to IAS (€)	+25%	+13%	
DPS according to IAS (€)	+44%	+22%	

Source: Citigroup Investment Research

We think the key reason consensus estimates are low is simply that RWE has been fairly downbeat in its guidance. If we are right with our forecasts, then RWE's share price should continue to perform well. Quite simply, the stock will be derated too quickly in terms of prospective P/E if the share price does not continue to rise.

We do not expect any major strategic developments at the company, other than a continued focus on its existing operations and some minor ongoing disposals (chiefly the rest of the waste business and the water operations in Chile, Spain and Thailand).

Valuation

Our latest sum of parts for RWE is set out in Figure 62 while Figure 63 provides the major valuation multiples based on our current forecasts.

Figure 62. RWE Sum of Parts

	Value (€m)	Value per share (€m)	Method	FY05E EBITDA (€m)	Reality check
Power	27,500	48	Chiefly based on DCF of component parts	2,632	10.4x FV/EBITDA multiple in 2005E
Energy	18,078	32	RABs and multiples of component parts	3,016	6.0x FV/EBITDA multiple in 2005E
npower	5,264	9	Per MW and per customer benchmarks	497	9.3x FV/EBITDA multiple in 2005E
Water	17,174	31	Regulatory asset bases	2,187	7.9x FV/EBITDA multiple in 2005E
Total core businesses	**68,017**	**120**		**8,332**	**8.1x FV/EBITDA multiple in 2005E**
Other/corporate overhead	-427	-1	7x EV/EBITDA multiple	-61	
Financial assets	3,489	6	Forecast book value at 31/12/05	522	
Total	**71,079**	**125**		**8,793**	**8.0x FV/EBITDA multiple in 2005E**
Net debt	-11,415	-20	Forecast book value at 31/12/05		
Pension liabilities	-11,942	-21	Forecast book value at 31/12/05		
Nuclear liabilities	-4,731	-8	Based on Citigroup model - current book value is €9.0bn		
Other liabilities	-5,606	-10	Based on Citigroup model - current book value is €11.9bn		
Minorities	-1,471	-3	Forecast book value at 31/12/05		
Net equity value	**35,915**	**63**			

Source: Citigroup Investment Research estimates

Sector average FY06E P/E and EV/EBITDA ratios would support €68-73 per share

Figure 63. Valuation Multiples

	FY05E	FY06E	FY07E
PE (pre-exceptional, pre-goodwill)			
RWE	13.3	9.8	9.3
Sector average	14.5	12.8	12.0
RWE share price at sector average	**60**	**72**	**71**
EV/EBITDA (adjusted)			
RWE	7.1	6.0	5.8
Sector average	7.6	7.1	6.7
RWE share price at sector average	**62**	**73**	**71**
EV/EBITDA (adjusted, pre associates)			
RWE	6.9	5.8	5.5
Sector average	7.1	6.6	6.2
RWE share price at sector average	**58**	**69**	**67**
Dividend yield			
RWE	3.6%	5.1%	5.9%
Sector average	4.3%	4.5%	4.9%
RWE share price at sector average	**45**	**62**	**65**

Source: Citigroup Investment Research

Our €65 target price is intended to be a compromise between the €63 per share sum of parts, and the evidence from the main valuation ratios which suggest that RWE would trade between €69 and €73 at a sector average rating in terms of FY06E EV/EBITDA or P/E.

Risks

We rate RWE 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 Citigroup quantitative research team, as a possible indicator of future stock-specific risk. After taking into account all factors, we think a Medium Risk rating is appropriate. RWE's high level of provisions and debt mean that the value of its equity is sensitive to the assumptions made. Other risks include regulatory risks in both the gas and the electricity markets in Germany and in the water markets in the UK and in the US as well as the risk that RWE may pay too much for future acquisitions. In addition, the group's financials are complex and provision movements complicate the reconciliation of profit and loss account to cash flow. Risks that could impede the share price from reaching our target price include the possibility that equity markets might fall. Also, our investment thesis could be undermined by renewed competition in German generation, or by regulatory change proving more severe than we currently anticipate leading to lower network profits. In addition, were RWE to recover its appetite for acquisitions, we would be concerned about the possibility of value destruction. Finally, if competition erupts in the German gas market, then the value of RWE's upstream assets might suffer.

Figure 64. Operating Result Breakdown

Operating result	2003A	2004A	2005E	2006E	2007E	2008E	2009E	2010E
Power	1,739	1,846	1,981	3,103	3,477	3,853	4,230	4,609
Energy	2,046	2,192	2,332	2,204	1,994	1,778	1,577	1,388
Npower	714	604	403	580	625	642	659	676
Water	1,374	1,389	1,519	1,553	1,593	1,635	1,685	1,716
Waste	76	76	0	0	0	0	0	0
Financial investments	-109	34	0	0	0	0	0	0
Discontinuing operations	-7	0	0	0	0	0	0	0
Other/group centre/consolidation	-282	-165	-61	9	9	9	9	9
Total	5,551	5,976	6,174	7,449	7,699	7,918	8,160	8,399

Source: Company reports and Citigroup Investment Research estimates

Figure 65. Key Financial Forecasts

Key financial figures for RWE	2003 A	2004 A	2005 E	2006 E	2007 E	2008 E	2009 E	2010 E
Recurrent net income (€m)	1282	1794	2310	3148	3311	3448	3600	3748
Pre-exceptional before goodwill EPS (€)	2.28	3.19	4.11	5.60	5.89	6.13	6.40	6.66
Reported EPS after goodwill (€)	1.69	3.80	4.19	5.23	5.52	5.76	6.03	6.29
Reported EPS before goodwill (€)	3.45	3.80	4.19	5.23	5.52	5.76	6.03	6.29
DPS (€)	1.25	1.50	1.95	2.80	3.22	3.54	3.90	4.29
Free cash flow (€m)	927	1499	1577	2671	2800	2904	3124	3340
Cashflow/share (€)	9.0	9.5	9.6	11.8	12.2	12.6	12.9	13.3
Net cash/(debt) (€m)	-17,838	-12,385	-11,415	-9,990	-8,922	-7,994	-7,036	-6,070
Gearing	221%	133%	114%	92%	78%	66%	56%	47%
Payout ratio based on clean earnings	55%	47%	47%	50%	55%	58%	61%	64%
EBITDA/net interest (x)	7.5	7.4	10.8	14.1	15.9	17.7	20.0	22.8

Source: Company reports and Citigroup Investment Research estimates

Figure 66. Group Financial Forecasts (€m)

Profit and Loss	2003 A	2004 A	2005 E	2006 E	2007 E	2008 E	2009 E	2010 E
Sales	43,875	42,137	41,035	43,251	44,646	46,099	47,616	49,172
Operating costs	34,912	32,905	32,678	33,604	34,724	35,934	37,186	38,483
Depreciation and amortisation (excluding goodwill)	3,277	3,166	2,951	3,058	3,089	3,119	3,148	3,176
Goodwill amortisation/impairment charges	985	492	0	0	0	0	0	0
Operating profit	4,701	5,574	5,406	6,589	6,833	7,046	7,282	7,513
Result from investments	300	846	720	528	534	540	546	552
Operating profit after result from investments	5,001	6,420	6,126	7,117	7,367	7,586	7,828	8,066
Revalorisation of provisions	-1,558	-1,327	-1,254	-1,266	-1,290	-1,316	-1,343	-1,371
Net interest expense	-1,131	-1,130	-763	-685	-626	-575	-522	-469
Other net financial income	-189	-28	0	0	0	0	0	0
Pre-tax profit	2,123	3,935	4,109	5,167	5,450	5,694	5,963	6,225
Tax	-1,187	-1,521	-1,480	-1,937	-2,044	-2,135	-2,236	-2,334
Post-tax profit	936	2,414	2,630	3,229	3,406	3,559	3,727	3,891
Minorities	17	-277	-275	-289	-303	-318	-334	-351
Net attributable profit before goodwill	1,938	2,137	2,355	2,940	3,103	3,241	3,392	3,540
Net attributable profit (pre exceptional)	1,282	1,794	2,310	3,148	3,311	3,448	3,600	3,748
Profit from operating activities	4,701	5,574	5,406	6,589	6,833	7,046	7,282	7,513
+ Result of investments	300	846	720	528	534	540	546	552
- Non-operating result	0	0	0	0	0	0	0	0
Operating result	5,551	5,976	6,174	7,449	7,699	7,918	8,160	8,399
EBITDA including operating income from investments	8,681	8,812	8,793	10,175	10,456	10,705	10,976	11,242
EBITDA excluding operating income from investments	8,476	8,400	8,271	9,647	9,922	10,165	10,430	10,690

Cash flow	2003 A	2004 A	2005 E	2006 E	2007 E	2008 E	2009 E	2010 E
Gross cash flow	5,289	4,928	5,559	6,725	6,954	7,158	7,378	7,594
Capital expenditure	-4,362	-3,429	-3,983	-4,054	-4,154	-4,254	-4,254	-4,254
Acquisitions	-5,373	-308	-63	0	0	0	0	0
Proceeds of disposals	1,872	3,320	500	0	0	0	0	0
Dividends	-895	-939	-1,044	-1,247	-1,732	-1,976	-2,166	-2,374
Issue/(redemption) of group equity	0	0	0	0	0	0	0	0
Other	2,754	1,578	-0	0	0	-0	0	-0
Change in net debt	-715	5,150	970	1,425	1,068	928	958	967

Balance sheet	2003 A	2004 A	2005 E	2006 E	2007 E	2008 E	2009 E	2010 E
Intangible assets	19,418	17,718	17,244	16,912	16,580	16,248	15,916	15,584
Property, plant and equipment	36,210	35,025	35,757	36,752	37,817	38,952	40,058	41,136
Financial assets	6,778	5,887	5,948	5,948	5,948	5,948	5,948	5,948
Stocks	3,285	2,043	2,074	2,105	2,136	2,168	2,201	2,235
Debtors	16,947	16,606	16,712	16,820	16,929	17,040	17,153	17,268
Cash and equivalents	11,796	12,539	12,000	12,000	12,000	12,000	12,000	12,000
Deferred tax assets and prepaid expenses	4,708	3,552	3,552	3,552	3,552	3,552	3,552	3,552
Total assets	99,142	93,370	93,287	94,089	94,963	95,909	96,828	97,724
Provisions	-37,671	-34,754	-34,997	-35,501	-36,027	-36,576	-37,148	-37,748
Debt	-31,790	-27,383	-25,874	-24,449	-23,381	-22,453	-21,495	-20,529
Other liabilities	-12,271	-11,736	-12,010	-12,568	-12,886	-13,150	-13,433	-13,738
Deferred tax liabilities and deferred income	-8,345	-8,304	-8,204	-8,104	-8,004	-7,904	-7,804	-7,704
Minority interests	-2,052	-1,537	-1,471	-1,602	-1,740	-1,884	-2,036	-2,196
Shareholders Funds	7,013	9,656	10,731	11,865	12,925	13,942	14,911	15,809

Source: Company reports and Citigroup Investment Research estimates

Notes

Notes

ANALYST CERTIFICATION

Appendix A-1

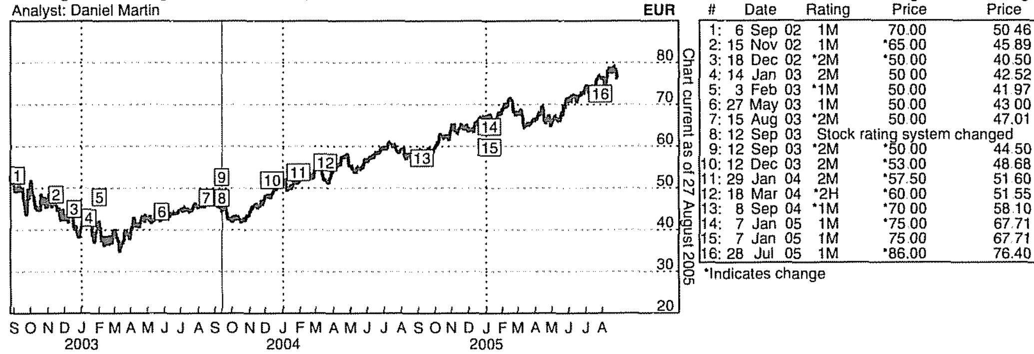
We, Daniel Martin, Alberto Ponti, Peter Atherton, Peter Bisztyga and Elisenne Verdoja, *hereby certify that all of the views expressed in* this research report accurately reflect our personal views about any and all of the subject issuer(s) or securities. We also certify that no part of our compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report.

IMPORTANT DISCLOSURES

E.ON (EONG.DE)

Ratings and Target Price History - Fundamental Research

Analyst: Daniel Martin



#	Date	Rating	Target Price	Closing Price
1:	6 Sep 02	1M	70.00	50.46
2:	15 Nov 02	1M	*65.00	45.89
3:	18 Dec 02	*2M	*50.00	40.50
4:	14 Jan 03	2M	50.00	42.52
5:	3 Feb 03	*1M	50.00	41.97
6:	27 May 03	1M	50.00	43.00
7:	15 Aug 03	*2M	50.00	47.01
8:	12 Sep 03	Stock rating system changed		
9:	12 Sep 03	*2M	*50.00	44.50
10:	12 Dec 03	2M	*53.00	48.68
11:	29 Jan 04	2M	*57.50	51.60
12:	18 Mar 04	*2H	*60.00	51.55
13:	8 Sep 04	*1M	*70.00	58.10
14:	7 Jan 05	1M	*75.00	67.71
15:	7 Jan 05	1M	75.00	67.71
16:	28 Jul 05	1M	*86.00	76.40

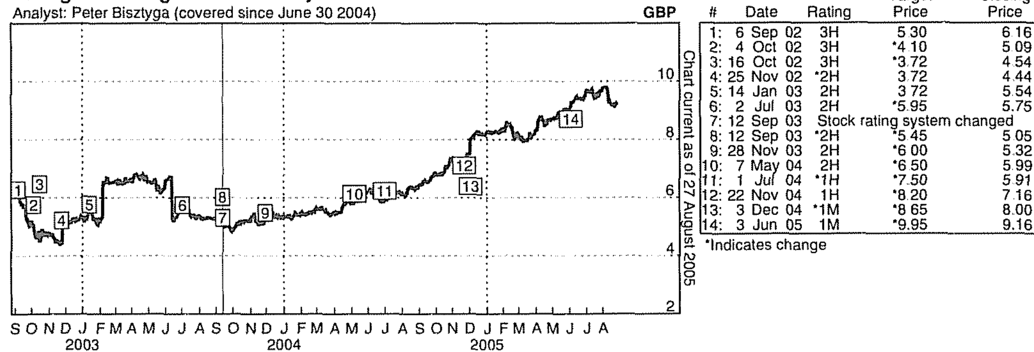
*Indicates change

—— Covered
······· Not covered

AWG (AWG.L)

Ratings and Target Price History - Fundamental Research

Analyst: Peter Bisztyga (covered since June 30 2004)



#	Date	Rating	Target Price	Closing Price
1:	6 Sep 02	3H	5.30	6.16
2:	4 Oct 02	3H	*4.10	5.09
3:	16 Oct 02	3H	*3.72	4.54
4:	25 Nov 02	*2H	3.72	4.44
5:	14 Jan 03	2H	3.72	5.54
6:	2 Jul 03	2H	*5.95	5.75
7:	12 Sep 03	Stock rating system changed		
8:	12 Sep 03	*2H	*5.45	5.05
9:	28 Nov 03	2H	*6.00	5.32
10:	7 May 04	2H	*6.50	5.99
11:	1 Jul 04	*1H	*7.50	5.91
12:	22 Nov 04	1H	*8.20	7.16
13:	3 Dec 04	*1M	*8.65	8.00
14:	3 Jun 05	1M	*9.95	9.16

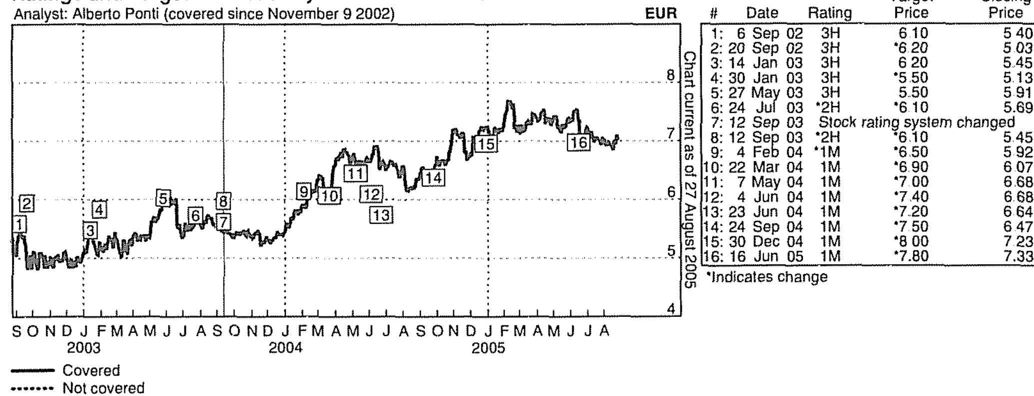
*Indicates change

—— Covered
······· Not covered

ENEL (ENEI.MI)

Ratings and Target Price History - Fundamental Research

Analyst: Alberto Ponti (covered since November 9 2002)



#	Date	Rating	Target Price	Closing Price
1:	6 Sep 02	3H	6.10	5.40
2:	20 Sep 02	3H	*6.20	5.03
3:	14 Jan 03	3H	6.20	5.45
4:	30 Jan 03	3H	*5.50	5.13
5:	27 May 03	3H	5.50	5.91
6:	24 Jul 03	*2H	*6.10	5.69
7:	12 Sep 03	Stock rating system changed		
8:	12 Sep 03	*2H	*6.10	5.45
9:	4 Feb 04	*1M	*6.50	5.92
10:	22 Mar 04	1M	*6.90	6.07
11:	7 May 04	1M	*7.00	6.68
12:	4 Jun 04	1M	*7.40	6.68
13:	23 Jun 04	1M	*7.20	6.64
14:	24 Sep 04	1M	*7.50	6.47
15:	30 Dec 04	1M	*8.00	7.23
16:	16 Jun 05	1M	*7.80	7.33

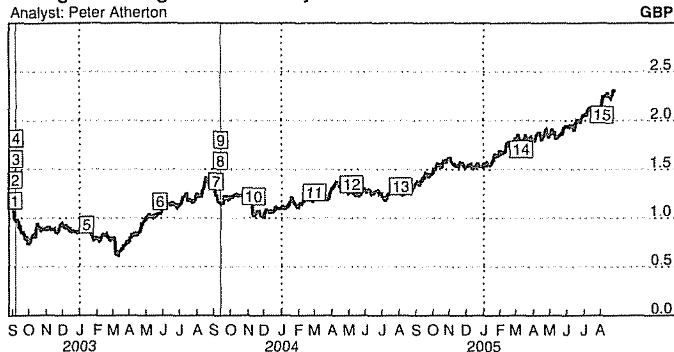
*Indicates change

—— Covered
······· Not covered

International Power PLC (IPR.L)

Ratings and Target Price History - Fundamental Research

Analyst: Peter Atherton



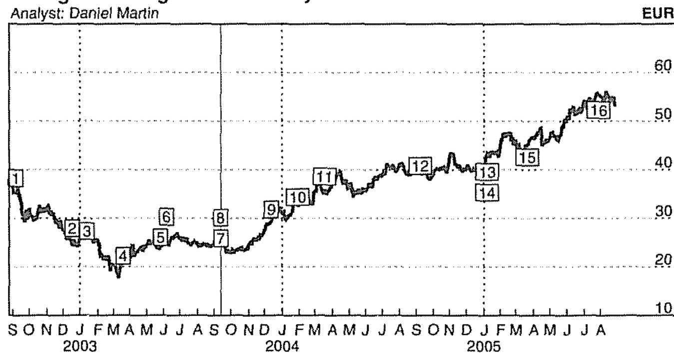
#	Date	Rating	Target Price	Closing Price
1:	30 Aug 02	1H	*2.30	1.17
2:	5 Sep 02	*3M	*1.15	1.00
3:	6 Sep 02	Stock rating system changed		
4:	6 Sep 02	*2M	*1.15	0.98
5:	14 Jan 03	2M	1.15	0.92
6:	27 May 03	2M	1.15	1.05
7:	4 Sep 03	2M	*1.30	1.22
8:	12 Sep 03	Stock rating system changed		
9:	12 Sep 03	*2H	*1.35	1.16
10:	12 Nov 03	2H	*1.20	1.03
11:	1 Mar 04	2H	*1.60	1.24
12:	6 May 04	*1M	*1.70	1.28
13:	4 Aug 04	*1H	1.70	1.26
14:	11 Mar 05	1H	*2.10	1.80
15:	4 Aug 05	*1M	*2.50	2.21

*Indicates change

RWE (RWEG.DE)

Ratings and Target Price History - Fundamental Research

Analyst: Daniel Martin



#	Date	Rating	Target Price	Closing Price
1:	6 Sep 02	2M	45.00	35.65
2:	18 Dec 02	2M	*35.00	24.65
3:	14 Jan 03	2M	35.00	27.15
4:	20 Mar 03	2M	*30.00	20.87
5:	27 May 03	2M	30.00	24.27
6:	6 Jun 03	*2H	30.00	24.78
7:	12 Sep 03	Stock rating system changed		
8:	12 Sep 03	*1H	*30.00	24.60
9:	12 Dec 03	1H	*34.00	29.20
10:	29 Jan 04	1H	*40.00	33.07
11:	18 Mar 04	1H	*44.00	35.37
12:	8 Sep 04	*1M	*47.00	39.29
13:	7 Jan 05	1M	*50.00	43.45
14:	7 Jan 05	1M	50.00	43.45
15:	22 Mar 05	1M	*55.00	45.10
16:	28 Jul 05	1M	*65.00	55.21

*Indicates change.

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% of companies in each rating category that are investment banking clients	48%	49%	28%
Utilities -- Europe (31)	29%	61%	10%
% of companies in each rating category that are investment banking clients	56%	58%	67%

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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.

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Merrill Lynch

Comment

Germany
Electric Utilities / ADR

11 November 2005

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E.ON

All Eyes on Glasgow

NEUTRAL

Reason for Report: Q3 Review, Changes in Estimates

Volatility Risk: LOW

Price - Local / ADR: EUR75.4 / $29.61

Estimates (Dec)	2004A	2005E	2006E	2007E	2008E
Reported EPS	6.60	10.86	7.07	7.39	7.82
Adjusted EPS	5.74	5.94	7.07	7.39	7.82
P/E	13.1	12.7	10.7	10.2	9.6
CEPS	9.1	10.0	3.7	12.3	12.7
Free CFPS	4.96	3.37	(4.82)	3.70	8.87
DPS	2.35	2.76	3.54	3.69	3.91
Yield %	3.1	3.7	4.7	4.9	5.2
Price/FCF	15.2	22.4	(15.6)	20.4	8.5
Net Debt	5483	(1376)	4152	4578	1714
EBITDA	10520	10371	11204	11710	12014
ADR Adjusted EPS	$2.60	$2.32	$2.76	$2.89	$3.06
ADR Free CFPS	$2.25	$1.32	$-1.88	$1.45	$3.47
ADR DPS	$1.06	$1.10	$1.38	$1.44	$1.53

Opinion & Financial Data

Investment Opinion – Local:	A-2-7
Investment Opinion – ADR:	A-2-7
Mkt. Value (EUR mn)/ Shares Outstanding (mn):	49689 / 659
Book Value/Share (Dec-04):	50.926
Price/Book Ratio:	1.48
ROE 2005E Average:	12.1%
Net Debt/Net Equity:	35.3%
Est. 5 Year EPS Growth:	8%
2005E P/E Rel. to Mkt:	88%

Stock Data

52-Week Range – Local:	80.85-63.45
52-Week Range – ADR:	$33.7-$27.6
Symbol / Exchange – Local:	EONAF / Frankfurt
Symbol / Exchange – ADR:	EON / New York
Bloomberg / Reuters:	EOA GR / EONG.DE
Shares/ADR:	0.33
Exchange Rate:	EUR0.85/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 retain our Neutral recommendation.
- The pending decision on ScottishPower continues to dominate. We expect a bid, if there is one, to come in above the stand-alone fair value of 605p.
- Meantime, the financial picture for EON remains very robust. We have upgraded our 2005/6 EPS forecasts, primarily due to lower financing costs.
- We have also reshaped our DPS growth profile in response to higher earnings. We now expect a 20% increase for 2005, up from 15% previously.
- Irrespective of any large acquisition, EON continues to infill its existing platforms. Investment in the gas chain, whilst not unexpected, has accelerated in 2005 focused on upstream and LNG.
- Valuation-wise, much appears to be priced in already, and EON has underperformed RWE by 23% since January and 5% since the announcement on SP.
- The shares are trading on 7.1x 2006E EV/EBITDA, a discount to the peer group on 7.7x, and there is increased yield support into 2006E on our new forecasts. However, we think it is appropriate to remain cautious ahead of any bid. Our SOP is unchanged at EUR83/share.

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Refer to important disclosures on pages 7 to 8. Analyst Certification on page 6.

What Has Changed?

EON's financial strength, allied to an apparent waning scope for self-help efficiencies in coming years, underline why the timing is good for a fresh acquisition. Earnings wise, we have raised our forecasts because of lower than anticipated interest charges. This has led us to increase dividend growth forecasts from 15% to 20%. Despite this, we remain wary ahead of clarity on whether EON does bid for ScottishPower, and on the price in particular.

All Eyes on Glasgow

The impact of the successful cost cutting and balance sheet restructuring of the last few years has shone through in EON's 2005E results so far, albeit helped by rising power prices. As the impact of the self-help drivers appears set to wane (restructuring in particular), the sense is of a company poised to inject new impetus into its portfolio, hence the declared interest in ScottishPower early in September.

Apparent value enhancement potential has to be the key goal for EON if it presses the button on ScottishPower. We believe SP is worth 605p on a stand-alone basis, if we assume cost-cutting and re-leveraging (see our latest on the subject, *Leveraging Value*, November 7th 2005). This analysis suggests EON may have to offer upwards of 610p to win board and shareholder approval.

Growth Investments in Gas

Most of the market's focus is on ScottishPower, but EON has continued to make infill acquisitions to bolster its existing market platforms, and generate growth.

The investment in gas or gas-related assets acquired or lined up during 2005 gives a flavour of how a cornerstone of the company's strategy is to leverage off Ruhrgas to capitalise on power/gas convergence.

- **Caledonian Gas:** EUR700m spent on 52mboe of upstream gas reserves, part of a strategy to reach up to 20% of gas needs through equity production.
- **NEGP:** the Baltic pipeline project, not due onstream until early next decade, but potentially a major infrastructure project for EON.
- **LNG Terminal**: EUR500m is earmarked for the Wilhermshaven in the Baltic, to receive 10Bcm of gas.
- **Upstream LNG**: EON wants upstream LNG and is in the process of negotiating with various producers for equity in a development project.
- **CCGT in Italy**: EUR400m is to be spent building a 800MW plant, with Ruhrgas supplying the gas.

Strategically, building up its gas position through the chain is the right move in our view (see our note *Best Platform*, January 28th 2005). Creating shareholder value is equally important for small as well as large deals, though may be less visible – and may also prove difficult in tight, high price upstream markets. EON's Caledonian acquisition cost of EUR13.65/boe set a new benchmark price for long-dated North Sea reserves (production plateaus in 2009E).

9 mths Results Lead to Upbeat Update

EON's 9month figures once again confirmed the upward momentum in earnings which has been evident through 2005, driven by power prices, cost-cutting and balance sheet restructuring. Management gave a more confident view on its prognosis for FY 2005.

Table 1: 9 Mths Results Review

	9mths 05A	9mths 04A	% change
Adjusted EBITDA	**7685**	**7169**	**-7%**
Adjusted EBIT	**5,524**	**5,185**	**7%**
Core Business Energy	**5,403**	**5,072**	**7%**
Central Europe	2,945	2,703	9%
Pan-European Gas	1,125	1,113	1%
UK	715	720	-1%
Nordic	600	489	23%
US-Midwest	278	275	1%
Corporate Center/Conso	-260	-228	14%
Degussa	121	113	
Interest charges	-791	-697	
Group IOP	**4,733**	**4,488**	**5%**
Net Book Gains	403	532	
Restructuring Costs	-14	-40	
Other non-operating income	50	772	
PBT	**5,172**	**5,752**	**-10%**
Taxes	-1,639	-1,688	
Minorities	-381	-367	
Income from Continuing	**3,152**	**3,697**	**-15%**
Income from Discontinued	3,247	270	
Group Net Income	**6,399**	**3,967**	**61%**
Reported EPS	9.71	6.04	61%
Reported EPS - continuing operations	4.78	5.63	-15%

Source: E.ON

On the results, 9mth adjusted EBIT rose 7% to EUR5524m (Mle EUR5504m, cons EUR5542m). Net Income EUR6399m (Mle 6476m, cons EUR6405m).

Operationally, the surprises were **Nordic** +59% in Q3 due to hedging and increased hydro in the mix; offset by the **UK** where EUR86m of CO_2 costs were recognised in the quarter for the first nine months. Other divisions were in line with our forecasts: **Central Europe** +12% for Q3 and +9% for 9mths (higher power prices), **PanEuropean Gas**

(Continued)

(+21% Q3 and +1% for 9mths), and **US-MidWest** (-8% for Q3 and +1% 9mths).

EON remains financially extremely strong. FCF for the 9m was EUR2.9bn, and with disposal proceeds resulted in a net *cash* position of EUR3.2bn end September - capex has been well down on our forecasts this year, though there should be a Q4 'catch up'.

A Touch more Upbeat on Guidance

We sense a more upbeat message reading between the lines – without wanting to get too excited about the subjective descriptions EON uses. The company expects full year 2005 Adjusted EBIT to exceed (previously 'slightly above') and Net Income 'substantially surpass' 2004, the latter due to capital gains on Viterra and other disposals.

In the mix, the outlook is unchanged for Central Europe, slightly better for PanEuropean Gas and Nordic, offset by lower expectations for UK/USA.

Forecasts Updated for 2005 and 2006

Earnings Upgrade

Table 2 thereafter summarises our change in estimates. Our projections for EBITDA and EBIT remain largely unchanged, but we have increased our estimates for net income for 2005 and 2006 (+5% and 3% respectively). This is mainly driven by lower net debt and hence lower financial expenses:

- **Capex:** we have lowered investments in PP&E and financial assets in 2005E by EUR2bn to EUR4.4bn. This explains the marginally lower EBITDA and EBIT post 2006E
- **CTA:** we have assumed the bulk of the EUR5.4bn pension trust will be financed in 2006E (vs 2005E previously)

Dividend Growth Upgrade

We have also upgraded our DPS growth profile in response to higher earnings. We now expect a 20% increase for 2005, up from 15% previously and have increased the payout ratio in 2006 to 50% from 45%. The front end step up and assumed 50% payout ratio leads to a marginal reduction in our DPS forecasts from 2007.

Table 2: Change in ML Estimates

(EURm)	2005E	2006E	2007E	2008E	2009E	2010E
Continuing EBITDA						
Old estimates	10,368	11,208	11,872	12,176	12,513	12,750
New estimates	10,371	11,204	11,710	12,014	12,350	12,586
% change	*0.0%*	*0.0%*	*-1.4%*	*-1.3%*	*-1.3%*	*-1.3%*
Continuing Operating Income						
Old estimates	7,378	8,242	8,774	9,067	9,392	9,622
New estimates	7,382	8,240	8,655	8,951	9,276	9,504
% change	*0.1%*	*0.0%*	*-1.4%*	*-1.3%*	*-1.2%*	*-1.2%*
Recurrent EPS						
Old estimates	5.64	6.87	7.46	7.88	8.46	8.94
New estimates	5.94	7.07	7.39	7.82	8.42	8.91
% change	*5.2%*	*3.0%*	*-1.0%*	*-0.8%*	*-0.6%*	*-0.3%*
DPS						
Old estimates	2.70	3.10	3.73	3.94	4.23	4.47
New estimates	2.76	3.54	3.69	3.91	4.21	4.46
% change	2.3%	14.0%	-1.0%	-0.8%	-0.6%	-0.3%

Source: Merrill Lynch estimates

Full financial statements are shown in the following pages.

Table 3: Profit and Loss Projections

EURm	2003A	2004A	2005E	2006E	2007E	2008E	2009E	2010E	04A -09E CAGR
Total Sales	**46,364**	**49,103**	**52,893**	**53,499**	**54,271**	**55,022**	**55,980**	**57,045**	**2.7%**
Growth	*27%*	*6%*	*8%*	*1%*	*1%*	*1%*	*2%*	*2%*	
Total EBITDA (incl associates)	**9,458**	**10,520**	**10,371**	**11,204**	**11,710**	**12,014**	**12,350**	**12,586**	**3.3%**
Growth	*25%*	*11%*	*-1%*	*8%*	*5%*	*3%*	*3%*	*2%*	
Core Business Energy	***8,580***	***9,792***	***10,262***	***11,095***	***11,601***	***11,905***	***12,242***	***12,477***	4.6%
Central Europe	*4,471*	*4,908*	*5,287*	*5,820*	*6,097*	*6,169*	*6,328*	*6,427*	
Pan-European Gas	*1,896*	*1,900*	*1,889*	*2,000*	*2,094*	*2,178*	*2,211*	*2,220*	
UK	*1,036*	*1,592*	*1,555*	*1,619*	*1,662*	*1,717*	*1,771*	*1,796*	
Nordic	*933*	*1,121*	*1,256*	*1,350*	*1,399*	*1,456*	*1,513*	*1,583*	
US-Midwest	*517*	*544*	*529*	*534*	*567*	*594*	*620*	*647*	
Corporate Center/Consolidation	*-273*	*-273*	*-254*	*-228*	*-218*	*-209*	*-201*	*-195*	
Viterra	*643*	*621*	*0*	*0*	*0*	*0*	*0*	*0*	
Degussa	*235*	*107*	*109*	*109*	*109*	*109*	*109*	*109*	
Total EBIT	**6,228**	**7,361**	**7,382**	**8,240**	**8,655**	**8,951**	**9,276**	**9,504**	**4.7%**
Growth	*34%*	*18%*	*0%*	*12%*	*5%*	*3%*	*4%*	*2%*	
Core Business Energy	*5,621*	*6,783*	*7,274*	*8,132*	*8,547*	*8,843*	*9,168*	*9,396*	6.2%
Central Europe	*2,979*	*3,602*	*3,976*	*4,508*	*4,747*	*4,818*	*4,976*	*5,075*	
Pan-European Gas	*1,463*	*1,428*	*1,427*	*1,537*	*1,611*	*1,695*	*1,727*	*1,736*	
UK	*610*	*1,017*	*1,027*	*1,107*	*1,129*	*1,161*	*1,211*	*1,236*	
Nordic	*546*	*701*	*787*	*895*	*941*	*1,012*	*1,061*	*1,123*	
US-Midwest	*317*	*349*	*352*	*353*	*378*	*407*	*435*	*462*	
Corporate Center/Consolidation	*-294*	*-314*	*-295*	*-269*	*-259*	*-250*	*-242*	*-236*	
Viterra	*456*	*471*	*0*	*0*	*0*	*0*	*0*	*0*	
Degussa	*151*	*107*	*109*	*109*	*109*	*109*	*109*	*109*	
Financial expenses	-1,663	-1,140	-1,004	-822	-949	-839	-626	-399	
PBET	4,565	6,221	6,378	7,419	7,706	8,112	8,650	9,105	
Extraordinary items and non op income	973	578	0	0	0	0	0	0	
PBT	**5,538**	**6,799**	**6,378**	**7,419**	**7,706**	**8,112**	**8,650**	**9,105**	**4.9%**
Income tax	-1,124	-1,947	-1,946	-2,216	-2,292	-2,400	-2,542	-2,663	
Minority interests	-464	-504	-520	-544	-547	-558	-562	-570	
Net income, continuing	**3,950**	**4,348**	**3,913**	**4,659**	**4,867**	**5,155**	**5,546**	**5,872**	**5.0%**
Discontinuing items / other	697	-9	3,247	0	0	0	0	0	
Group Net Income	**4,647**	**4,339**	**7,160**	**4,659**	**4,867**	**5,155**	**5,546**	**5,872**	**5.0%**
Recurrent Group Net Income	**2,891**	**3,770**	**3,913**	**4,659**	**4,867**	**5,155**	**5,546**	**5,872**	**8.0%**
Reported EPS (EUR p.s.)	7.11	6.60	10.86	7.07	7.39	7.82	8.42	8.91	5.0%
Recurrent EPS (EUR p.s.)	**4.42**	**5.74**	**5.94**	**7.07**	**7.39**	**7.82**	**8.42**	**8.91**	**8.0%**
DPS (EUR p.s.)	**2.00**	**2.35**	**2.76**	**3.54**	**3.69**	**3.91**	**4.21**	**4.46**	**12.4%**
Payout ratio (on recurrent earnings)	*45%*	*41%*	*47%*	*50%*	*50%*	*50%*	*50%*	*50%*	

Source: Merrill Lynch estimates

Table 4: Cash Flow Projections

EURm	2003A	2004A	2005E	2006E	2007E	2008E	2009E	2010E	04A -09E CAGR
Net income	4,647	4,339	7,160	4,659	4,867	5,155	5,546	5,872	
Minority Interests	464	504	520	544	547	558	562	570	
Income from discontinued operations	-1,137	9	-3,247	0	0	0	0	0	
D&A *Impairments*	3,272	3,256	2,988	2,963	3,055	3,062	3,074	3,081	
Gains / Losses on Disposals	-1,815	-900	-403	0	0	0	0	0	
Change in provisions	1,586	36	129	-5,569	-237	-315	-404	-507	
Change in deferred taxes	-132	0	0	0	0	0	0	0	
Change in working capital	-1,191	-900	-530	-138	-121	-100	-122	-122	
Other non-cash items	-156	-372	0	0	0	0	0	0	
Cash Flow from Operations	**5,538**	**5,972**	**6,617**	**2,459**	**8,111**	**8,361**	**8,656**	**8,894**	**7.7%**
Disposals	7,035	3,457	6,500	0	0	0	0	0	
Investments	-9,196	-5,285	-4,395	-5,635	-5,671	-2,516	-2,516	-2,516	
Change in *liquid funds*	2,200	1,232	0	0	0	0	0	0	
Cash Flow from Investments	**39**	**-596**	**2,105**	**-5,635**	**-5,671**	**-2,516**	**-2,516**	**-2,516**	**33.4%**
Free cash flow	**2,878**	**3,260**	**8,723**	**-3,176**	**2,440**	**5,845**	**6,140**	**6,378**	**13.5%**
Net change in treasury stock	7	0	0	0	0	0	0	0	
Payment of cash dividends	-1,621	-1,598	-2,058	-2,352	-2,865	-2,981	-3,128	-3,332	
Net proceeds from financial liabilities	-1,931	-2,845	0	0	0	0	0	0	
Cash flow from Financing	**-3,545**	**-4,461**	**-2,058**	**-2,352**	**-2,865**	**-2,981**	**-3,128**	**-3,332**	**-6.9%**
Net cash income / outgoings	2,032	915	6,664	-5,528	-426	2,864	3,012	3,047	
Forex impact on net cash	-43	-60	0	0	0	0	0	0	
Cash from discontinued operations	-10	0	0	0	0	0	0	0	
Change net cash & equivalents	**1,979**	**855**	**6,664**	**-5,528**	**-426**	**2,864**	**3,012**	**3,047**	**28.6%**
Cash at y/e	3,321	4,176	10,840	5,312	4,886	7,751	10,762	13,809	

Source: Merrill Lynch estimates

Table 5: Balance Sheet Projections

EURm	2003A	2004A	2005E	2006E	2007E	2008E	2009E	2010E
Net Goodwill	13,955	14,454	14,162	14,162	14,162	14,162	14,162	14,162
PPE & Intangibles	46,950	47,351	38,360	41,032	43,648	43,102	42,544	41,978
Financial Assets	17,725	17,263	17,263	17,263	17,263	17,263	17,263	17,263
Fixed Assets	78,630	79,068	69,786	72,457	75,074	74,527	73,969	73,404
Inventories	2,477	2,647	2,851	2,884	2,926	2,966	3,018	3,075
Receivables	18,025	17,883	18,595	18,678	18,783	18,886	19,017	19,163
Liquid Funds, Non-Cash	7,474	7,840	7,840	7,840	7,840	7,840	7,840	7,840
Cash & Cash Equivalents	3,321	4,176	10,840	5,312	4,886	7,751	10,762	13,809
Non-Fixed Assets	31,297	33,099	40,126	34,714	34,435	37,443	40,637	43,887
Other	1,923	1,895	1,930	1,928	1,930	1,934	1,940	1,947
TOTAL ASSETS	**111,850**	**114,062**	**111,842**	**109,099**	**111,440**	**113,905**	**116,546**	**119,238**
Shareholders' Equity	29,774	33,560	31,063	33,901	36,441	39,166	42,140	45,246
Minority Interests	4,625	4,144	4,154	4,165	4,176	4,187	4,199	4,210
Provisions	34,206	34,242	34,371	28,802	28,566	28,251	27,846	27,339
Financial Liabilities	21,787	20,301	20,106	20,106	20,106	20,106	20,106	20,106
Operating Liabilities	14,113	14,054	14,440	14,418	14,444	14,487	14,548	14,629
Other	7,345	7,707	7,707	7,707	7,707	7,707	7,707	7,707
TOTAL EQUITY & LIABILITIES	**111,850**	**114,062**	**111,842**	**109,099**	**111,440**	**113,905**	**116,546**	**119,238**
Balance sheet ratios	**2003A**	**2004A**	**2005E**	**2006E**	**2007E**	**2008E**	**2009E**	**2010E**
Net Debt (Net cash)	*7,855*	*5,483*	*-1,376*	*4,152*	*4,578*	*1,714*	*-1,298*	*-4,344*
Net Debt/Capitalisation	*21%*	*14%*	*-5%*	*11%*	*11%*	*4%*	*-3%*	*-11%*
Net Debt + Fin Provisions	*31,919*	*29,676*	*17,248*	*22,540*	*22,651*	*19,382*	*15,863*	*-4,344*
(Net Debt + Fin Prov)/(Capitalisation + Fin Prov)	*52%*	*47%*	*36%*	*40%*	*38%*	*33%*	*27%*	*-11%*
ROCE	*10%*	*11%*	*12%*	*13%*	*13%*	*13%*	*14%*	*14%*
EBITDA/Total net interest expenses	*5.7x*	*9.2x*	*10.3x*	*13.6x*	*12.3x*	*14.3x*	*19.7x*	*31.5x*
EBITDA/Net interest on financial debt	*14.3x*	*16.0x*	*65.3x*	*91.7x*	*41.0x*	*54.9x*	*215.5x*	*-115.2x*

Source: Merrill Lynch estimates

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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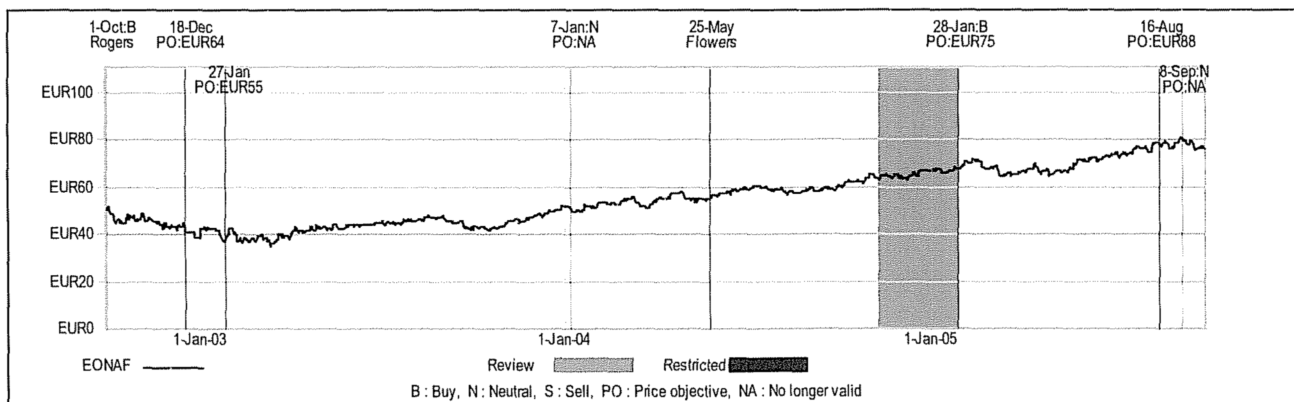
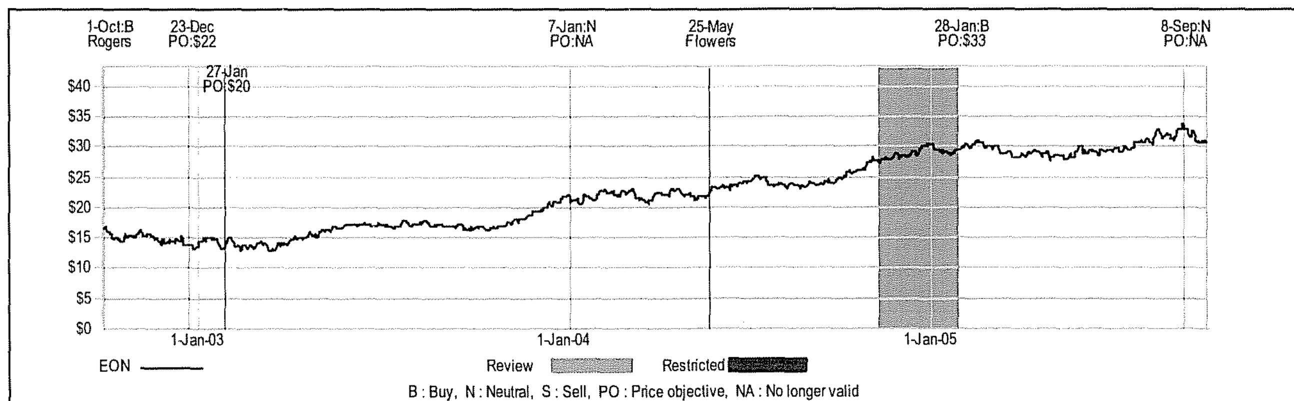
EONAF Price Chart



The 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. Chart current as of September 30, 2005.

EON Price Chart



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Investment Rating Distribution: Utilities Group (as of 30 September 2005)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	36	32.73%	Buy	21	58.33%
Neutral	65	59.09%	Neutral	30	46.15%
Sell	9	8.18%	Sell	2	22.22%

Investment Rating Distribution: Global Group (as of 30 September 2005)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1076	40.21%	Buy	350	32.53%
Neutral	1399	52.28%	Neutral	412	29.45%
Sell	201	7.51%	Sell	36	17.91%

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iQprofile[SM] E.ON

E.ON has transformed itself from domestic conglomerate to Europe's biggest energy utility, with a portfolio of mainly vertically integrated assets across Germany, Central Europe, the Nordic Region, the UK and the US. It is active in both electricity and gas and its subsidiary Ruhrgas is likely to be central to future growth from this platform as power/gas convergence gathers pace over the next decade.

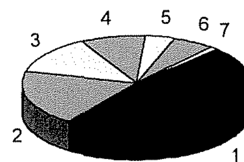
Key Income Statement Data

(EUR mn)	2003A	2004A	2005E	2006E	2007E
Sales	46364	49103	52893	53499	54271
EBITDA Adjusted	9458	10520	10371	11204	11710
Depreciation and Amort.	(3230)	(3159)	(2988)	(2963)	(3055)
EBIT Adjusted	6228	7361	7382	8240	8655
Net Interest And Other Inc	(1663)	(1140)	(1004)	(822)	(949)
Tax Expense / Benefit	(1124)	(1947)	(1946)	(2216)	(2292)
Net Income (Adjusted)	2891	3770	3913	4659	4867
Avg Fully Dil Shares	654	657	659	659	659

Key Cash Flow Data

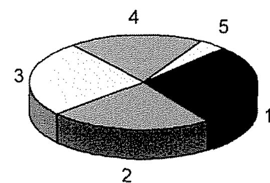
(EUR mn)	2003A	2004A	2005E	2006E	2007E
Net Income (Reported)	4647	4339	7160	4659	4867
Depreciation and Amort.	3230	3159	2988	2963	3055
Change in Working Capital	(1191)	(900)	(530)	(138)	(121)
Deferred Taxation Charge	0	0	0	0	0
Other Adjustments, Net	(1148)	(626)	(3000)	(5025)	310
Cash Flow from Operations	5538	5972	6617	2459	8111
Capital Expenditure	(2660)	(2712)	(4395)	(5635)	(5671)
(Acq) / Disp. of Investments	(6536)	(2573)	(1491)	(1539)	(1539)
Other Cash Inflow/(Outflow)	9235	4689	7991	1539	1539
Cash Flow from Investing	39	(596)	2105	(5635)	(5671)
Share Issue / (Repurchase)	0	(18)	0	0	0
Cost of Dividends Paid	(1621)	(1598)	(2058)	(2352)	(2865)
Cash Flow from Financing	(3545)	(4461)	(2058)	(2352)	(2865)
Non Cash Chgs to Debt	(53)	(60)	0	0	0
Change in Net Debt	(4016)	(3820)	(6664)	5528	426
Net Debt	7855	5483	(1376)	4152	4578

2004A EBIT



	%
1 Central Europe	46 9
2 Pan-European Gas	18.6
3 UK	13 3
4 Nordic	9 1
5 US-Midwest	4.5
6 Viterra	6.1
7 Degussa	1.4

2004A Generation Capacity Germany



%	
27.5	Nuclear 1
22 7	Hard coal 2
26.1	Lignite 3
19 2	Gas / fuel oil 4
4.5	Hydro 5

Key Balance Sheet Data

(EUR mn)	2003A	2004A	2005E	2006E	2007E
Property, Plant and Equip.	46950	47351	38360	41032	43648
Goodwill	13955	14454	14162	14162	14162
Other Intangible Assets	n/a	n/a	n/a	n/a	n/a
Other Non-Current Assets	18269	17980	17980	17980	17980
Trade Receivables	6047	6534	7246	7329	7434
Cash And Equivalents	11776	12850	19514	13986	13560
Other Current Assets	14853	14893	14579	14610	14654
Total Assets	111850	114062	111842	109099	111440
Long-Term Debt	19631	18333	18138	18138	18138
Other Non-Current Liabs	43707	43971	44046	38477	38241
Short-Term Debt	n/a	n/a	n/a	n/a	n/a
Other Current Liabs	14113	14054	14440	14418	14444
Total Liabilities	77451	76358	76624	71033	70822
Total Equity	34399	37704	35218	38066	40617
Total Equity And Liabilities	111850	114062	111842	109099	111440

iQ Method-Business Performance

	2003A	2004A	2005E	2006E	2007E
Return On Cap Employed %	4.8	5.6	5.4	6.2	6.5
Return On Equity %	10.4	11.9	12.1	14.3	13.8
Operating Margin %	13.4	15.0	14.0	15.4	15.9
Free Cash Flow (MM)	2878	3260	2223	(3176)	2440

iQ Method-Quality of Earnings

	2003A	2004A	2005E	2006E	2007E
Cash Realisation Ratio x	1.9	1.6	1.7	0.5	1.7
Asset Replacement Ratio x	0.8	0.9	1.5	1.9	1.9
Tax Rate %	24.6	31.3	30.5	29.9	29.7
Net Debt/Equity %	22.8	14.5	(3.9)	10.9	11.3
Interest cover x	3.5	3.8	5.8	7.5	7.1

iQdatabase[SM]

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2006 ANALYST REPORTS

E.ON

Details, details, details

€91.81
02 March 2006

Electric Utilities

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- E.ON are scheduled to release detailed FY05 results on March 9 at around 10am CET, with a conference call at 2pm CET. Outline group results were announced on February 21 (see Table 1).
- **Detail 1 – results:** With 12 separate divisional reporting lines, even if reported core EBIT came in within 1% of consensus expectations, there could be substantial deviations in divisional performance.
- **Detail 2 – Deal timetable:** By necessity E.ON management were somewhat vague on the timetable of their bid for Endesa at the conference call of February 21. Now that the Gas Natural bid has been approved by the CNMV we would look for an update on E.ON's proposed timetable, and possibly what they might do in the event of a Gas counterbid.
- **Detail 3 – Deal economics post regulation:** The Spanish government launched a law decree on February 24 that (a) increased the powers of the energy regulator (CNE) and (b) introduced a temporary cap on the wholesale power price that can be passed through to retail customers. See our March 1 note "Iberdrola – Decree on 2006 provisional measures" for more information. We'd look for E.ON comments on these changes, and whether they might affect their view of the deal's economics.
- **Detail 4 – The day job:** Uncertainty regarding German energy policy, network price regulation and CO2 all continue. We'd look for management comments in this regard also.

Group level results pre-announced on February 21

Table 1: E.ON FY05 results

€m	FY04A	FY05A	% ch.
Core energy EBITDA	9,792	10,282	5%
Core energy EBIT	6,783	7,326	8%
Net income, group	4,339	7,420	71%
Cash from operations	5,800	6,554	13%
EPS	6.60	11.26	71%
DPS	2.35	7.00	198%

Source: Company reports

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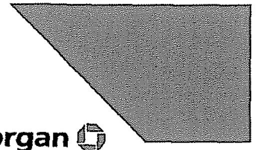

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6 January 2006

BUY (1)
Medium Risk (M)

E.ON (EONG.DE)

Price target raised to €100

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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 (%)
2003A	42,541	8,426	4.24	4.24	21.0	1.1	8.7	2.00	2.2
2004A	44,745	10,099	5.52	5.52	16.1	0.9	7.2	2.35	2.6
2005E	51,637	9,850	5.87	5.87	15.1	1.1	7.4	7.01	7.9
2006E	50,685	10,595	6.60	6.72	13.5	1.0	6.9	3.24	3.6
2007E	50,751	10,909	6.84	6.83	13.0	1.1	6.7	3.81	4.3

52W Price Range: €89.72 to 64.50				Price Performance (%)	Ytd	-1m	-3m	-12m
Expected Share Price Return	12.5%	Shares Outstanding	683.6m	Absolute	1.60	9.40	13.90	37.30
Expected Dividend Yield	7.9%	Market Cap.	€60,764.6m	Relative to Local	-0.39	4.45	4.67	5.98
Expected Total Return	20.4%	ROE (Curr Yr)	11.5%	Relative to DJ STOXX	-0.03	6.04	7.25	6.98

Sources: Company reports and Citigroup Investment Research estimates

Price: €88.89	Target:€100.00	Rating: Unchanged	EPS: Changed

Europe

Summary

- **We are upgrading our E.ON price target to €100 per share (previously €90), excluding an anticipated €7 per share dividend distribution in March 2006**
- **As with RWE, we are upgrading our FY07E achieved power price assumption from €37/MWh to €40/MWh and also adopting harsher conservative carbon allocation assumptions for 2008-2012**
- **Our forecasts also now factor in disposal of Degussa**
- **Our SoP valuation now stands at €99 per share at 31 December 2006 and takes into account the current market value of E.ON 6.4% stake in Gazprom**
- **We retain a Buy/ Medium Risk (1M) rating**

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Opinion

In an accompanying sector report published today[1], we are shifting to new power price and carbon price assumptions for RWE, which remains one of our top five utility stocks. The purpose of this short note is to make the same adjustments to our forecasts for E.ON. We are also taking other recent developments into account, including the rise in the value of E.ON's stake in Gazprom and the agreement with RAG to exit from Degussa. Chiefly, because we see no near-term solution to E.ON's underleveraged balance sheet, we have taken the stock off our list of top five utility stocks. However, the stock remains undervalued in our view, and we are maintaining our Buy rating with a target price raised from €90 per share to €100 per share (not counting a €7 per share dividend distribution due in March).

Forecast changes

The chief changes we are making to our assumptions are as follows:

- **Power prices** – We are sticking with an achieved power price estimate of €35/MWh for FY06E but raising our assumption for FY07E from €37/MWh to €40/MWh. Our long-run power price assumption rises from €43/MWh to €47/MWh, in line with our latest estimate of the new entrant generation price in Germany.
- **Emissions trading** – We now assume the German government takes advantage of the provision to auction off 10% of the permits it allocates for the 2008-2012 period. As with RWE, we now assume the total shortfall for the 2008-2012 period is 25%, against 10% previously, which we assume E.ON fill by buying permits at €20/tonne.
- **Degussa** – We factor in the disposal of E.ON's 43% stake in Degussa for €2.3bn, in line with E.ON's announcement of 19 December 2005. Also, we assume E.ON pays a special dividend of €4.25 per share in March 2005 on top of the ordinary dividend, which we forecast at €2.76 per share.

The first two issues are discussed in more detail in our sector report[1]. As a result of these changes, our pre-exceptional EPS estimates change as follows:

- for FY06E, we are downgrading by 2%, to €6.60; and
- for FY07E and FY08E we are marginally upgrading to €6.84 in both years.

Balance sheet

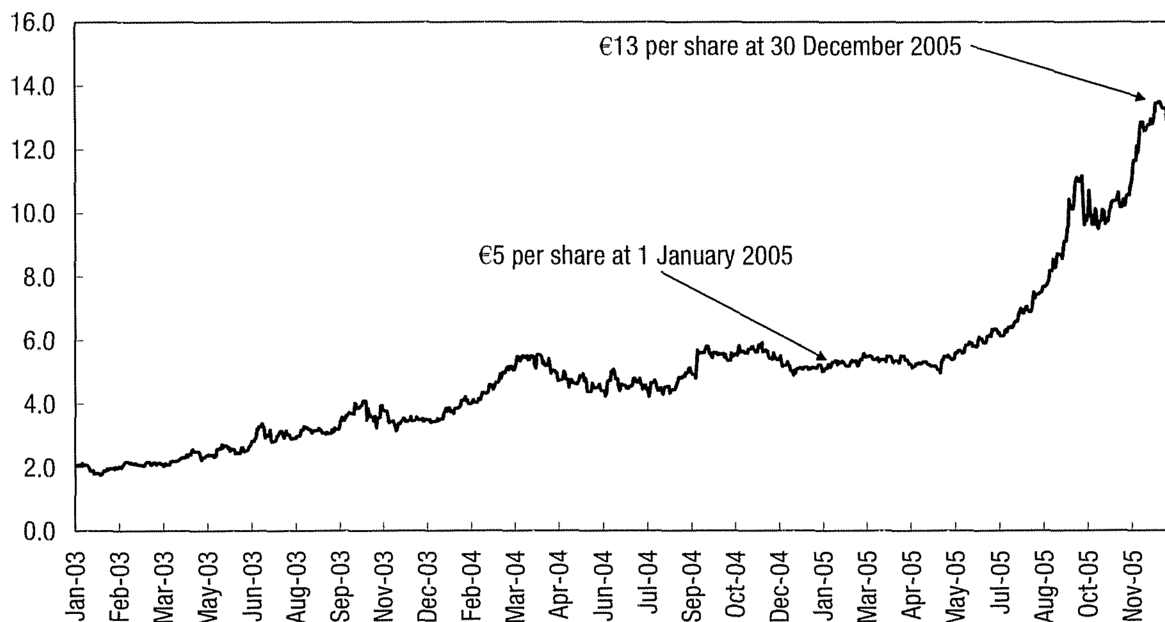
E.ON, of course, remains grossly underleveraged. We expect E.ON, having walked away from Scottish Power on 22 November 2005, to remain underleveraged for the foreseeable future. We are sceptical that the company will announce a further special dividend (on top of the Degussa payment) or carry out a share buy-back to releverage the balance sheet, and we do not anticipate any major investments in the near term that would effectively accomplish the same thing. We would not be surprised were E.ON to revive its interest in ScottishPower in due course, and we would view this as a potential positive trigger for E.ON's shares. However, we suspect it will not materialise until 2H06. Any such acquisition is unlikely to close until 2007, when Scottish Power should complete the Pacificorp disposal. Reaching agreement over price is still likely to prove a major stumbling block in the way of any takeover of ScottishPower by E.ON.

Valuation

The E.ON sum of parts calculation has become increasingly affected by movements in the share price of Gazprom, in which E.ON owns a 6.43% stake. As Figure 1 sets out, the market value of this asset has risen from €3.6bn (or €5.1 per E.ON share) at 1 January 2005 to €9.0bn, or €13.0 per E.ON share, at the end of December. This asset is accounted for as part of E.ON's financial assets, which are marked to market at the balance sheet date.

[1] See *Utilities 2006 Earnings outlook remains robust*, 6 January 2006

Figure 1. Value of E.ON's 6.43% Stake in Gazprom at Market Prices (€ per E.ON Share)



Source: Bloomberg and Citigroup Investment Research Analysis

Our last published valuation of E.ON took the financial assets basically at the 31 December 2004 balance sheet valuation of €17.5bn. This of course failed to capture the rise in the Gazprom share price. We are correcting for this in the SoP calculation below, which is based on the current market value of Gazprom. Our valuation also takes into account the €4.25 special dividend to be distributed in relation to the Degussa disposal (i.e. it is "ex" the Degussa special dividend). In total, our SoP now stands at €99 per share against our last published estimate of €93 per share.

Figure 2. E.ON Summary Sum of Parts

	Value (€m)	*Value per share (€m)*	*Method*	*FY06E EBITDA (€m)*	*Reality check*
Central Europe	39,264	57	Chiefly based on DCF of component parts	5,668	6.9x FV/EBITDA multiple in 2006E
Pan-European gas	9,582	14	DCF/RAB benchmarking	1,647	5.8x FV/EBITDA multiple in 2006E
UK	11,173	16	£0.3m per MW, £160 per customer and RABs	1,613	6.9x FV/EBITDA multiple in 2006E
Nordic	10,535	15	Assumed EBITDA multiple	1,317	8.0x FV/EBITDA multiple in 2006E
US-Midwest	4,049	6	Assumed EBITDA multiple	540	7.5x FV/EBITDA multiple in 2006E
Corporate centre	-1,320	-2	Assumed EBITDA multiple	-189	7.0x FV/EBITDA multiple in 2006E
Total core businesses (ex associates)	**73,283**	**106**		**10,595**	**6.9x FV/EBITDA multiple in 2006E**
Financial assets	19,229	28	Estimated book value at 31/12/06 including current market value of Gazprom	725	
of which 6.42% of Gazprom	9,552	14			
Total	**92,512**	**134**		**11,320**	**0**
Net cash	2,751	4	*Forecast book value at 31/12/05*		
Pension liabilities	-8,269	-12	Forecast book value at 31/12/05		
Nuclear liabilities	-8,184	-12	Based on Smith Barney model - current book value is €12.3bn		
Other liabilities	-5,844	-8	Based on Smith Barney model - current book value is €13.0bn		
Minorities	-4,252	-6	Forecast book value at 31/12/05		
Net equity value	**68,713**	**99**			

Source: Citigroup Investment Research

Based on the FY06E and FY07E P/E and EV/EBITDA multiples, a sector average rating would imply a share price of between €86 and €104 per share. The P/E multiples are arguably distorted by E.ON's unleveraged balance sheet, and the headline EV/EBITDA is affected by the fact that the financial assets generate little return. Stripping these out in line with book value (i.e. focussing on the pre-associate EV/EBITDA multiple), a sector average multiple suggests a share price in excess of €100. This would rise further were we to adjust for the financial assets at current market value.

Taking into account both our revised SoP and the valuation multiples, we have opted for a €100 target price. Taking into account our forecast for a dividend distribution of €7.0 per share in March 2006, this should provide a total return of 20% based on the current share price.

Figure 3. Valuation Multiples

	FY06E	FY07E
PE (pre-exceptional, pre-goodwill)		
E.ON	13.5	13.0
Sector average	13.7	12.6
E.ON share price at sector average	**90**	**86**
EV/EBITDA (adjusted)		
E.ON	7.7	7.5
Sector average	7.8	7.3
E.ON share price at sector average	**91**	**87**
EV/EBITDA (adjusted, pre associates)		
E.ON	6.4	6.2
Sector average	7.4	6.9
E.ON share price at sector average	**104**	**100**
Dividend yield	3.7%	4.3%
E.ON	4.4%	4.8%
Sector average	**74**	**79**
E.ON share price at sector average	13.5	13.0

Source: Citigroup Investment Research

Figure 4. Divisional Breakdown (€m)

Adjusted EBIT	2003A	2004A	2005E	2006E	2007E	2008E	2009E	2010E
Central Europe	2,979	3,602	4,194	4,410	4,608	4,670	4,766	4,868
Pan-European Gas	1,463	1,428	1,430	1,664	1,574	1,462	1,350	1,334
UK	610	1,017	1,028	1,060	1,093	1,125	1,157	1,190
Nordic	546	701	746	849	959	1,076	1,199	1,330
US-Midwest	317	349	350	350	357	364	371	378
Corporate centre/consolidation	-319	-314	-330	-231	-231	-231	-231	-231
Core businesses	**5,596**	**6,783**	**7,418**	**8,103**	**8,360**	**8,466**	**8,613**	**8,870**
Viterra	456	471	0	0	0	0	0	0
Degussa	176	107	150	0	0	0	0	0
Total continuing operations	**6,228**	**7,361**	**7,568**	**8,103**	**8,360**	**8,466**	**8,613**	**8,870**

Source: Company reports and Citigroup Investment Research estimates

Figure 5. Key Financial Items

	2003 A	2004 A	2005 F	2006 F	2007 F	2008 F	2009 F	2010 F
EPS from ongoing operations (€)	6.04	6.62	6.52	7.36	6.84	6.84	6.95	7.17
EPS from discontinued operations/other (€)	1.07	-0.01	4.93	0.00	0.00	0.00	0.00	0.00
Total reported group EPS (€)	7.11	6.61	11.45	7.36	6.84	6.84	6.95	7.17
Adjusted EPS (€)	4.24	5.52	5.87	6.60	6.84	6.84	6.95	7.17
DPS (€)	2.00	2.35	7.01	3.24	3.81	3.93	4.04	4.17
Cashflow/share (€)	9.6	9.8	9.9	11.4	11.8	11.9	12.2	12.5
Free cash flow (€m)	2,878	3,260	2,649	3,616	3,535	3,646	3,824	4,078
Net cash (debt) (E.ON definition) (€m)	-7,855	-5,483	2,632	2,751	3,647	4,255	4,939	5,772
Gearing	*26%*	*17%*	*-4%*	*-4%*	*-6%*	*-7%*	*-8%*	*-9%*
Payout ratio based on clean earnings	47%	43%	119%	49%	56%	57%	58%	58%
EBITDA/net interest expense	8.5	9.2	24.5	25.0	27.7	29.0	30.7	33.7

Source: Company reports and Citigroup Investment Research estimates

Figure 6. Group Financial Forecasts (€m)

Profit and Loss	2003 A	2004 A	2005 F	2006 F	2007 F	2008 F	2009 F	2010 F
Sales	42,541	44,745	51,637	50,685	50,751	51,011	51,291	51,685
Operating costs	33,991	34,922	41,787	40,090	39,842	39,942	40,026	40,118
Adjusted EBITDA before associates	8,550	9,823	9,850	10,595	10,909	11,069	11,265	11,568
Adjusted EBITDA including associates	9,458	10,520	10,575	11,165	11,474	11,628	11,820	12,117
Depreciation	-3,230	-3,159	-3,048	-3,103	-3,155	-3,203	-3,248	-3,288
Adjusted EBIT	6,228	7,361	7,527	8,062	8,319	8,425	8,572	8,829
of which associates & income from investments	908	697	725	570	565	560	555	549
Adjusted interest income	-1,663	-1,140	-904	-888	-869	-869	-866	-855
Net book gains	1,257	589	403	0	0	0	0	0
Restructuring costs and non-operating earnings	-479	-108	-14	0	0	0	0	0
Other non-operating earnings	195	97	50	0	0	0	0	0
Pre-tax profit	5,538	6,799	7,062	7,175	7,449	7,556	7,706	7,973
Tax	-1,124	-1,947	-2,235	-2,270	-2,359	-2,433	-2,482	-2,569
Minorities	-464	-504	-529	-556	-583	-613	-643	-675
Discontinued items/other	697	-9	3,247	500	0	0	0	0
Net attributable profit	4,647	4,339	7,545	4,848	4,507	4,510	4,581	4,729
Adjusted net attributable profit	2,772	3,621	3,871	4,348	4,507	4,510	4,581	4,729

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

Cash flow	2003 A	2004 A	2005 F	2006 F	2007 F	2008 F	2009 F	2010 F
Gross cash flow	5,538	5,972	6,199	7,416	7,685	7,796	7,974	8,228
Capex	-2,660	-2,712	-3,550	-3,800	-4,150	-4,150	-4,150	-4,150
Acquisitions	-6,536	-2,958	-1,451	-1,200	0	0	0	0
Disposal proceeds	7,463	1,825	8,752	2,800	0	0	0	0
Dividends	-1,621	-1,598	-1,835	-5,098	-2,639	-3,038	-3,140	-3,245
Issue/(redemption) of group equity	-7	0	0	0	0	0	0	0
Other/change in scope of consolidation	2,966	1,990	0	0	0	0	0	0
Change in net debt	5,143	2,519	8,115	118	896	608	684	833

Balance Sheet	2003 A	2004 A	2005 F	2006 F	2007 F	2008 F	2009 F	2010 F
Intangible assets	4,153	3,788	3,440	3,125	2,838	2,578	2,341	2,127
Property plant and equipment	42,797	43,563	40,539	42,751	44,033	45,740	46,879	48,455
Financial assets	17,725	17,263	17,676	17,961	18,243	18,523	18,800	19,075
Stocks	2,477	2,647	2,687	2,727	2,768	2,809	2,852	2,894
Receivables	18,025	18,436	18,567	18,700	18,836	18,975	19,116	19,260
Cash and equivalents	10,795	12,016	5,000	5,000	5,000	5,000	5,105	5,938
Other assets	1,923	1,895	1,895	1,895	1,895	1,895	1,895	1,895
Total assets	97,895	99,608	89,803	92,159	93,613	95,519	96,987	99,644
Debt	-19,631	-18,333	-3,202	-3,083	-2,187	-1,579	-1,000	-1,000
Provisions	-34,328	-34,242	-33,829	-34,622	-35,445	-36,297	-37,181	-38,097
Trade creditors	-3,778	-3,662	-3,735	-3,810	-3,886	-3,964	-4,043	-4,124
Other liabilities	-13,449	-13,516	-16,279	-13,320	-13,219	-12,821	-12,426	-12,035
Minorities	-4,625	-4,144	-4,197	-4,252	-4,311	-4,372	-4,436	-4,504
Shareholders Funds	29,774	33,560	36,410	40,920	42,414	44,336	45,750	47,733

Source: Company reports and Citigroup Investment Research estimates

Investment Thesis

We rate E.ON Buy/ Medium Risk (1M) with a €90 target price. We believe the core German electricity business should benefit over the next couple of years from higher wholesale power prices, and we are relaxed about the potential impact of regulatory changes on network profits. We also think the competitive threat to Ruhrgas in Germany is manageable, at least for the next few years. This leaves scope for the strong financial fundamentals of E.ON to assert themselves. Under CEO Wulf Bernotat, E.ON has steadily become a much more shareholder-friendly company over the last 2 years and recently adopted a new, more generous dividend policy. The main cloud on the horizon is that the company suffers from an increasingly underleveraged balance sheet. E.ON is likely to resolve this problem by making large acquisitions. Although we are concerned about the risk of overpayment by E.ON, we suspect the advantage of a more efficient balance sheet structure will lead to share price upside. We also believe the strength of the German wholesale power market still has scope to drive the share price higher.

Valuation

We use a sum-of-parts method applying a variety of valuation techniques to the various divisions. For the German electricity business we use DCF for generation and use comparable company analysis to value networks. We apply EV/EBITDA multiples to the downstream gas and international businesses, save Powergen, where we value the power stations and supply business in line with recent trade sale multiples and derive a network valuation based on the regulatory asset base. For Ruhrgas we use a SOP technique. Non-core valuations are based on agreed sales prices or estimated market values. Financial assets are taken at book value, while nuclear liabilities are subtracted at a value generated by a separate DCF model. Pension provisions are deducted at book value and a portion of the book value of other provisions is also subtracted. Our latest SOP valuation is €99 per share. We cross check our sum-of-parts valuation by reference to valuation multiples at group level. On the current FY06E sector average core EV/EBITDA multiple, E.ON would trade at €104 per share. Overall, we think a target price of €100 looks reasonable.

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 Citigroup 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 P&L 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.

ANALYST CERTIFICATION

Appendix A-1

I, Daniel Martin, research analyst and the author of this report, 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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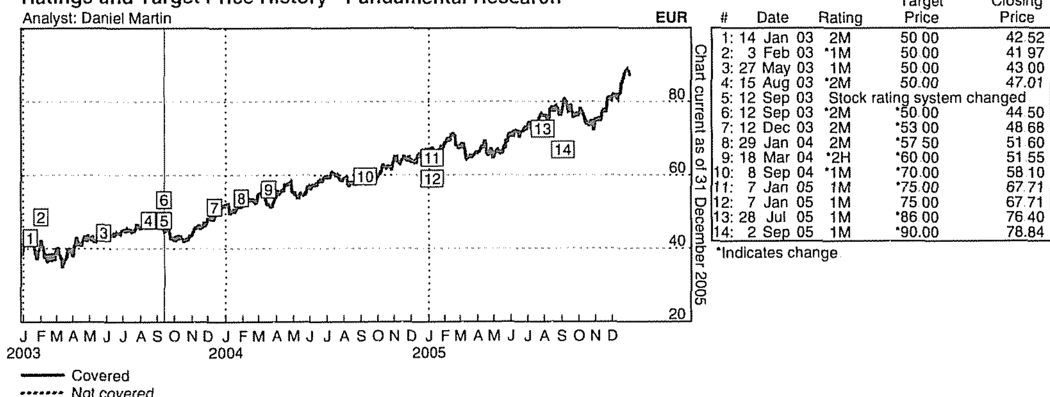
E.ON (EONG.DE)

Ratings and Target Price History - Fundamental Research

Analyst: Daniel Martin



#	Date	Rating	Target Price	Closing Price
1:	14 Jan 03	2M	50.00	42.52
2:	3 Feb 03	*1M	50.00	41.97
3:	27 May 03	1M	50.00	43.00
4:	15 Aug 03	*2M	50.00	47.01
5:	12 Sep 03	Stock rating system changed		
6:	12 Sep 03	*2M	*50.00	44.50
7:	12 Dec 03	2M	*53.00	48.68
8:	29 Jan 04	2M	*57.50	51.60
9:	18 Mar 04	*2H	*60.00	51.55
10:	8 Sep 04	*1M	*70.00	58.10
11:	7 Jan 05	1M	*75.00	67.71
12:	7 Jan 05	1M	75.00	67.71
13:	28 Jul 05	1M	*86.00	76.40
14:	2 Sep 05	1M	*90.00	78.84

*Indicates change.

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ADDITIONAL INFORMATION IS AVAILABLE UPON REQUEST

E.ON AG

Strong Fundamentals Clouded By M&A

Company Update **NEUTRAL**

Equity | Germany | Electric Utilities
11 January 2006

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Dividends Sooner, Acquisitions Later?

The lack of an immediate acquisition opportunity may lead management to address shareholder returns in the coming months. We expect 20% ordinary DPS growth for 2005E; the EUR4.25/share special dividend from Degussa; and wonder whether an open-ended buy-back might be in the offing until a realistic target appears. Moreover, power market fundamentals are buoyant. However, E.ON is not the most sensitive play on wholesale prices, the restructuring is essentially over after the Degussa sale, and the clear corporate ambition for a major acquisition somewhat shades the other strong medium term positives in our view.

This note updates our forecasts and valuation for our latest, higher assumptions on power prices.

Limited Upside to Sector Rating

Our SOP valuation is now EUR98/share (up from EUR83/share) mainly due to higher power price assumptions and the recent strength in Gazprom's share price. This value includes EUR4.25/share special dividend. The SOP implies a sector average 2007E EV/EBITDA multiple of 7.8x, which we believe is appropriate given the degree of M&A uncertainty. We retain our Neutral recommendation.

Estimates (Dec)

(EUR)	2003A	2004A	2005E	2006E	2007E
	IFRS	IFRS	IFRS	IFRS	IFRS
EPS (Reported)	7.11	6.60	10.81	7.65	7.39
EPS (Adjusted)	4.42	5.74	5.88	6.83	7.39
EPS Change (YoY)	*28.7%*	*29.8%*	*2.5%*	*16.2%*	*8.1%*
Dividend / Share	2.00	2.35	7.07	3.42	3.69
ADR EPS (Adjusted - US$)	1.86	2.60	2.31	2.75	2.97
ADR Dividend / Share (US$)	0.84	1.06	2.78	1.37	1.49
EBITDA (Adjusted)	9,458	10,520	10,371	11,070	11,964

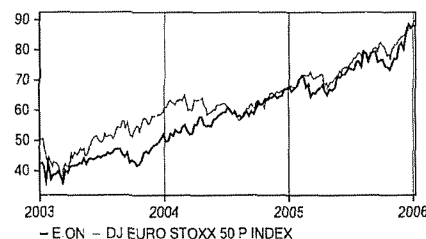
Valuation (Dec)

	2003A	2004A	2005E	2006E	2007E
P/E	19.9x	15.3x	15.0x	12.9x	11.9x
Dividend Yield	2.26%	2.66%	8.00%	3.87%	4.18%
EV / EBITDA*	9.32x	8.38x	8.50x	7.96x	7.37x
Free Cash Flow Yield*	4.98%	5.61%	3.75%	-6.67%	3.24%
EV/EBITDA (Adjusted)	---	---	8.47x	8.00x	7.46x

* For full definitions of *iQmethod*SM measures, see page 11

Stock Data

Price (Common / ADR)	EUR88.03 / US$35.60
Investment Opinion	A-2-7 / A-2-7
Volatility Risk	LOW / LOW
52-Week Range	EUR63.90-89.88
Market Value (mn)	EUR58,012
Shares Outstanding (mn)	659.0 / 1,979.0
Average Daily Volume	2,820,551
ML Symbol / Exchange	EONAF / GER
ML Symbol / Exchange	EON / NYS
Bloomberg / Reuters	EOA GR / EONG.DE
ROE (2005E)	12.0%
Net Dbt to Eqty (Dec-2004A)	35.3%
Est. 5-Yr EPS / DPS Growth	9.2% / 13.7%
Free Float	91.1%



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Refer to important disclosures on page 12 to 14. Analyst Certification on page 11.

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iQprofile[SM] E.ON AG

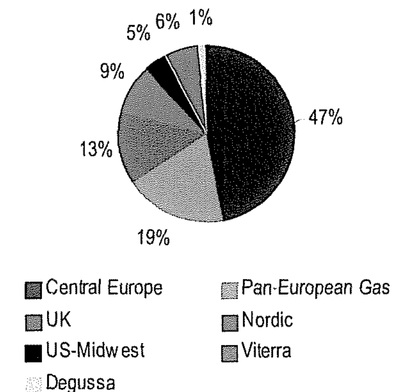
Key Income Statement Data (Dec)	2003A	2004A	2005E	2006E	2007E
(EUR Millions)	IFRS	IFRS	IFRS	IFRS	IFRS
Sales	46,364	49,103	52,893	54,885	57,931
EBITDA Adjusted	9,458	10,520	10,371	11,070	11,964
Depreciation & Amortization	(3,230)	(3,159)	(2,988)	(2,968)	(3,167)
EBIT Adjusted	6,228	7,361	7,382	8,102	8,798
Net Interest & Other Income	(1,663)	(1,140)	(1,055)	(894)	(1,056)
Tax Expense / Benefit	(1,124)	(1,947)	(1,932)	(2,160)	(2,302)
Net Income (Adjusted)	2,891	3,770	3,875	4,504	4,869
Average Fully Diluted Shares Outstanding	654	657	659	659	659
Key Cash Flow Statement Data					
Net Income (Reported)	4,647	4,339	7,122	5,042	4,869
Depreciation & Amortization	3,230	3,159	2,988	2,968	3,167
Change in Working Capital	(1,191)	(900)	(530)	(254)	(371)
Deferred Taxation Charge	0	0	0	0	0
Other Adjustments, Net	(1,148)	(626)	(3,000)	(5,563)	335
Cash Flow from Operations	5,538	5,972	6,580	2,193	7,999
Capital Expenditure	(2,660)	(2,712)	(4,395)	(6,078)	(6,114)
(Acquisition) / Disposal of Investments	(6,536)	(2,573)	(1,491)	(639)	(639)
Other Cash Inflow / (Outflow)	9,235	4,689	7,991	3,439	639
Cash Flow from Investing	39 0	(596)	2,105	(3,278)	(6,114)
Share Issue / (Repurchase)	0	(18 0)	0	0	0
Cost of Dividends Paid	(1,621)	(1,598)	(2,058)	(5,192)	(2,812)
Cash Flow from Financing	(3,545)	(4,461)	(2,058)	(5,192)	(2,812)
Non Cash Changes to Debt	(53 0)	(60 0)	0	0	0
Change in Net Debt	(4,016)	(3,820)	(6,627)	6,277	927
Net Debt	7,855	5,483	(1,339)	4,938	5,865
Key Balance Sheet Data					
Property, Plant & Equipment	46,950	47,351	38,360	39,170	42,117
Goodwill	13,955	14,454	14,162	14,162	14,162
Other Intangibles	---	---	---	---	---
Other Non-Current Assets	18,269	17,980	17,980	17,980	17,980
Trade Receivables	6,047	6,534	7,246	7,518	7,936
Cash & Equivalents	11,776	12,850	19,477	13,200	12,273
Other Current Assets	14,853	14,893	14,579	14,698	14,882
Total Assets	111,850	114,062	111,805	106,730	109,351
Long-Term Debt	19,631	18,333	18,138	18,138	18,138
Other Non-Current Liabilities	43,707	43,971	44,046	38,477	38,241
Short-Term Debt	---	---	---	---	---
Other Current Liabilities	14,113	14,054	14,440	14,566	14,777
Total Liabilities	77,451	76,358	76,624	71,182	71,156
Total Equity	34,399	37,704	35,180	35,548	38,195
Total Equity & Liabilities	111,850	114,062	111,805	106,730	109,351
Key Metrics					
iQmethod[SM] **- Bus Performance***					
Return On Capital Employed	4 76%	5 65%	5 33%	6 13%	6 76%
Return On Equity	10.4%	11 9%	12 0%	14.4%	14 9%
Operating Margin	13 4%	15 0%	14 0%	14 8%	15 2%
Free Cash Flow (MM)	2,878	3,260	2,185	(3,885)	1,885
iQmethod[SM] **- Quality of Earnings***					
Cash Realization Ratio	1 92x	1 58x	1 70x	0 49x	1 64x
Asset Replacement Ratio	0 82x	0 86x	1 47x	2 05x	1 93x
Tax Rate	24 6%	31 3%	30 5%	30 0%	29 7%
Net Debt/Equity	22 8%	14 5%	-3 81%	13 9%	15 4%
Interest Cover	3 54x	3 81x	5 79x	7 27x	6 89x

* For full definitions of *iQmethod*[SM] measures, see page 11

Company Description

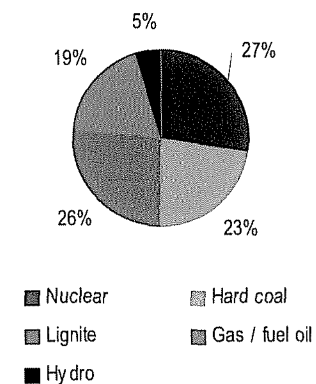
E ON has transformed itself from domestic conglomerate to Europe's biggest energy utility, with a portfolio of mainly vertically integrated assets across Germany, Central Europe, the Nordic Region, the UK and the US It is active in both electricity and gas and its subsidiary Ruhrgas is likely to be central to future growth from this platform as power/gas convergence gathers pace over the next decade

Chart 1: 2004A EBIT



Source: Merrill Lynch Estimates

Chart 2: 2004A Generation Capacity Germany



Source: Merrill Lynch Estimates

Stock Data

Shares / ADR	0 33
Price to Book Value	1.9x

High Quality Generation Mix

The focus of this note is to reassess E.ON's earnings and valuation in the light of our new, higher wholesale power price assumptions.

E.ON's sensitivity to power prices is lower than RWE's. This is a function of the lower production in Germany (c120TWh), the broader diversification of assets (E.ON has more gas assets for example) and lower financial gearing. E.ON also has a further 26TWh of output in Sweden exposed to Nordpool prices. **Each EUR1/MWh on the EEX forward price would increase EBIT by around EUR120m, or c1.5%.** However, the practice of forward selling a year or more ahead means that E.ON will typically benefit from any price rise 12-18 months later.

E.ON has a high quality generation mix in Germany. As well as 46% of output being non-fossil fuel nuclear (34%) and hydro (12%) E.ON has 30% hard coal. The improving dark spread should boost overall profitability into 2007, once existing hedges unwind.

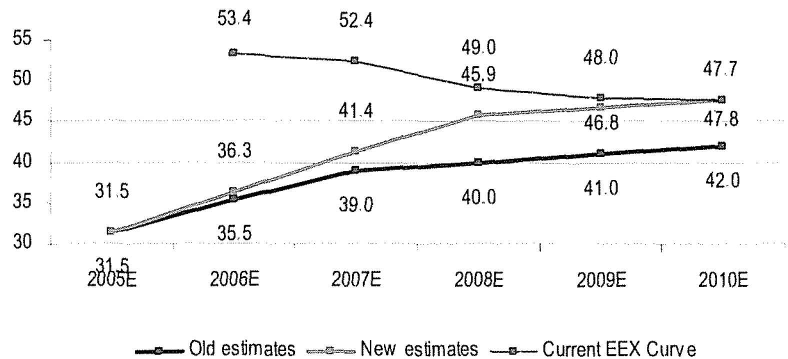
ML Price Assumptions Raised

Our forecasts for E.ON are based on the current EEX forward curve, adjusted in 2005/6/7 to reflect the lagged impact of the 12-18 month hedging programme. We have made substantial changes to our electricity price forecasts, which had not been adjusted since September, to reflect the significant move upwards in the curve in the last few weeks.

The main changes are to the longer dated end of the power curve. For example, we now use EUR45/MWh held in real terms, which gives an outturn of EUR47.8/MWh in 2010, versus EUR42/MWh previously.

The EUR36.3/MWh realised baseload price used in our 2006 forecasts reflects forward sales already in place. E.ON sold most of its 2006 output well before the recent run up in prices. Similarly, the EUR41.4/MWh we have used in 2007 reflects our estimate of the forward sales – we anticipate E.ON has already hedged upwards of 60% of sales (56% declared in November).

Chart 3: ML Assumptions E.ON's Realised Price (EUR/MWh)



Source: Merrill Lynch estimates, EEX

Financials

The impact of current high prices will not feed through in full to E.ON's P&L until 2008, assuming the forward curve remains at these levels, given the company's hedging strategy.

We have also adjusted our forecasts to account for the sale of Degussa, announced in December 2005, with the EUR2.8bn proceeds being fully paid back to shareholders through a EUR4.25/share exceptional dividend (payable in 2006).

Our 2005E forecasts remain unchanged, and for 2006E actually fall marginally, mainly due to the higher investment plans announced in December 2005. We have raised our recurrent EBIT forecasts for 2007 by 2% and 2008-10E by 7-9%. EPS forecasts for 2008E and beyond also rise by 5-6%.

We expect a 6.4% EBIT CAGR (2004A-2009E), mainly driven by Central Europe (9.4% CAGR) and Nordic (12.1%).

Full financial statements are shown at the end of this section.

Table 1: Changes in ML estimates (EURm)

	2005E	2006E	2007E	2008E	2009E	2010E
Continuing EBITDA						
Old estimates	10,371	11,204	11,710	12,014	12,350	12,586
New estimates	**10,371**	**11,070**	**11,964**	**12,800**	**13,300**	**13,560**
% change	*0%*	*-1%*	*2%*	*7%*	*8%*	*8%*
Adjusted EBIT						
Old estimates	7,382	8,240	8,655	8,951	9,276	9,504
New estimates	**7,382**	**8,102**	**8,798**	**9,576**	**10,059**	**10,315**
% change	*0%*	*-2%*	*2%*	*7%*	*8%*	*9%*
Recurrent EPS						
Old estimates	5.94	7.07	7.38	7.82	8.41	8.91
New estimates	**5.88**	**6.83**	**7.39**	**8.24**	**8.92**	**9.45**
% change	*-1%*	*-3%*	*0%*	*5%*	*6%*	*6%*
DPS						
Old estimates	2.82	3.53	3.69	3.91	4.21	4.45
New estimates	**7.07**	**3.42**	**3.69**	**4.12**	**4.46**	**4.73**
% change	*151%*	*-3%*	*0%*	*5%*	*6%*	*6%*

Source: Merrill Lynch estimates

German Legislation in 2006

There is a great deal of regulatory and political change underway in Germany which will affect utilities. Regulation-wise, the key issue in 2006 is that the regulator will announce tariff cuts in Spring based on the existing framework. Later in the year, new forward-looking tariff calculations will come into play. We continue to assume that tariff cuts will cumulatively reach cEUR560m by 2008, and that the net effect on E.ON after assuming cost cuts will be cEUR280m or 4% of 2005E EBIT.

The German nuclear debate will continue to rumble on, given fresh impetus by the energy security worries resulting from Gazprom cutting gas supplies via Ukraine. We continue to believe that nuclear life extensions are inevitable during this parliament. Pressure for the disparate views to reach a workable consensus may accelerate post-Ukraine. We estimate that life extensions are worth at least EUR5/share to E.ON net of an assumed windfall tax.

Other issues include the Federal Cartel Office plans to reduce the length of gas contracts between resellers and Distribution companies, which affects E.ON most because of its share in the gas market. This is expected to end up in Court and the case may take at least a year to resolve. The FCO has also dealt with customer complaints with power prices, a familiar story across Europe.

Investment Plans and Dividends

E.ON has announced its investment programme for 2006E-2008E last December, totalling EUR EUR18.6bn, at par with the EUR18.7bn plan for 2005-07E. The focus is however shifting to 'growth' rather investment in existing assets, with the new programme being effectively a bigger commitment to concrete projects - e.g. EUR2.0bn allocated last year to upstream gas investment is excluded from the new programme.

The plan earmarks EUR7.2bn for 'growth' (EUR4.2bn) with increases in Generation, T&D, Gas and Supply. Financial investments are much reduced to EU2.3bn (EUR6.1bn); this reduction is accounted for largely by upstream gas (above) and the reduced likelihood of buying the Statkraft stake in E.ON Sverige.

The decision to pull back from ScottishPower in November 2005 has been well received by investors – E.ON was the 2nd best performing Pan-European utility in Q4 2005. With ScottishPower off the agenda for the time being we raised our forecast DPS in November to EUR2.76/share, an increase of 20% versus 15% previously. The sale of Degussa should allow a special dividend of EUR2.8bn, or EUR4.25/share in the summer of 2006E.

This mix of ordinary and special dividends will still leave E.ON with an extremely inefficient balance sheet through 2006E. We believe E.ON still intends to grow through acquisitions, and ScottishPower still perhaps the most likely near term target. However, any fresh approach to ScottishPower cannot be made until May 2006 at the earliest; and price is likely to remain an issue. Alternative bid targets are not obvious and as such much more distant prospects.

These factors raise the possibility that E.ON announces an open-ended buy back programme in 2006. This would be a means of staving off further deterioration in balance sheet efficiency, whilst keeping the flexibility to make an acquisition if the opportunity arises.

Table 2: Profit and Loss Account (EURm)

	2003A	2004A	2005E	2006E	2007E	2008E	2009E	2010E	04A -09E CAGR	05E -10E CAGR
Total Sales	**46,364**	**49,103**	**52,893**	**54,885**	**57,931**	**58,209**	**58,753**	**59,734**	*3.7%*	*2.5%*
Growth	*27%*	*6%*	*8%*	*4%*	*6%*	*0%*	*1%*	*2%*		
Total EBITDA (incl associates)	**9,458**	**10,520**	**10,371**	**11,070**	**11,964**	**12,800**	**13,300**	**13,560**	*4.8%*	*5.5%*
Growth	*25%*	*11%*	*-1%*	*7%*	*8%*	*7%*	*4%*	*2%*		
Margin	*20%*	*21%*	*20%*	*20%*	*21%*	*22%*	*23%*	*23%*		
Core Business Energy	8,580	9,792	10,262	11,070	11,964	12,800	13,300	13,560		
Central Europe	*4,471*	*4,908*	*5,287*	*5,901*	*6,356*	*6,806*	*7,005*	*7,097*		
Pan-European Gas	*1,896*	*1,900*	*1,889*	*2,000*	*2,063*	*2,121*	*2,197*	*2,206*		
UK	*1,036*	*1,592*	*1,555*	*1,526*	*1,698*	*1,832*	*1,917*	*1,942*		
Nordic	*933*	*1,121*	*1,256*	*1,350*	*1,529*	*1,675*	*1,767*	*1,860*		
US-Midwest	*517*	*544*	*529*	*534*	*570*	*605*	*640*	*675*		
Corporate Center/Consolidation	*-273*	*-273*	*-254*	*-240*	*-252*	*-238*	*-227*	*-219*		
Viterra	643	621	0	0	0	0	0	0		
Degussa	235	107	109	0	0	0	0	0		
Total EBIT	**6,228**	**7,361**	**7,382**	**8,102**	**8,798**	**9,576**	**10,059**	**10,315**	*6.4%*	*6.9%*
Growth	*34%*	*18%*	*0%*	*10%*	*9%*	*9%*	*5%*	*3%*		
Margin	*13%*	*15%*	*14%*	*15%*	*15%*	*16%*	*17%*	*17%*		
Core Business Energy	5,621	6,783	7,274	8,102	8,798	9,576	10,059	10,315		
Central Europe	2,979	3,602	3,976	4,587	4,987	5,433	5,632	5,724		
Pan-Euro Gas	1,463	1,428	1,427	1,537	1,567	1,625	1,701	1,709		
UK	610	1,017	1,027	1,014	1,148	1,235	1,310	1,336		
Nordic	546	701	787	895	1,016	1,154	1,238	1,323		
US-Midwest	317	349	352	351	373	408	445	483		
Corporate Center/Consolidation	-294	-314	-295	-281	-293	-279	-268	-260		
Viterra	456	471	0	0	0	0	0	0		
Degussa	151	107	109	0	0	0	0	0		
Financial expenses	-1,663	-1,140	-1,055	-894	-1,056	-1,027	-874	-632		
PBET	**4,565**	**6,221**	**6,327**	**7,208**	**7,742**	**8,549**	**9,185**	**9,683**		
Extraordinary items and non operating income	973	578	0	0	0	0	0	0		
PBT	**5,538**	**6,799**	**6,327**	**7,208**	**7,742**	**8,549**	**9,185**	**9,683**	*6.2%*	*8.9%*
				-30%	-30%	-29%	-29%	-29%		
Income tax	-1,124	-1,947	-1,932	-2,160	-2,302	-2,516	-2,684	-2,816		
Minority interests	-464	-504	-520	-544	-571	-605	-621	-636		
Net income, continuing	**3,950**	**4,348**	**3,875**	**4,504**	**4,869**	**5,429**	**5,880**	**6,230**		
Discountinuing items / other	697	-9	3,247	538	0	0	0	0		
Group Net Income	**4,647**	**4,339**	**7,122**	**5,042**	**4,869**	**5,429**	**5,880**	**6,230**		
Growth	*67%*	*-7%*	*64%*	*-29%*	*-3%*	*12%*	*8%*	*6%*		
Recurrent Group Net Income	**2,891**	**3,770**	**3,875**	**4,504**	**4,869**	**5,429**	**5,880**	**6,230**	*9.3%*	*10.0%*
Growth	*29%*	*30%*	*3%*	*16%*	*8%*	*12%*	*8%*	*6%*		
Reported EPS (EUR p s.)	*7.11*	*6.60*	*10.81*	*7.65*	*7.39*	*8.24*	*8.92*	*9.45*	***6.2%***	***-2.6%***
Recurrent EPS (EUR p.s.)	*4.42*	*5.74*	*5.88*	*6.83*	*7.39*	*8.24*	*8.92*	*9.45*	***9.2%***	***10.0%***
DPS (EUR p.s.)	*2.00*	*2.35*	*7.07*	*3.42*	*3.69*	*4.12*	*4.46*	*4.73*	***13.7%***	
Of which exceptional			*4.25*							
Payout ratio (on reported earnings)	*28%*	*36%*	*65%*	*45%*	*50%*	*50%*	*50%*	*50%*		
Payout ratio (on recurrent earnings)	*45%*	*41%*	*120%*	*50%*	*50%*	*50%*	*50%*	*50%*		

Source: Merrill Lynch estimates

Table 3: Cash Flow (EURm)

	2003A	2004A	2005E	2006E	2007E	2008E	2009E	2010E	04A -09E CAGR	05E -10E CAGR
Net income	4,647	4,339	7,122	5,042	4,869	5,429	5,880	6,230		
Minority Interests	464	504	520	544	571	605	621	636		
Income from discontinued operations	-1,137	9	-3,247	-538	0	0	0	0		
Depreciation, Amortisation, Impairments	3,272	3,256	2,988	2,968	3,167	3,224	3,241	3,245		
Gains / Losses on Disposals	-1,815	-900	-403	0	0	0	0	0		
Change in provisions	1,586	36	129	-5,569	-237	-315	-404	-507		
Change in deferred taxes	-132	0	0	0	0	0	0	0		
Change in working capital	-1,191	-900	-530	-254	-371	-108	-99	-117		
Other non-cash items	-156	-372	0	0	0	0	0	0		
Cash Flow from Operations	**5,538**	**5,972**	**6,580**	**2,193**	**7,999**	**8,835**	**9,238**	**9,488**	**9.1%**	**7.6%**
Disposals	7,035	3,457	6,500	2,800	0	0	0	0		
Investments	-9,196	-5,285	-4,395	-6,078	-6,114	-5,400	-2,616	-2,616		
Change in securities > 3 months and other liquid funds	2,200	1,232	0	0	0	0	0	0		
Cash Flow from Investments	**39**	**-596**	**2,105**	**-3,278**	**-6,114**	**-5,400**	**-2,616**	**-2,616**	**34.4%**	**-204.4%**
Free cash flow	**2,878**	**3,260**	**8,685**	**2,193**	**7,999**	**3,435**	**6,622**	**6,872**	**15.2%**	**-4.6%**
Net change in treasury stock	7	0	0	0	0	0	0	0		
Payment of cash dividends	-1,621	-1,598	-2,058	-5,192	-2,812	-3,027	-3,323	-3,564		
Net proceeds from financial liabilities	-1,931	-2,845	0	0	0	0	0	0		
Cash flow from Financing	**-3,545**	**-4,461**	**-2,058**	**-5,192**	**-2,812**	**-3,027**	**-3,323**	**-3,564**	**-5.7%**	**11.6%**
Net cash income / outgoings	2,032	915	6,627	-6,277	-927	408	3,299	3,309		
Forex impact on net cash	-43	-60	0	0	0	0	0	0		
Cash from discontinued operations	-10	0	0	0	0	0	0	0		
Change net cash & equivalents	**1,979**	**855**	**6,627**	**-6,277**	**-927**	**408**	**3,299**	**3,309**	**31.0%**	**-13.0%**
Cash at y/e	**3,321**	**4,176**	**10,803**	**4,526**	**3,599**	**4,007**	**7,307**	**10,615**		

Source: Merrill Lynch estimates

Table 4: Balance Sheet (EURm)

	2003A	2004A	2005E	2006E	2007E	2008E	2009E	2010E
Net Goodwill	13,955	14,454	14,162	14,162	14,162	14,162	14,162	14,162
PPE & Intangibles	46,950	47,351	38,360	39,170	42,117	44,293	43,668	43,039
Financial Assets	17,725	17,263	17,263	17,263	17,263	17,263	17,263	17,263
Fixed Assets	**78,630**	**79,068**	**69,786**	**70,596**	**73,543**	**75,719**	**75,094**	**74,464**
Inventories	2,477	2,647	2,851	2,959	3,123	3,138	3,167	3,220
Receivables	18,025	17,883	18,595	18,867	19,285	19,323	19,397	19,532
Liquid Funds, Non-Cash	7,474	7,840	7,840	7,840	7,840	7,840	7,840	7,840
Cash & Cash Equivalents	3,321	4,176	10,803	4,526	3,599	4,007	7,307	10,615
Non-Fixed Assets	**31,297**	**33,099**	**40,089**	**34,192**	**33,847**	**34,308**	**37,711**	**41,207**
Other	1,923	1,895	1,930	1,942	1,961	1,956	1,956	1,963
TOTAL ASSETS	**111,850**	**114,062**	**111,805**	**106,730**	**109,351**	**111,983**	**114,761**	**117,634**
Shareholders' Equity	**29,774**	**33,560**	**31,026**	**31,382**	**34,018**	**37,008**	**40,174**	**43,470**
Minority Interests	4,625	4,144	4,154	4,165	4,177	4,189	4,201	4,214
Provisions	34,206	34,242	34,371	28,802	28,566	28,251	27,846	27,339
Financial Liabilities	21,787	20,301	20,106	20,106	20,106	20,106	20,106	20,106
Operating Liabilities	14,113	14,054	14,440	14,566	14,777	14,722	14,727	14,797
Other	7,345	7,707	7,707	7,707	7,707	7,707	7,707	7,707
TOTAL EQUITY & LIABILITIES	**111,850**	**114,062**	**111,805**	**106,730**	**109,351**	**111,983**	**114,761**	**117,634**

Source: Merrill Lynch estimates

Table 5: Balance Sheet Ratios

	2003A	2004A	2005E	2006E	2007E	2008E	2009E	2010E
Net Debt (Net cash)	7,855	5,483	-1,339	4,938	5,865	5,457	2,157	-1,151
Net Debt/Capitalisation	21%	14%	-5%	14%	15%	13%	5%	-3%
Net Debt + Fin Prrovisions	31,080	29,547	22,855	23,563	24,252	23,530	19,826	16,010
(Net Debt + Fin Prov)/(Capitalisation + Fin Prov)	51%	47%	42%	43%	42%	39%	33%	27%
ROCE	10%	11%	12%	13%	13%	14%	14%	15%
EBITDA/*Total net interest expenses*	5.7x	9.2x	9.8x	12.4x	11.3x	12.5x	15.2x	21.5x
EBITDA/Net interest on financial debt	14.3x	16.0x	64.9x	76.4x	34.9x	35.8x	52.1x	184.4x

Source: Merrill Lynch estimates

Valuation and Sensitivity Analysis

We are increasing our SOP valuation to EUR98/share from EUR83/share previously. The valuation has been rolled forward to 31st December 2006 and includes EUR4.25ps to be paid as an exceptional dividend from the Degussa sale in 2006.

Higher power prices account for the bulk of the increase. We have used a base load EEX price of EUR45/MWh from 2007E (adjusted for forward sales), held in real terms. In addition, the rise in the value of the Gazprom stake accounts for EUR3.8/share of delta, after an assumption for capital gains tax.

We have also amended our assumptions for 2006-2008E capex following the Company's update last December which affects end 2006E net debt.

The table below shows the multiples implied by E.ON's current trading multiples. We believe E.ON should trade at the peer group multiple of c7.7x 2007E EV/EBITDA. This indicates EUR94/share, including the EUR4.25 special dividend in 2006E.

Table 6: Sum of the Parts Valuation

Division	EUR m	EUR p.s.	% EV	Method	Implied multiple	
Central Europe	48,438	70	*51%*	694628.6347	8.2x	7.723283076
Pan-European Gas	11,901	17	*13%*	DCF, 7.25% WACC	6.8x	06E EBITDA
United Kingdom	9,497	14	*10%*	DCF and Premium to RAV	6.2x	06E EBITDA
Nordic	11,526	17	*12%*	DCF, 7.5% WACC	8.5x	06E EBITDA
US	4,180	6	*4%*	DCF, 6% WACC	7.8x	06E EBITDA
Gas Financial Assets	9,208	13	*10%*	PE, Market Value post tax		
Corporate Center	-2,983	-4	*-3%*	DCF, 9% WACC	7.0x	06E Cash Costs
EV	**91,767**	**133**	***97%***		**8.3x**	**06E EBITDA**
Treasury Shares	2,889	**4**	***3%***	Market price based		
Total Enterprise Value	**94,657**	**137**	***100%***		**8.4x**	06E EBITDA
(Net Financial Debt) / Cash	-4,938	-7	*0%*			06E
Provisions	-19,555	-28	*0%*			
Nuclear	-14,359	-21				06E
Pension	-3,203	-5				06E
Mining / Environmental	-1,994	-3				06E
Minority Interests	-5,290	-8	*0%*			06E Adj. Book
Equity Value as of 31 dec 2006	**64,873**	**93.8**	***69%***			
Equity Value before payment of EUR4.25 exceptional dividend		**98.0**				

Source: Merrill Lynch estimates

Table 7: Trading and Valuation Multiples

	EV/EBITDA				P/E				Div yield(1)				FCF yield			
	2005E	2006E	2007E	CAGR	2005E	2006E	2007E	CAGR	2005E	2006E	2007E	CAGR	2005E	2006E	2007E	CAGR
E.On @ Trading price	**8.5x**	**8.0x**	**7.5x**	**4.8%**	**15.0x**	**12.9x**	**11.9x**	**9.3%**	**3.2%**	**3.9%**	**4.2%**	**13.7%**	**15.0%**	**3.8%**	**13.8%**	**15.2%**
E.On @ Fair Value	**9.1x**	**8.4x**	**7.8x**	**4.8%**	**16.7x**	**13.8x**	**12.7x**	**9.3%**	**2.9%**	**3.6%**	**3.9%**	**13.7%**	**13.4%**	**3.5%**	**12.9%**	**15.2%**
RWE	8.6x	7.6x	7.1x	4.8%	14.6x	13.3x	11.5x	13.2%	2.9%	3.8%	4.3%	15.5%	9.5%	7.4%	7.9%	16.2%
Fortum	11.4x	10.3x	9.0x	6.4%	18.9x	16.8x	14.3x	12.4%	3.6%	3.9%	4.2%	7.2%	8.3%	5.9%	6.8%	3.7%
Verbund	16.2x	11.4x	10.1x	15.9%	22.8x	17.0x	14.9x	19.1%	1.5%	2.4%	2.7%	25.8%	4.7%	5.4%	6.1%	39.3%
European competitive market	*8.6x*	*8.2x*	*7.7x*	*4.3%*	*15.7x*	*14.1x*	*13.0x*	*7.7%*	*3.7%*	*4.4%*	*4.7%*	*11.0%*	*5.6%*	*5.8%*	*6.6%*	*17.3%*

(1) Based on regular dividend, ie excluding extraordinary dividned for E ON (EUR4.25ps in 2005E) and RWE (EUR1.2ps in 2006E based on a 50% regular payout) Source: Merrill Lynch estimates

Sensitivity Analysis

We have run a sensitivity analysis on a range of power prices of EUR45-50/MWh from 2007 through to the end of the decade. The table below shows the implied earnings and sum-of-parts valuation for our base case, with the sensitivity analysis ranging up to EUR104/share.

Table 8: Earnings and Valuation Sensitivity to Power Price (EUR/MWh)

Base Case	2006E	2007E	2008E	2009E	2010E
Assumption EEX price (EUR/MWh)	37.5	45.0	45.9	46.8	47.8
EBIT pre exceptional	8,102	8,798	9,576	10,059	10,315
Recurrent EPS	6.8	7.4	8.2	8.9	9.5
Valuation post excep div (EUR ps)	**93.8**				
Valuation pre excep div (EUR ps)	**98.0**				
Mid Case					
Assumption spot price (EUR/MWh)	37.5	47.5	48.5	49.4	50.4
EBIT pre exceptional	8,102	8,897	9,829	10,316	10,578
Recurrent EPS	6.8	7.5	8.5	9.2	9.8
Valuation post excep div (EUR ps)	**96.9**				
Valuation pre excep div (EUR ps)	**101.2**				
High Case					
Assumption spot price (EUR/MWh)	37.5	50.0	51.0	52.0	53.1
EBIT pre exceptional	8,102	8,996	10,082	10,574	10,841
Recurrent EPS	6.8	7.6	8.8	9.5	10.1
Valuation post excep div (EUR ps)	**100.1**				
Valuation pre excep div (EUR ps)	**104.3**				

Source: Merrill Lynch estimates

Table 9: Companies Mentioned

Company	ML Symbol	Q-R-Q		Price
E.ON	E.ONAF	A-2-7	EUR	88
E.ON (ADR)	E.ON	A-2-7	$	36
RWE	RWNFF	A-1-7	EUR	62
RWE (ADR	RWEOY	A-1-7	$	75
Fortum	FOJCF	B-1-7	EUR	17
Verbund	VBUOF	A-1-7	EUR	310

Source: Merrill Lynch

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.

iQmethod℠ Measures Definitions

Business Performance	Numerator	Denominator
Return On Capital Employed	NOPAT = (EBIT + Interest Income) * (1 - Tax Rate) + Goodwill Amortization	Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill Amortization
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5-Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A
Quality of Earnings		
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	Net Debt = Total Debt, Less Cash & Equivalents	Total Equity
Interest Cover	EBIT	Interest Expense
Valuation Toolkit		
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	Market Cap. = Current Share Price * Current Basic Shares
Enterprise Value / Sales	EV = Current Share Price * Current Shares + Minority Equity + Net Debt + Other LT Liabilities	Sales
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

iQmethod℠ is the set of Merrill Lynch standard measures that serve to maintain global consistency under three broad headings: Business Performance, Quality of Earnings, and validations. The key features of iQmethod are: A consistently structured, detailed, and transparent methodology. Guidelines to maximize the effectiveness of the comparative valuation process, and to identify some common pitfalls.

iQdatabase℠ is our real-time global research database that is sourced directly from our equity analysts' earnings models and includes forecasted as well as historical data for income statements, balance sheets, and cash flow statements for companies covered by Merrill Lynch.

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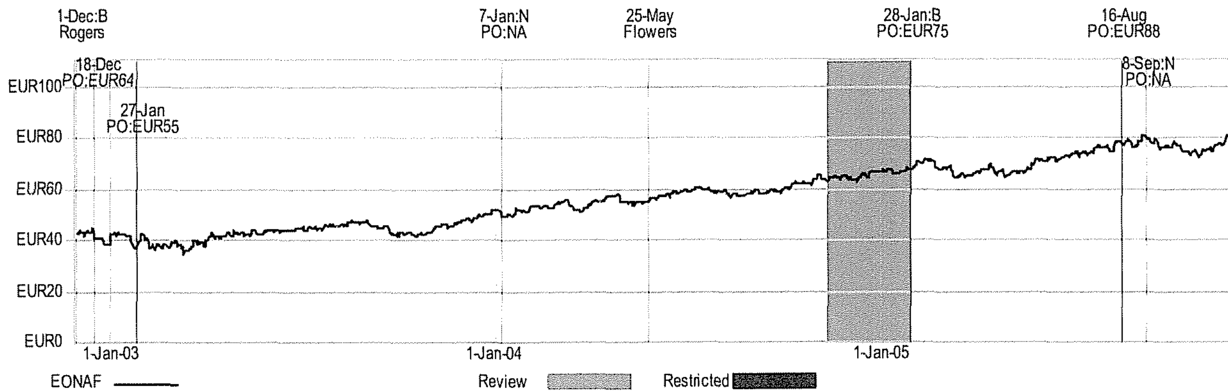
Important Disclosures

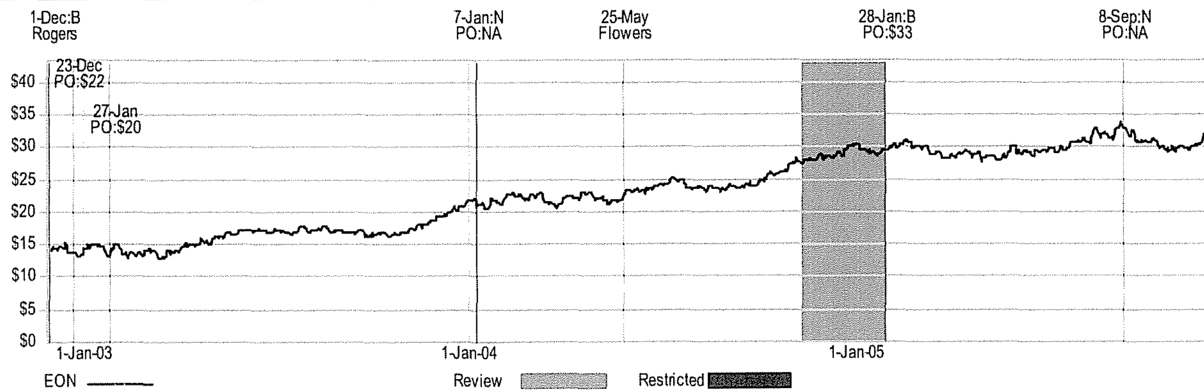
EONAF Price Chart



B : Buy, N : Neutral, S : Sell, PO : Price objective, NA : No longer valid

The 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 Chart current as of September 30, 2005

EON Price Chart



B : Buy, N : Neutral, S : Sell, PO : Price objective, NA : No longer valid

The 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 Chart current as of September 30, 2005

Investment Rating Distribution: Utilities Group(as of 31 Dec 2005)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	38	33.93%	Buy	21	55.26%
Neutral	64	57.14%	Neutral	28	43.75%
Sell	10	8.93%	Sell	3	30.00%

Investment Rating Distribution: Global Group(as of 31 Dec 2005)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1119	40.44%	Buy	376	33.60%
Neutral	1429	51.64%	Neutral	401	28.06%
Sell	219	7.91%	Sell	44	20.09%

* 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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