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Industry View
Cautious

Utilities

Environment Still Tough, More Headwinds Coming, Stay Cautious

More underperformance to come: Oversupply is still building up in European gas and power markets as: (1) new capacity is rolled out, and (2) the demand 'rebound' fails to materialise. Power prices and generation spreads have weakened materially since late 2009. We cut mid term EPS forecasts by 13% for the generation exposed and integrated names. Consensus is still too bullish on the big-cap utilities.

Supply/demand tracker still finds cause for concern We track demand evolution and new power station additions to show that reserve margins will increase substantially in the next 2-3 years. Capacity additions are still skewed to non-renewable capacity and power market volatility has declined – all bad news for gencos.

Gas market still a drag. We highlight that gas market liquidity has increased markedly. We expect gas prices to remain subdued given current oversupply, storage inventories and new LNG capacity.

Adjusted profits are well below reported levels: We now revise earnings and valuations for generation exposed companies to reflect the short-term (2-3 year) benefits of free carbon allocations and hedges. Our numbers show "clean" profit growth rates – this underpins our sector preferences.

Big-Cap rating changes: We downgrade both E.ON and Iberdrola to Underweight, and Scottish and Southern to Equal-weight. We upgrade Centrica to Overweight, and Enel to Equal-weight.

Our most preferred list: EDF, National Grid, Snam Rete Gas, A2A, Centrica and GDF SUEZ

Our least preferred list: Iberdrola, E.ON, Gas Natural, Verbund, and Pennon

New in this report

Seven reasons to stay cautious on utilities

Stock implications – Stick defensive, buy near-term growth

Our Rating Changes

Upgrading ↑	From	To
Centrica	Equal-weight	Overweight
Enel	Underweight	Equal-weight
Downgrading ↓	**From**	**To**
E.ON	Equal-weight	Underweight
Iberdrola	Equal-weight	Underweight
Scottish & Southern	Overweight	Equal-weight

Also Published Today

Southern European Generators: *Italian electricity prices outperform Spain: ENEL up to EW; IBE down to UW*

UK Utilities: *Cautious on Commodity: Buy National Grid and Centrica*

RWE: Robust, Decent Growth, But Not Quite Cheap Enough Yet

GDF SUEZ: Relative Attractions Remain Despite ST Uncertainty

E.ON: *Downgrade to Underweight: Lower relative growth prospects still not discounted*

Iberdrola: *Growth Lower than Sector; Premium Not Justified – UW*

Enel: Net Cash Flow Achieved – Upgrade to EW

Why We Remain Negative on the Utility Sector – 7 Key Drivers

Driver #1: The scale of the power and gas demand recovery will continue to disappoint. Our demand tracker shows that the much-anticipated rebound has yet to occur. Industrial production will drive the eventual power/gas demand recovery but the economic rebound seems to be faltering.

Driver #2: New capacity additions mean that power and gas markets will be oversupplied in 2010-12. Our power station tracker shows that reserve margins will increase markedly in almost all regions. We also show that the bulk of capacity additions in 2010-12 are thermal, not renewable. Thus, pricing power must weaken, we think.

Driver #3: Power prices will continue to decline, leading to earnings downgrades and lower growth prospects. Power prices in most markets have fallen substantially since October 2009. We don't expect any short-term reversal and there could be more weakness in medium-term pricing.

Driver #4: Spot gas market liquidity will enhance competition, and put pressure on mid-stream gas margins. Volumes in European gas hubs have increased markedly. Liquidity, if persistent, should mean higher competition and lower margins.

Driver #5: Balance sheets are at close to full capacity, or slightly higher, across the sector. More deleverage still to come? In general, credit ratings have little room for slippage yet leverage ratios are close to tapped out. In some cases deleveraging looks inevitable.

Driver #6: We see 6% downside to 2011 consensus forecasts, and we cut our 2013 forecasts by 13%. We mark our estimates to market for 2010-13, triggering lower forecasts. We expect consensus to move too, given the reporting season is upon us.

Driver #7: Valuations are not that compelling, especially when adjusted for the significant short-term effects of free carbon allocations and hedges. The "clean" 2010e PE is 14.9x, and the "clean" 2010e EV/EBITDA is 8.5x

Key Rating Changes and Our Most/Least Preferred Lists

Rating Upgrades

We upgrade Centrica to Overweight, with a new price target increased to GBp 330 (25% upside).

We upgrade Enel to Equal-weight, with a new price target of EUR 4.00 (7% upside).

Rating Downgrades

We downgrade Iberdrola to Underweight, with a new price target lowered to EUR 5.70 (2% downside).

We downgrade E.ON to Underweight, with a new price target lowered to EUR 27 (5% upside).

We downgrade Scottish and Southern to Equal-weight, with a new price target of GBp 1,300 (13% upside)

Our Key Sector Preferences

Most Preferred List:
EDF
National Grid
Snam Rete Gas
A2A
Centrica
GDF SUEZ

Least Preferred List:
Iberdrola
E.ON
Gas Natural
Verbund
Pennon

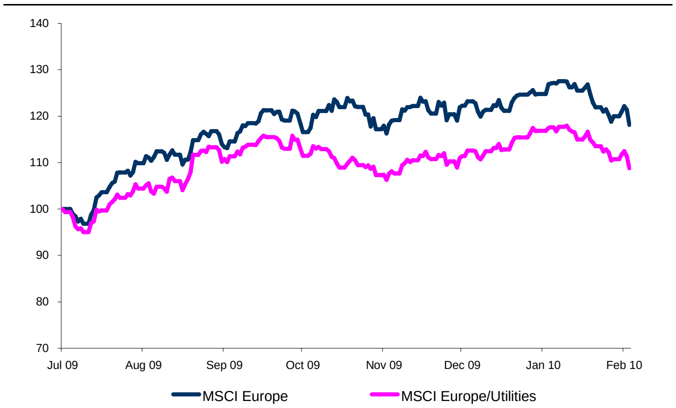
Seven Reasons to Stay Cautious on Utilities

We still see plenty of reasons to be cautious on the utility sector, even after continuing weak performance (see Exhibit 1). The main drivers of our stance are related to the increasing oversupply in power and gas markets, a slow demand side recovery, lower midstream gas margins, the risk of further deleveraging and thus downside risk to medium term earnings estimates. In addition, we think valuations fail to fully reflect the risk and are vulnerable to disappointments in many cases.

We don't yet believe that consensus accurately reflects the weak operating environment, which has deteriorated further since we downgraded our sector view in October – power prices have declined by approximately 15% and gas prices by around 20%. We also expect a muted outlook from many management teams at the upcoming results season. Although the sector does look a little cheap relative to the market in a historical context, this is not that attractive given the weaker growth outlook and the negative earnings momentum.

Exhibit 1

The sector has underperformed the market by 10% since July last year



Source: FactSet, Morgan Stanley Research

We have reassessed our forecasts to reflect lower electricity and gas prices, and pushed the transition to our long term power price assumptions out to 2015 (vs 2013 previously). Utilities will soon be actively hedging 2013 production at the current forward prices, so it seems silly to assume otherwise. This has meant that we cut forecasts by 2% on average for 2012 and 13% for 2013 for the generation exposed utilities. Our forecasts for the regulated stocks have not changed as much – in fact we upgrade estimates slightly for National Grid.

We make a number of rating changes. Our stockpicking now favours: (1) regulated stocks, and (2) integrated utilities that offer the best near term growth – this will be a rare bird – and most solid earnings momentum. We upgrade Centrica (to OW) and Enel (to EW). We downgrade Iberdrola, E.ON (both to UW) and SSE (to EW). Our most preferred and least preferred stocks are shown opposite.

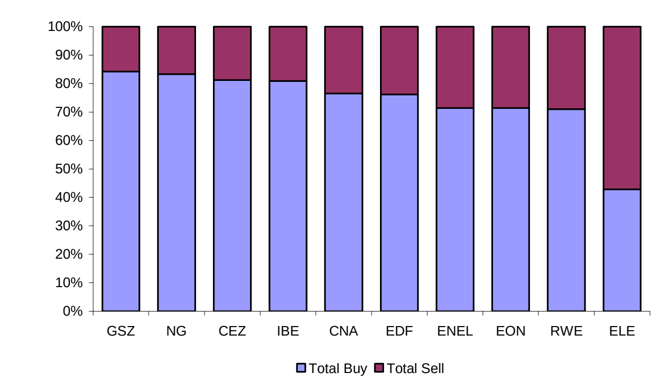
Key debates around our sector stance

We moved to a cautious stance on the utility sector in October 2009. We have had a lot of feedback on this call, with many investors looking for reasons to turn more positive. In this short section we discuss some of the most common pushback, and explain why we disagree. In the following section we outline in more detail the key reasons we remain fundamentally negative.

Debate #1: It's a consensus call to be Cautious on utilities. We don't believe this is really the case. Many commentators appear to be trying to "call the bottom" in the sector, arguing that we should look through the trough. We'd be happy to look through a tough period, but in our view the simple facts are that consensus is still far too high. Medium- term power prices have fallen by approximately 15% since we lowered our sector stance, and we think earnings estimates have a way to fall yet. More importantly, Bloomberg data show that consensus is still bullish on the biggest stocks in the sector, so by definition there seems to be plenty of room for consensus to become more bearish.

Exhibit 2

Consensus still overwhelmingly bullish on big cap European utilities (buy vs sell recommendations)



Source: Bloomberg, Morgan Stanley Research

Debate #2: Power plant cancellations will save the day and avoid an oversupplied market. This is a neat theory, if it were accurate. Yes, there are a lot of power plant cancellations but this is always to be expected. As a rule of thumb, only 1 in 4 power plant projects that gets announced is actually built.

Plants under construction are still set to commission as planned – no stations that have entered construction have been cancelled or delayed. We do not think cancellations of potential new projects down the line are enough to alleviate the current overcapacity. What is needed is mothballing of existing plants – which has not happened so far.

We track power station additions very carefully, and our supply-demand models only include those plants that are either in construction or where we have a very high level of confidence that they will go ahead very soon. Just taking these additions into account shows that reserve margins will increase materially and that pricing power will erode.

Debate #3: Capacity additions are mainly renewables, and therefore won't really depress prices as the wind doesn't blow all the time. Again this is an elegant theory, but not accurate, in our view. The bulk of the capacity additions we are tracking over the next few years is made up of coal and gas power plants, and these will add to the level of 'proper' overcapacity.

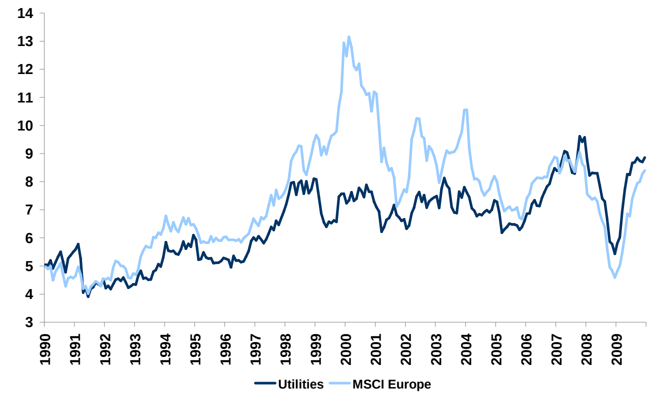
Another argument that we often hear is that adding renewables to an ageing power plant fleet will mean higher volatility, and that utilities will reap the rewards of this. But our analysis of power market observed volatility across Europe shows that over the last six months volatility has actually decreased markedly. This is hardly surprising – oversupplied markets should be less volatile than 'tight' markets.

Debate #4: A sharp demand recovery will save the day. Clearly, this could be true. However, as yet, and as we show in this report, there is no evidence of a sustained demand recovery. Given our forecasts for European industrial production, we believe that it will take years, not months, for a material power or gas demand recovery in Europe to come about. We think some industrial demand will simply not return, and some will only return slowly.

Debate #5: Utilities are cheap, aren't they? We are not so sure. We do not find a 13.2x 2010e PE multiple with less than 5% expected EPS growth (2009e-2013e CAGR) and 6% downside risk to 2011 consensus earnings all that appealing. In addition, looking at a 12 month trailing EV/EBITDA, the sector is trading at just under 9x, which is at a premium of approximately 8% to the broader market (see Exhibit 3).

Exhibit 3

Utilities trade at a small premium on EV/EBITDA vs the market – Relative valuation not compelling



Source: Worldscope, MSCI, Datastream, Morgan Stanley Research
Note: Chart shows Trailing EV/EBITDA data

So what would make us more positive?

Of course, we accept that there will be a time to take a more constructive view of the potential upside in the Utility sector. Below we highlight a number of the 'early warning signals' that we look for before becoming more bullish:

- **Material mothballing announcements:** We believe that mothballing could be needed to turn around the oversupply, and we will watch carefully for any signs of plants being taken out of commission. This could especially be the case for older coal and gas plants.
- **A demand spike:** For the reasons outlined earlier, we are not especially worried about a demand spike given our view on the economy and the ongoing effect of energy efficiency measures chipping away at demand growth. However if we are wrong, for whatever reason, and demand does snap back aggressively, this would make us less bearish. We are wary of reading too much into demand data that is not weather adjusted.
- **Cutting capex:** So far, few European utilities have materially reduced their planned capex programmes. We are sceptical that many will do this. However, we would view material capex cuts as positive for two reasons: (1) It would mean less new generation capacity added to the markets, and (2) It would mean that balance sheet metrics benefit, and therefore less deleveraging would be needed.

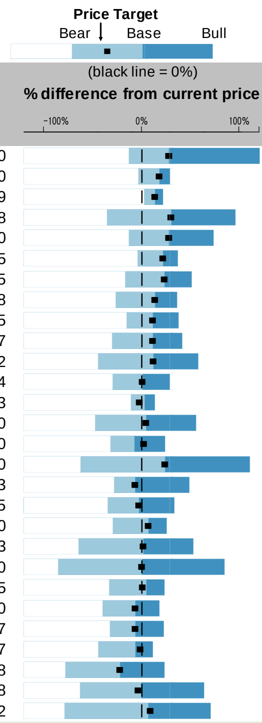
The European Utility Order of Preference

Exhibit 4

Order of preference and risk-reward profiles

* O = Overweight; E = Equal-weight; U = Underweight

	Company	Rating*	Share Price	Price Target	Comments
1.	EDF	O	39	50	Rising ARPU drives strong EPS growth
2.	National Grid	O	634.0	750	Cheap defensive, with potential for EPS upgrades due to US recovery
3.	Snam Rete Gas	O	3.4	3.9	Attractive regulation, business plan coming soon
4.	A2A	O	1.4	1.8	Strong cash flow supports future dividends
5.	Centrica	O	270.4	330	In sweet spot in 2010, attractively valued
6.	GDF-SUEZ	O	28.0	34.5	Strong balance sheet, strong EPS growth expected
7.	Severn Trent	O	1133	1285	Good dividend yield, attractive valuation vs peers
8.	ACEA	O	7.7	9.8	Potential restructuring story not in the price
9.	Suez Environnement	O	16.1	16.5	Waste recovery and secular growth in water
10.	Red Electrica	E	36.6	37	Regulated EPS growth
11.	RWE	E	64.6	72	Decent growth but tough to outperform if power prices fall
12.	Enel	E	3.9	4	Expected capex cut to restore FCF generation
13.	Enagas	E	16	15.3	Visible earnings, upside risks on dividends
14.	Cez	E	919	920	Decent growth but tough to outperform if power prices fall
15.	International Power	E	320	300	Recent M&A discussions highlight long term asset value
16.	Scottish & Southern	E	1163	1300	Defensive profile, but short term momentum tougher
17.	EDP	E	2.7	3	High gearing compensated by visible earnings
18.	Endesa	E	22.1	21.5	Strong balance sheet mitigates local market risk
19.	Drax	E	409	430	Loser in low gas price world, but hedging offers near term protection
20.	Edison	E	1	1.3	Attractive assets but market environment remains volatile
21.	United Utilities	E	531.0	570	Attractive valuation vs peers, but small concerns regarding the balance
22.	Northumbrian	U	278.3	275	Below peer group dividend yield, but M&A rumors persist
23.	Pennon	U	524.5	490	Below peer group dividend yield
25.	Iberdrola	U	6	5.7	Valuation does not compensate for local market and balance sheet risk
26.	E.ON	U	27	27	Low growth makes valuation unattractive
27.	Gas Natural	U	13.9	10.8	Largest relative long gas position justifies negative stance
24.	Fortum	U	18.6	18	Oversupplied Nordic Market brings downside risk to mid-term estimates
28.	Verbund	U	29.26	32	Weak power prices, unhedged portfolio and stretched balance sheet



Source: Morgan Stanley Research estimates
For valuation methodology and risks associated with the price targets mentioned, please refer to the full report, which is available through your sales representative, Client Link at www.morganstanley.com, or other electronic systems.

Exhibit 5

Order of preference grid

Preferred ← → Least Preferred

	Regulated Networks	Renewable + Water	Integrated	Generation
Preferred	National Grid Snam Rete Gas	Acciona	EDF Centrica A2A GDF SUEZ	
	Severn Trent Red Electrica Enagas United Utilities Federal Grid NWG Pennon	Suez Environnement EDP Renovaveis Iberdrola Renovables	ACEA RWE ENEL SSE EDP Endesa PPC	CEZ IPR Drax Edison RusHydro Fortum
Least Preferred		EDF Energies Nouvelles	Iberdrola E.ON Gas Natural	Verbund

Source: Morgan Stanley Research estimates.

Seven Reasons to Stay Cautious on Utilities

Driver #1: The scale of the power and gas demand recovery will continue to disappoint

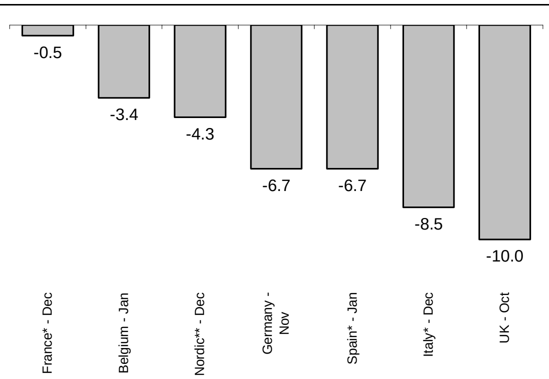
Over the last six months the bulls have been waiting in vain for a sustained recovery in power and gas demand. On a weather adjusted basis (where such data is readily available) most European power markets are seeing demand running some 7% below the pre-crisis level. (See Exhibit 6).

Of course, the deterioration is slowing, or even partly reversing in many markets. But we continue to believe that it is the absolute level of demand that matters, not the rate of change. With demand 7% below pre-crisis levels, this means that 4-5 years of demand growth have effectively been destroyed.

What will drive a rebound in demand? As Exhibits 7 and 8 show, industrial demand accounts for 35-40% of total power and gas demand. When one considers that an element of services demand is industrial driven, the proportion of demand that is linked to industrial production is close to 50% on average. This also neatly explains why European gas and power demand fell by around 7% in 2009 when European IP fell by 14%.

But as Exhibits 9 and 10 show, the rebound we have seen so far in IP is minimal, and we expect only a slow rebound in the absolute level of IP, perhaps by 2013-14. This, coupled with the faltering nature of the economic recovery, is why we remain cautious on both the speed and the scale of the recovery in power and gas demand.

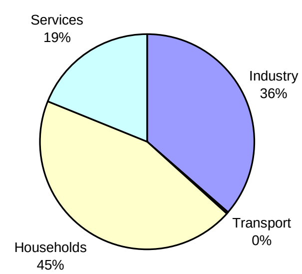
Exhibit 6
Net monthly change in electricity consumption since same month two years ago (%)



Source: Bloomberg, Morgan Stanley Research
* = weather adjusted data ** = weather adjusted data, MS Estimate

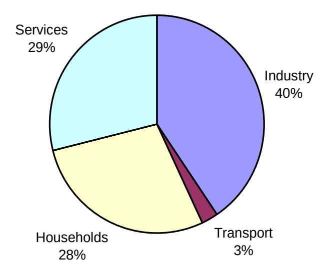
Since the crisis began, European Utility managements have become more and more bearish on: (1) the impact of the economic crisis and (2) the speed of a power and gas market recovery. We believe that consensus is too optimistic here and that the slow economic recovery, characterized by Morgan Stanley Research economists as "Bumpy, Below-Par and Boring", will mean a slow and disappointing power and gas demand rebound.

Exhibit 7
Industrial and Service sectors comprise 55% of total EU 27 gas consumption (2007)



Source: Eurostat

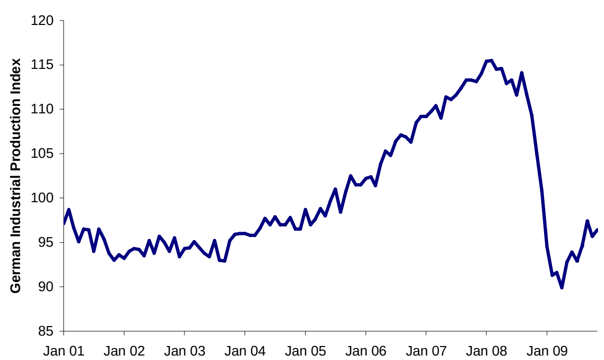
Exhibit 8
Industrial sectors comprise 40% of total EU 27 electricity consumption (2007)



Source: Eurostat

Exhibit 9

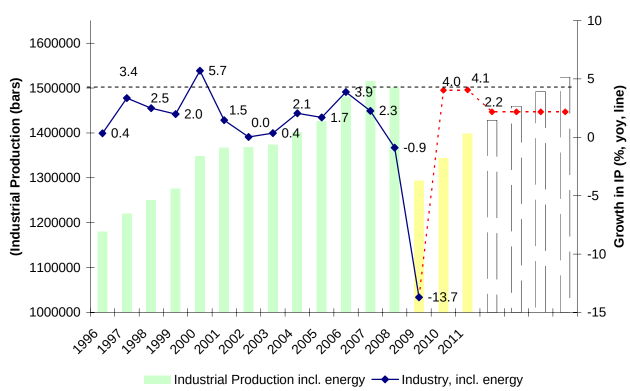
German Industrial Production rebound is modest



Source: Datastream, Deutsche Bundesbank

Exhibit 10

We expect a slow recovery in European IP overall



Source: Morgan Stanley Research (estimates for 2010 onwards)

Driver #2: New capacity additions mean that power and gas markets will be oversupplied in 2010 & 2011

We believe that the equity market is too sanguine about the overcapacity that is building up in gas and power markets, and which we feel will be an enduring feature of 2010 and 2011, at least. In our view, consensus will be disappointed as this overcapacity becomes more obvious and as it weighs on power and gas prices.

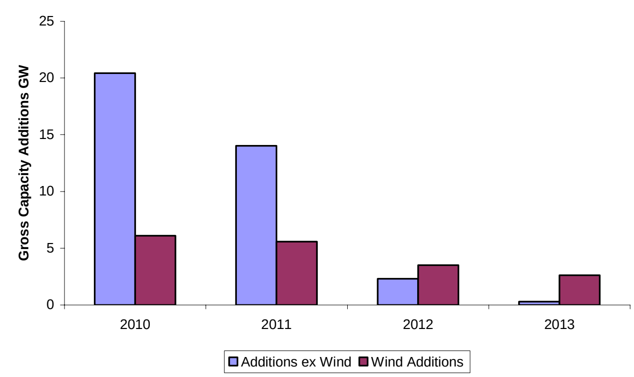
If anything, the situation in the power markets is easier to explain than in the gas market, where there are more variables, and more game theory to consider. Exhibit 11 summarises the new capacity additions that we have tracked in the key European power markets (UK, Germany, Nordic, Spain and Italy). This exhibit also refutes one of the misconceptions that is often bandied around on the sector – the bulk of the capacity additions are in thermal (gas and coal) power stations, not just renewables. This means the increase in capacity is real, not notional.

Many bulls would argue that adding renewables capacity will not necessarily depress power prices as the wind does not always blow and the additional thermal capacity is needed just as back-up. We'd make two points here. First, even a rudimentary analysis of the Spanish power market shows that a big increase in renewables capacity, coupled with an increase in thermal generation, can lead to a collapse in power prices and power price volatility. Secondly, as Exhibit 11 shows, the bulk of capacity being added is thermal, not renewable. Thus, we think that the build out of capacity is meaningful and will lead to lower pricing power and gross margins.

Exhibit 12 shows our forecast reserve margin analysis, which takes into account these capacity additions and our demand forecasts. This shows that we expect a meaningful increase in reserve margins – by 15-20 percentage points – on most markets. This level of increase is very material in an electricity market context.

Exhibit 11

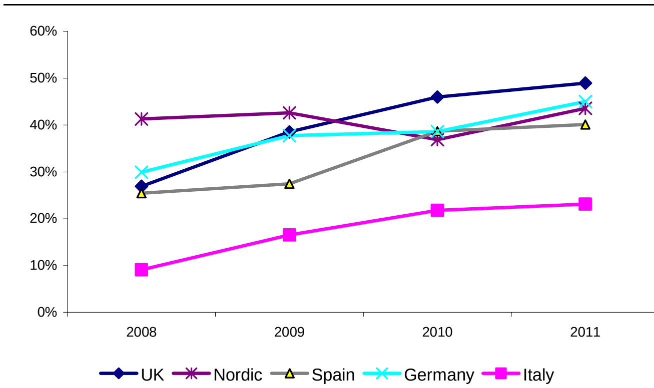
The bulk of new capacity additions (2010-13e) are thermal, not just renewables …



Source: Morgan Stanley Research (estimates for 2010 onwards)

Exhibit 12

… So power market reserve margins should therefore increase materially by 2012 …



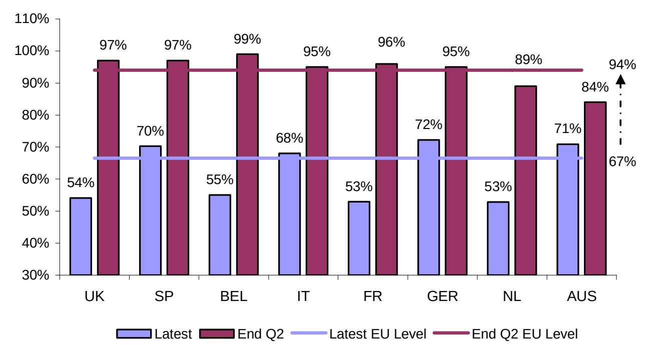
Source: Company data, Morgan Stanley Research(estimates for 2010 onwards)

In the gas market the new capacity is a little more complex. It is straightforward to show that there is a substantial increase in LNG (both liquefaction and regasification) capacity coming over the next 12-24 months. This is all capacity that is under construction and we believe it is very likely to be partly utilised.

It is also worth highlighting that, even after a very cold winter, there is still a lot of gas in storage in Europe. Exhibit 13 shows that storage stocks were almost full as we entered the winter, but are still quite full in many cases, especially Germany, Spain, Italy and Austria. Unless there is another very cold snap, the typical pattern is that much of the gas still in store will be sold out in late Q1, which could further dampen hub-based gas prices.

Exhibit 13

European gas storage – Still at reasonable levels but expect storage to sell down in late Q1



Source: GIE,Morgan Stanley Research

Of course, there are really two gas markets in Europe. The first is the typical long-term contract (LTC) gas that is imported from Russia, Norway, Holland and other countries. Typically, these are take-or-pay contracts with minimum take levels and prices indexed to a basket of oil based products.

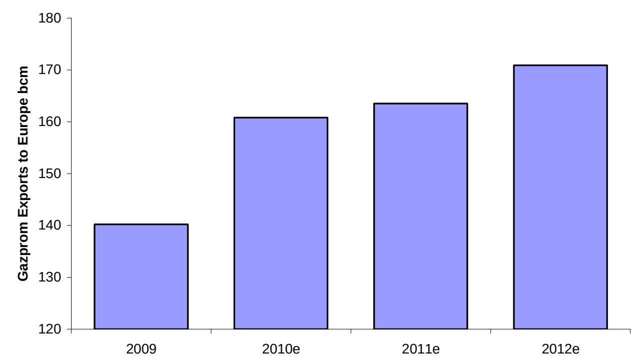
The second, which is emerging and growing rapidly, is the hub-based gas market. Separate regional markets like the NBP (UK), TTF (Dutch), Zeebrugge (Belgian) and NGC (German) hubs have developed where free market gas is traded on a spot and forward basis. The differentials between these hub prices are now small.

There is much debate at present as to whether the gas producers will be willing to renegotiate these LTC's to reduce the minimum take volumes and change the pricing formulas to include more spot gas indexation. A reduction in minimum take volumes would potentially reduce some of the oversupply of gas.

We think some renegotiations are inevitable, but it is worth noting that very recently Gazprom stated that it was planning to substantially increase gas volumes exported into Europe, as shown in Exhibit 14. Ultimately, our view is that the renegotiations alone will not clear the surplus of gas in Europe – for this we think we will also need a demand rebound.

Exhibit 14

Gazprom's expected gas Exports to Europe will increase markedly – More supply coming

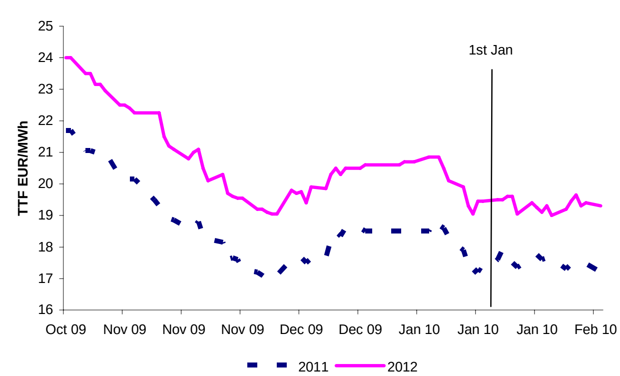


Source: Company data, Morgan Stanley Research, e = Morgan Stanley Research estimates

In our opinion, the degree to which the main European gas and power markets are oversupplied was made very obvious during the recent cold snap. As we showed in our recent report, gas and power prices have actually declined since the start of the cold spell. We think it is hardly a sign of a tight market, if pricing falls as demand hits weather-induced record highs.

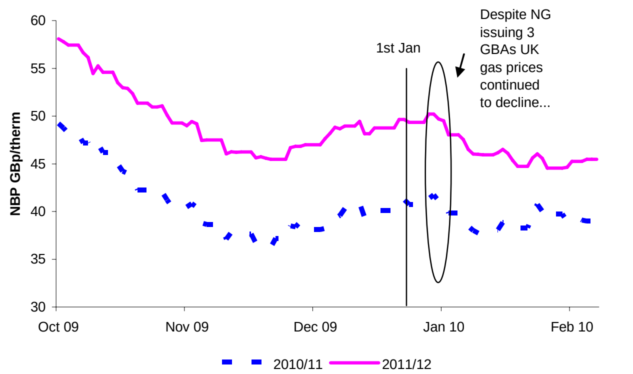
Exhibit 15

European gas prices since the start of winter



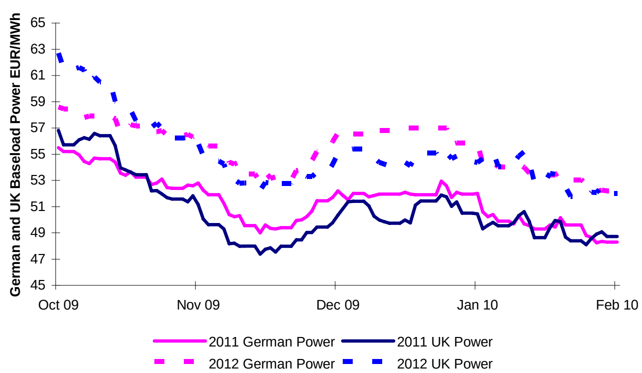
Source: Bloomberg, Morgan Stanley Research

Exhibit 16
UK gas prices since the start of winter



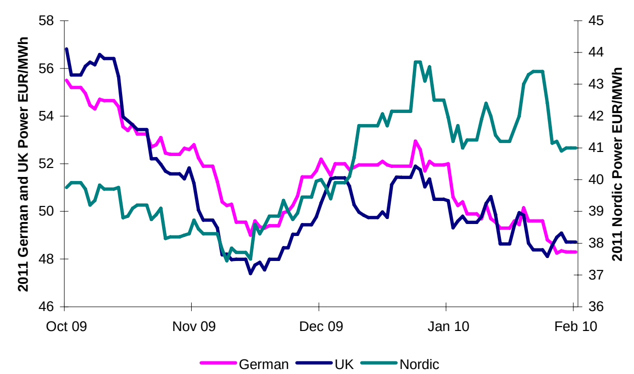
Source: Bloomberg, Morgan Stanley Research

Exhibit 17
UK and German power since the start of winter



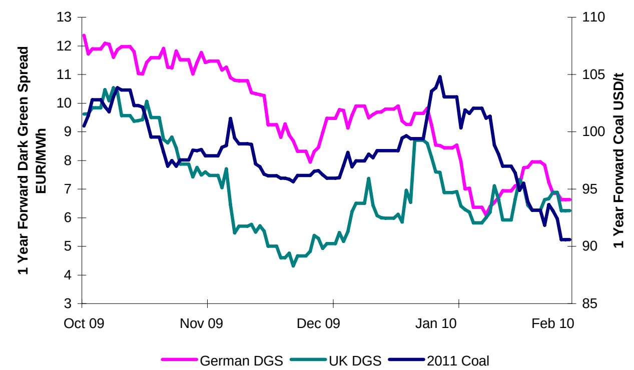
Source: Bloomberg, Morgan Stanley Research

Exhibit 18
UK, German and Nordic 2011 power prices



Source: Bloomberg, Morgan Stanley Research

Exhibit 19
UK and German 1 year forward dark green spreads and coal



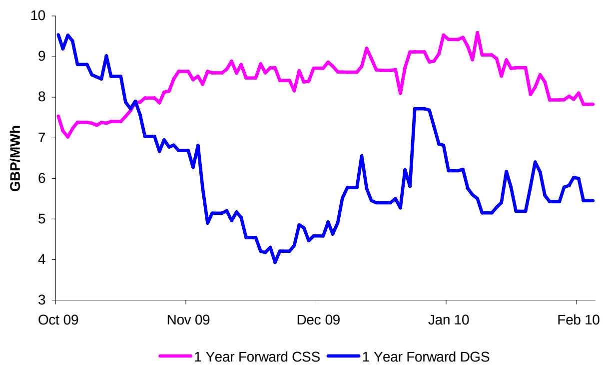
Source: Bloomberg, Morgan Stanley Research

Driver #3: Power prices will decline, leading to earnings downgrades and lower growth prospects

Given our view on the degree of overcapacity building up in the power markets, it is hardly surprising that we are bearish on power prices. Again, we feel that consensus is too sanguine here and that current consensus estimates do not take the weak power price estimates into account.

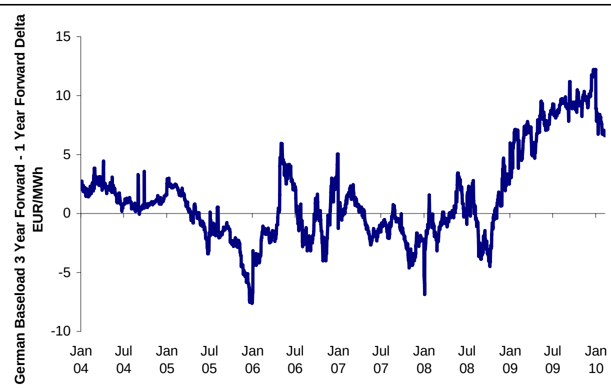
Its also worth noting that a significant decline in power prices and generation spreads has already happened, and the deterioration has been quite rapid. The contango between the 2011 and 2013 forward power prices has unwound substantially, as shown in Exhibit 21, but we still feel there is further to go.

Exhibit 20
UK clean dark and spark spreads



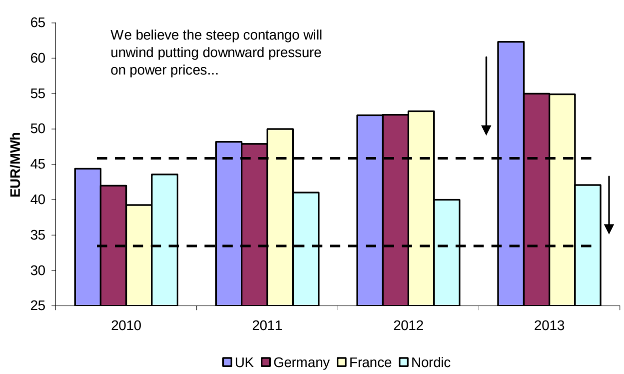
Source: Bloomberg, Morgan Stanley Research

Exhibit 21
The "contango" (3yr vs 1yr German forward power prices) has unwound, but still more to come …



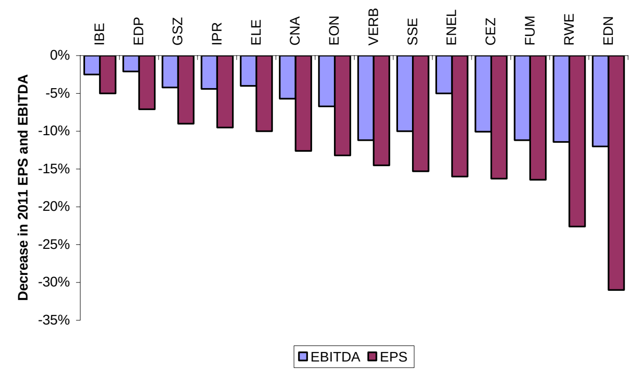
Source: Bloomberg, Morgan Stanley Research

Exhibit 22
European wholesale power price contango



Source: Spectron Group, Nordpool, Morgan Stanley Research

Exhibit 23
Who is most exposed to falling power prices? Decrease in 2011 EPS and EBITDA Following a 5 EUR/MWh decline in power assuming no hedging



Source: Company data, Morgan Stanley Research

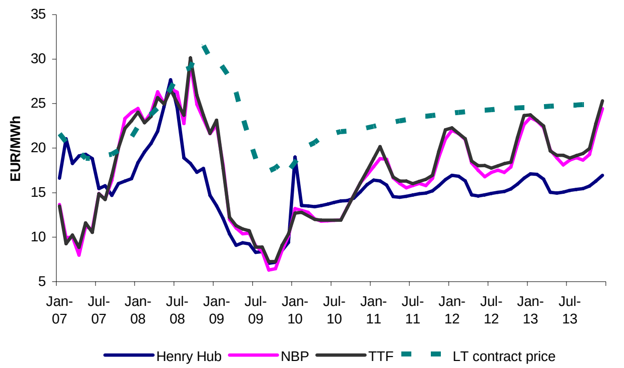
Driver #4: Spot gas market liquidity will enhance competition – pressure on midstream gas margins?

Spot gas markets are developing in Europe, and we think the impact of these on the utility sector is underestimated. This impact will come in two ways: (1) lower midstream gas margins for all but the savviest, trading orientated midstream operators, and (2) lower power prices in those markets where Hub based gas prices are currently well below the implied LTC price, and the current forward curves imply that this will be the case for a long time to come. This is shown in Exhibit 24. But gradually we think that LTC renegotiations will close the gap, bringing LTC gas prices down.

Exhibits 25-26 show that the liquidity in gas hubs like TTF (Holland) and NCG (Germany) is increasing very materially, and very quickly. Assuming that this liquidity stays in the market, we think this should lead to higher competition and therefore some pressure on midstream margins.

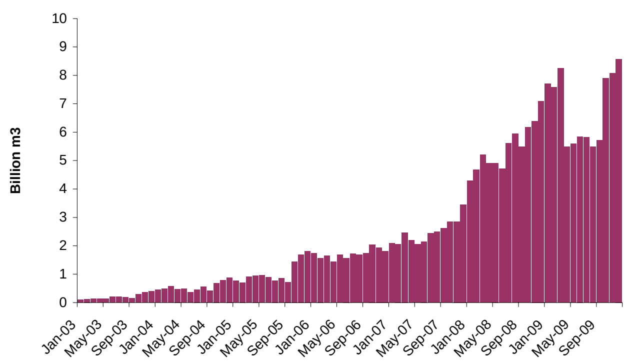
This may put even more focus on the earnings prospects and valuation of mid-stream gas businesses. We think it is interesting that consensus seems to value the midstream businesses of the big utilities quite differently.

Exhibit 24
Spot gas vs. long-term contract gas prices – Spot gas set to remain at a sizeable discount …



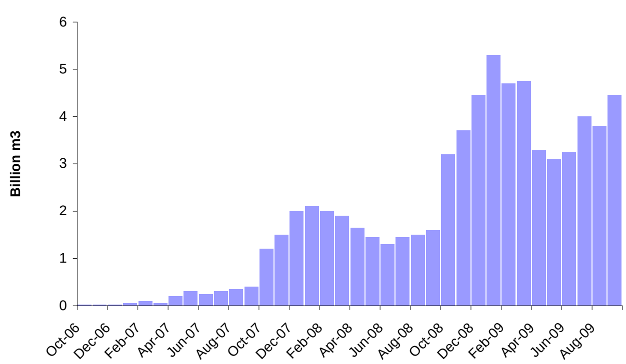
Source: Bloomberg, Morgan Stanley Research

Exhibit 25
Structural increase in Dutch spot gas (TTF) volumes …



Source: TTF, Morgan Stanley Research

Exhibit 26
… And in the volumes traded at the new German spot gas (NCG) hub

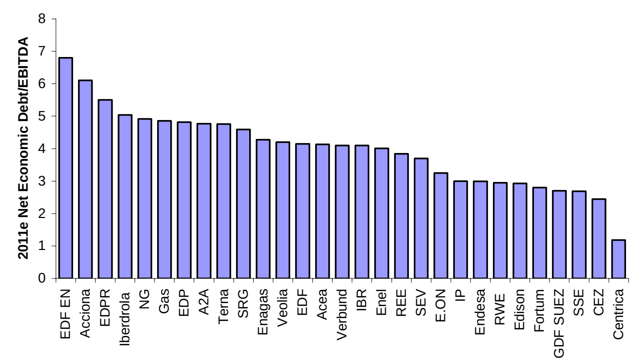


Source: NetConnect Germany, Morgan Stanley Research

Driver #5: Balance sheets are becoming stretched across the sector

History suggests that rating agencies take a while to adjust to a 'new reality'. In our view, the utility sector is entering a period when this new reality (lower demand, overcapacity, lower power prices and spreads, earnings downgrades) is quite a lot tougher than it was in the utility bull market of 2007-2008. As this becomes clearer, we are concerned that there may be further pressure to deleverage in order to keep strong credit ratings. Exhibits 27-28 show the leverage ratios (economic net debt/EBITDA 2011) and credit ratings for the sector. For the big integrated companies we believe that a maximum of 3x economic net debt/EBITDA should be the new target, and

Exhibit 27
2011e net economic debt/EBITDA



Source: Company data, Morgan Stanley Research

Exhibit 28
Utilities' credit ratings

Company	S&P rating	Outlook	Moody's rating	Outlook
EDF	A+	STABLE	Aa3	STABLE
RWE	A	NEG	A2	NEG
E.ON	A	STABLE	A2	STABLE
GDF SUEZ	A	POS	Aa3	STABLE
Fortum	A	STABLE	A2	STABLE
Endesa	A-	STABLE	A3	STABLE
Enel	A-	STABLE	A2	NEG
EDP	A-	NEG	A3	STABLE
Centrica	A-	-	A3	STABLE
National Grid	A-	STABLE	Baa1	STABLE
Scottish and Southern	A-	STABLE	A3	STABLE
Gas Natural	BBB+	NEG	-	-
Veolia	BBB+	NEG	A3	NEG
Edison	BBB+	NEG	Baa2	NEG
International Power	BB	STABLE	Ba3	STABLE
Suez Environnement	-	-	A3	NEG

Source: Bloomberg, Morgan Stanley Research

Exhibit 27 shows that few companies are below this at present. This is likely to mean slower investment in new projects, or disposals that would mean earnings dilution.

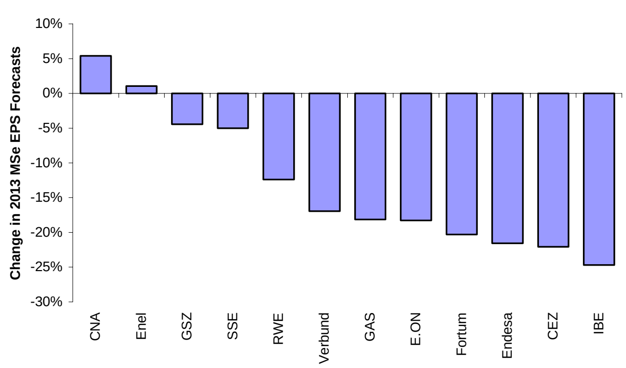
Driver #6: We see 6% downside to consensus earnings forecasts

In the very short term, utilities have a lot of hedging (ie margin protection), especially for 2010. In 2011, and even more so in 2012, this hedging falls away, and thus the sector is more and more exposed to the risks of lower power prices. The current hedging ratios are shown in Exhibit 31.

Other risks to earnings forecasts for the sector are: (1) a slower than expected economic recovery that could dent the growth prospects of the environment/waste stocks, (2) continued pressure on mid-stream gas margins, (3) potential earnings deterioration either from asset sales or cuts in growth capex plans. As Exhibit 30 shows, there have already been huge cuts in consensus earnings estimates for the sector. But in our view there are yet more to come. Our forecasts are 6% below consensus, on average, for the sector in 2011 as shown in Exhibit 33. It is difficult to get good consensus data for later years, but we suspect the same trend is evident there too. Thus we expect further downgrades to come, which will make it hard for the sector to generate positive relative performance.

Exhibit 29

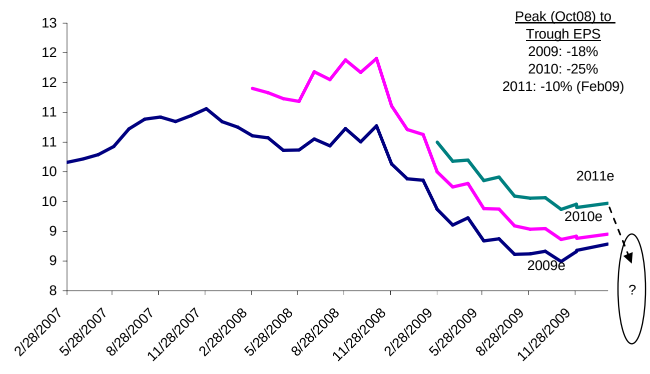
Change in 2013e MS EPS Forecasts



Source: Company data, Morgan Stanley Research

Exhibit 30

Consensus EPS forecasts have declined materially but there is still more risk



Source: Factset, Morgan Stanley Research

Exhibit 31

Power hedges are falling away fast – A risk to sector earnings power

	Power Sold Forward		
Company	**2010**	**2011**	**2012**
Drax (%)	90	60	--
Fortum (%)	70	40	--
Cez (%)	>90	>25	>4
RWE (%)	>90	>65	>30
E.ON (%)	100	80	30
Enel (%)	80	30	--
IBE (%)	50	--	--
Endesa (%)	50	--	--
EDP (%)	70	--	--
GDF SUEZ (%)	>90	>40	--
Verbund (%)	44	--	--

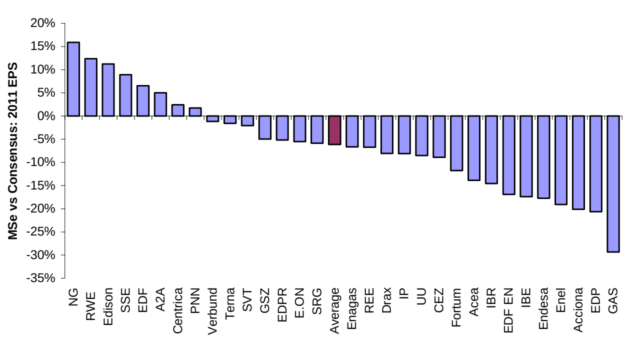
Source: Company data, Morgan Stanley Research

Exhibit 32
New vs old commodity assumptions

	2010e	2011e	2012e	2013e	2014e	2015e
Crude Oil (USD/bbl)						
New	72.5	81.7	84.1	92.0	98.0	104.0
Old (16/11/2009)	74.0	76.9	78.9	84.0	84.0	84.0
Ger Baseload (EUR/MWh)						
New	43.2	50.15	53.70	57.05	61.03	65.00
Old (16/11/2009)	46.9	52.6	56.0	65.0	65.0	65.0
Ger Peakload (EUR/MWh)						
New	57.1	68.1	73.6	78.9	85.4	91.0
Old (16/11/2009)	65.9	76.6	81.5	91.0	91.0	91.0
TTF Gas (EUR/MWh)						
New	16.1	17.7	19.3	20.6	22.9	25.2
Old (16/11/2009)	15.4	20.0	21.8	25.2	25.2	25.2
UK Baseload (GBP/MWh)						
New	40.7	43.6	46.7	48.0	51.0	54.0
Old (16/11/2009)	42.4	47.8	51.1	54.0	54.0	54.0
UK Gas (GBp/therm)						
New	42.5	44.5	47.8	51.1	52.5	54.0
Old (16/11/2009)	41.1	51.7	56.5	54.0	54.0	54.0
Spanish CSS (EUR/MWh)						
New	(4.0)	0.0	4.0	4.0	8.0	9.2
Old (16/11/2009)	(4.0)	0.0	0.0	14.3	14.6	15.0
Italian CSS (EUR/MWh)						
New	12.0	10.0	10.0	12.0	13.2	14.5
Old (16/11/2009)	11.0	10.0	10.0	14.3	14.6	15.0

Source: Morgan Stanley Research estimates

Exhibit 33
Our forecasts are 6% below consensus for 2011



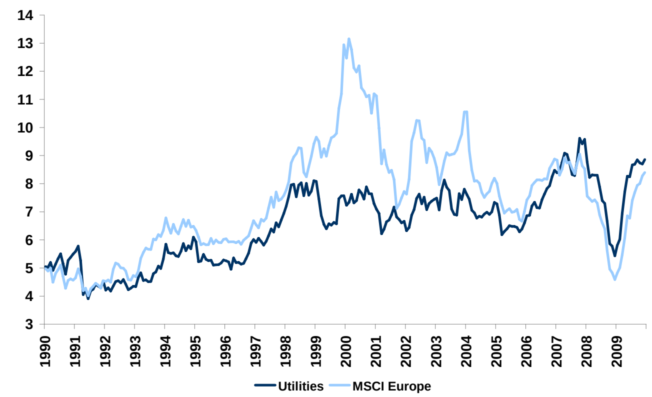
Source: Bloomberg, Company data, Morgan Stanley Research estimates

Driver #7: Valuations are not compelling

The sector is trading on 13.2x 2010e PE multiple, a 7.8x 2010e EV/EBITDA multiple and offers an average expected dividend yield of 5% for 2010.

Our preferred valuation metric, adjusting for capital structure differences, is EV/EBITDA, and Exhibit 34 shows that, on a trailing basis, the utility sector actually trades at a small premium to the market, which is pretty unusual in a historical context.

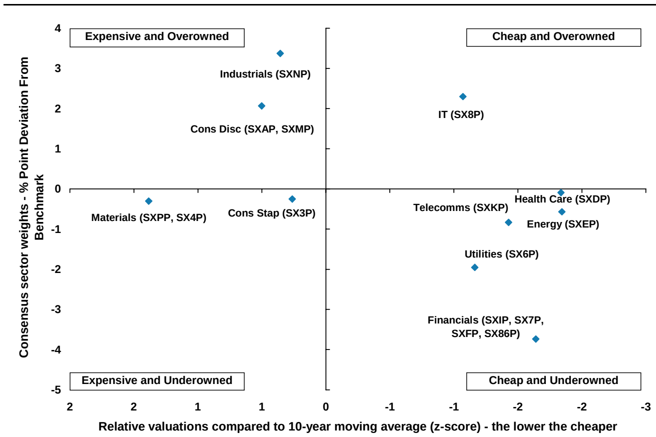
Exhibit 34
Utilities trading at small premium on EV/EBITDA vs market – Relative valuation not compelling



Source: Worldscope, MSCI, Datastream, Morgan Stanley Research
Note: Chart shows Trailing EV/EBITDA data

Based on some valuation data used by the Morgan Stanley European Equity Strategy team (shown in Exhibits 35 and 36) the sector does look somewhat undervalued and underowned, but the case for neither is terribly compelling, in our view. The sector hardly stands out as a value play or as an ownership play.

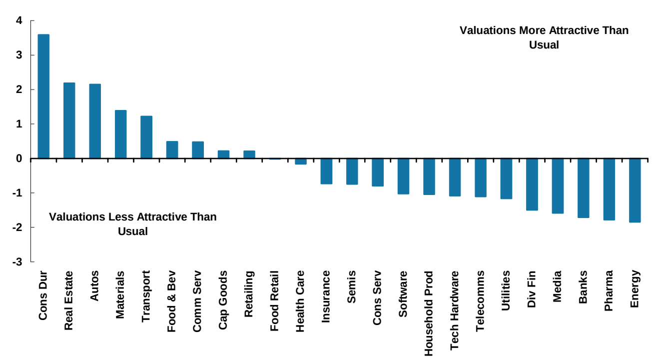
Exhibit 35
Sectors - Relative valuations & ownership compared to the historical norm



Source: MSCI, EPFR, Datastream, Morgan Stanley Research

Exhibit 36

Sector valuation based on relative metrics compared to its 10-year moving average (Z-score)



Source: MSCI, Worldscope, Datastream, Morgan Stanley Research

Our preferred valuation analysis is to consider valuations adjusted where possible for free carbon allocations and for the short-term energy hedges. Why adjust the ratios? We think it is pretty clear that, barring a huge global reversal of climate policy, there will be no free allocations of EUAs (carbon credits) post 2012 for all major European utilities, bar CEZ.

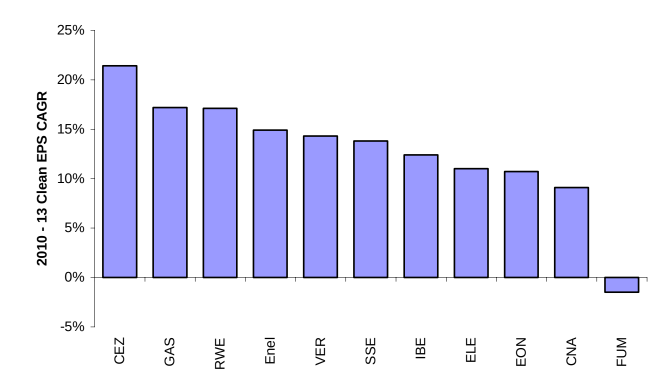
Thus, the earnings of these businesses are flattered by this short-term, finite earnings stream from these free allocations. To adjust, we strip out the benefit of the phase two allocations from annual profits. Importantly, we also adjust the equity value of the companies being analysed, reducing this by the NPV of the remaining free allocations. This is fair, as the freely allocated EUAs could be sold and thus have a clear market value.

In addition, we believe that the value from short-term (2-3) year hedges of forward power sales and fuel purchases add value, but only in a short-term way. Hedging can smooth the evolution of prices, but ultimately a power generator will always receive the market price. So if power prices stay where the curves are right now, this is what would determine utilities' earnings. Thus, we also adjust for the profit from, and value (NPV) of, these hedges. This is a complex adjustment, but we think it offers a useful cross-check on the true multiples that these businesses are trading on.

This shows that most utilities actually trade on quite high underlying multiples, and we have a clear preference for those that trade cheaply on an underlying EV/EBITDA basis and that offer the best underlying profit growth.

Exhibit 37

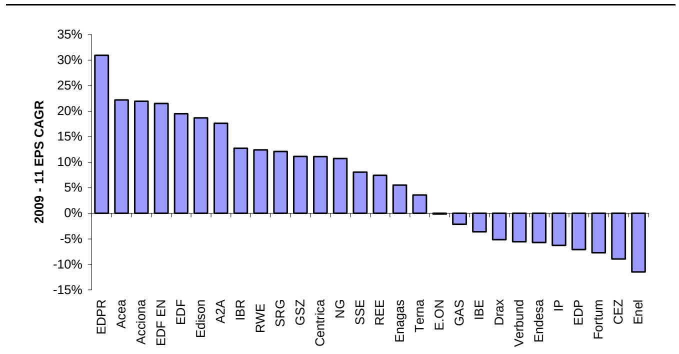
2010 – 2013 "clean" EPS CAGR



Source: Morgan Stanley Research estimates

Exhibit 38

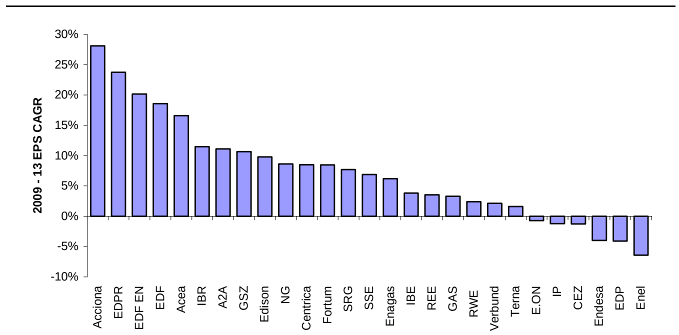
2009 – 2011 headline EPS CAGR



Source: Morgan Stanley Research estimates

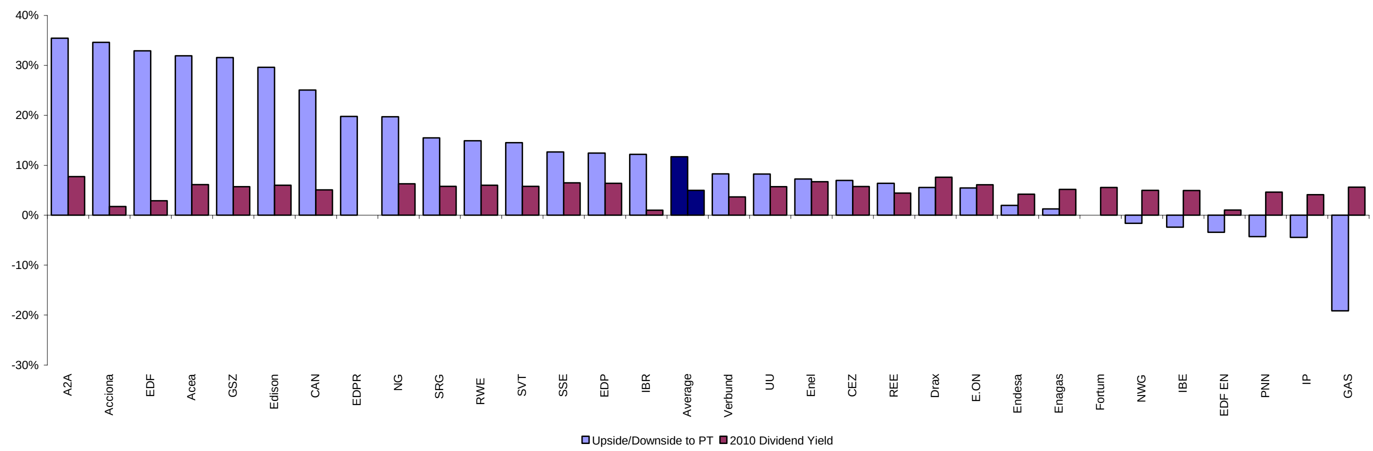
Exhibit 39

2009 – 2013 headline EPS CAGR



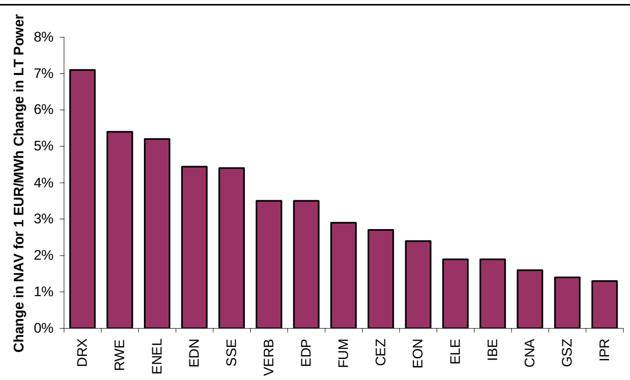
Source: Morgan Stanley Research estimates

Exhibit 40
Average total return across sector



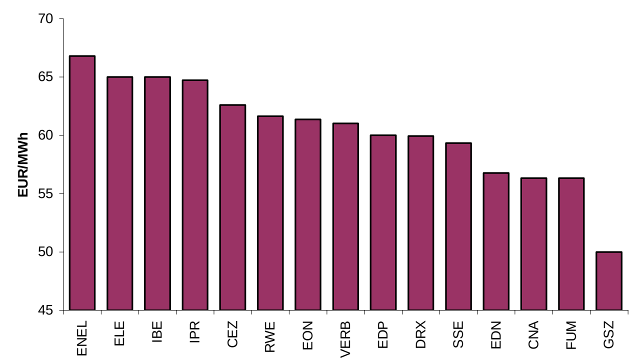
Source: Morgan Stanley Research estimates

Exhibit 41
Fair value sensitivity to LT change in power



Source: Morgan Stanley Research estimates

Exhibit 42
LT power price discounted in current share price



Source: Morgan Stanley Research estimates

Stock Implications – Stick Defensive, and Buy Near-term Growth

Most preferred list: EDF, National Grid, Snam Rete Gas, A2A, Centrica, GDF Suez

Least preferred list: Iberdrola, E.ON, Verbund, Gas Natural, Pennon

Prefer regulated utilities, and low commodity price exposure - National Grid, SRG, EDF, A2A all offer great regulated (or quasi-regulated in the case of EDF) value

Look for growth in near term – Keep GDF Suez as a conviction Overweight, although we recognise new guidance as a potential pitfall

Avoid expensive, slow growth integrated names - Downgrade Iberdrola and E.ON to Underweight, as both offer less than average growth at high underlying valuations

Our revised sector thesis leads to a number of changes in our stock preferences. In general, we downgrade names where we see earnings momentum, quality or growth deteriorating most. We have a clear preference for regulated utilities where we see value. We keep our preference for integrated names like GDF SUEZ and EDF, which have lower than average commodity exposure and sector leading growth. We now only see upside risk to EPS at 8 utilities, some of which are also in our preferred list.

Exhibit 43

Key rating changes

Upgrading	From	To
Enel	Underweight	Equal-weight
Centrica	Equal-weight	Overweight
Downgrading	**From**	**To**
Iberdrola	Equal-weight	Underweight
E.ON	Equal-weight	Underweight
Scottish & Southern	Overweight	Equal-weight

Source: Morgan Stanley Research

For more detail on our stock views, see our individual stock and sub-sector notes also published today:

Southern European Generators: Italian electricity prices outperform Spain: ENEL up to EW; IBE down to UW

UK Utilities: Cautious on Commodity: Buy National Grid and Centrica

RWE: Robust, Decent Growth, But Not Quite Cheap Enough

Yet

GDF SUEZ: Relative Attractions Remain Despite ST Uncertainty

E.ON: Downgrade to Underweight: Lower relative growth prospects still not discounted

Iberdrola: Growth Lower than Sector; Premium Not Justified – UW

Enel: Net Cash Flow Achieved – Upgrade to EW

Regulated utilities still seem attractive to us given their risk profile – Overweight National Grid and Snam Rete Gas. We keep our preference for National Grid (Overweight), and raise our price target to GBp 750 based on a lower debt position and optimism on the US recovery. We also highlight Snam Rete Gas as being exposed to favourable regulation and trading at a very attractive valuation.

GSZ looks attractive, even with lower profits in Global Gas, and we therefore stick with our Overweight. We think GSZ offers good growth and a defensive profile and that consensus estimates should now have rebased enough.

We also keep faith in EDF as a top pick, as we view it as a relatively low risk, quasi-regulated play. The tariff reform remains the prize, and one that we believe will be delivered.

We continue to favour A2A as we like its short gas position in Italy, which is material in the scale of the company.

We stay cautious on the generators and stay Underweight Fortum and Verbund. We are also cautious on Drax. We believe both power prices and volumes will still disappoint. We now have no Overweight ratings on any of the pure gencos, and maintain our Underweight stance on Fortum and Verbund.

We would avoid the low growth, earnings exposed integrated names – we downgrade E.ON and Iberdrola to our least preferred list. We believe earnings growth will disappoint, and that valuations look unappealing in this context at both E.ON and IBE. For E.ON we forecast negligible earnings growth in the medium term.

Swap preferences for Centrica over SSE. We downgrade SSE to Equal-weight after good recent performance. We have trimmed earnings forecasts, and think the gas tariff cuts by

Centrica may make it harder for SSE to grow next year. Centrica looks cheaper on an adjusted basis now, and even though we have some concerns over recent acquisitions we believe that it will outperform SSE.

Exhibit 44

Headline sector valuation multiples - flattered by hedges and free carbon allocations

	P/E				EPS CAGR (%)	EV/EBITDA				EBITDA CAGR (%)	Dividend Yield (%)			
	2010e	2011e	2012e	2013e	09-13	2010e	2011e	2012e	2013e	09-13	2010e	2011e	2012e	2013e
EON	9.2	9.0	8.7	9.3	-0.7	7.3	7.1	7.1	7.3	1.6	6.1	6.3	6.3	6.4
RWE	8.7	7.8	7.8	9.0	2.4	6.4	6.0	5.9	6.2	3.9	6.0	6.4	6.4	6.7
GSZ	13.4	11.3	10.3	9.3	10.6	6.8	6.1	5.6	5.0	7.3	5.7	6.1	6.6	7.0
IBE	12.6	12.4	11.6	9.9	3.8	8.4	8.4	8.2	7.7	5.1	4.9	4.8	5.2	6.0
ELE	11.8	11.9	12.8	12.4	-4.0	6.4	6.7	6.9	6.7	-1.9	4.2	4.2	3.9	4.0
GAS	10.7	11.3	11.2	9.5	3.3	8.4	8.4	8.2	7.4	1.0	5.6	5.3	5.3	6.3
Enel	9.0	10.4	11.6	10.6	-6.4	6.7	6.9	7.0	6.6	-0.8	6.6	5.8	5.2	5.7
CNA	11.3	10.3	9.6	9.2	9.0	6.2	5.6	5.4	5.3	9.2	5.1	5.3	5.6	5.9
SSE	10.2	9.1	8.0	8.1	7.1	8.2	7.4	6.8	6.7	7.9	6.5	6.9	7.4	7.9
FUM	11.7	12.8	12.7	11.4	-0.5	8.6	9.1	8.9	8.2	1.8	5.6	5.6	5.6	5.6
VER	17.3	14.9	13.3	12.2	2.1	10.3	9.3	8.5	7.9	2.9	3.6	3.6	3.6	3.8
CEZ	9.6	10.1	9.6	8.9	-1.7	7.4	7.7	7.5	7.0	2.6	5.4	5.1	5.3	5.7

Source: Morgan Stanley Research estimates

Exhibit 45

Revised sector valuation multiples – Adjusted for free carbon allocations and short term energy hedges

	Clean P/E				EPS CAGR (%)	Clean EV/EBITDA				EBITDA CAGR (%)
	2010e	2011e	2012e	2013e	10-13	2010e	2011e	2012e	2013e	10-13
EON	11.7	11.0	10.0	9.2	10.7	8.3	7.8	7.7	7.3	5.2
RWE	13.1	11.9	10.4	9.3	17.1	7.8	7.5	6.9	6.3	10.0
GSZ	16.6	12.1	10.6	9.3	22.3	7.3	6.3	5.7	5.0	11.0
IBE	15.0	13.0	11.7	9.9	12.4	9.1	8.6	8.3	7.7	8.9
ELE	16.7	13.4	13.9	12.2	11.0	7.2	7.0	7.1	6.6	3.9
GAS	15.2	13.0	12.3	9.4	17.2	9.5	8.8	8.5	7.3	7.3
ENEL	15.4	12.6	13.1	10.1	14.9	7.9	7.0	7.1	6.6	5.5
CNA	11.7	10.7	9.9	9.2	9.1	6.3	5.7	5.5	5.3	7.7
SSE	11.4	10.2	8.7	8.1	13.8	8.9	8.1	7.2	6.7	12.6
FUM	11.3	13.5	13.3	11.9	-1.5	8.4	9.4	9.2	8.5	0.2
VER	22.0	15.4	13.8	12.2	14.3	11.8	9.5	8.6	7.9	22.4
CEZ	17.6	14.2	12.7	10.7	21.4	10.3	9.4	8.8	7.8	15.7
Average	**14.9**	**12.6**	**11.7**	**10.1**	**14.0**	**8.5**	**7.9**	**7.5**	**6.9**	**9.2**

Source: Morgan Stanley Research estimates

Most Preferred

Risk-Reward Snapshot: Electricite de France (EDF.PA, OW, PT €50)

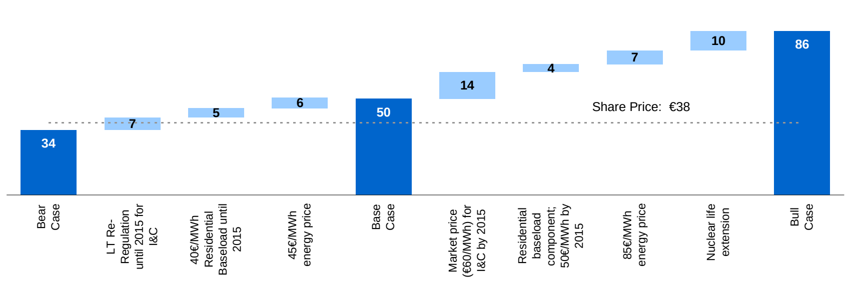
Current share price offers an excellent entry point into the long-term value of existing nuclear and hydro assets, in our view

Source: FactSet (historical share price data), Morgan Stanley Research estimates

Scenario Summaries

Bull case **€86**	**Accelerated convergence and life extension:** Tariffs reach replacement cost of new nuclear by 2015. Long-term wholesale power price at €85/MWh. Nuclear lifetime extension to 60 years.
Base case **€50**	**Base case Champsaur implementation:** Baseload component reaches our estimate for the cost of existing nuclear of €45/MWh by 2015 for residential clients. I&C tariffs grow more rapidly, to €50/MWh in 2015. Long-term electricity price at €65/MWh. No nuclear lifetime extension.
Bear case **€34**	**Pro-consumer political decision:** Baseload component at €40/MWh and €45/MWh for residential and I&Cs, respectively, in 2015, i.e. at or below full costs of existing production, on our estimates. Long-term wholesale power price at €45/MWh. No nuclear lifetime extension.

Bear to Bull: Main drivers are outcome for tariff reform and nuclear life extension



Source: Morgan Stanley Research estimates

Why Overweight?

- EDF should deliver superior earnings growth in a period of weak commodity prices in Europe, thanks to its tariffs rising from a low base.
- We believe the stock offers an inexpensive entry point to the long-term value of existing nuclear and hydro assets, as the strong, positive bias of our risk-reward valuation analysis shows.
- **Operational improvement:** We believe that EDF should be able to lift its nuclear load factor to at least 79% over the next five years from the depressed level of 72% in 2009.
- **Cost synergies:** There are substantial cost synergies to harness at EDF, as the group transitions towards European best practice.

Key Value Drivers

- Long-term wholesale electricity prices in regional market.
- CO2: €20/t in Phase 2 and beyond; no free allocation in Phase 3.
- Regulated tariff increase: residential (+2.2% 2010-15); I&Cs (+3.8% 2010-15).

Potential Catalysts

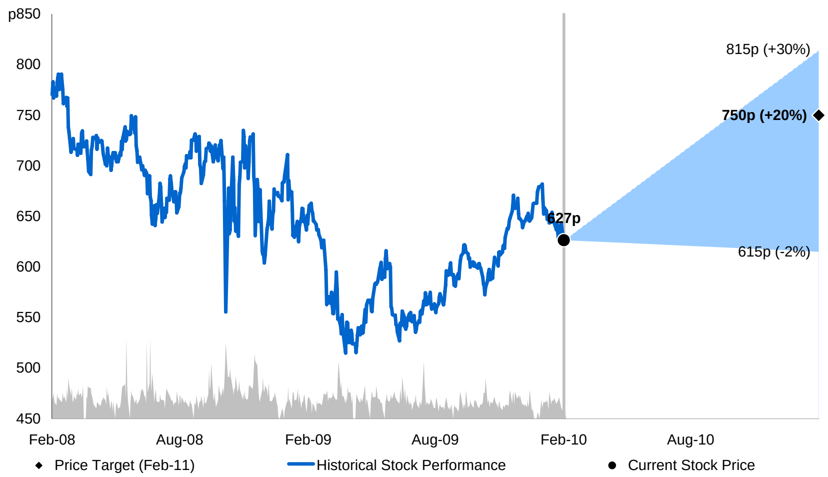
- **Tariff reform**: publication of a draft law, then debate in Parliament in 1H10.
- **Disposals:** potential announcement of UK networks disposal in 1H10.
- **FY 2009 earnings:** February 11, 2010.

Company Guidance

- **2009**
  - EBITDA of around €17bn
  - Ordinary net income of around €3.7-3.8bn

National Grid (NG.L, Overweight, PT 750p)

Plausible bull case (strong US recovery) and limited downside drive attractive risk-reward



Source: **FactSet (historical share price data),** Morgan Stanley Research

Valuation Scenario Summaries

Bull Case: 815p ***UK regulation stable, best in class US performance***	UK Valuation: 10% Premium to RAV US Valuation: 1.5x Rate Base
Base Case: 750p ***UK regulation stable, US recovery***	UK Valuation: 10% Premium to RAV US Valuation: 1.35x Rate Base
Bear Case: 615p ***Tougher UK regulation, no US recovery***	UK Valuation: 0% Premium to RAV US Valuation: 1.2x Rate Base

Exhibit 46

Successful US Rate Plans will drive upside to EPS in the coming years

Rate Case upside to PAT (GBPm)	Effective	2009/10	2010/11	2011/12	Cumulative
LIPA Generation	Feb-09	29	-	-	29
Mass Electric	Jan-10	5	14	-	19
Rhode Island Electric	Mar-10	-	18	-	18
Massachusetts Gas	Jan-11		12	36	48
NIMO Electric	Jan-11	-	24	70	94
Total Additional Earnings		34	68	106	207
Upside included in EPS (p/sh)		**1.4**	**2.7**	**4.3**	**8.4**
Prior MSe EPS (p/sh)		**57.1**	**56.8**	**60.9**	**63.7**
Upside from US rate plans (%)		**2.5**	**4.8**	**7.1**	**13.3**

Source: FactSet (historical share price data), Morgan Stanley Research estimates

Why Overweight?

- Our new price target of 750p implies decent upside, and the shares could re-rate materially beyond this if NG can start to deliver best-in-class US performance.
- NG has a lower risk profile than most of the sector – it has no near-term UK regulatory reviews and no exposure to a potential contango collapse.
- The US recovery is well under way, with 2 important rate cases over the next 12 months.
- We see 13% upside to consensus EPS forecasts for March 2012 as good upside from US rate cases feeds through to earnings

What's new?

- We show the upside from US rate cases in detail, and how it should feed through to EPS in the next 3 years
- More successful rate plans completed in Massachusetts and LIPA

Where are we different?

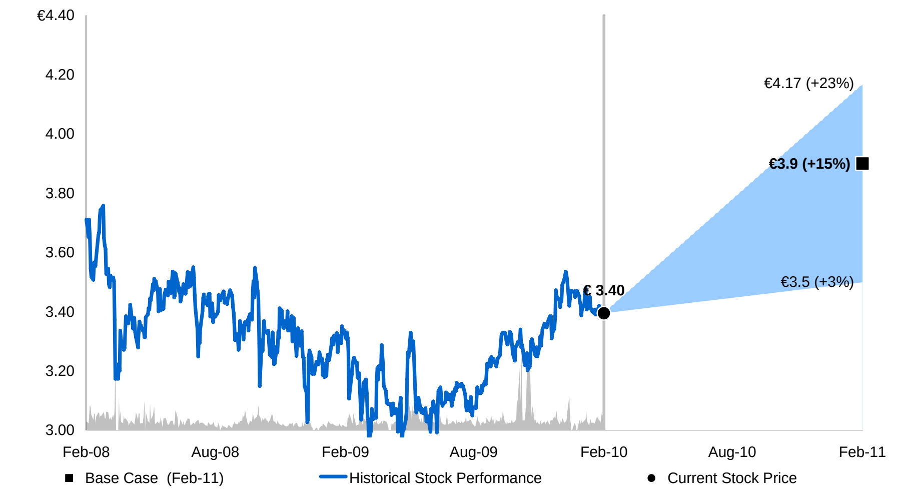
- We believe that NG can turn around its US operations through a series of rate cases. While not risk free, we think the odds are in NG's favour.
- We believe that NG can run its US operations well. The performance of the Keyspan units shows that where NG has up-to-date rate plans, it can materially outperform.

Potential Catalysts

- News from the Rhode Island electric rate case due to settle in Q1, and broader US developments.
- Strong FY results expected in May.

Risk-Reward Snapshot: SRG (SRG.MI, Overweight, PT €3.9)

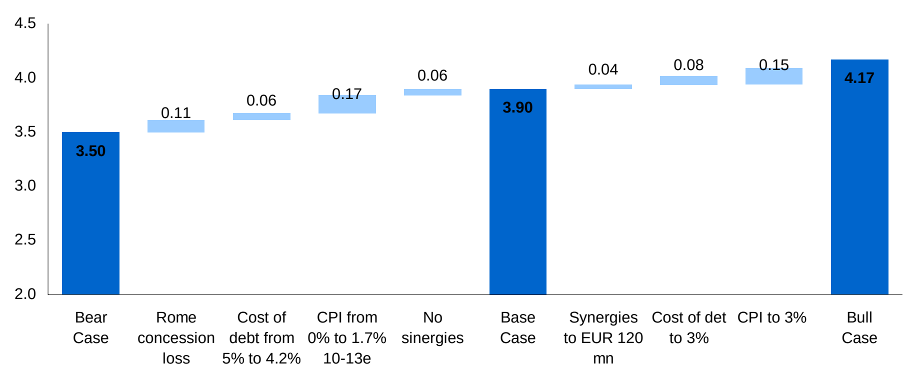
Bear case is in the price



Source: FactSet (historical share price data), Morgan Stanley Research estimates

Price Target €3.9		Derived from base-case scenario.
Bull Case €4.17	10.2x 2009e EV/EBITDA	**Benign regulatory review, strong synergies and high inflation.** We assume a 6.9% allowed return and ~€100mn of synergies, €60mn above management's very conservative guidance. We assume a higher inflation rate (3.0%) in 2010-13.
Base Case €3.90	9.8x 2009e EV/EBITDA	**Fair regulatory framework.** We assume the regulator allows a 6.55% return on RAB (middle of the range announced in July) and that management delivers €60mn worth of synergies from the integration of Stogit and Italgas, just above guidance.
Bear Case €3.50	9.2x 2010e EV/EBITDA	**Tough regulatory review, low inflation and high cost of debt.** We assume the regulator allows only a 6.1% pre-tax return, that inflation averages 0% in 2010-13 and that the cost of debt spikes to 5.5%. We also assume SRG loses the Rome concession.

SRG is most geared to rising inflation



Note: We have modelled scenarios based on what we consider the key drivers of the stock's value over the next 12 months. There is, however, the potential for outright downside in the stock price due to other factors that we consider to be relatively unlikely.
Source: Morgan Stanley Research estimates

Why Overweight?

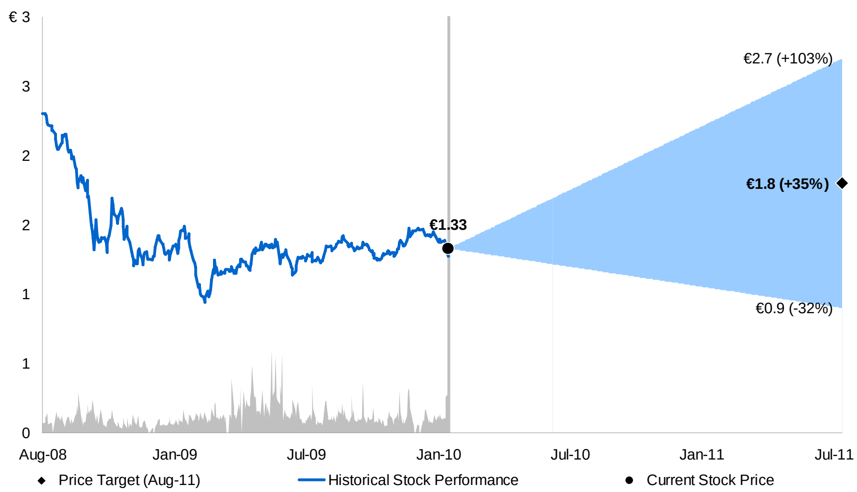
- **SRG offers restructuring and value creation opportunities** following its acquisition of Stogit and Italgas, and thanks to €6bn of incentivised development capex. We estimate this should lead to 11.2% growth in equity RAB p.a. (including dividend) during 2009-13.
- **Strong RAB growth** reflects cost cutting, capex incentives, the link of revenues to gas demand growth, the low cost of debt and partial recovery of the group's tax liability, given the extension of the regulated asset life. We believe these factors are not captured by consensus estimates.
- **The stock offers a stronger than average financial structure** in the sub-sector (net debt to RAB < 50%) and a sustainable and growing 6.3% dividend yield. Even so, it trades at a 6% discount to RAB and at 11.5x 2011e P/E, is in line with other more risky regulated names.

Key Value Drivers

- Implementation of the capex plan is the most relevant value driver, in our view.
- Cost cutting

Risk-Reward Snapshot: A2A (A2.MI, €1.33, Overweight, PT €1.80)

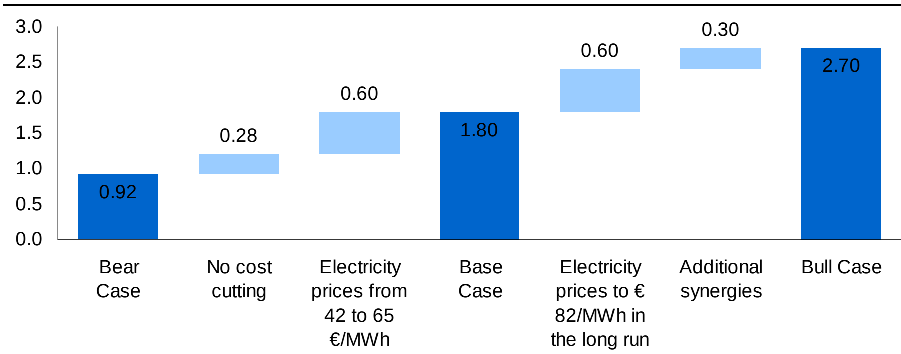
Shares not pricing in short gas position, restructuring potential



Source: FactSet (historical share price data), Morgan Stanley Research estimates

Price Target €1.80		Derived from base-case scenario.
Bull Case €2.70	10.6X 2010e EV/EBITDA	**Cost cutting and strong commodities.** Italian electricity prices reach €82/MWh. In the long run we assume an additional €100mn of cost cutting.
Base Case €1.80	7.7x 2010e EV/EBITDA	**Restructuring leads to €110mn real cost cuts in 4 years.** Long-term spark spreads fall to €14/MWh and electricity prices reach €65/MWh in the long run.
Bear Case €0.9	5.3 2010e EV/EBITDA	**Poor commodity outlook and failure to deliver synergies.** A2A does not cut costs. Long-term electricity prices in Italy of €42/MWh.

Valuation is geared to commodities and cost cutting (€)



Source: Morgan Stanley Research estimates

Why Overweight?

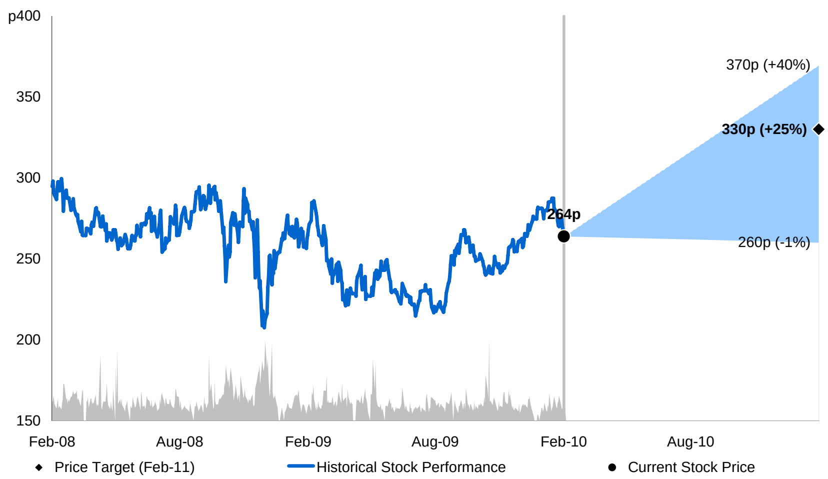
- **We consider A2A an excellent way to play the recovery.** (very sensitive to oil and commodity prices), while its sizeable exposure to regulated assets and short gas position provide defensiveness. Discount to multiples, an attractive dividend and interesting catalysts add to this compelling investment story.
- **Strongest cash flow generator in Europe.** On 5 February management announced a new €2.5bn capex plan for 2010-14e, €500mn below previous guidance. This should free up significant free cash flow, in turn support the dividend and reassure investors about the group's financial structure.
- **Management plans to sell financial stakes could also revive interest in the stock.** If successful, A2A's financial position would look robust, reassuring the market on dividends and relaunching the group's consolidation strategy.

Potential Catalysts

- **Asset disposals:** Management has signalled its intention to sell its stake in Alpiq (in negotiations with EDF over control of Edison).
- **Dividend announcement.** Although management has already clarified its long-term dividend policy (~€300mn p.a. will be distributed in dividends), the decision on the 2009 divided, to be distributed in May, is still pending. We expect management to announce it in March.

Centrica (CNA.L, Overweight, PT 330p)

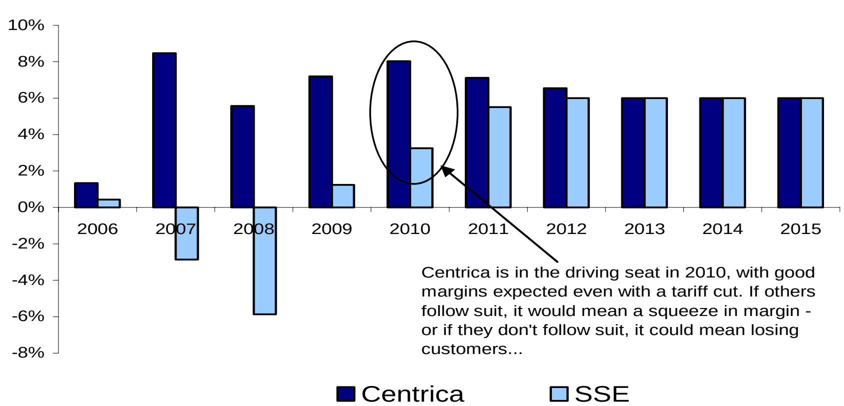
Supply sweet spot drives momentum for the price pace-setter in 2010



Source: FactSet (historical share price data), Morgan Stanley Research

Bull Case: 370p ***'High energy prices, stable margins, nuclear reliability good'***	BGRE margins: 8%; BGS margins: 16%; LT power price: £60/MWh; LT spark spread: £10/MWh; British Energy valuation: £2.3bn; Venture valuation: £1.5bn
Base Case: 330p ***'Stable energy prices, margin recovery'***	BGRE margins: 6%; BGS margins: 16%; LT power price: £54/MWh; LT spark spread: £10/MWh; British Energy valuation: £1.8bn; Venture valuation: £1.25bn
Bear Case: 260p ***'Tougher regulatory scrutiny in supply as recession bites'***	BGRE margins: 4%; BGS margins: 12%; LT power price: £48/MWh; LT spark spread: £8/MWh; British Energy valuation: £1.3bn; Venture valuation: £975m

Centrica has the momentum in 2010 with downstream margins – it has already cut tariffs once, and could do so again



Source: Bloomberg, Morgan Stanley Research (estimates from 2009 onwards)

Why upgrade to Overweight?

- Centrica should continue to win back market share as it has more flexibility to cut retail prices than its peers – 2010 should be a sweet spot for supply
- British Gas brand is getting even stronger – good upside in the Services business and better customer stickiness
- Power and gas price exposure is negative for upstream profits, but the downstream business is well positioned
- Management track record improving.
- Integration of British Gas going well, and further cost savings bode well.
- Attractive growth and valuation upside not reflected in current price

What's new?

- Forecasts updated for acquisitions and weaker energy markets and demand.
- Updated analysis of balance sheet strength – some headroom but likely to be reserved for growth.
- Comparison of PE and EV/EBITDA multiples with the beneficial effect of free carbon allocations stripped out

Where are we different?

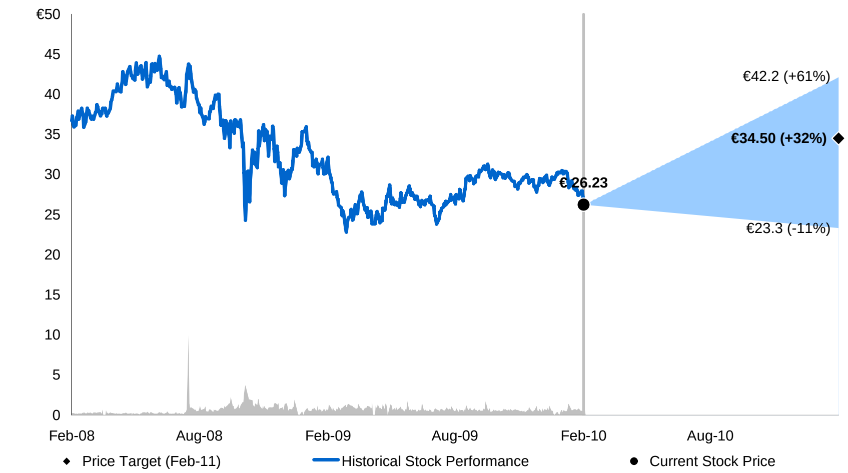
- We believe that Centrica is positively correlated to energy prices.
- We don't believe super-normal margins are possible in the medium term but Centrica is very well positioned for 2010.

Potential Catalysts

- Results on 25 February and upbeat outlook for margins
- Continued market share gains

Risk-Reward Snapshot: GDF SUEZ (GSZ.PA, Overweight, PT €34.50)

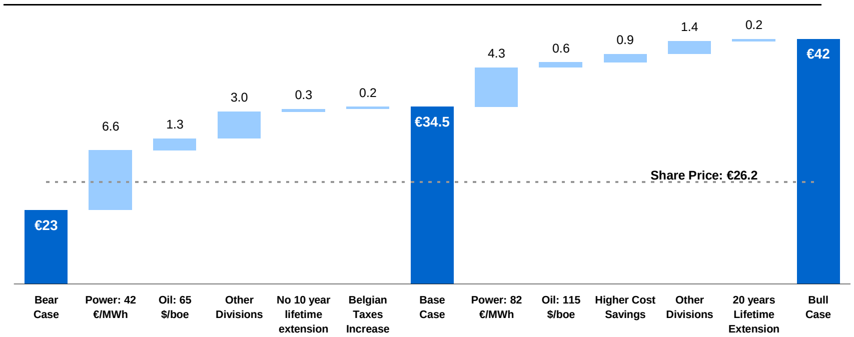
Balanced portfolio offers more upside than downside



Source: FactSet (historical share price data), Morgan Stanley Research estimates

PT€34.50	We set our price target at our base case sum-of-the parts valuation.
Bull case €42	**Higher for longer power prices, value creation through reinvestment, additional cost savings, and bull case valuation for SEV.** This scenario reflects a rebound in commodity prices and the need for new capacity over time (we assume long-term power prices at €85/MWh), an extra €300 million of cost cutting.
Base case €34.5	**Long–term power prices at €65/MWh,** existing cost-cutting programme, market value for listed subsidiaries, and no value for value creation through deployment of its balance sheet strength.
Bear case €23	**Depressed energy prices globally.** We assume long-term power prices at €45/MWh on average, but do not take into account systemic risk in overseas geographies or new tax levies in key markets.

Bull to bear: key drivers are the power price, cost saving and economic environment



Source: Morgan Stanley Research estimates

Why Overweight?

- The stock is trading on attractive 2010e multiples of EV/EBITDA (6.8x), FCF yield (14.2%), cheaper than its peer group, and a secure dividend yield of 5.7%. The relative attractiveness is even greater when adjusting the peer group for CO2 allowances and hedges (see Exhibit 23).
- **Superior growth, less exposure to weak European prices:** We expect 10.6% ordinary EPS growth over 2009-13e, a premium to the sector, while having less exposure to weak commodity prices.
- **Reinvestment story:** The company could put its strong balance sheet to use to fit its strategy as a play on power and gas convergence, with a global business model.
- **Ongoing merger benefits:** The group is undergoing one of the largest integration processes in the industry, leading to substantial synergy benefits.

Key Value Drivers

- **Long-term power prices:** We assume €65/MWh (baseload) in 2015.
- **Long-term WACC:** an average of 8.2%, for the group, with asset betas adapted to each business risk profile.
- **Capex level:** We have assumed €34 billion over 2008-10e, slightly above company guidance.

Potential Catalysts

- **French gas tariffs increase:** 1 April 2010
- **FY09 results:** 4 March 2010

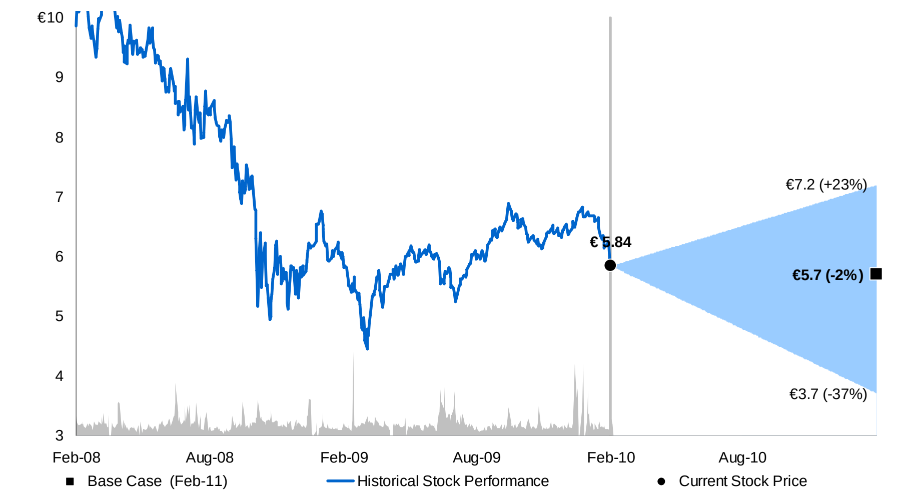
Company Guidance

- EBITDA of €17-18 billion in 2011.
- Average annual capex of €10 billion between 2008-10e.
- Ratings target: strong A.

Least Preferred

Risk-Reward Snapshot: Iberdrola (IBE.MC, €5.84 Underweight, PT €5.7)

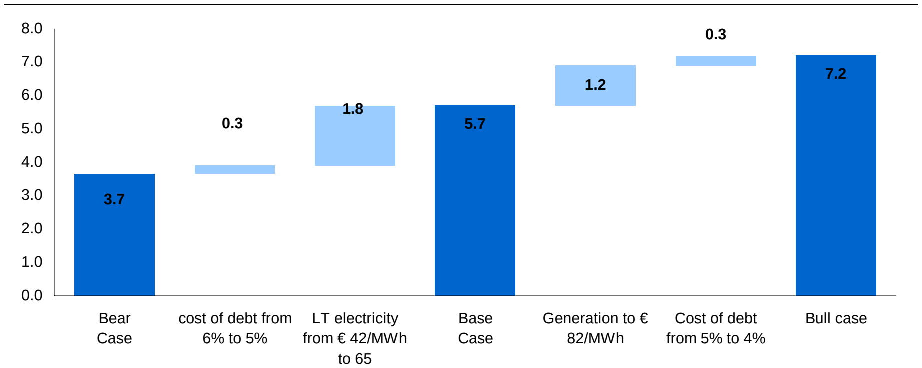
IBE: 2% downside risk compares poorly with 12% upside offered by the sector



Source: FactSet (historical share price data), Morgan Stanley Research estimates

Bull Case €7.2	9.6x 2010e EV/EBITDA	**Strong outlook for commodities and reduction in cost of debt.** Higher long-term generation prices (€82/MWh from 2015) and a reduction in the cost of debt from 5% to 4% would boost valuation by 25%, implying 23% upside potential.
Base Case €5.7	8.5x 2010e EV/EBITDA	**Long-term recovery of Spanish power price.** Our base case assumes that the power price in Spain will reach €65/MWh in 2018, that electricity bills in the UK will decline by 10% and that the cost of debt will average 5% in the long run.
Bear Case €3.7	7.1x 2010e EV/EBITDA	**Weak electricity prices and higher cost of debt**. If we were to assume electricity prices remain in the region of €42/MWh, in line with current 2011 forward prices, our valuation would reduce by 32%. Our bear case also assumes an increase in the group cost of debt to 6%, which hurts cash flow. This would suggest 37% downside risk to the share price.

Share price already discounts recovery in Spain. But no signals so far



Source: Morgan Stanley Research estimates

Why Underweight?

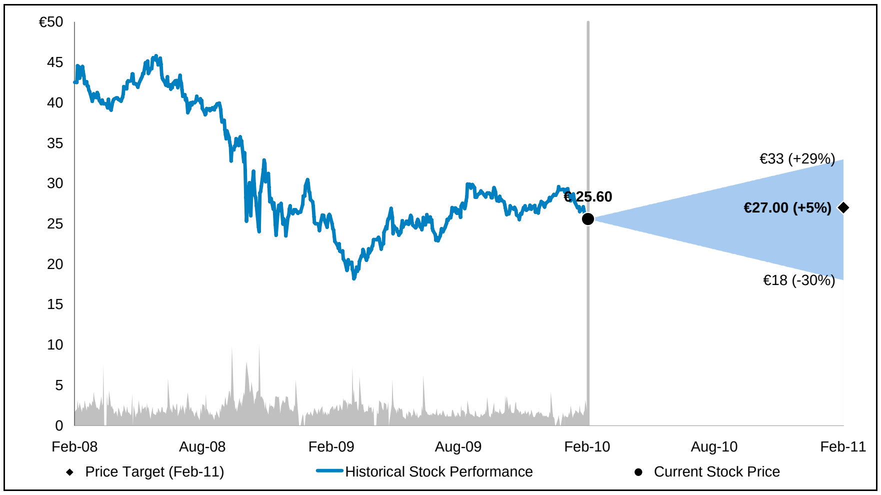
- **Low power price in Spain puts pressure on growth prospects and balance sheet.** With spot prices consistently falling over the last two years, a worsening supply-demand balance and increased regulatory risk, we can no longer look through the poor Spanish power price. Marking to market the Spanish power price would erase growth, add pressure to the balance sheet and imply 37% downside risk to the share price (our bear case).
- **Base case is still for a gradual recovery in Spanish power prices. IBE growth is below the sector.** Over the longer term (2009-2013e) we expect IBE EBITDA to grow at 5.1% and EPS to growth at 3.8% versus 6.6% and 7.2% for the sector. Therefore, given the group's ~4x Net debt/EBITDA, a premium to the sector (12.6% EV/EBITDA and 9.7% P/E 2011e) no longer looks justified.
- **High quality assets, but in the wrong country.** We see no driver for Spanish generation prices to return to new entrant level in the foreseeable future. We are no longer willing to pay replacement costs for Spain.
- **Downside risk doesn't compare well with 12% average upside potential for the sector.** Valuing the regulated assets at RAB and IBR at the current market price gives a target price of €5.7. Excluding IBR, Iberdrola trades at 8x 2011e EV/EBITDA, still a 10% premium to the sector.

Potential Catalysts

- On February 24, management will present FY results and provide a strategic update.
- IBE is targeting non-strategic asset disposals by year-end.
- Rate case at Energy East should complete in 2010.

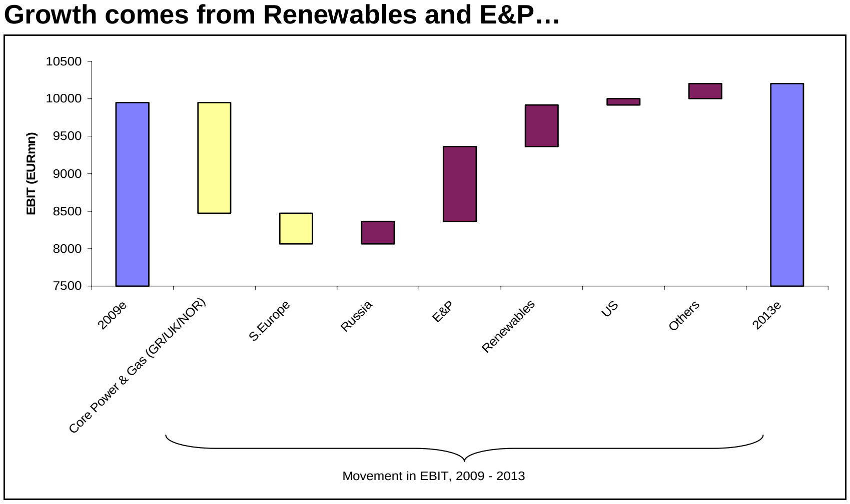
E.ON (EONGn.DE, Underweight, PT €27)

Limited upside to our target price – risks to the downside



Bull Case: €33 ***"Higher power prices, more growth"***	11.8x Base Case 10e EPS 11.6x Base Case 13e EPS	LT German Baseload: €82/MWh LT Coal: $109/tonne LT Carbon: €25/tonne Nuclear Life Extensions: 8 years
Base Case: €27 ***"Power prices recover to new entrant levels, nuclear life extensions"***	10x Base Case 10e EPS 9.9x Base Case 13e EPS	LT German Baseload: €65/MWh LT Coal: $80/tonne LT Carbon: €20/tonne Nuclear Life Extensions: 8 years
Bear Case: €18 ***"Energy prices collapse, no growth, nuclear shut-down"***	6.4x Base Case 10e EPS 6.3x Base Case 13e EPS	LT German Baseload: €41/MWh LT Coal: $48/tonne LT Carbon: €10/tonne Nuclear Life Extensions: 0 years

Growth comes from Renewables and E&P…



Source: Morgan Stanley Research estimates
Note: Assuming current hedging

Why Underweight?

- We believe E.ON offers less growth relative to peers, and the valuation looks unappealing when adjusted for growth rate.
- Our forecasts show EPS growth of -1.7% 2008-13, and are 5-15% below consensus for 2010-13
- We recognize E.ON's solid assets. However, we see cheaper ways to play the sector, with better growth prospects.

What's new?

- Lower power price forecasts drive earnings downgrades approximately 5-7% below consensus for 2010-2012.
- Analysis of underlying valuations excluding carbon allocations and hedges.

Where are we different?

- We believe that the contango in European power and gas prices could further collapse – back to historical averages – putting pressure on E.ON's power generation and mid-stream gas earnings.
- Our forecasts now take account of all announced disposals and current forward power prices, and are 5-15% below consensus for 2010-13.

Where could we be wrong?

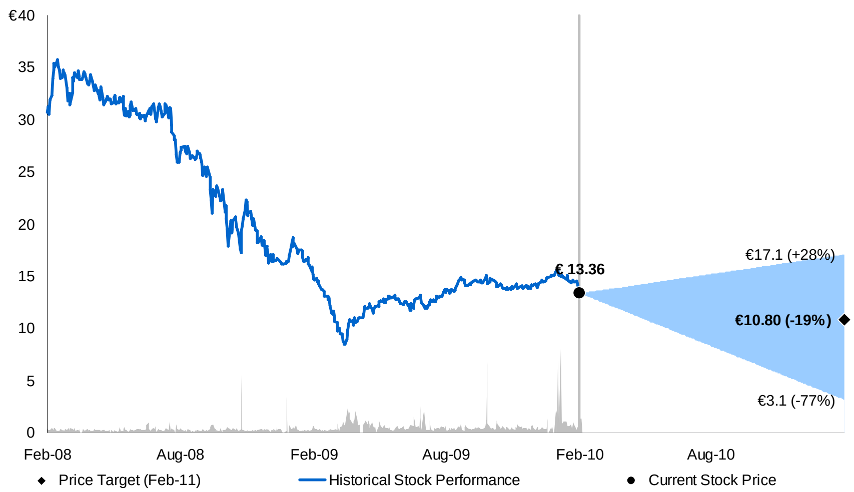
- A rally in power and gas prices before earnings estimates are corrected would be positive for the E.ON investment case.
- Operational improvements and cost cutting, especially with a new CEO incoming, could prompt growth.

Potential catalysts

- E.ON reports FY 2009 results on 10 March. We expect limited updated guidance until later in the year, after the new CEO takes charge in May.

Risk-Reward Snapshot: Gas Natural (GAS.MC, Underweight, PT €10.8)

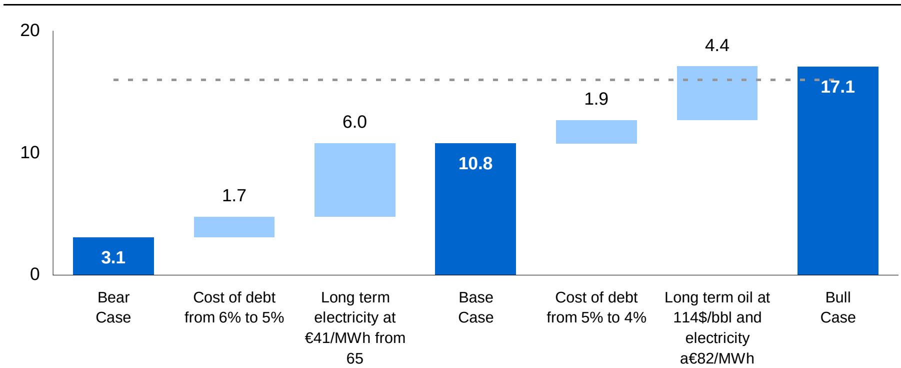
Unattractive profile; risks to stock greatly outweigh upside potential



Source: FactSet (historical share price data), Morgan Stanley Research estimates

Bull Case €17.1	9.1x 2010e EV/EBITDA	**Lower cost of debt and higher commodities post 2012.** We assume that Gas Natural's cost of debt falls to 4% and long-term electricity prices reach €82/MWh.
Base Case €10.8	7.5x 2010e EV/EBITDA	**Tough Spanish market until 2012.** We assume no spark spreads in Spain until 2012 and a gradual recovery after that to €65/MWh in 2018. We also assume a long-term cost of debt in the region of 5%.
Bear Case €3.1	5.4x 2010e EV/EBITDA	**Low energy prices post 2012.** Low energy prices persist post 2012 with €42/MWh for electricity in Spain. We also assume cost of debt increases to 6%.

Share price discounts electricity prices at €73/MWh in the long term



Source: Morgan Stanley Research estimates

Why Underweight?

- **Valuation is unappealing, in our view.** Despite its significant exposure to LatAm (lower multiples), Gas Natural trades at a 19.4% premium to the integrated utilities on 2010e EV/EBITDA an in line on P/E despite the higher gearing.
- **The slowdown in the Spanish economy is hitting Gas Natural,** in particular, given its long position in gas and exposure to thermal generation. Following the 4.9% decline in electricity demand in Spain, we think group production will decline by 19% in 2009, leading to a 12% reduction in like-for-like EBITDA. Pressure on earnings is likely to continue in 2010, when some hedging at Union Fenosa will expire.
- **Gearing remains high:** Debt will decline in 2010e following successful disposals and securitisation of the tariff deficit. However, we expect net debt/EBITDA to remain above 4x in the medium term, making Gas Natural one of the most geared stocks in our universe. Nevertheless, in 2009 Gas Natural successfully issued bonds, which extended the debt duration and reduced volatility.
- **The group's risk profile remains high,** with exposure to GDP trends in Spain, FX in LatAm and interest rates.
- **Risk-reward skew is asymmetric.** Given the threat of an earnings shortfall, upside potential is not large enough to offset these concerns.

Key Value Drivers

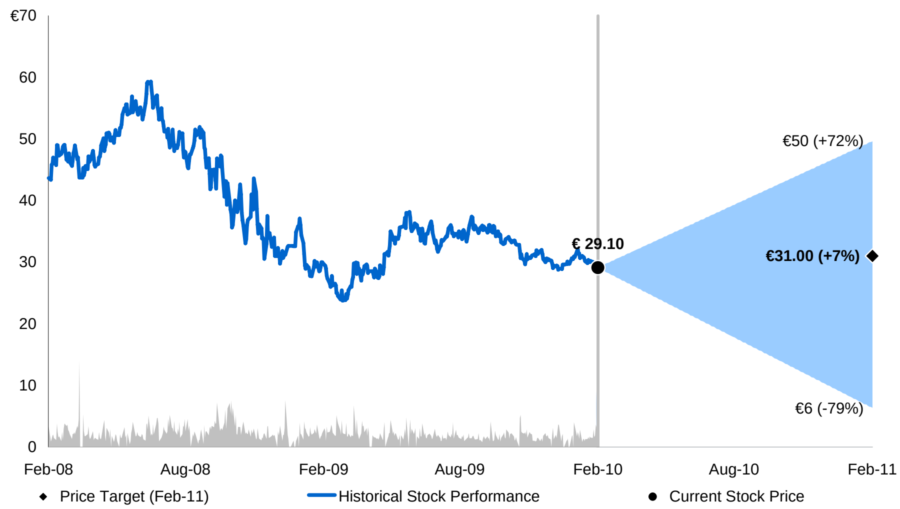
- Spanish GDP and spark spreads, LatAm currencies, interest rates.

Potential Catalysts

- Announcement of securitization of the Spanish tariff deficit.
- Further disposals.

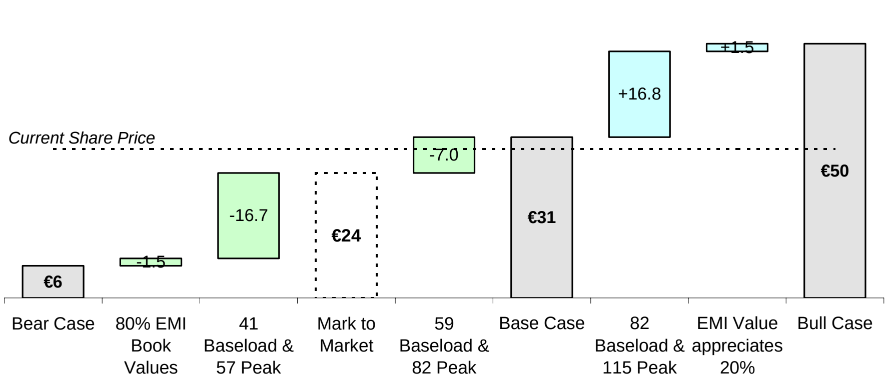
Risk-Reward Snapshot: Verbund (VERB.VI, Underweight, PT €31)

Little upside in a lower for longer power price environment



Bull Case: €50 (reduced from €55)	Higher power prices, associates valued at a 50% premium to book value.	LT Austrian baseload: €82/MWh LT Austrian peakload: €115/MWh
Base Case/PT: €31	Power prices recover to new entrant levels. Normalized hydro production levels. Associates at book value.	LT Austrian baseload: €65/MWh LT Austrian peakload: €91/MWh
Bear Case: €6 (reduced from €16)	Energy prices lower for longer. Associates valued at a 50% discount to book value.	LT Austrian baseload: €41/MWh LT Austrian peakload: €57/MWh

Bear to Bull: Power price assumptions are the key drivers



Source: FactSet (historical share price data), Morgan Stanley Research estimates

Why Underweight?

- Verbund looks expensive relative to the sector on medium-term multiples.
- 7% downside to our price target is below the sector average of c.+10%. In our sector base case, which assumes lower power prices for longer, we favour more defensive profiles.
- High gearing exacerbates the effect of falling power prices and the company's low hedging position.
- Downside risk to consensus estimates (we are 10% below 2010e consensus net income).

Key Value Drivers

- Long-term power prices are the main driver of NAV (+/-€1/MWh implies +/-€1.1 per share).
- An improvement in credit ratios would be beneficial (2010e economic Net debt/EBITDA of 4.3x).
- Hydro coefficient depends on factors such as the weather. While we assume long-term production normalization, +/-10bps to LT hydro coefficient has a +/-€ 4.4 impact on NAV per share.

Potential Catalysts

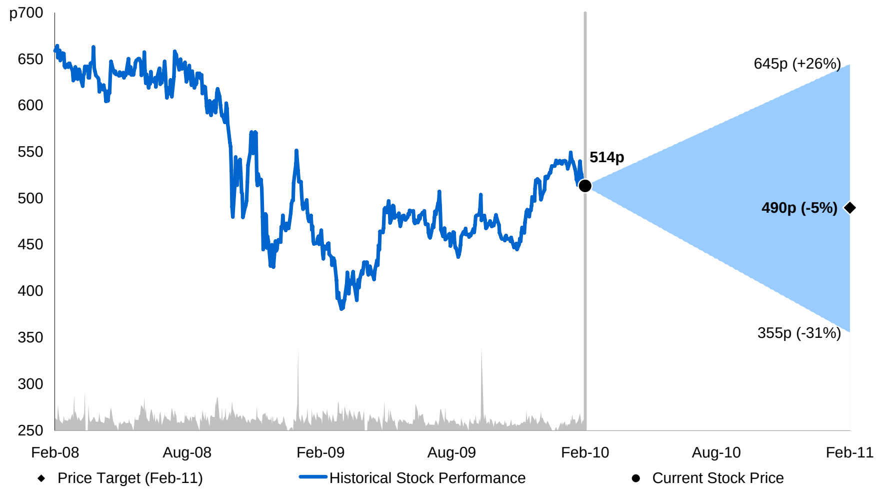
- EEX power price changes.
- FY09 results on 2 March 2010.
- 1Q10 results on 27 April 2010.
- 1H10 results on 27 July 2010.

2009 Guidance

- EBIT and net income slightly lower than in previous year.
- Dividend payout of at least 45%.

Pennon (PNN LN) – Underweight, PT 490p

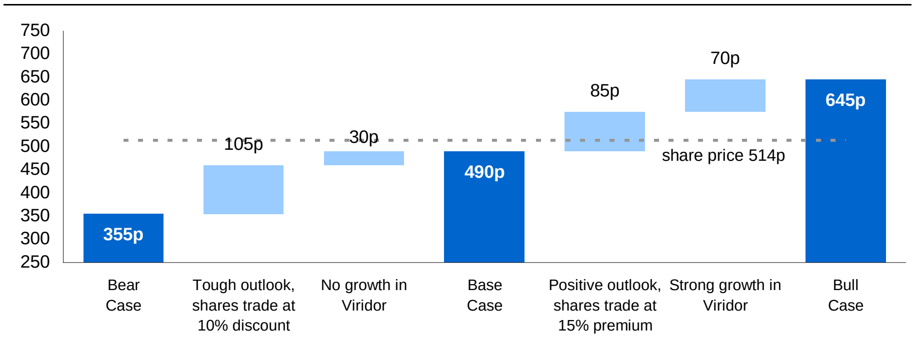
PNN trades at an 7% premium to RAB, well ahead of the peer group. We are Underweight on valuation



Scenario Summaries

Bull Case: 645p ***'Positive environment for watcos; and strong growth in Viridor'***	Assumes a 15% premium to RAB to reflect a beneficial inflationary environment Viridor: Implied 8.3x cal 11e EV/EBITDA, in line with current implied March 2010 multiple including growth pipeline
Base Case: 490p ***'Maintaining financeability'***	Allowed Return 4.5%. Period of Outperformance: 2010-25. This implies the stock should be trading at a 4% premium to RAB. Viridor: Implied 6.2x 2010e EV/EBITDA excluding growth
Bear Case: 355p ***'Tough outlook for watcos, and no growth from Viridor***	A 10% discount to RAB as fears around deflation return, and opex and capex efficiencies prove elusive. Implied Viridor multiple of 6.2x cal 11e EV/EBITDA

Valuation is driven by regulatory allowed return, and the Viridor outlook – our bear case assumes value destruction in water



Source: FactSet (historical price data), Morgan Stanley Research estimates

Why Underweight?

- Pennon trades at a 7% premium to RAB, ahead of the sub-sector average of 4%.
- Our price target of 490p implies 5% downside from the current share price.
- Pennon has a robust balance sheet, but its yield looks disappointing in 2010/11, at 4.6% versus the sector at 5.5%.
- The outlook for UK wholesale prices remains challenging, and this could weaken Viridor earnings in the meantime.

Key Value Drivers

- In our base case, we now assume a 4% premium over the RAB for financial outperformance.
- We forecast Viridor operating profit will increase this year on the back of the strong UK power prices already hedged. However, we have moved our 2010/11 earnings for Viridor down slightly to reflect weaker UK power prices.

Potential Catalysts

- Potential sale of EDF's UK electricity distribution business.
- Full year results to be published on 25 May.
- Further news flow around Viridor performance for 2010.

Valuation Methodologies and Risks

National Grid
We have a new price target of 750p, where we value the UK business at a 10% premium to RAB, and the US business on a 1.35x rate base multiple. Our bull case bakes in a US multiple of 1.5x rate base, and our bear case bakes in a multiple of 1.2x rate base as well as the UK business at RAB.

Iberdrola
We derive our price target from a DCF-based sum-of-the-parts valuation of each of the company's divisions using market prices for the listed holdings (Iberdrola Renovables, EDP and Gamesa). This includes electricity production, supply and distribution in Spain, electricity production supply and distribution in the UK and regulated activities in the US. We use an average WACC of 7.4% and a 1.5% long-term growth rate**.**

Verbund
We value the company's businesses individually using all available reported divisional information. We believe that a sum-of-the-parts model best allows us to capture the growth potential, capital intensity and risk profiles of the group's businesses. We use the most appropriate valuation approaches for each division, depending on the data available. While we use a DCF for Power, we value the Grid at RAB. We calculate 2013 group WACC at 6.8%. We assume a terminal growth rate of 2%.

EDF
We value EDF through a sum of the parts using DCF, book and market value, and EBITDA multiples. For the DCF of the Generation and Supply business, we use a long-term WACC of 6.4%, a growth rate in perpetuity of 2%, and an ARPU (excluding price neutral segments) of €47.5/MWh in 2013. We value the Supply business within the Generation division, as it is indistinguishable from the generation activity; the two are complementary, with the supply business offering a natural hedge to volumes generated.

Pennon
We value the regulated water business based on its 2010/11 RAB. We then make adjustments to take into account the clawback of past efficiencies and the value creation spread in AMP5/6/7. In total this amounts to a 4% premium to RCV. We value Viridor waste at £1055million, which implies an EV/EBITDA of 6.7x on 2010e for the underlying business. We use DCF calculations to value the various divisions, discounted using the group WACC of 6.5%. This implies £5.6/m3 of consented void for landfill, with power generation at £1,840/kW. Given the strong PBIT growth of the business (22% CAGR over the past 8 years), we believe our more conservative assumptions are justified. We do not rule out further tuck-under acquisitions, where management has been very successful deploying capital over the past decade.

GDF SUEZ
On our sum-of-the-parts analysis the stock is worth €34.50. We calculate this fair value using the assumptions in our base case analysis, with baseload power prices in central/western Europe averaging €65/MWh in the long run, long-term oil prices at $ 104/bbl, CO_2 at €20/t, and no political initiatives affecting valuation in the company's core markets. We use a mix of DCF models (using business-specific WACCs), market values and book values.

Gas Natural
We value Gas Natural's equity at €9.9 billion, implying a value of €10.8 per share, which we set as our new price target. We derive our valuation using a sum-of-the parts approach, reflecting the value of the individual divisions of the combined entities. We value the generation capacity at €6.7bn or €447/KW, at a 30% discount to replacement costs. This discount is justified, in our view, by the condition of the Spanish generation market which, we believe, will not be able to generate new entrant prices in the medium- to long term. We value the Spanish gas distribution business at €8.3bn, using a DCF based on a WACC of 6.2%. Our valuation implies a multiple of 9.7x EBITDA in 2010e. We value the Spanish electricity distribution assets at €4.9bn, again using a DCF based on a WACC of 6.2% and 1.5% long-term growth rate. Our valuation implies 9.0x 2010e EBITDA.

Centrica
We have increased our DCF-based sum of the parts valuation to 330p from 280p for predominantly two reasons – 1/ lowering our net debt assumption to remove the negative effect of margin cash that has already been charged through earnings and the cash flow, and 2/ a lower WACC to take in to consideration the increased balance of the Centrica business model post the integration of VPC and the purchase of the 20% stake in British Energy. We assume long-term margins of 6% for BG residential and 16% for Home Services.

A2A
DCF-based sum of the parts, assuming **l**ong-term spark spreads fall to €14/MWh and electricity prices reach €65/MWh

in the long run, with €745KW for electricity and networks at a 9.7% premium to RAB.

Snam Rete Gas

Our valuation is based on a DCF approach, where we use a WACC of 5.6% using the group RAB as a terminal value. We add to the 2009e RAB of SRG, Italgas and Stogit, the NPV of the value created by incentives on development capex, cost cutting above the regulator's targets and the value created by a lower cost of debt than that assumed by the regulator. We add to our valuation the group's financial assets. In this regard we consider the group treasury shares (196mn shares valued at a market price of €3.5 per share) and the other shareholdings (AES, Napoletana gas, Siciliana gas and other Italgas non consolidated participations). We value these assets at €495mn or 11x 2009e P/E, in line with the sector average.

E.ON

We value E.ON on a sum of the parts

Exhibit 47

E.ON Summary SOTP

	EURm	EUR/share
Central Europe	34,940	18.3
Pan European Gas	19,790	10.4
UK	11,190	5.9
Nordic	9,815	5.2
US Midwest	4,082	2.1
Russia	3,635	1.9
Southern Europe	6,237	3.3
ECR (Climate & Renewables)	7,545	4.0
Energy Trading	3,750	2.0
Corporate Centre	(1,008)	(0.5)
Total Enterprise Value	**99,976**	**52.5**
Investments	2,823	1.5
Net Debt	(29,225)	(15.3)
Provisions	(18,705)	(9.8)
Minorities	(3,874)	(2.0)
Equity Value	**50,995**	**26.8**
Shares in issue (m)	1,905	

Source: Morgan Stanley Research estimates

The key risks to our price targets are captured in our bull and bear scenarios.

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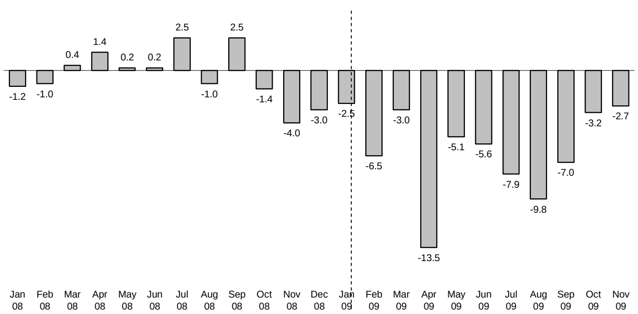
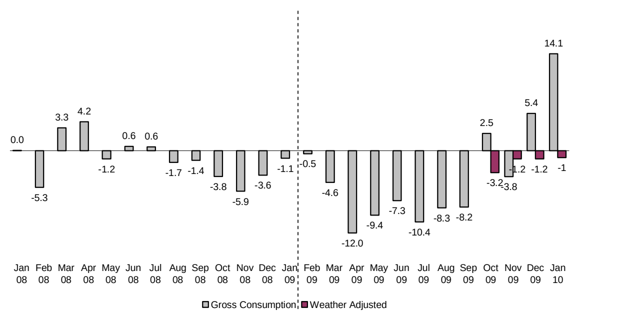
Appendix: Consumption Trend Tracker

Exhibit 48
Germany (non-weather adjusted)



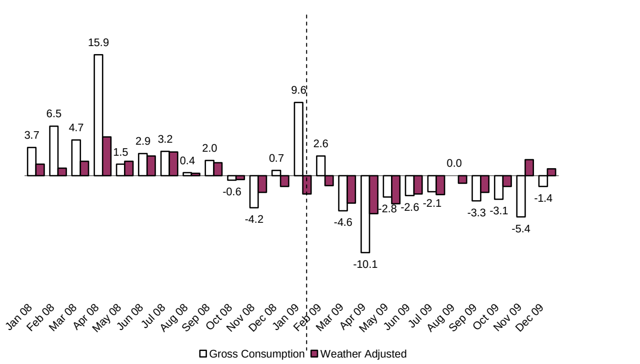
Source: Bloomberg, Morgan Stanley Research

Exhibit 51
Nordic



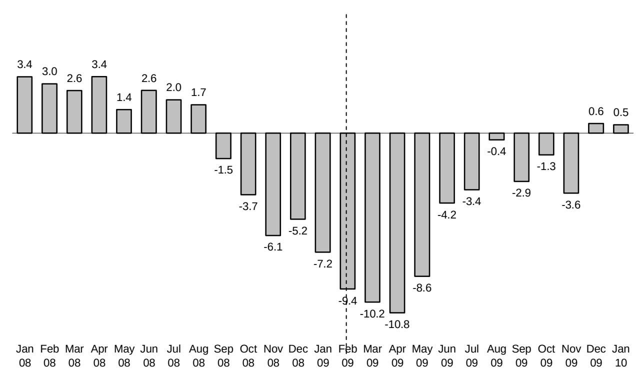
Source: Bloomberg, Morgan Stanley Research

Exhibit 49
France



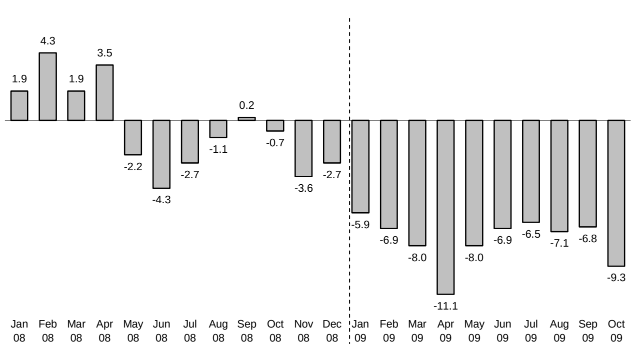
Source: Bloomberg, Morgan Stanley Research

Exhibit 52
Spain (weather adjusted)



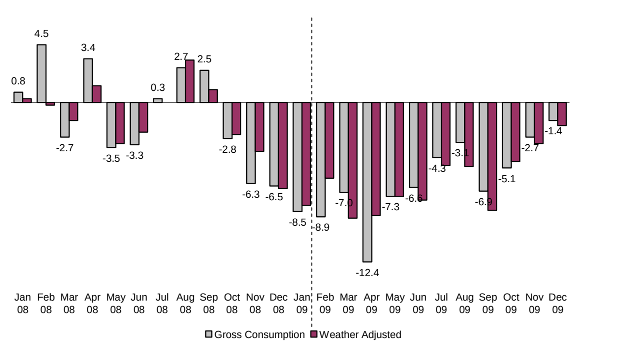
Source: Bloomberg, Morgan Stanley Research

Exhibit 50
UK (non-weather adjusted)



Source: Bloomberg, Morgan Stanley Research

Exhibit 53
Italy



Source: Bloomberg, Morgan Stanley Research

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Total	**2,504**		**723**		

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Industry Coverage:Utilities

Company (Ticker)	Rating (as of)	Price* (02/08/2010)
Nicholas J Ashworth, CFA		
Drax (DRX.L)	E (10/13/2009)	408p
Pennon Group (PNN.L)	U (01/22/2010)	514p
United Utilities (UU.L)	E (01/22/2010)	530p
Antonella Bianchessi		
A2A SpA (A2.MI)	O (10/13/2009)	€1.27
ACEA (ACE.MI)	O (01/27/2010)	€7.5
EDP (EDP.LS)	E (11/28/2008)	€2.7
ENEL (ENEI.MI)	U (10/14/2008)	€3.77
Edison (EDN.MI)	E (10/13/2009)	€1.01
Enagas (ENAG.MC)	E (08/13/2009)	€15.1
Endesa (ELE.MC)	E (07/10/2009)	€21.13
Gas Natural (GAS.MC)	U (05/07/2009)	€13.32
IRIDE S.p.A. (IRD.MI)	++	€1.3
Iberdrola (IBE.MC)	E (10/13/2009)	€5.85
PPC (DEHr.AT)	E (03/26/2009)	€10.9
Red Electrica (REE.MC)	E (08/13/2009)	€34.55
Snam Rete Gas (SRG.MI)	O (08/13/2009)	€3.4
Terna (TRN.MI)	NA (04/23/2009)	€2.88
Bobby Chada		
Centrica (CNA.L)	E (10/13/2009)	267p
E.ON (EONGn.DE)	E (05/07/2009)	€25.95
International Power (IPR.L)	E (10/13/2009)	321p
National Grid plc (NG.L)	O (10/13/2009)	629p
Northumbrian Water Group (NWG.L)	U (01/22/2010)	279p
RWE AG (RWEG.DE)	E (10/13/2009)	€63.58
Scottish & Southern (SSE.L)	O (06/05/2008)	1,165p
Severn Trent (SVT.L)	O (01/22/2010)	1,127p
Igor Kuzmin		
CEZ (CEZP.PR)	E (05/28/2009)	CZK873
Federal Grid Co of Unified Energy System (FEES.RTS)	U (12/17/2009)	US$.01
RusHydro (HYDR.RTS)	E (12/15/2008)	US$.04
Sean Lee, CFA		
Fortum (FUM1V.HE)	U (05/28/2009)	€18.07
Verbund (VERB.VI)	U (11/26/2009)	€29.1
Emmanuel Turpin		
EDF (EDF.PA)	O (10/13/2009)	€37.9
GDF SUEZ (GSZ.PA)	O (10/13/2009)	€26.48
Suez Environnement (SEVI.PA)	O (08/28/2009)	€15.81
Veolia Environnement (VIE.PA)	++	€23.23

Stock Ratings are subject to change. Please see latest research for each company.
* Historical prices are not split adjusted.