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German Utilities

The Long & Winding Road

Reason for Report: Review of Sector

Industry

Highlights:

- **E.ON and RWE should both see a rebound in core German electricity profits in 2002 as prices stabilise and cost cutting comes through. We expect E.ON's core electricity EBIT to increase by 30% and for RWE's to increase by 40% on a like-for-like basis. In 2003 and beyond, however, profit growth from German electricity is likely to slow as cost claw back and cartel investigations hit network profits.**
- **The other major theme for the German utilities is continued conglomerate streamlining. As the two groups sell non-core assets and reinvest in the core, we estimate E.ON will be reallocating nearly double the capital in proportional and absolute terms than RWE will at around 80% of enterprise value.**
- **We expect E.ON to make a further four non-core disposals in 2002 on top of the recently announced partial disposal of Degussa. We would also expect E.ON to make a reasonably large (EVUSD8-10bn) US investment in mid-2002. RWE is likely to be much less active – we do not expect to see any non-core disposals in 2002, and management has committed to a period of integration before launching further acquisitions.**
- **This report also details the sum-of-parts valuation analysis that we have applied to both E.ON and RWE on a detailed basis. We draw readers' attention to the accompanying company reports *"E.ON - Fireworks"* and *"RWE - The Right Stuff"* both dated 24 May 2002 for detailed investment cases for both stocks.**
- **E.ON is trading at a 18% discount to our price objective of EUR68, and we rate the stock as an intermediate term BUY, long term NEUTRAL.**
- **RWE is trading at a 11% discount to our price objective of EUR45, and we rate the stock as an intermediate and long term BUY.**

Table 1: Sector Coverage

					Last Act	Earnings per Share		
	Symbol	Opinion	Ccy	Price	Yr End	Last Act Yr	Frcst Yr 1	Frcst Yr 2
E.ON	EONAF	B-2-3-7	EUR	57.1	Dec 2001	3.06	3.92	3.99
1:1 ADR	EON	B-2-3-7	$	52.9	Dec 2001	$2.72	$3.48	$3.56
RWE	RWEOF	B-2-2-7	EUR	41.8	Dec 2001	2.31	2.46	2.74
1:1 ADR	RWEOY	B-2-2-7	$	38.7	Dec 2001	$1.96	$2.15	$2.40

Merrill Lynch & Co.
Global Securities Research & Economics Group
Global Fundamental Equity Research Department

Executive Summary

What Has Changed?

E.ON and RWE should both see a rebound in core German electricity profits in 2002 as prices stabilise and cost cutting comes through. In 2003 and beyond, however, German electricity profit development is likely to slow as cost claw back and cartel investigations hit network profits.

The other major theme for the German utilities is non core disposals and reinvestment. E.ON is the key play on this theme. We expect E.ON to make a further four non-core disposals in 2002 following the recent Degussa deal, and to make a reasonably large (EV USD8-10bn) US investment. Long term, we see RWE as having a heavier weighting in the higher growth gas, water and waste management industries and hence perhaps being the ultimate winner.

E.ON is trading at a near 18% discount to our new price objective of EUR68, and we rate the stock as an intermediate term BUY, long term NEUTRAL. RWE is trading at a 11% discount to our objective of EUR46, and we rate the stock an intermediate and long term BUY.

■ Profitability in German Electricity

The German electricity industry will remain an important driver of group profits for both RWE and E.ON despite their major reinvestment plans.

Competitive Market

In the competitive business, the German wholesale and supply industries continue to obey short term supply/demand balances rather than achieving notional, long-term economic price levels. We therefore base our forecasts on prices indicated by the futures market, and incorporating cash cost cutting plans.

Network Operations

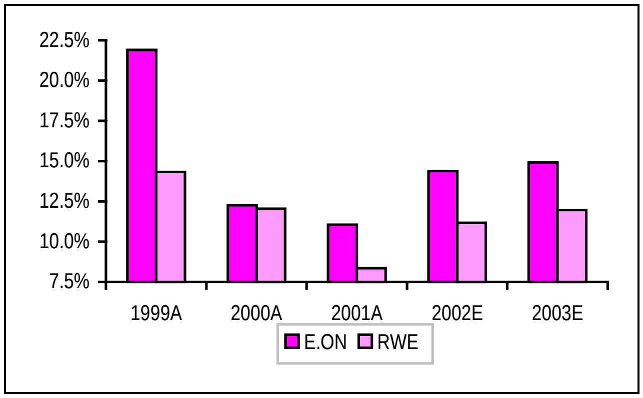
On the network side of the business the structure of price setting is cost plus in nature, and we therefore will see prices falling on a rolling 2 year forward basis as the clawback of the two group's cost cutting comes through.

An additional risk comes from the cartel investigations into network pricing. Both E.ON and RWE have subsidiaries that are being investigated, accounting for 15% and 11% of volumes sold respectively.

We do not see these pressures as being a one-off, and we therefore incorporate a cut of 6% in network prices over-and-above the cost-plus requirements.

We therefore expect to see a strong rebound in margins in 2002 and to a lesser extent in 2003 for both RWE and E.ON.

Chart 1: Electricity Division EBIT Margins



Source: Merrill Lynch E stimates

Looking further ahead, however, the fact that RWE is later to the cost cutting process than E.ON means that its earnings momentum (excluding M&A) is expected to be better in the core electricity business. Over the period 2001 to 2006 our forecasts call for a 1% CAGR in E.ON's electricity operating profits, and for RWE 7%.

Table 2: German Electricity Profit Drivers

	E.ON Energie		RWE Energie	
2001A-2006E	EUR m	% 2001 EBIT	EUR m	% 2001 EBIT
Wholesale & Supply	**373**		**892**	
Wholesale Price Change	93	4.6%	105	5.2%
Wholesale Cost Cutting	280	15.5%	787	43.6%
Networks	**-310**		**-147**	
Network Cost Cutting	100	5.5%	268	14.8%
Cost Cutting Claw-back	-160	-8.9%	-221	-12.2%
Impact of 10% Cartel Cut	-250	-13.8%	-194	-10.8%
Change in Core Elec. EBIT	**63**	**3.5%**	**745**	**41.3%**
Annualised	13	**0.8%**	149	**7.2%**

Source: Merrill Lynch Estimates

■ Streamlining the Conglomerates

Disposals and Free-financing

Both E.ON and RWE are disposing of non-core assets with a view to reinvesting in their core utility operations. We see E.ON as being much more exposed to this process in both absolute, relative and timing terms.

We expect E.ON to dispose of its stakes in Stinnes and its three telecoms assets on top of its recently announced sale of stake in Degussa by the end of 2002 (EUR5.9bn value, 9% of enterprise value), and of all its non-core assets by the end of 2003 (EUR14.7bn or 21% of EV).

By contrast, we do not expect RWE to sell any non-core assets in 2002, but we are confident it will meet its commitment to sell its EUR5.1bn of assets (8% of EV) by end 2003.

When added to investments already committed to, and adjusting for potential balance sheet leverage, we estimate that E.ON will be reallocating capital equivalent to over 80% of EV by the end of 2003 compared to just over 40% for RWE.

Table 3: Capital Reallocation

	E.ON		RWE	
	EUR m	% EV	EUR m	% EV
Disposals (EV)	20981	30%	5236	8%
2002	6158	9%	0	0%
2003	14823	21%	5236	8%
Commitments	21490	31%	16515	26%
Free-financing capability	14918	22%	5412	9%
Aggregate reallocation	**57389**	**83%**	**27164**	**44%**

Source: Merrill Lynch estimates

E.ON Strategy

We expect E.ON to focus its reinvestments into the US, with PUHCA registered, integrated electricity and gas assets contiguous to LG&E with an EV in the USD8-10bn range the main targets. We would also expect to hear some news on the proposed Ruhrgas acquisition, where we believe price cuts will be needed to get government approval for the deal.

Short term we see this strategy being a sensible way to reallocate capital out of the non-core assets into areas that potentially have a variety of (as yet unquantified) synergy benefits with existing operations. Long term, however, E.ON is acquiring inherently low growth assets.

RWE Strategy

RWE has put in place many of the components for its multi-utility strategy, and post-Innogy we do not expect to see any major acquisitions before 2003. At that stage we would see the US energy industry as being a potential target area.

Long term RWE’s strategy makes a lot of sense to us, particularly if it can successfully leverage its multi-utility platform. Short term, however, the challenge for RWE currently is to successfully integrate the announced acquisitions - ie Transgas, Innogy and American Water Works.

We feel confident about the effectiveness of the shareholder value benchmarks for both companies, and believe both should be able to generate positive EVA on the basis of our forecast perimeter:

Table 4: Comparison of Economic Value Added

	2001	2002E	2003E	2006E
E.ON, Energy only				
RoCE, Pre-tax	12.0%	12.7%	12.6%	12.1%
WACC, Pre-tax	10.5%	10.5%	10.5%	10.5%
Absolute EVA, Post-tax, EURm	171	362	403	308
Abs. EVA, Post-tax, % mkt. cap	0.5%	1.0%	1.1%	0.8%
RWE, Core Utility only				
RoCE, Pre-tax	10.6%	11.1%	11.2%	11.5%
WACC, Pre-tax	9.3%	9.5%	9.3%	9.2%
Absolute EVA, Post-tax, EURm	252	375	491	682
Abs. EVA, Post-tax, % mkt. cap	1.1%	1.6%	2.1%	2.9%

Source: Merrill Lynch Estimates

- We would note that RWE’s EVA is substantially higher than that of EON. This is due partly due to RWE’s exposure to water, gas and waste management.

Valuation

We prefer a sum-of-parts approach, which we feel is applicable given ongoing changes in structure of the groups.

- **Electricity –** We use a DCF approach to arrive at a target EV/EBITDA for electricity of 7.5x 2002E.
- **Gas** - European gas companies trade at around 8.8x EV/EBITDA. Given that RWE’s acquisition of Transgas and E.ON’s acquisition of Ruhrgas should bring synergy benefits, this multiple may prove to be prudent.
- **Water** - RWE Thames Water's principle asset is its UK regulated operations, which we value at RAV. To this we add the international businesses, which we value in-line with Ondeo (Suez) and Vivendi Water at 10x 2002E EBITDA.
- **Waste** - The European waste management companies are trading on around 7x 2002E EBITDA currently, which we would see as appropriate given RWE's exposure is mostly to Europe and particularly the troubled German market.
- **Non-core** - Where non-core assets are quoted, we have used the traded valuation, which covers Heidelberg and Hochtief for RWE and Stinnes for E.ON. We value E.ON’s Degussa stake at the agreed EUR38 per share to be paid by RAG. For Shell-DEA (RWE) we have used a downstream industry average of 5x forecast debt adjusted free cash flow. For Viterra (E.ON) we have used an 8.2x 2002 EBITDA multiple implied by a DCF of the business. For E.ON's telecoms assets we have used an updated version of the methodology used in the ML report "*The Utility Phone Book*", December 2001.

This gives us a sum-of-parts valuation and price objective of EUR68 for E.ON and EUR46 for RWE.

Table 5: Sum-of-parts Valuation

	E.ON		RWE	
	EUR m	EUR ps	EUR m	EUR ps
Enterprise Value	69261	106.2	62354	109.4
Energy	44828	68.8	41488	72.8
Water			10579	18.6
Waste			2412	4.2
Non-core	24433	37.5	7876	13.8
Net debt	3833	5.9	-2928	-5.1
Provisions	-20456	-31.4	-27881	-48.9
Minorities	-7675	-11.8	-5188	-9.1
Equity value	44650	68.5	26357	46.2

Source: Merrill Lynch Estimates

RWE is currently trading at a premium to E.ON on the basis of EBITDA, suggesting perhaps that the market has already priced in its growth prospects relative to E.ON.

Table 6: Comparative Valuation Multiples

2002E	P/E	EPS CAGR	EV/EBITDA	EBITDA CAGR	Yield
E.ON	14.6x	8%	6.7x	5%	3.4%
RWE	16.3x	9%	7.6x	11%	3.5%
Suez	20.8x	13%	7.4x	8%	3.5%
Vivendi Environnement	17.0x	15%	7.1x	8%	2.4%
Endesa	12.2x	0%	7.9x	4%	4.3%
Enel	22.9x	-1%	7.1x	-2%	4.9%
Pan-Euro Utilities	17.1x	7%	8.3x	5%	4.1%

Source: Merrill Lynch Estimates. Earnings growth figures for first five forecast years
Priced at 17th May 2002

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German Electricity	**2.**	*2002 will be a year of recovery for core German electricity profits. From 2003, however, cost claw back and cartel threats to network profits are expected to put a cap on long term growth.*	**12**
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1. Valuation

We use a sum-of-parts approach to valuing the German utilities. Given the two group's current EVA performance, we would not apply a reinvestment risk discount. We are therefore setting a EUR68 price objective (+20%) for E.ON and a EUR46 price objective (+10%) for RWE.

We expect to wait another 18-24 months before the applicable comparable valuations for the two groups to diverge, with RWE following the other multi-utilities and E.ON the global energy groups.

Sum-of-parts

Sum-of-parts valuation used

In common with our approach to the other large European utilities we have used a sum-of-parts approach to valuing the German utilities.

Additionally, given that sum-of-parts is basically a collective set of judgements we have calculated both a base-line and an upside-case set of valuations. This is also in recognition of changing market preferences for differing business models within the utility sector.

■ Electricity

We have used two approaches for our valuation of the electricity operations of the German utilities.

DCF suggests 7.5x '02 EBITDA for electricity assets

- **Discounted Cash Flow**: In the table below we have added together the electricity operations of E.ON and RWE to arrive at an appropriate target multiple. Using the group's own post-tax WACC, and assuming flat real (ie 2% nominal) growth going forward we arrive at a multiple of 7.5x 2002 EV/EBITDA.

Table 7: DCF Analysis – E.ON & RWE Electricity Combined

EUR m	2002E	2003E	2004E	2005E	2006E	Terminal
EBITDA	10014	11219	11199	11191	11294	
Imputed Tax	1917	1960	1895	1832	1810	
Capex	5160	5240	5386	5537	5693	
FCF	2937	4020	3918	3821	3791	86150
WACC	6.2%					
Terminal Growth Rate	2%					
NPV	75460					
Year 1 multiple of EBITDA	**7.5**					

Source: Merrill Lynch Estimates. E.ON's "electricity" business includes gas assets in Germany, which account for 10% of the EBITDA and operating profit of the division

Sector average rating 8.2x '02 EBITDA, close to Powergen acquisition

- **Comparatives / M&A**: The sector average for the electricity companies is around 8.2x 2002E EV/EBITDA. This valuation is also well below ratings associated with acquisitions occuring in the sector. We estimate the Powergen entrance multiple for E.ON to be around 8.1x 2002 EV/EBITDA.

We have formulated a base case valuation using our forecasts and the 7.5x multiple implied by the DCF model. The upside case removes the 6% cartel price cut and uses the 8.1x multiple implied from Powergen.

■ Gas

RWE's acquisition of Transgas, and E.ON's proposed acquisition of Ruhrgas demonstrate the growing strategic importance of the gas industry to the future of both groups. We would consider two data points for valuing gas assets:

Gas sector trades on around 8.7 x '02 EBITDA

- **Traded multiples**: There are currently four quoted European gas companies that are integrated or focussed on networks. These five trade at a blended average of 8.7x 2002 (E) EV/EBITDA.

Table 8: Trading Multiples Of European Gas Companies

Company	EV	EV/EBITDA	% group EV
Gas Natural	13381	8.5x	22%
Snam Rete Gas	9796	7.6x	16%
Centrica	14097	9.9x	23%
Average	**37274**	**8.7x**	

Source: Merrill Lynch Estimates. Figures for Gas Natural are consensus and for Distrigas/Fluxys are drawn from our Suez model

M&A in gas is around 9.5 - 10x EBITDA

- **M&A**: E.ON's acquisition of Ruhrgas is being carried out on an implicit multiple of 2002E EV/EBITDA of 9.5x. In discussions E.ON have stated that this is overstating what they believe the multiple to be on a US GAAP accounting basis and allowing for synergies, but have provided no reconciling data. RWE's acquisition of Transgas is being done on a implicit multiple of 11.5x 2002E EV/EBITDA reported and 9.5x adjusted for the new regulatory deal.

We have used the comparative multiple of 8.7x EV/EBITDA and the M&A-implied 9.5x multiple for the upside case. We do not see the reported M&A multiples as being necessarily appropriate as they do not include any potential synergy benefits that would reduce the entrance multiple.

■ Water

RWE has entered, via its acquisition of Thames Water initiated in 2000, the relatively limited competitive space of the global water industry. We would identify three data points for a valuation:

Valuing UK at RAV and intl at 10x gives an implicit 7.6x '02 EBITDA for Thames Water

- **Sum-of-parts**: Thames Water's biggest asset is its UK regulated operations. In 2002 we estimate these account for 78% of the divisions EBITDA. Recently released information from OFWAT state a RAV for Thames of EUR7.72bn (GBP4.76bn) at March 2003. To this we would add the international business, which we value at 10x 2002E EBITDA. This yields an overall implicit multiple of 7.6x 2002E EBITDA.
- **Acquisition**: RWE's acquisition of Thames Water at EUR11.7bn is equivalent to 8.1x our 2002E EBITDA.
- **Comparables**: The main comparables for Thames Water are Ondeo (owned by Suez) and Vivendi Water (Vivendi Environnement). Our sum-of-parts operations for these businesses is based on 10x 2002E EBITDA.

We have used the sum-of-parts valuation for our base valuation, the comparables as the upside case. Note that we do not include American Water Works in our valuation as they deal will not complete until H1 2003, and out sum-of-parts is based on 2002 figures.

Waste Management

We value waste at 7x '02 EBITDA to reflect the troubles in Germany

RWE Umwelt showed in 2001, as did Sita (Suez) and Onyx (Vivendi Environnement) that waste management is a cyclical business. This goes particularly for RWE Umwelt, which (we estimate) derives the bulk of its revenues and virtually all its profits from the depressed German market. There are two points of reference for a valuation:

- **Comparatives**: There is very little in the way of local comparatives – in Europe there is just Shanks, WRG and Lassila. These trade on an average EV/EBITDA multiple of 6.8x 2002E. Including the US operators additionally yields a slightly lower multiple of 6.6x 2002E, although these are mostly collection companies operating in an inherently lower margin business.
- **M&A**: There has been a relatively high turnover of assets in the trash sector in the past three years. These have averaged an EV/EBITDA multiple of around 7.5x first year forecast.

Given the structural problems in the German business, our base line valuation uses the approximate 7x multiple from the comparables, or EUR2.4bn. We use the M&A multiple for our upside-case, or EUR2.6bn, but would note that there is little chance of RWE selling its waste management activities.

Non-Core

Both groups have a number of non-core items. As a general rule we use the market value for the stake if a stock is quoted – ie Stinnes for E.ON and Heidelberger Drueck & Hochtief for the RWE. For our upside-case valuations we have used ML price objectives where appropriate. Where the non core assets are not quoted we use other methods:

Quoted non-core assets are valued at prevailing market prices

Degussa (E.ON)

E.ON's recently announced plans to sell part of its stake to Ruhrkohle AG (RAG) has a stated price of EUR38 per share. Whilst this only explicitly covers 15 – 35% of E.ON's 65% we have used this as a guideline price for the whole stake. We would note that the book value of E.ON's stake is equivalent to EUR30 per share.Viterra (E.ON)

Viterra can be valued on either a DCF or property yield basis

E.ON's real estate business is a hybrid property development and rental company combined with a number of facilities management type services. A DCF of the business gives a valuation of EUR4.0bn, or an implicit EV/EBITDA 2002E of 8.2x.

Alternatively it is possible to value Viterra using a sum-of-parts approach. If we assume an 75/25 split in EBITDA between property development and services, and use a property yield of 6.5% and an 8x 2002E EV/EBITDA multiple for the services we get a valuation of nearer EUR6.3bn. This is the approach used recently by our Credit Analyst (*"The Utility Meter"*, April 3rd 2002).

Telecoms (E.ON)

In our report "*The Utility Phone Book*", December 2001 we valued the telecoms assets of E.ON at around EUR3.6bn. Given the recent derating of the telecoms sector, including the wireless operators, this is probably now too high.

E.ON appears relatively inured to falling telco valuations

We have therefore revalued the stake in Bouygues Telecom in-line with the recent Bouygues/Telecom Italia valuation and the stake in ONE by a similar amount.

It is worth noting that E.ON has a collar arrangement with France Telecom covering their 102m shares in Orange SA, locking in a price of at least EUR9.5 and up to EUR12.5 per share. This gives a base-case valuation of the telecoms assets of EUR2.5bn.

Shell DEA (RWE)

The merger of RWE's DEA with Shell's German downstream operations presumably involves a merger ratio and exit price (given the put option in place). Unfortunately this has not been made public. We therefore value Shell-DEA on the basis of a sector average 5x 2002E EV/debt adjusted cash flow, or EUR1.2bn.

■ Sum-of-parts valuation summary

The tables below draws the sum-of-parts components together.

Table 9: E.ON Sum-of-parts valuation

		Base-line			Best-case		
	Stake	EUR m	EUR/share	% EV	EUR m	EUR/share	% EV
Energy	100%	44828	68.8	64.7%	50438	77.4	64.1%
Non-core		24433	37.5	35.3%	28292	43.4	35.9%
Chemicals	65%	14812	22.7	21.4%	14812	22.7	18.8%
Real Estate	100%	4008	6.1	5.8%	6300	9.7	8.0%
Telecoms	100%	2329	3.6	3.4%	3577	5.5	4.5%
Logistics	66%	3284	5.0	4.7%	3603	5.5	4.6%
Enterprise Value		69261	106.2		78729	120.7	
less: Net debt & financial assets		3688	5.7	5.3%	3688	5.7	4.7%
less: provisions		-20456	-31.4	-29.5%	-20456	-31.4	-26.0%
Less: Minorities		-7843	-12.0	-11.3%	-7843	-12.0	-10.0%
Equity Value		**44650**	**68.5**	64.5%	**54119**	**83.0**	68.7%

Source: Merrill Lynch

Table 10: RWE Sum-Of-Parts Valuation

		Base-line			Best-case		
	Stake	EUR m	EUR/ Share	% EV	EUR m	EUR/ Share	% EV
Energy		41488	72.8	66.5%	46376	81.4	65.4%
Electricity	100%	30274	53.1	48.6%	34270	60.1	48.3%
Gas	100%	11214	19.7	18.0%	12106	21.2	17.1%
Water	100%	10579	18.6	17.0%	14130	24.8	19.9%
Waste	100%	2412	4.2	3.9%	2584	4.5	3.6%
Non-core		7876	13.8	12.6%	7834	13.7	11.0%
Downstream Oil	50%	1225	2.1	2.0%	1225	2.1	1.7%
Printing Technology	50%	5021	8.8	8.1%	5021	8.8	7.1%
Construction	56%	1630	2.9	2.6%	1588	2.8	2.2%
Enterprise Value		62354	109.4		70924	124.4	
less: Net Debt & Financial Assets		-2928	-5.1	-4.7%	-2928	-5.1	-4.1%
less: Provisions		-27881	-48.9	-44.7%	-27881	-48.9	-39.3%
less: Minorities		-5188	-9.1	-8.3%	-5188	-9.1	-7.3%
Equity Value		**26357**	**46.2**	42.3%	**34927**	**61.3**	49.2%

Source: Merrill Lynch Estimates

Conglomerate or Reinvestment Risk Discount?

Historically, many market commentators have applied a conglomerate discount to the valuation of RWE and E.ON. This was understandable when proposed non-core sales were not proceeding - not least because of the punitive system of capital gains taxation which prevailed prior to 2001.

We believe that a classic conglomerate discount is no longer appropriate - capital gains are currently tax free, and demonstrable progress has been made on the disposal programmes, particularly by E.ON.

Both E.ON & RWE continue to reallocate cash

Both E.ON and RWE are still in the middle of an ongoing process of restructuring - selling non-core assets to reinvest in expansion of the core utility operations.

E.ON is clearly going through a larger restructuring, as shown in the table below, and is reallocating almost twice as much capital as RWE on a proportional and absolute basis. In our opinion, this makes reinvestment risk an issue.

Table 11: Reallocation Of Capital Scenario

	E.ON			RWE		
	EUR m	% EV	% Mkt. Cap	EUR m	% EV	% Mkt. Cap
Disposals (EV)	20675	30%	56%	5236	8%	22%
2002	5920	9%	16%	0	0%	0%
2003	14755	21%	40%	5236	8%	22%
Commitments	21490	31%	58%	16515	26%	69%
Free-financing Capability	14757	21%	40%	5412	9%	23%
Aggregate Reallocation	**56923**	**83%**	**153%**	**27164**	**44%**	**114%**

Source: Merrill Lynch Estimates

Both E.ON & RWE are creating shareholder value

An examination of the RoCE criteria for the two groups suggests that, based on our forecasts and assuming only the completion of deals already announced, RWE will generate much more shareholder value going forward than E.ON in its core operations.

Table 12: Summary Of EVA Position In Context

	2001	2002E	2003E	2004E	2005E	2006E
E.ON, Energy only						
RoCE, Pre-tax	12.0%	12.7%	12.6%	12.0%	11.9%	12.1%
WACC, Pre-tax	10.5%	10.5%	10.5%	10.5%	10.5%	10.5%
Absolute EVA, Post-tax, EURm	171	362	403	282	276	308
Abs. EVA, Post-tax, % mkt. Cap	0.5%	1.0%	1.1%	0.8%	0.7%	0.8%
RWE, Core Utility only						
RoCE, Pre-tax	10.6%	11.1%	11.2%	11.5%	11.4%	11.5%
WACC, Pre-tax	9.3%	9.5%	9.3%	9.2%	9.2%	9.2%
Absolute EVA, Post-tax, EURm	252	375	491	667	644	682
Abs. EVA, Post-tax, % mkt. Cap	1.1%	1.6%	2.1%	2.8%	2.7%	2.9%

Source: Merrill Lynch Estimates

We do not differentiate or discount the two groups on deal-making ability

E.ON has an opportunity, given its high level of capital to reallocate, to catch up with RWE in terms of shareholder value creation. We believe that, in order to achieve this, E.ON will need to reinvest most of its capital for reallocation at returns of 11-13% pre-tax. We would note that, on a reported basis, the acquisition of Ruhrgas could achieve 14%, but we would not take this as a necessary sign of success.

The converse is true, of course, in that RWE is also reallocating a lot of capital, and has a stiff benchmark in its existing businesses and pre-announced acquisitions to stay up with. We would not say that this is a bad place to be strategically of course.

For now, then, we would say that it is too early to say that RWE justifies a premium rating to E.ON on the basis of its creation of shareholder value. The ball, however, is very much in E.ON's court, and the next deal (probably in the US) to be announced could be crucial in swinging market opinion on E.ON.

Price Objective

Taking a discount to our base case valuation is, we believe, overly negative given that both groups are currently generating shareholder value even though both have already carried out a high degree of capital restructuring.

It is too early, however, to be overly optimistic on valuation as there are still risks present. To reach a balance, then, we use our base-case valuation for our 12 month price objective. Once the restructuring of the groups is complete, elements of the upside-case valuation may become appropriate, but we feel that now is not yet the time.

In conclusion, then, we set our E.ON price objective at EUR68 per share, or 20% above the current share price and our RWE price objective at EUR46 per share, or 10% above the current share price.

Comparative Multiples

Given that RWE is effectively now structured as a multi-utility, it raises the question as to whether it should now be valued relative to the other large multi-utilities, Vivendi Environnement and Suez. Similarly E.ON should perhaps be compared to the other large, integrated/international energy companies.

Current RWE is trading at a premium to E.ON, suggesting that an element of this differential rating is already in place. However we believe that both groups are undervalued - E.ON more so than RWE.

Table 13: Comparative Valuation, 2002E

EUR m	Rec.	QRQ	F'n	Price	Objective	% Upside	Mkt. Cap	EV	P/E	EPS CAGR	EV /EBITDA	EBITDA CAGR	Yield
E.ON	Neutral	B-2-3-7	q	57.5	68.0	18%	37170	61739	14.6x	8%	6.7	5%	3.4%
RWE	Buy	B-2-2-7	q	41.4	46.0	11%	23570	61152	16.3x	9%	7.6	11%	3.5%
Suez	Buy	B-2-2-7	q	32.2	36.0	12%	31281	59368	20.8x	13%	7.4	8%	3.5%
Vivendi Env.	Buy	B-2-2-7	q@	37.0	44.0	19%	12809	28843	17.0x	15%	7.1	8%	2.4%
Endesa	Buy	B-2-2-7	q	17.0	21.0	24%	17988	41690	12.2x	0%	7.9	4%	4.3%
Enel	Strong Buy	B-1-2-7	qp	6.6	8.0	21%	40155	66436	22.9x	-1%	7.1	-2%	4.9%
European Utilities						7%	336215	613652	17.1x	7%	8.3	5%	4.1%

Source: Merrill Lynch Estimates. % Upside for sector is a weighted average of the upside (downside) to price objective for the constituent companies

2. German Electricity

Whilst E.ON and RWE are pursuing major focus and reinvestment strategies, one of the most important drivers of earnings remains the profitability of the core German electricity business. Whilst we believe that the issue of profitability in wholesale and supply is largely done and is readily quantifiable, the network operations remain a concern.

The principle risk is that cartel-induced price pressure will push network prices down beyond the cost-plus requirements of the Association Agreements.

As a consequence, whilst we expect a strong recovery in profits in 2002 (30% for E.ON, 40% for RWE) the compound growth over the period 2001 – 2004/5 is forecast to be a lot more typical of utilities at +1% for E.ON and +7% for RWE. Note that these figures exclude the impact of M&A, which is discussed in the next chapter.

Earnings Recovering for Now

Earnings now recovering post market-opening, but not out of the woods yet

The relatively lack lustre share price of the German utilities in the past three years has largely been the result of falling profitability in the core domestic electricity business. Prices now appear to have stabilised, and cost cutting plans are yielding fruit, suggesting that earnings in 2002 should recover strongly.

Whilst we would agree with this prognosis, we would note that this recovery in earnings is not fully sustainable.

We would identify four factors driving the profitability of the core domestic electricity businesses:

Factor 1: Wholesale/Supply Prices

Both E.ON and RWE are net shorts of generation

In simple terms both RWE and E.ON are net shorts of wholesale electricity for their supply businesses. This is position is being extended by the withdrawal of capacity, although much of this has had low utilisation rates, limiting the impact on the net position. In 2001 E.ON met just 63% of their own sales (ex trading) from own production and RWE around 70%.

Table 14: Own Generation As A % Of Non-Trading Sales

	E.ON		RWE	
GWh	**2000**	**2001**	**2000**	**2001**
Total Sales	211.1	318.2	234.8	300.9
Sales ex Trading	187.6	225.7	209.4	211.8
Own Generation	124.6	141.8	138.3	147.5
Purchases	86.5	176.4	96.6	153.4
Purchases ex Trading	63.0	83.9	71.2	64.3
% non Trading Sales Generated	**66.4%**	**62.8%**	**66.0%**	**69.6%**

Source: Merrill Lynch Estimates

The group's structures mean that they should be positively impacted by lower wholesale prices assuming that the benefits are not passed directly through to consumers. From the group's net short positions we estimate that a EUR1/MWh move in wholesale prices should shift the operating profits of E.ON and RWE by around EUR80m.

Wholesale profit forecasts based on EEX forward prices

Going forward we have used wholesale price assumptions based on current forward markets, ie prices quoted on EEX, as the basis for our forecasts. This is based on the assumption that wholesale prices in Germany will continue to be set by the existing marginal operators – ie coal – rather than the theoretical new entrant. The movement of EEX prices to date suggests this to be the case, and we do not see significant new gas capacity being built in Germany at present.

Table 15: Change In Wholesale Prices

EUR / MWh	2001A	2002E	2003E	2004E
Baseload	26.9	23.3	23.4	24.35
Peakload	35.6	33	33.75	34.05
Vol. Weighted Average	28.9	26.5	26.8	27.6
Change		**-2.4**	**0.3**	**0.7**
Impact on E.ON, EURm		191	-28	-70
Impact on RWE, EURm		196	-27	-63

Source: EEX, Merrill Lynch Estimates

Profit fall of past due to predatory pricing in supply, which has now ended

As an aside, we believe that the fall in profits at the German utilities was not because of lower wholesale profits per se. Rather that the fall in prices meant that new entrants could potentially buy power at a lower price than the incumbents could generate for. The incumbents chose to defend market share via predatory pricing to end customers whilst still generating from own-plant, hence the fall in profits.

To tackle this the German utilities have now (a) stopped predatory pricing and (b) aimed to cut costs.

Factor 2: Cost Cutting in Wholesale & Supply

Cost cutting well established, more to follow

Cost cutting by the German utilities is not a new story, with both companies having well-established plans in place. By the end of 2001 E.ON had cut costs of around EUR1.9bn and RWE around EUR1.4bn in their core utility businesses. Both have substantial work yet to do:

Table 16: Cost Cutting Programmes, Core Utility Operations

	E.ON		RWE	
	EUR m	% '01 EBIT	EUR m	% '01 EBIT
Up to Dec 2000	1490	73.1%	685	25.8%
During 2001	380	18.6%	680	25.7%
Plans for Future	**385**	**18.9%**	**1190**	**44.9%**
Annualised	385	18.9%	397	15.0%
Total	2255	110.6%	2555	96.4%

Source: Merrill Lynch Estimates

Note that stated plant withdrawals are not the whole story

In the wholesale and supply business, both groups are cutting capacity and improving efficiency in their remaining operations. On capacity cutting it is worth deploying a pinch of salt to the figures stated by the companies. Stated plant closures of around 5000MW for each company actually equate to taking operating plant off stream of more like 2300MW for E.ON and 2900MW for RWE.

Table 17: Plant Shutdowns

	E.ON		RWE	
2001-2003, comp to 2000 y/e	MW capacity	% installed	MW capacity	% installed
Stated Reduction	4909	18.3%	5000	15.6%
Plant Remaining in Cold Storage	755	2.8%	1200	3.7%
Shutdown of Cold Storage Plant	293	1.1%		
Plant put in Seasonal Cold Storage	249	0.9%		
Plant put in Full Cold Storage	1333	5.0%		
Cancelled l.t. Contracts			900	2.8%
Operating Plant Closed	**2279**	**8.5%**	**2900**	**9.0%**

Source: Merrill Lynch Estimates

RWE have more cost cutting left to do than E.ON

E.ON expect to cut the costs from wholesale and supply by around EUR280m by 2004 (16% of 2001 EBIT) and RWE by EUR790m (44% of 2001 EBIT). We would note that:

- E.ON, when stating their cost cutting plans, also include "opportunity cost cutting" (particularly in terms of marketing costs) from the time of the merger. We exclude these from our forecasts.
- RWE appears to have much higher cost cutting plans proportionally than E.ON. This is primarily due to (a) E.ON cutting more aggressively early on, (b) RWE having a higher proportion of controllable costs as a % of all operating costs. E.ON's electricity operations had EBIT margins of 11% vs 8.5% for RWE in 2001.

Cost cutting retained, wholesale price changes passed through

We would expect the two group's to be able to retain most of the benefit of this cost cutting in the medium term, whereas the changes in wholesale prices are likely to be passed through to consumers directly.

Additionally, both groups have indicated that there is the potential for further cost cutting, both as a result of continuing internal and external benchmarking, and as a result of integration of recent or forthcoming acquisitions. For prudence, however, we do no include any cost cutting above and beyond that already announced.

Factor 3: Cost Cutting in Networks

Through a steady process of merging distribution companies, as well as stand-alone efficiency improvements, both RWE and E.ON are cutting their network costs. Both companies are somewhat reticent about the magnitude of these cuts, which is perhaps understandable given the regulatory sensibilities involved.

Network cost cutting under-way . . .

Reading between the lines of public statements, we estimate that RWE will cut its network costs by around EUR270m between 2002 and 2004, and E.ON by EUR100m. These come on top of cuts in 2001 of EUR100m by RWE and EUR95m for E.ON.

This is not the whole story, however. The German system of network price setting, enshrined in the *VerbaendeVereinbarung 2+* (Association Agreement) is essentially cost plus in nature. On an annual basis the companies submit their accounts to the local Economics Ministry in order to obtain approval for their network charges.

. . . but clawback inevitable under the cost-plus system

Put simply, costs cut today cannot be retained in perpetuity. We have assumed a two stage claw-back of cost cutting, which should be in-line with the rolling maximum 2-year price review applicable under the Federal Electricity Tariff Regulations (FETR, or *BTO Elt*). We have started this process in our forecasts from mid 2002 running through to mid-2004.

Table 18: Network Cost Cutting & Clawback

EUR m	2002	2003	2004	2005	2006	2007
RWE						
Cost Cutting	152	57	59	0	0	0
Clawback	-33	-84	-103	-89	-39	-20
Net Change	119	-27	-44	-89	-39	-20
% Division EBIT	5.0%	-1.1%	-1.9%	-4.0%	-1.8%	-1.8%
E.ON						
Cost Cutting	100	0	0	0	0	0
Clawback	-32	-65	-65	-33	0	0
Net Change	68	-65	-65	-33	0	0
% Division EBIT	3.4%	-2.0%	-1.7%	-1.0%	0.0%	0.0%

Source: Merrill Lynch

Factor 4: Cartel Investigation into Network Pricing

There is no formal electricity price regulation in Germany. Instead network price formulae are set under the Association Agreement, which is formed by consultation between the associations for industrial users (BDI & VIK), producers/traders (ARE) and the system operators (DVG and VKU under the VDEW umbrella).

The actual setting of prices and approval for network access is set using these agreements, and is an unusual approach in Europe. It has also led to a great many complaints to the federal cartel office (FCO) by new entrants and users that the rules are not being implemented fairly.

Cartel investigations also underway, some 20% price cuts made, E.ON and RWE are still exposed

In Q4 2001 the cartel office launched initial investigations in 22 operators. These were chosen on the basis of having much higher prices than the cartel office felt was appropriate given their comparators. Of these:

- Thirteen have either been cleared of any charges or voluntarily cut their prices. The most recent is Stadtwerke Wesertal (recently sold by Fortum to E.ON) which cut by 20% following the formal launch of an investigation against it and nine others.
- Of the nine that remain under investigation, 3 are owned by E.ON (representing just under 15% of volumes sold) and 3 by RWE (just under 11% of volumes sold). The remainder are the *Stadtwerken* of Darmstadt, Mainz, Lindau and Lauenberg.

Table 19: Utilities Under FCO Investigation Owned By RWE & E.ON

Operator	Owner	Volume - GWh	% Group
Avacon	E.ON	14969	6.6%
Thueringer Energie (TEAG)	E.ON	8547	3.8%
Energie Mitteldeutschland (EAM)	E.ON	9900	4.4%
Envia	RWE	13200	6.2%
Mitteldeutsche Energie (MEAG)	RWE	6500	4.4%

Source: Merrill Lynch Estimates

The gas industry may have opened the Pandora's box of independent regulation

There is also the potential for further developments from a regulatory perspective, as recent developments in the gas industry show. On 15th April 2002 talks between signatories to the original gas Association Agreement broke down – to quote Wolfgang Prangenberg, the spokesman for the gas distributors:

" There was an unbridgeable gap between negotiators on the key issues of calculation of grid fees" (Financial Times, 16th April 2002)

The response from the Economics Minister, Werner Mueller, is telling perhaps on the future of regulation if the Association Agreements do not work on an ongoing basis:

"A functioning regulator could start work on January 1st 2003. This is not a huge disaster, but the major damage it does is to mirror the state of the economic system, when in the end it cries out for government regulation" (Financial Times, 16th April 2002)

The gas companies have subsequently stepped back from the brink, and have managed to negotiate a new association agreement. However, having opened the Pandora's box of independent regulation we would expect to see the government raise this as an issue again.

At the very least we would expect the government to bolster the powers of the cartel authorities to oversee and investigate the implementation of the association agreements for both electricity and gas.

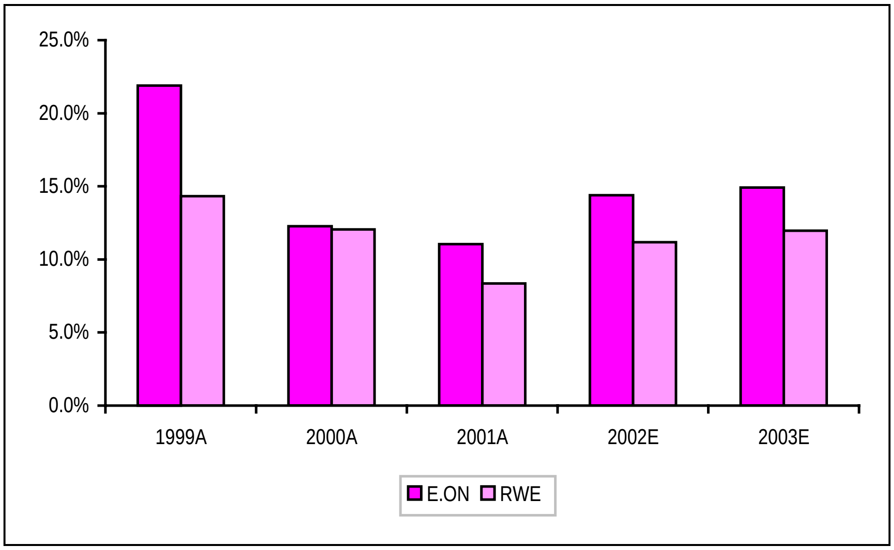
We have taken 6% off all network revenue in our forecast to avoid disappointment later

To this end we have factored in an additional 6% cut in all network fees over the next three years (weighted into 2003 mainly).Whilst this may seem a little extreme given current regulatory activity, we would note that:

- The current investigations of E.ON and RWE could result in revenue cuts of 2-3% if the example of Wesertal is followed.
- E.ON have committed to potentially cutting prices as one of the concessions for approval for Ruhrgas, opening the potential for further price cuts as a quid-pro-quo for M&A approvals.

Taking all these items together, then, we do expect a short term recovery in earnings, as shown in the chart below.

Chart 2: Development of Electricity EBIT Margins - Excluding M&A



Source: Merrill Lynch Estimates

On a long term view, however, we would expect the compound growth in operating profits to be below the 2002 level, with 7% for RWE and 1% for E.ON.

Table 20: Net Change in Domestic Electricity Operation Profits

	E.ON		RWE	
2001A-2006E	**EUR m**	**% 2001 EBIT**	**EUR m**	**% 2001 EBIT**
Wholesale & Supply	**373**		**892**	
Wholesale Price Change	93	4.6%	105	5.2%
EUR1/MWh Change in Wholesale Price	84	4.1%	82	4.5%
Wholesale Cost Cutting	280	15.5%	787	43.6%
Networks	**-310**		**-147**	
Network Cost Cutting	100	5.5%	268	14.8%
Cost Cutting Claw-back	-160	-8.9%	-221	-12.2%
Impact of 10% Cartel cut	-250	-13.8%	-194	-10.8%
Change in Core Elec. EBIT	**63**	**3.5%**	**745**	**41.3%**
Program Period	End 2004		End 2005	
Compound Earnings Growth of Domestic Electricity Operations	**13**	**0.8%**	**149**	**7.2%**

Source: Merrill Lynch Estimates

3. Reinvestment Strategies

Both E.ON and RWE are disposing of non core assets in order to grow their core utility operations. E.ON is much more exposed to this process than RWE, with disposals and reinvestment equivalent to an estimated 80% of EV compared to 40% from RWE. We would expect E.ON to make up to EUR6bn of disposals in 2002, versus our expectation of none for RWE.

Going forward the groups are following different paths – E.ON is becoming a global integrated energy group, RWE a global multi-utility. E.ON is likely to be active this year, with a large US energy investment on the horizon. RWE will be less active during 2002. In the long term we expect RWE's strategy to yield better growth opportunities than E.ON's.

Focus - Non-Core Disposals

Both E.ON and RWE have completed several non-core disposals, although proportionally E.ON has done four times as much as RWE. Both have more to do, although E.ON has nearly 3x as much in non-core as RWE on a proportional basis.

E.ON is likely to be active on non-core disposals during 2002

From a timing perspective, we would expect E.ON to announce the sale of up another four non-core assets this year on top of the recently announced sale of a stake in Degussa and two next year. We do not expect to hear announcements from RWE on non-core assets in 2002.

■ History of Restructuring

Both E.ON (formally Veba and Viag) and RWE have had a strategy of disposing of non-utility assets since the mid- (in the case of Veba) to late (in the case of Viag & RWE) 1990s.

E.ON has already sold EUR28bn of non-core and RWE5.6bn

Thus far, E.ON has done a lot more work in this regard than RWE in both absolute and proportional terms. E.ON has sold assets with a combined value of EUR28.3bn (43% of EV) and RWE EUR5.6bn (9.5% of EV).

Clearly, E.ON had a lot more work to do in the first place having (a) a broader base of industrial assets and (b) a focus purely on electricity compared to a multi-utility approach of RWE.

Of the total, the majority (66%) has been in the telecoms sector, where the groups have been relatively successful in exiting towards the top of the market.

Table 21: Non-core Asset Disposals to Date

		Sector	Enterprise Value	% EV
E.ON	**Total disposals**		**28345**	**42.6%**
	Viag Interkom	Telecoms	11400	17.1%
	E-plus	Telecoms	3800	5.7%
	Veba Oel	Oil	3300	5.0%
	VAW	Aluminium	3100	4.7%
	Veba Electronics	Distribution	2600	3.9%
	Orange Communications	Telecoms	1600	2.4%
	Klockner & Co	Distribution	1100	1.7%
	Cablecom	Telecoms	870	1.3%
	o.tel.o fixed line	Telecoms	575	0.9%
	MEMC	Silicon Wafers	0	0.0%
RWE	**Total disposals**		**5850**	**9.5%**
	E-plus	Telecoms	3600	5.8%
	Condea	Chemicals	1300	2.1%
	o.tel.o fixed line	Telecoms	575	0.9%
	Various	Real estate	375	0.6%

Source: Merrill Lynch Estimates

Future of Restructuring

We expect this process to continue in the coming three years, with E.ON again likely to be more active than RWE in both absolute, relative and timing terms.

E.ON

E.ON has committed to the SEC, as part of its Powergen acquisition, that it will sell all non-electricity assets within 3-5 years of the completion of the deal. In reality, and based on statements by the company, we would expect the sales to be completed more quickly than this. We would not expect a repeal of PUHCA (presaged by the recent Comprehensive Energy Bill) to change this strategy.

We expect E.ON to sell up to EUR5.9bn of non-core in 2002 and EUR14.9bn in 2003

On the basis of management statements, we would expect to see four sales plus the recently announced partial Degussa sale 2002 raising at least EUR6.1bn EV (9% of EV) and two sales in 2003 raising EUR14.8bn EV (22% of EV).

The sticking point on Stinnes and Viterra will be how the sales are achieved. All are quite large for simple on-market placements, and logical trade acquirers/partners are not immediately apparent right now. The method for disposal of the remaining Degussa stake is clear – ie a secondary placement. The timing is ambiguous though – it will be some time after RAG acquires 50.1% in May 2004, and before the SEC imposed deadline of June 2007.

Table 22: E.ON Non-Core Asset Disposals

Asset	Operations	Stake	Equity Value	EV	Likely Strategy	Sale by
Degussa (1)	Speciality Chemicals	14.5%	1133	1133	Placement	July 2002
Orange SA	Telecoms	102m shares	950	950	Sale to France Telecom	June 2002
Bouygues Telecom	Telecoms, France	17.50%	1200	1200	Sale to Bouygues	Dec 2002
ONE	Telecoms, Austria	50%	320	320	Sale to Orange	Dec 2002
Stinnes	Logistics	65.50%	1384	2555		Dec 2002
Viterra	Real Estate	100%	3910	3910		Dec 2003
Degussa (2)	Speciality Chemicals	50.1%	3914	10913		Dec 2003
Total, 2002E			**4987**	**6158**		
Total, 2003E			**7824**	**14823**		

Source: Merrill Lynch Estimates

RWE

RWE's non-core disposal programme is smaller than E.ON's. We do not expect to see asset sales from RWE this year. Management statements at recent analyst meetings give a target of end 2003 at the latest for the disposal of the non core assets.

We don't expect any non-core sales from RWE in 2002, but should see EUR5.1bn in 2003

We expect RWE's four asset sales in 2003 to raise around EUR5.1bn EV, which is equivalent to around 8% of our target EV. Note that management, in statements on their recent bond road show, cite a target EUR5bn from these disposals.

Again, the sticking point on two of the sales - Heidelberg and Hochtief - is the route by which RWE can monetise its majority stake.

Table 23: RWE Non-Core Asset Disposals

Asset	Operations	Stake	Equity Value	EV	Likely Strategy	Sale by
Heidelberger Drueck	Printing Machines	50.02%	2278	2746		Dec 2003
Shell-DEA	Downstream Oil	50%	1225	1225	Sale to Shell	Dec 2003
Hochtief	Construction	56%	847	797		Dec 2003
Real Estate Assets	Property	100%	375	375	Trade sale	Dec 2003
Total, 2002E			**0**	**0**		
Total, 2003E			**4724**	**5142**		

Source: Merrill Lynch Estimates

We estimate E.ON’s "war chest" at EUR14.5bn and RWE’s at EUR5.8bn

■ Capital for Reinvestment

As a rough guide, we estimate the group’s “war chests” by taking the non-core disposals, plus balance sheet leverage on the remaining core assets less investments that have already been committed to. This yields “war chest” of EUR14.5bn for E.ON (20% of EV), and around EUR5.8bn for RWE (9% of EV).

Table 24: Free Financing Capability

EUR m	E.ON	RWE
Non-core Assets	**+20675**	**+5236**
Balance Sheet Gearing	**+15572**	**+16692**
Target Net Debt:EBITDA	3.0	3.0
Current Net Debt:EBITDA	0.4	0.6
Gross Debt	14189	15625
Cash & Securities	11829	11111
Core EBITDA	5977	7068
Committed Acquisitions	**-21490**	**-16515**
Powergen	-15500	
Ruhrgas	-5990	
Innogy		-7879
American Water Works		-8636
Free Financing Capability	**+14757**	**+5412**

Source: Merrill Lynch Estimates

We would note that these estimates exclude (a) moving to lower credit ratings, and (b) equity financing. On the former both groups have stated a commitment to at least a strong single-A status. On the latter, neither will rule out capital raising or paying with shares if the opportunity is compelling enough.

E.ON Reinvestment Potential

E.ON is building a global, integrated energy business

E.ON's strategy is to build up its global, integrated electricity and gas assets. The acquisition of Powergen provides a platform for US investments. We would expect to see E.ON embark on two US acquisitions in the next two years, starting as soon as this summer.

We do not see the Ruhrgas transaction being approved ahead of the elections in September without substantial concessions from E.ON, potentially making it a deal for 2003. Acquisitions in Iberia or LatAm are possible, but look unlikely until the US and Ruhrgas deals are done.

■ Strategy

E.ON's overall strategy is to develop a global integrated energy (electricity & gas, upstream & downstream) business. The main developments in this direction have been a big push into Scandinavia (Sydkraft), the UK and the US (Powergen).

Powergen has been acquired as a US platform

The E.ON management have been quite explicit that their acquisition of Powergen was done with the aim of using the company as a platform for expansion primarily in the US. In that regard E.ON management have the (somewhat nebulous) aim of being one of the five largest energy utilities in the US in the medium term.

Synergy benefits will be needed to offset low organic growth in energy

We see this strategy as providing a sensible route for reinvestment of non-core assets, and a careful integration of the assets could yield substantial (but not yet quantified) synergies for the group. The focus on the US makes also makes sense given the clear legal and regulatory framework and the availability of targets.

However, we would note that the inherent growth prospects (ie ex-synergies) available from the electricity assets that E.ON are acquiring are inherently lower than those available from the water and waste management assets that RWE is pursuing.

Targets

US

E.ON will aim at PUHCA registered, integrated electricity/gas assets contiguous to LG&E

E.ON have indicated at various analyst meetings that the main focus for their next US investments would be fully integrated, PUHCA registered utilities that are contiguous to LG&E, and that are of a reasonable size.

A review of potential targets with our US Electric team yields the potential names: Ameren, Allegheny, AEP, Cinergy, Nisource and PPL. Of these we would say that AEP is probably too big, and that there may be an element of complication resulting from the ownership of nuclear plant by Ameren, AEP and PPL.

Table 25: US Utilities of Potential Interest to E.ON

		Mkt. Cap	EV	Generation MW		Customers			P/E	
Company	Ticker	USD m	USD m	Operating	Developing	Electricity	Gas	Other Assets	2002	2003
Ameren	AEE	6252	9020	12563		1.5m	299k		13.6	12.8
Allegheny	AYE	4435	7633	12000	2600	1.7m		Telecoms	9.7	9.1
AEP	AEP	14859	24279	38000		4.9m		Coal, Australia, UK (Seeboard)	12.3	11.5
Cinergy	CIN	5946	9431	13000		1.5m	0.5m		12.8	12.1
Nisource	NI	4806	10459	3382		430k	3.2m	Upstream reserves 31BCM	11.3	10.8
PPL	PPL	6268	10399	10300	2100	1.3m	73k	LatAm, Europe (WPD in UK)	10.4	9.8

Source: Merrill Lynch Estimates

Public Utility Holding Company Act (PUHCA)

Introduced in 1935, PUHCA aimed to prevent the monopolisation of electricity on a national basis.

If a company is registered under PUHCA it faces certain restrictions:

- No shareholder can own more than 10% of the company.
- The registered company cannot own non-utility assets, which means electricity assets in the strictest sense.
- The registered company cannot acquire non-contiguous assets, although1992 EPACT modified PUHCA 1935 to allow generation plant to be operated outside of regulated region. This represents something of a paradox - FERC is not keen on contiguous mergers on market power grounds.
- The registered companies has to maintain a gearing ratio of no more than 70%.

PUHCA is administered by the SEC.

UK

Powergen likely to aim for further mass in the UK

Powergen does not currently have a critical mass position in the UK under the usual definition - ie 5m customers. At the end of calendar 2001 Powergen actually had 3.51m customer accounts, of which 3.1m are retail.

The main asset currently for sale in the UK is Seeboard, which is being sold by AEP. CSW acquired Seeboard in November 1995 for an EV of £1.27bn. Seeboard currently has just under 2m subscribers, 37.5% of Medway (675MW CCGT power plant) & 50% of Shoreham (400MW CCGT), and a network with a RAV of £520m in y/e 2002 prices.

The required price from AEP (according to various press reports) is around £1.5bn, or EUR2.4bn. Competition is likely to be stiff, with SSE and EDF also bidding. The deal cannot be completed before June given tax restrictions on AEP following the CSW merger nearly two years ago.

If Powergen is unsuccessful, there are other options: acquire several smaller players from the market share "tail"; or operate a sub-scale business and attempt to build the business organically. Neither of these are particularly attractive in our view.

Ruhrgas

The largest outstanding acquisition for E.ON outside of Powergen is the proposed acquisition of control in Ruhrgas. Ruhrgas, simply put, is E.ON's equivalent in gas with upstream (via contracts), networks and downstream (via municipal shareholdings).

Ruhrgas acquisition aims to create an horizontal & vertically integrated group

E.ON's acquisition of Ruhrgas takes the form of acquisitions in intermediate shareholdings from several sellers including RAG, RWE, ThyssenKrupp, BP and Vodafone. The result of these acquisitions would give E.ON 59.8% of Ruhrgas.

Price paid looks quite full without synergies

We estimate the deal outlay - on the basis of statements by E.ON - to be around EUR5.99bn. On the basis of our pro-forma forecasts this is equivalent to a EV/EBITDA of around 9.5x - 10.2x 2002E on the basis of German GAAP. This price appears to be in strategic-premia territory. That said, the deal will be judged by E.ON on the basis of its internal EVA benchmark, which would be value accretive on the basis of book capital employed.

Clearly this is a deal that needs to be predicated on synergy benefits. E.ON will not outline quantifiable synergies between the groups, making it difficult to provide a judgement on final valuation, although there may be room to (a) cut costs at Ruhrgas on a stand-alone basis (b) joint purchasing synergies and (c) joint trading opportunities.

Deal approval may prove tough, with price cuts on the agenda

So far E.ON has not been able to get cartel approval for the deal. The German Federal Cartel Office has ruled against the deal, saying repeatedly that the deal is not in the interest of German consumers. E.ON has appealed directly to the government, via the Economics Minister, to over-rule the cartel, which is its right within German law. A ruling is due by July.

Very recent statements by E.ON (interview with Mr Hartmann in the *Rhenische Post*, April 18th 2002) suggest that it may now also be willing to offer price reductions in return for approval of the Ruhrgas deal.

We believe that these price reductions could form the hub of future discussions on deal approval as they give the government the ability to over-rule the cartel on the basis that the revised deal terms would, in fact, be in consumers interests.

The problem for E.ON will lie in balancing its synergy benefits against the price reductions in order to ensure that the deal is still value accretive. To give some context, each 5% cut in network prices by E.ON is around EUR200m.

Iberia & Latin America

Little action seen on Iberia/LatAm scene for E.ON in short term

Clearly, with two US investments with a combined equity investment upwards of EUR12bn and EUR6bn for Ruhrgas on the horizon, there is likely to be little in the way of additional reinvestment beyond that point within the context of E.ON’s current financial flexibility.

In meetings we have had with the company, they have suggested that Latin America may be interesting, but they would only invest with a partner. We would see this as indicating the potential for another Powergen-style deal.

The potential partners are limited in scope. We find it interesting that it emerged last year that E.ON owns a 4.9% stake in Union Fenosa.

■ Timing

E.ON expect the acquisition of Powergen to complete in late May/early June once SEC approval has been obtained. We believe that the main sticking point is the position of Allianz as a major shareholder (10%). A solution to this could include simply a commitment to sell rather than a sale per se.

Next US deal due during summer 2002 with follow up summer 2003

Given that the deal was announced in April 2001, and given that Powergen had been scouting for US acquisitions for five years before that, we would not be surprised to see E.ON launch another acquisition over the summer of 2002.

E.ON have stated that they would probably look to make two acquisitions. Given that Powergen (ie LG&E) has taken a year to complete, we could expect a second US deal from E.ON (ie third for Powergen) to come in summer 2003.

We would be cautious on being overly-definitive on long-term plans, however. The co-CEOs of E.ON (Ulrich Hartmann and Wilhelm Simpson) are due to retire from their current positions in May 2003. We expect to hear an announcement on succession by December 2002. Clearly, the new CEO is likely to review strategy. For now, though, we don't expect to see any major strategic changes, particularly given E.ON's forthcoming PUHCA registration.

RWE Reinvestment Potential

RWE has built a global multi-utility business

Whilst RWE has a multi-utility business model, we would expect future acquisitions to focus on energy, and more specifically the US. We would not, however, expect to see any major acquisitions beyond those already announced during 2002.

■ Strategy

RWE's overall strategy is to develop a global multi-utility (electricity, gas, water and waste) business, and has been actively acquiring in each of these business areas except waste in the past 8 months.

Since September RWE has announced the acquisition of EUR20.7bn of assets - American Water Works (EUR8.6bn), Transgas (EUR4.05bn), Highland Energy (EUR180m) and most recently Innogy (EUR7.88bn).

Components for the Multi-utility platform have been bought on a stand-alone basis, synergies to follow

We believe that, long term, RWE's strategy of investing in a multi-utility platform should yield better growth than E.ON's integrated energy strategy. However this has required a substantial investment programme so far without a clear definition of multi-utility synergies. We would note, however, that management have stated that the deals they have made are designed to be economic on a stand-alone basis.

■ Targets

Next acquisition likely to be in energy

We would expect RWE's next targets to be in the energy sector:

- **Water**: RWE, via its acquisition of Thames and proposed acquisition of American Water Works, has (we believe) essentially completed its global platform. Further developments is likely to come through contract wins and municipal privatisation. Regional acquisitions are also possible - for example Bouygues's Saur would provide an entry point to the French and African markets.
- **Waste**: RWE have indicated that the waste management business is very much a European-specific operation for them.
- **Electricity / Gas**: Clearly there are investment opportunities globally, although we would expect the group to focus on the US (where they have few assets currently outside of water and mining) and to keep a watching brief on the upstream gas industry and deals elsewhere (especially east) Europe.

US

Assuming that PUHCA is not repealed, RWE cannot buy registered electricity and gas assets given their shareholder structure (including an aggregate 33% holding by municipalities and Allianz) and assets held (water, waste management and non-core holdings).

US electricity acquisition possible, but not just yet

In recognition of this RWE have stated at their analyst meetings in September 2001 and March 2002 that their preference is for power generating assets and would look for synergies with Consol. The latter would be a function of geography, and Consol (RWE's quoted coal company) is mostly in the Appalachian region.

RWE's requirements are therefore a lot less defined than those of E.ON. Discussions with our US colleagues suggest that Constellation, Mirant or PPL may be potentially interesting to RWE.

At current prices all three are around the right size for a "one-shot" deal for RWE in the US. We would see Mirant as possibly being less interesting given that it does not have a customer base to hedge its output against.

More importantly, we do not believe that RWE (unlike E.ON) see a US energy acquisition as a "must-have".

Table 26: US Utilities of Potential Interest to RWE

		Mkt. Cap	EV	Generation		Customers			P/E	
Company	Ticker	USD m	USD m	Operating	Developing	Electricity	Gas	Other Assets	2002	2003
Constellation	CEG	4843	7483	9000	3000	1.1m	0.6m	Energy services	11.2	10.2
Mirant	MIR	2953	7941	16000	2200	na	na	Asia, Europe (WPD in UK)	5.4	5.4
PPL	PPL	6268	10399	10300	2100	1.3m	73k	LatAm, Europe (WPD in UK)	10.4	9.8

Source: Merrill Lynch

Europe

RWE is currently notably absent from Scandinavia, Iberia, Italy and Poland. Whilst there are potentially players available, limited free financing RWE would have to choose between a reasonable sized European deal and a large US deal.

Few major European targets apparent given timing and financial constraints

- **Scandinavia**: The Scandinavian industry is well along the path of consolidation, with the emergence of a few major players - Vattenfall, E.ON (via Sydkraft), Fortum and Statkraft/Statnett.
- **Iberia**: As is the case for Scandinavia, RWE faces a group of four large groups that are likely to exceed their scale potential - in the absence of a merger of course. In most strategic reviews given by management to date, Southern Europe has not been on the agenda for RWE.
- **Italy**: RWE's statements on deal timing (below) are likely to mean that they will be too late to acquire the Interpower assets for sale by Enel. They may look for further deals with local operators (including municipalities) or green field developments, but these are unlikely to lead to significant (in an RWE context) acquisition.
- **Poland**: On the electricity side, RWE has been shortlisted for the acquisition of 25% of the Warsaw utility Stoen (0.72m customers), although with a reported value (Platt's Commodity News, 28 November 2001) for the stake of USD174m it is hardly a major acquisition. The biggest asset for sale is the G8 group of distributors, for which RWE has not been a shortlisted bidder as yet. RWE is more active in gas, and has stakes in two distributors with an aim of selling 1TWh of gas in Poland in the long term. The bottom line is that we expect to see expansion in Poland to be "organic" in nature.

Overall, then, we do not expect to see any major European energy acquisitions from RWE in the near term.

Upstream Gas

RWE have an extreme short position in upstream gas. RWE currently produce around 2BCM of gas compared to 26BCM of sales to customers post-Transgas, leaving the group to buy the remainder on the open market. The acquisition of Highland Energy offsets a small part of this short, bringing total reserves of around 2BCM for EUR180m (e) which adds to RWE's existing 34BCM reserves.

RWE is short upstream gas, but major acquisitions unlikely

There are no major pure-gas E&P companies, so we would expect RWE to pursue the joint venture approach being followed by many utilities currently.

Timing

Management statements at time of Innogy deal announcement state that they are unlikely to be making any major acquisitions this year. This is eminently reasonable given that each of their major utility divisions are currently trying to complete/integrate major acquisitions.

No new major deals expected in 2002

We would also note that the current CEO, Dietmar Kuhnt, is due to step down from the executive board at the end of this year. We would expect to hear some news on his replacement some time over the summer. We would not expect the new CEO to change strategy radically, although implementation and timing is clearly something that may change.

Reinvestment Risk Assessment

Both RWE & E.ON are going through major disposals and reinvestment

Taking all these items together - disposals, acquisitions committed to and remaining free-financing capability - we believe that E.ON is likely to allocate over twice as much capital as RWE on both an absolute and a relative basis. The key differentiation is that RWE has effectively already defined most of its reallocation via committed acquisitions compared to E.ON.

Table 27: Reallocation of Capital Scenario

	E.ON			RWE		
	EUR m	% EV	% Mkt. Cap	EUR m	% EV	% Mkt. Cap
Disposals (EV)	20675	30%	56%	5236	8%	22%
2002	5920	9%	16%	0	0%	0%
2003	14755	21%	40%	5236	8%	22%
Commitments	21490	31%	58%	16515	26%	69%
Free-financing Capability	14757	21%	40%	5412	9%	23%
Aggregate Reallocation	**56923**	**83%**	**153%**	**27164**	**44%**	**114%**

Source: Merrill Lynch Estimates

This raises the issue of reinvestment risk. It is therefore worth considering the groups' metrics for reinvestment (ie measures of Economic Value Added) and how they are performing, both in terms of the current asset base and in proposed acquisitions.

Measuring Shareholder Value

E.ON & RWE have a similar approach to measuring shareholder value

In its most basic form this takes the form of a series of strict financial criteria for new deals, and a willingness to show in explicit terms that these conditions are being met. To summarise the current calculations:

- **RoCE**: Functionally, RWE and E.ON apply the same calculation to RoCE, although there are minor presentational differences.

Table 28: Approaches to Calculate RoCE

EUR m, 2001A	E.ON	RWE
Internal Operating Profit	3553	
+ Interest Income & Interest on Provisions	710	
EBIT	**4263**	**3360**
+ Goodwill Amortisation	588	
EBITA		
+ Operating Result from Investments		664
EBITA/Operating Result	**4851**	**4024**
Capital Employed/Operating Assets	47687	37860
Intangible & Tangible Assets	44744	40441
Investments in Associates	10103	6245
Cumulative Goodwill Amortisation	1871	654
Inventories/Receivables	14327	12771
Non-interest Bearing Items	-23358	-22251
RoCE	**10.3%**	**10.6%**

Source: Companies

- **WACC**: The two German groups apply the same approach to WACC, although with slightly different figures incorporated as summarised in the table below. Note that the key hurdle rate for both groups is the pre-tax WACC, in keeping with the pre-tax RoCE calculated.

Table 29: Approaches to Calculate WACC

2001A	E.ON	RWE
Risk Free Rate	5.6%	5.5%
Market Premium	5.0%	5.0%
Beta	0.7	0.8
Cost of Equity, Post-tax	**9.5%**	**9.1%**
Cost of "debt", Pre-tax	5.9%	6.0%
Cost of "debt", Post-tax	**3.8%**	**4.1%**
Equity Weight	45%	40%
"Debt" Weight	55%	60%
WACC, **Post-tax**	6.2%	6.2%
WACC, Pre-tax	**9.5%**	**9.5%**

Source: Companies

Both E.ON & RWE looking for accretion in year 1 pre-goodwill and RoCE>WACC by year 3 from acquisitions

Both groups have also stated explicit criteria for new acquisitions:

- **RWE**: Deals should be earnings-accretive from year one, pre goodwill, and achieve a RoCE in excess of pre-tax WACC after no more than three years post transaction.
- **E.ON**: Deals should be earnings accretive from year one, pre goodwill, and achieve a RoCE in excess of capital cost after no more than three years post-transaction. Normally the group looks for acquisitions to make WACC +1-2% points. The group also wants to only make acquisitions with a low country risk.

The next question, of course, is whether they are achieving their aims.

Shareholder Value Performance

Our forecasts for the groups include acquisitions that have already been committed to, with the exception of E.ON's acquisition of Ruhrgas, the terms and concessions of which are not yet known, and RWE's acquisition of Innogy.

On the basis of our forecasts, shown in the table below, we see E.ON's core utility business generating around EUR360 - 400m in 2002 and 2003. The fall beyond that point is due to the gradual claw-back of network cost cutting. We do, however, expect E.ON to be able to continue to generate value throughout the forecast period.

E.ON expected to generate EVA throughout the forecast period

Table 30: E.ON EVA Position

	2001A	2002E	2003E	2004E	2005E	2006E
RoCE	12.0%	12.7%	12.6%	12.0%	11.9%	12.1%
WACC	10.5%	10.5%	10.5%	10.5%	10.5%	10.5%
Absolute EVA, Post-tax, EURm	171	362	403	282	276	308
Absolute EVA, EUR per Share	0.26	0.56	0.62	0.43	0.42	0.47
Absolute EVA % Mkt. Cap	**0.5%**	**1.0%**	**1.1%**	**0.8%**	**0.7%**	**0.8%**

Source: Merrill Lynch Estimates

RWE's generation of economic value added is larger than E.ON's in both absolute and proportional terms. Whilst this is driven by all four divisions, it is worth noting the differing dynamics:

- **Electricity**: The main positive driver is the cost cutting programme, which is more extensive than that at E.ON. The fall at the end of the forecast period is due, as is the case for E.ON, to network cost cutting clawback.
- **Gas**: The integration of Transgas, the subsequent implementation of the regulatory deal there, and organic growth across the division drive the expansion of EVA.
- **Water**: The initial negative returns of the division are largely due to the heavy burden of goodwill from the acquisition of Thames. Excluding goodwill the 2002 EVA would be EUR13m, rising to EUR460m at the end of the forecast period. The returns are also boosted by the acquisition of American Water Works.
- **Waste**: The growth in returns at RWE Umwelt is less significant than at the other divisions, although we would note that a cyclical downturn later in the forecast period could prove damaging.

We would draw attention to the absolute EVA line in the table below. One of RWE's key targets is to grow the absolute EVA number to EUR1bn by 2003. We see two differences between our forecast and RWE's target:

- If we add-back the goodwill at Thames of EUR330m the group will just achieve their target.
- We would also identify our assumption of a 6% cut in network tariffs in the electricity business, which cuts EUR190m from EVA spread across 2002 - 2004.

All RWE divisions should be EVA positive by end of forecast period

Table 31: RWE EVA Position

	2001	2002E	2003E	2004E	2005E	2006E
RoCE	**10.6%**	**11.1%**	**11.2%**	**11.5%**	**11.4%**	**11.5%**
Electricity	11.4%	14.8%	15.0%	14.8%	13.6%	12.7%
Gas	21.5%	10.7%	12.2%	15.4%	17.2%	19.3%
Water	6.8%	6.8%	7.2%	7.7%	7.8%	8.2%
Waste	10.5%	11.4%	12.5%	13.8%	15.3%	16.1%
WACC	**9.3%**	**9.5%**	**9.3%**	**9.2%**	**9.2%**	**9.2%**
Electricity	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%
Gas	11.0%	11.0%	11.0%	11.0%	11.0%	11.0%
Water	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
Waste	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%
Absolute EVA, Post tax, EURm	**252**	**375**	**491**	**667**	**644**	**682**
Electricity	135	474	510	500	380	289
Gas	208	-15	52	180	246	314
Water	-96	-97	-93	-46	-28	27
Waste	5	12	22	33	46	52
Absolute EVA, EUR per Share	0.44	0.66	0.86	1.17	1.13	1.20
Absolute EVA % Mkt. Cap	**1.1%**	**1.6%**	**2.1%**	**2.8%**	**2.7%**	**2.9%**

Source: Merrill Lynch Estimates

The bottom line is that, on the basis of current businesses and proposed acquisitions, we expect RWE to do a better job of increasing shareholder value in the coming five years than E.ON.

That said, E.ON is also more a work in progress, with another estimated EUR21bn of free financing capability pre-Ruhrgas available. In order to "catch-up" with the proportional EVA being generated by RWE, E.ON will need to reinvest its free financing capability at a return on capital employed of 11-13% pre-tax.

E.ON needs to invest at 11-13% RoCE to achieve RWE's levels of EVA

Table 32: RoCE Required for E.ON to Match RWE's Proportional EVA

	2001	2002	2003
RWE Abs.EVA%Mkt Cap	1.1%	1.6%	2.1%
E.ON Abs.EVA%Mkt Cap	0.5%	1.0%	1.1%
Absolute EVA Uplift Required, Pre-tax	365	365	598
Free Financing Capability	21335	21335	21335
Required EVA	**1.7%**	**1.7%**	**2.8%**
WACC	9.5%	9.5%	9.5%
Required RoCE	**11.2%**	**11.2%**	**12.3%**

Source: Merrill Lynch Estimates

Ruhrgas would achieve that aim on a book basis, but not on a cash basis

One deal that could meet the group's criteria would be the proposed acquisition of Ruhrgas. As shown below, under the standard approach used by RWE & E.ON the acquisition of Ruhrgas would generate a RoCE of around 14.9% if we exclude generic provisions. Note that this analysis excludes any concessions or potential synergies.

Table 33: EVA Perspective of Ruhrgas

	2002E, book
Operating Result	777
Capital Employed	5217
Intangible & Tangible Assets	4245
Investments in Associates	191.6
Cumulative Goodwill Amortisation	1
Inventories/Receivables	1278.7
Non-interest bearing Items ex Generic Provisions	-2849
Goodwill from Acquisition	2350
RoCE pre-tax	**14.9%**
Absolute EVA, Pre-tax	281

Source: Merrill Lynch Estimates

What this underlines, however, is that the next two US deals from E.ON will be critical in allowing E.ON to achieve a similar level of value creation to RWE going forward.

By extension, these deals represent a major risk/opportunity in regard to our positive investment stance on E.ON.

4. Companies Mentioned In This Report

Table 34: Utilities Mentioned in this Report

Company	ML Code	Q-R-Q	F'n	CCY	Price
AEP	AEP	B-3-2-7	p	USD	43.8
Allegheny	AYE	B-2-1-7	p	USD	35.2
Ameren	AEE	B-3-3-7		USD	43.3
American Water Works	AWK	Restricted		USD	43.3
Centrica	CNTCF/CNTCY	B-3-2-7	q	GBp	223
Cinergy	CIN	B-2-1-7	p	USD	35.5
Constellation	CEG	C-2-2-7		USD	28.9
E.ON	EONAF/EON	B-3-2-7	q	EUR	57.45
Endesa	ELEZF/ELE	B-2-2-7	q	EUR	16.99
Enel	ESOCF/EN	B-1-2-7	p	EUR	6.62
Fortum	FOJCF	Restricted	q	EUR	6.06
Gas Natural	GASNF	B-3-2-7	q@	EUR	19.90
Innogy	INLGF	Restricted	q	EUR	273.3
Lassila+Tikanoja	LASLF	B-2-2-7	q	EUR	19.13
Lattice	LICEF	Restricted	q	GBp	185
Mirant	MIR	D-3-2-9		USD	8.15
Nisource	NI	B-3-2-7	p	USD	23.03
Powergen	PWGRF	B-3-3-7	q	GBp	776
PPL	PPL	C-2-1-7	p	USD	34.45
RWE	RWEOF/RWEOY	B-2-2-7	q	EUR	41.3
Scottish Power	SCPWF/SPI	B-4-3-8	q	GBp	405
Shanks	SHMCF	B-1-1-7	q	GBp	167
Snam Rete Gas	SNMRF	B-3-3-9	q	EUR	2.99
Suez	SUZAF	B-2-2-7	q	EUR	32.4
TXU	TXU	B-2-1-7	p	USD	52.2
Verbund	VBUOF	C-2-3-7	q	EUR	91.48
Vivendi Environnement	VIVEF	B-2-2-7	q	EUR	36.96
WRG	WSRGF	B-4-3-7	q	GBp	432

Source: Merrill Lynch Estimates. Prices as at 17th May2002

Table 35: Other Companies Mentioned in this Report

Company	ML Code	Q-R-Q	F'n	CCY	Price
Allianz	ALLZF/AZ	B-3-2-7	r	EUR	261
BASF	BFASF/BF	B-3-3-7	q	EUR	48.75
Bouygues	BOUYF	Rvw	q	EUR	34.16
BP	BPAQF/BP	A-1-1-7	j	GBp	596
Degussa	DGNDF	C-3-4-7	q	EUR	34.98
France Telecom	FNCTF/FTE	C-3-2-8	qp	EUR	21.99
Heidelberger Drueckmaschinen	HBGRF	B-3-1-7	qp	EUR	51.25
Hochtief	HOCFF	C-2-2-8	q	EUR	23.55
Orange	ORGEF	Rvw	q	EUR	6.02
Shell	SHTCF/SC	A-1-1-7	#q	GBp	533
Stinnes	SNJJF	C-2-2-7	q@	EUR	27.7
ThyssenKrupp	TYEKF	C-3-3-8	q	EUR	17.41
Vodafone	VODPF/VOD	Rvw	q@	GBp	110

Source: Merrill Lynch Estimates. Prices as at 17th May 2002

Restricted: Solicitation of Commission Orders Prohibited

Merrill Lynch is currently acting as financial advisor and has rendered a fairness opinion to RWE AG, in connection with its proposed acquisition of American Water Works Company Inc, which was announced on September 17, 2001. RWE AG has agreed to pay a fee to Merrill Lynch for its financial advisory services, a significant portion of which is contingent upon the consummation of the proposed transaction.

Merrill Lynch is acting as financial advisor and corporate broker to RWE AG in connection with its recommended cash offer for Innogy Plc announced on March 22, 2002. 'RWE AG has agreed to pay a fee to Merrill Lynch for its services, a significant portion of which is contingent upon the consummation of the proposed transaction.

The proposed transaction is subject to the acceptance by the shareholders of Innogy
This research report is not intended to (1) provide voting advice, (2) serve as an endorsement of the proposed transaction, or (3) result in the procurement, withholding or revocations of a proxy.'

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