

Utilities: current situation and near-term outlook

28 February 2012

General tendency

The reform of electric utilities, which was planned for market liberalization, increasing competition and attract more investors into the sector, in recent years has adopted a distorted shape because of the desire of the Government to restrain the growth in electricity tariffs. Socio-political factors subdued development of the sector: all market players were held hostage to regulatory measures, resulting in a reduction of investment attractiveness of the electricity segment, and the fall of the capitalization of the leading energy companies.

In the future, the investment climate and the industry will be also forced to form in the conditions of pressure of regulators. Electric power companies, while in the rigid tariff control, are facing an acute need to improve operational efficiency in order to neutralize the effects of deviations from the original course of reform and survive in the current environment.

Tariff decisions taken by the Government back in 2011, cover the first half of the year for generators and grid companies; retailers are expecting news at the end of March. We expect that near the end of the year the situation will change in the direction of weakening the "manual control" in the case that there is a real threat to non-fulfillment of the investment programs of power companies on the background of a difficult situation attracting borrowed funds.

Certainty about the rules for the electricity industry is of fundamental importance for business of all companies in this segment. This year, we expect not only new rules for the wholesale and retail electricity and power markets, but also a change on the part of antitrust regulation in the sector. The changes will affect both the degree of control by the FAS, and the whole review of the department's position regarding the new business model for electricity markets.

However, despite the mentioned risks, the situation of a significant drop in the cost of electric power companies in 2011 provides a good opportunity for long-term investment.

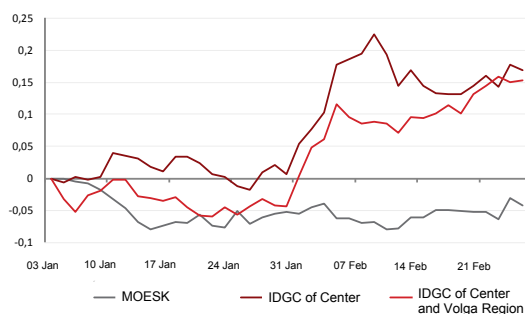
Ticker:	MRKP	MRKC	MSRS
Current price, \$:	0,0059	0,0254	0,054
Target price, \$:	0,0073	0,031	0,06
Potential:	24%	22%	11%

Grids

The market is waiting the review of the long-term RAB parameters, which must be made by April 1. IDGC Holding, however, expects a clearer picture not earlier April-May. If the proposed rate of return is approved, (FTS proposed to approve the new rate of return on equity up to December 31, 2012 at a rate of 12%, for the period from 2013 to 2017 - at 11%) the base of RAB is more likely to be reduced, which is not a positive signal for grid companies.

On the other hand, the drivers of growth in the sector in the near future may be the signals to start privatization. According to the plans voiced by IDGC Holding, in the second half of year it is planned to privatize one of the subsidiaries of the Holding. There have been first advances in respect of IDGC of Centre and Volga Region (AFK System - "Kirovenergo"), IDGC of Urals (Artyom Bykov "EnergoKurgan" - "Kurganenergo"), the probability of privatization is present for IDGC of Siberia (Oleg Deripaska - "Buryatenergo").

Dynamics of the shares of IDGC of Center, IDGC of Center and Volga Region and MOESK since the beginning of 2012



Source: Reuters

Please, be also reminded that in the spring the issue of transfer to Gazprombank's trust management of the share of IDGC Holding in MOESK may be raised again, which now is at 50.9%. According to the previously entered strategic agreement, the term of trust management will be 3.5 years, a moratorium on the sale of the transferred shares in the management - 1 year. If approved by FAS in the future the Gazprombank's share in the capital structure of MOESK can be increased to approximately 31% (as of today it is about 5%). As a result of 3.5 years the stock of IDGC Holding in MOESK will be kept at not less than 25%. Although there are legal restrictions on the merger of generation and transmission assets in one structure, the likelihood of such development in the future is not excluded in the light of the ever-changing rules of the game in the sector.

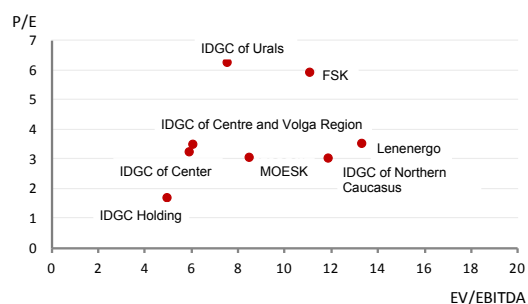
Also on February 27 the Board of Directors of Tomsk Distribution Company (TDC) reviewed the item of prior approval of the agreement of transfer of the company under the management of LLC "ERDF East" (Russian "daughter" of French ERDF). Today, the signing of the transfer took place, according to which "ERDF East" will start performing the functions of a sole executive body on 1 March this year.

Privatization of 4.11% stock of FSK is postponed for an indefinite term due to the complexity of objective valuation of the company, as well as in anticipation of a more competitive market, which will make it possible to lift the stock price up to par (0.5 ruble). In general, FSK will feel good: growth rate of its tariffs will certainly be kept at higher levels than for IDGC. Moreover, the company will not be affected with elimination of direct contracts on power transmission from the beginning of 2012. However, the company's capital investment program is so impressive (2012 - 196 billion rubles, the program for 2010-2014 - 952.4 billion rubles), and in conditions of limited growth of tariff rates the company may still face problems of funding.

The taken by IDGC Holding steps on consolidation of TGCs in the structure of IDGC may also have positive effect. Due to the limitation of growth of tariff rates for IDGC, their profitability depends largely on the growth of uncontrolled costs, which include fees for services of TGCs (the growth in 2011 about 30%), charges for services of FSK (growth of about 20%), as well as the cost of losses compensation. Consolidation of TGCs can reduce costs of IDGC for their services. This, undoubtedly, would have a positive effect on the profitability of operating distribution grid companies.

In the current environment to increase operating cash flow grid companies will focus on cost optimization. However, even in the face of declining of the 10-year capital expenditure program of IDGC Holding up to 20% (from \$100-120 billion down to \$93 billion), taking into account the need to implement the investment programs of subsidiaries (the minimum necessary amount of the investment program of IDGC Holding is \$2-2.5 billion per year), the credit load of IDGC will grow. In this regard, the market may see a new wave of additional issues in favour of the Holding that increases the risk of diluting the interest

Comparative evaluation by multipliers according to preliminary results of 2011



Source: calculations of IC BFA

of minority shareholders.

Given the fact of freezing the electricity prices until the middle of this year, the main growth of indicators of IDGC will be in the second half. According to the plans of grid companies, it is not planned to have a significant increase in electricity supply in 2012, and some companies may reduce this figure. In this regard, we expect the reduction in profits in the coming reporting periods. The strongest will be the companies that will effectively control their operating costs and are aimed at reducing them. Our favorites in the grid segment are IDGC of Centre and Volga Region, IDGC of Centre and MOESK.

According to preliminary data for 2011, in our opinion, IDGC Holding, IDGC of Centre and Volga Region, IDGC of Centre and MOESK are undervalued. In operational terms MOESK demonstrated the best results, having managed to increase the electricity supply by 2% against the same or negative dynamics of other IDGCs. Distribution losses in the grid were reduced by 2%, in the long term for the current year they are planned to be reduced by another 6%. IDGC of Centre and Volga Region kept its supply of electricity at the last year's level, but the losses were also reduced by 3%.

According to preliminary data, the following distribution grid companies showed the best dynamics of financial indicators:

Growth rates	2011/2010	IDGC of Centre and Volga Region	IDGC of Center	MOESK
Revenue		18%	13%	12%
Operating profit		50%	42%	-17%
EBITDA		46%	10%	7%
Net profit		134%	10%	14%

Source: companies' reports, calculations of IC BFA

Indicator, \$ mln	Preliminary financial results of 2011		
	IDGC of Centre and Volga Region	IDGC of Center	MOESK
Revenue	2 185	2 317	4 219
EBIT	213	379	721
EBITDA	336	463	1 361
Net profit	112	177	595
EBIT Margin	10%	16%	17%
EBITDA Margin	15%	20%	32%
Net Margin	5%	8%	14%

Source: companies' reports, calculations of IC BFA

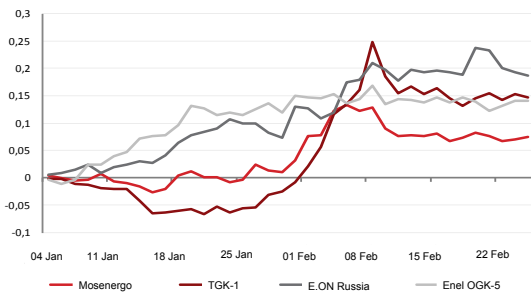
Ticker:	EONR	MSNG	TGKA	OGKE
Current price, \$:	0,093	0,064	0,0004	0,073
Target price, \$:	0,135	0,09	0,0005	0,09
Potential:	46%	40%	32%	24%

Generation

On the eve of elections government regulation and control in the sector increased, which had a negative impact on its capitalization. However, since the capitalization of generating companies was restored by 13%, which is slightly less than in the grid segment (20%), which adds some relative attractiveness to generators in terms of opportunities for further growth.

Generating companies are under pressure to fulfill obligations under the programs within the power delivery contract, which the main investment potential of the segment was shifted to. According to the obligations per the power delivery contract the generators that have completed or fulfilled the greater part their investment program are in the best position within the power delivery contract. Among the companies we allocated it refers to OGK-5 (100% realization of its capital investments within the power delivery contract), E.ON Russia (67%), TGC-1 (61%) and Mosenergo (61%). E.ON Russia has to implement the last investment project: the construction of STU-800 at Berezovskaya GRES power plant which is scheduled for completion by 2014. According to our calculations, the free cash flow of the company will be positive already following the results of the current year, in connection with what we can expect that the company will spend the funds for dividend payments. TGC-1, in contrast to Mosenergo, which has the main commissioning of new capacity for 2013-2014, is to complete most of its projects in 2012, which also will have a positive effect on the free cash flow of the company and will allow to direct the funds to repay debt.

Dynamics of the shares of Mosenergo, TGK-1, E.ON Russia and OGK-5 from the beginning of 2012



Source: Reuters

The problem of ensuring the profitability of modernization of existing generating facilities has not completely solved yet, which accounts for only maintenance budgets of companies and investments into which has no guarantees of return on investment. Currently, the government considers proposals to start the power delivery contract-2 mechanism, which aims to encourage a deep reconstruction of generating capacity to improve the efficiency of the old units. It is expected that decisions will be taken in the spring.

In general, there was a rather weak operational dynamics for companies of the generating sector in 2011. The reduction of heat energy supply was associated with higher ambient air temperature and the early end of the heating season. Falling energy production in some companies is associated with the modernization and repair of units.

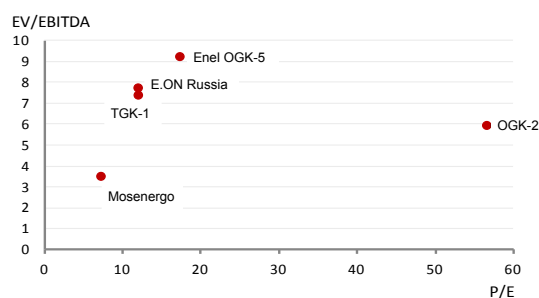
According to the annual operating results, the greatest growth of electricity generation was shown by E.ON Russia thanks to the commissioned this year new units at Surgutskaya GRES (two CCGT-400 units with the total capacity of 800 MW), Yayvinskaya GRES (400 MW CCGT), Berezovskaya GRES (the capacity was increased by 50 MW). Also, thanks to the commissioning of new energy efficient facilities good growth was demonstrated by TGC-1 (4.4%). Despite the higher ambient air temperature in 2011, several companies were distinguished by heat energy supply: Enel OGK-5 and Volga TGK increased it by 4% each.

Operational results for 2011

	OGK-2	E.ON Russia	Enel OGK-5	TGK-1	Mosenergo	TGK-5	TGK-6	Volga TGK	TGK-9
Electric energy generation, mln kWh	79 700	62 467	42 435	28 362	64 600	10 282	11 672	25 259	14 163
Change	-3,4%	11,7%	-6,0%	4,4%	-0,6%	-1,3%	0,6%	0,0%	-2,1%
Heat energy supply, thousan Gcal	6 300	1 758	6 783	26 053	66 400	15 801	17 345	47 974	37 950
Change	-6,4%	-12,9%	4,0%	-9,6%	-4,9%	-3,4%	0,0%	3,8%	-4,8%

Source: companies' reports, calculations of IC BFA

Comparative evaluation by multipliers according to preliminary results of 2011



Source: calculations of IC BFA

Construction of new transmission lines within the investment program of FSK should make it possible to enlarge free power transfer zones and decrease their number: first down to twenty in 2015, and further on - down to four. The movement on the planned by the reform path towards the liberalization of the electricity and power market should be expressed in increasing competition in the free power transfer zones, as well as the decline of "forced" generation. However, firstly, this amalgamation of zones can be purely administrative, if the development of grid infrastructure of the zones is not involved. Secondly, the merger does not cancel the "manual control" in the form of price caps on power. These measures can have a positive impact on the business of the most efficient generators, which will increase the share of its market presence by working to reduce costs.

In our opinion, E.ON Russia, OGK-5, Mosenergo and TGK-1 have the strongest competitive position in the sector.

Preliminary financial results of 2011

Indicator, \$ mln	E.ON Russia	Enel OGK-5	TGK-1	Mosenergo
Revenue	2 318	2 116	1 963	5 471
EBITDA	787	372	320	837
Net profit	490	149	122	354
EBITDA Margin	34%	18%	16%	15%
Net Margin	21%	7%	6%	6%

Source: companies' reports, calculations of IC BFA

In the case of RusHydro the company is facing a prospect of an additional issue, diluting the interest of minority shareholders. Under the capitalization increase of the hydro generator to finance its investment program the additional placement of shares is planned in the amount of 11 billion shares, 11% of which is more likely to be bought by Vnesheconombank for 64 billion rubles. This measure is a kind of alternative to the planned in 2012 privatization. The direct privatization of the state-owned stock in RusHydro (58.6%), which is expected to decrease to 50% plus 1 stock is transferred for the prospect of no earlier than 2015 with the need to implement major projects such as restoration of the Sayano-Shusheskaya power plant, construction of the Boguchanskaya and Zagorskaya PSPP-2 hydropower stations. In 2012 we expect deterioration in financial performance of RusHydro due to the fact that the targeted investment component was excluded from the tariff of the hydro generator in connection with the need to reduce the average selling price to the consumer by 12.5%.

Retailers

It is difficult to predict what changes will occur in the supply sector management in the near future. We will try to outline the main trends in the energy retail business.

First of all, the market expects the Draft Guidelines for the operation of retail electricity markets to be prepared by March 20, which will help bring greater clarity to the picture of the sector. However, we do not exclude that the Interagency Working Group will amend Resolution # 877, which again may increase regulatory risks. In the case of entry into force of Resolution # 877 in the form of its announcement, the margin of retail companies will reduce already in the second quarter of 2012. Lack of a differentiated approach to the regulation of retail companies may hit hard individual members of the sector - particularly those with bad established work on the repayment of debt by consumers. The issue of non-payment is also very keen for power supply companies due to the fact that banks are not willing to lend to "retailers" with negative dynamics of their profits. As a result, the outcome of the year for a number of retail companies can be loss of status of a guaranteed supply company (GSC) and withdrawal from the market, bankruptcy.

As support for such retail companies it is proposed to create a single supplier of last resort at the federal level, which in case of insolvency of a regional GSC (bankruptcy, failure to supply electricity), will be able to replace it. Federal supplier of last resort would support the bankrupt supplier for six months, then as now in the event of loss of status of GSC by a retailer its duties are transferred to a territorial distribution grid company, which is a part of IDGC Holding. The first possible candidate for this role was United Power Retail Company (OESK) belonging to state energy holding INTER RAO UES. The possible acquisition of the status of the federal supplier by OESK - another step of INTER RAO on the way to expansion in the energy retail sector.

However, INTER RAO - not the only contender for the increase in market share and influence on it. Among the potential major players in the sector we have identified Gazprom and RusHydro. Plans of smaller groups such as Roskommunenergo owned by former employees from the USSR Ministry of Housing and Utilities and former managers of RAO UES of Russia, and EnergoStrim, known for its disregard of the interests of minority shareholders of companies under its control, are unknown and difficult to predict. Recently EnergoStrim has been actively pursuing efforts to strengthen corporate secrecy: some preparations for the delisting of securities of companies controlled by the reverse stock split (consolidation). These actions are bringing additional risks infringing on the rights of minority shareholders of supply companies controlled by the holding company.

Independent retail companies (IRC) will be under particular threat due to increased competition with suppliers of last resort. In connection with the loss of their margin suppliers of last resort will conduct a more aggressive policy against keeping old and attracting new customers, which in turn will increase the pressure on independent retailers. The opportunity of customers' shift from suppliers of last resort directly to the wholesale market for electricity and power, or to IRCs was deferred from January 1, 2012 to the middle of the year, which also limits opportunities of independent retailers.

Major changes in the sector's activity will occur only in the second quarter of this year, which retains the ability to obtain fairly good financial results of a number of retail companies and their payment of high dividends for 2011 and first quarter of 2012. In this regard, we highlight a few papers with a high level of expected dividend yield.

Our favorite - Mosenergosbyt, which paid the last dividends following the results of the first half of 2010. On 28 March 2012 it will be one year since INTER RAO owns a controlling stake, which, in accordance with the law, disclaims liability of the company to pay taxes on dividends. We expect that

INTER RAO will use this fact to pay solid dividends for 2011. The data for other retail companies are listed in the table.

	Dividend yield	Dividend 2011, \$	Rate of return	Estimated record date
Mosenergosbyt, JSC	60%	0,0026	14%	May
Samaraenergo	50%	0,0028	14%	April, May
Energosbyt Rostovenergo, JSC	60%	0,002	13%	April
Petersburg retail company, JSC	70%	0,03	11%	May
Tambov ESK	80%	0,0007	11%	April, May
Krasnoyarskenergosbyt, JSC	80%	0,014	10%	April, May
Chelyabenergosbyt	100%	0,0009	9%	May
Permenergosbyt, JSC	70%	0,197	7%	April

Source: calculations of IC BFA

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