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Alfa·Bank

Portfolio Investments into Russian Utilities: Opportunities and Risks

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Reform progressed significantly in 2006-2007...



- **The launch of the new model of the electricity market (NOREM)** and approval of new rules for the electricity market on September 1.
- **The government agreed to accelerate electricity market liberalization**, which should be complete by 2011
- **Accordingly the government intends to liberalize the domestic gas market**
- **Successful “pilot” IPO of OGK-5:** 10x oversubscribed, placed with a significant premium to the market at \$320/kW vs. \$300/kW for Russian GenCos on average
- **Impressive deal with OGK-3:** Norilsk Nickel paid 17% premium to average OGK valuation valuing the company at \$602/kW
- **The future destiny of the networking business has become clearer:** RAB regulation instead of the “cost plus” tariff, approval of new configuration of interregional DisCos (MRSKs).
- **UES and the government have approved a large-scale investment program of \$120 bln through 2010.**

... but big, “noisy” events are still ahead

- 15 IPOs of generating companies (OGKs and TGKs) are set for 2007
- All supply companies and some generating assets will be auctioned in 2007-2008
- The first round of UES's reorganization, the spin-off of OGK-5 and TGK-5, in 3Q07
- The clarification and implementation of deregulation for the capacity market, which is an extension of the electricity market
- Development of new tariff regulations for networking companies (DisCos and TransCos) assuming rate-of-return tariffs instead of the current “cost plus”
- The start of the consolidation process in DisCos (MRSK), TransCos (directly into the Federal Grid Company) and Hydro-OGK
- The completion of consolidation in the generating segment (TGKs and Far East Energy Company)

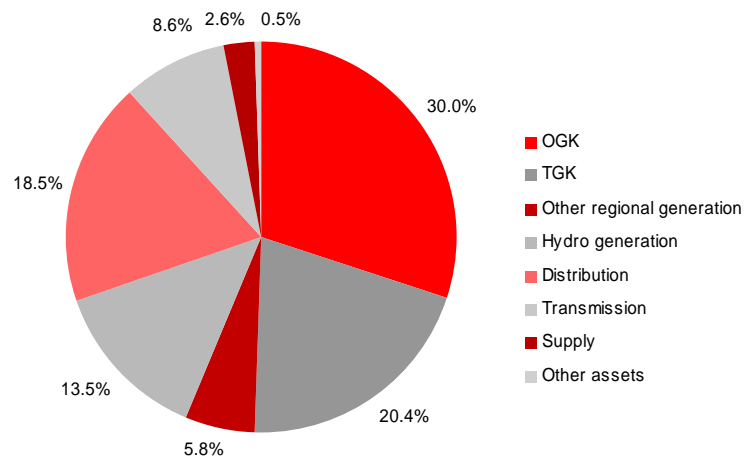
| Company | Period | Mcap, \$ mln | IPO Size, \$ bln | Pre-money | Post-money | Current UES's stake | Post-IPO UES's stake |
|---------------------------|--------|--------------|------------------|-----------|------------|---------------------|----------------------|
| OGK-1 | Nov-07 | 5,915 | 1,855 | 31.4% | 23.9% | 91.7% | 69.8% |
| OGK-2 | Sep-07 | 4,216 | 2,595 | 61.6% | 38.1% | 80.9% | 50.1% |
| OGK-3 | Mar-07 | 8,025 | 3,100 | 61.0% | 37.9% | 59.7% | 37.1% |
| OGK-4 | Jul-07 | 5,527 | 2,587 | 46.8% | 31.9% | 89.6% | 61.0% |
| OGK-6 | Nov-07 | 4,008 | 1,536 | 38.3% | 27.7% | 93.5% | 67.6% |
| TGK-1 | Jul-07 | 4,136 | 2,647 | 64.0% | 39.0% | 55.7% | 34.0% |
| TGK-3 (Mosenergo) | Mar-07 | 6,784 | 2,760 | 40.7% | 28.9% | 50.9% | 36.2% |
| TGK-4* | Nov-07 | 1,595 | 593 | 37.2% | 27.1% | 50.0% | 36.5% |
| TGK-5* | May-07 | 1,261 | 462 | 36.6% | 26.8% | 64.8% | 47.5% |
| TGK-6 | Nov-07 | 1,483 | n/a | n/a | n/a | 61.9% | n/a |
| TGK-7 (Volzhskaya TGK)* | Aug-07 | n/a | n/a | n/a | n/a | n/a | n/a |
| TGK-8 (South GenCo)* | Sep-07 | 1,367 | 1,072 | 78.4% | 43.9% | 49.8% | 27.9% |
| TGK-9 | Oct-07 | 1,709 | 1,102 | 64.5% | 39.2% | 50.1% | 30.5% |
| TGK-10 | Nov-07 | 1,762 | 529 | 30.0% | 23.1% | 81.6% | 62.8% |
| TGK-12 (Kuzbassenergo) | Aug-07 | 2,303 | 688 | 29.9% | 23.0% | 49.0% | 37.7% |
| TGK-13 (Yeniseyskaya TGK) | Nov-07 | 1,480 | n/a | n/a | n/a | 56.1% | n/a |

Source: UES

Note: * additional issue size – Alfa Bank Research estimates

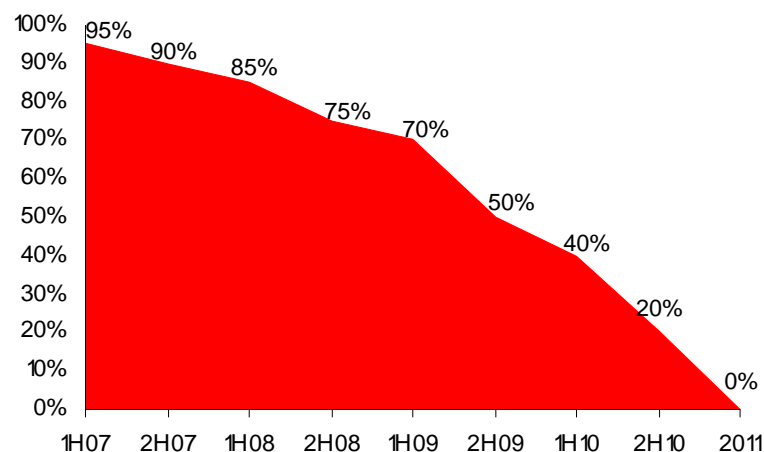
UES: Undervalued Exposure to the Sector

UES value breakdown



Source: Bloomberg, Alfa Bank Research

Liberalization of the Electricity Market



Source: Alfa Bank Research

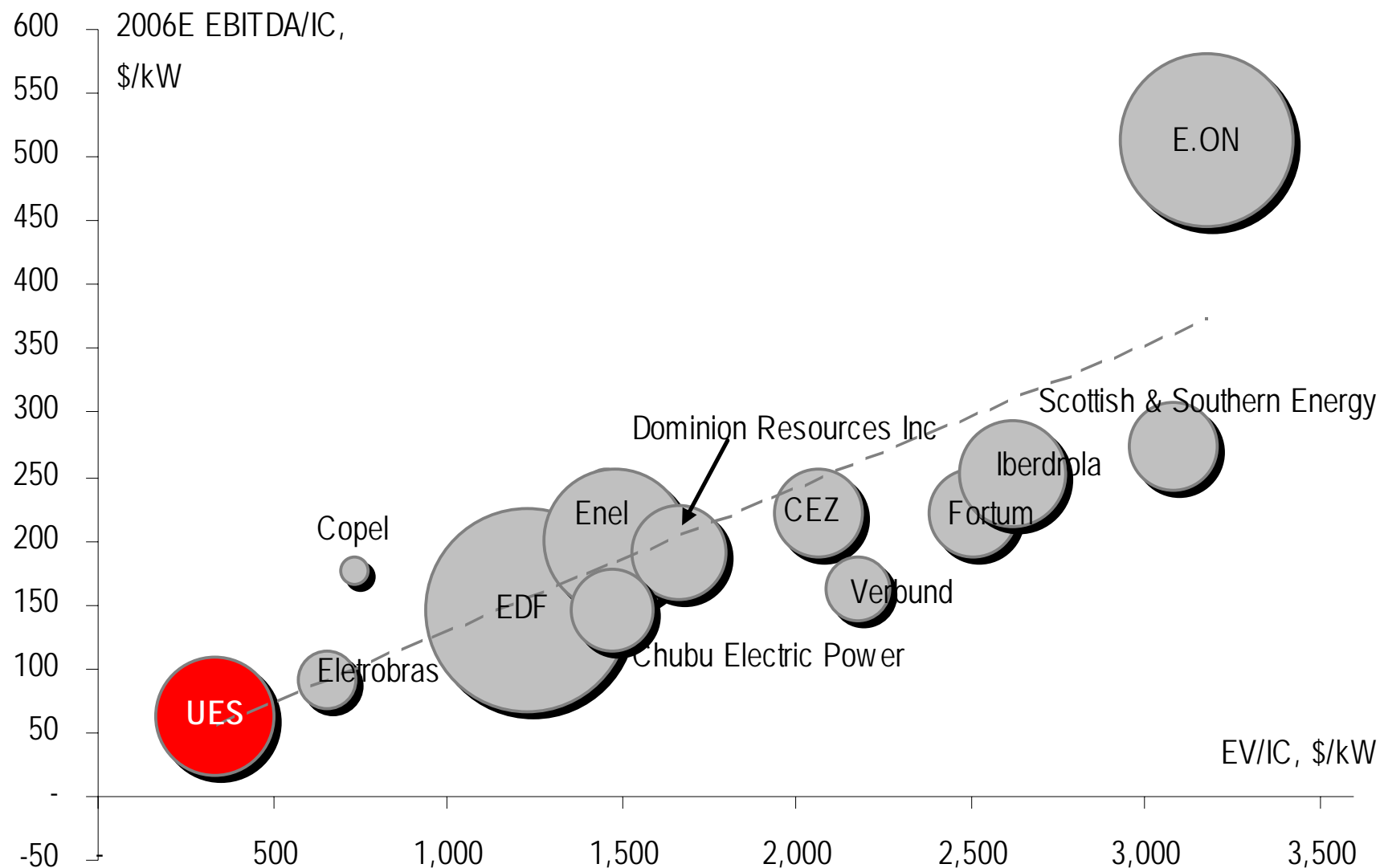
- Very liquid proxy for the hot theme of utilities reform, trading with a 26% discount to its market-based sum-of-the-parts value
- Attractively priced vs. global peers on production, capacity bases
- Forthcoming improvement in cash productivity will boost sector's valuation

UES will benefit, *inter alia*, from:

- Accelerated liberalization of the electricity market
- Fast-growing electricity demand
- Unlocking value of different lines of the utilities business
- Massive investment inflows into the sector
- Upcoming privatization of thermal GenCos through their IPOs, the bulk of which fall in 2007

Cash productivity is still lagging

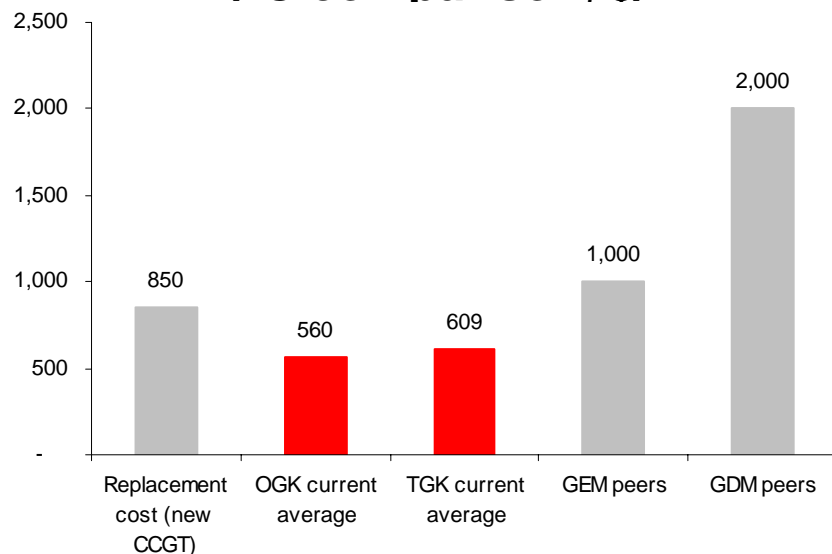
EV/kW vs. 2006E EBITDA/kW



Note: size of bubbles reflects MCAPs
Source: Bloomberg, company data, Alfa Bank Research

Generation: Not so cheap anymore...

EV/IC comparison. \$/kW

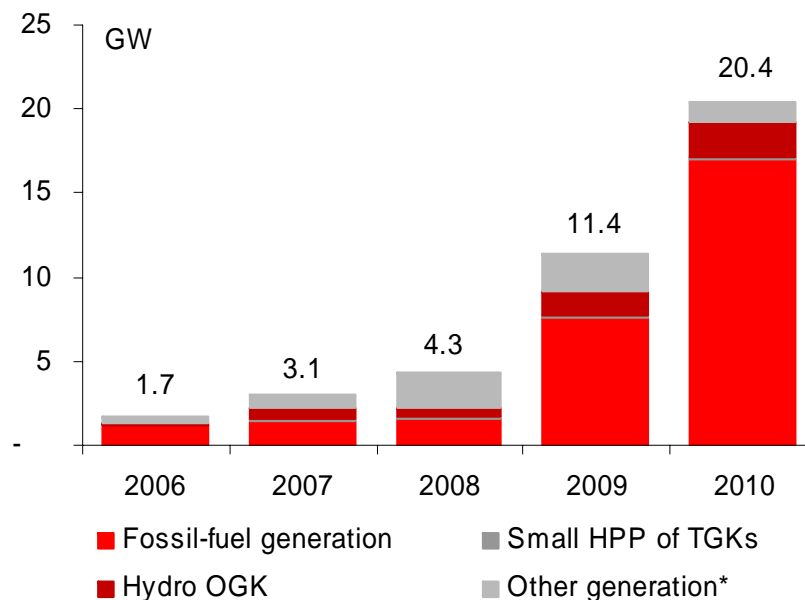


Source: Bloomberg, Alfa Bank Research

- Apart from UES, GenCos lead the sector in terms of MCAP
- Electricity market liberalization has been accelerated
- Fundamentally, valuations of Russian GenCos should finally approach GEM levels, but in a gradual manner following growing cash productivity that currently lags substantially behind that of GenCos outside Russia

- Ahead of forthcoming IPOs, generation is becoming the most fashionable theme in the utilities sector
- OGK-3 deal proved that strategic investors are ready to pay significant premiums, which looks supportive for GenCo stocks
- Fundamentally, generation looks clearer than the other lines of business

New capacity plans for 2006-2010



Note: * not attributable to UES
Source: UES

M&A and IPO deals in generation provide fascinating value implications

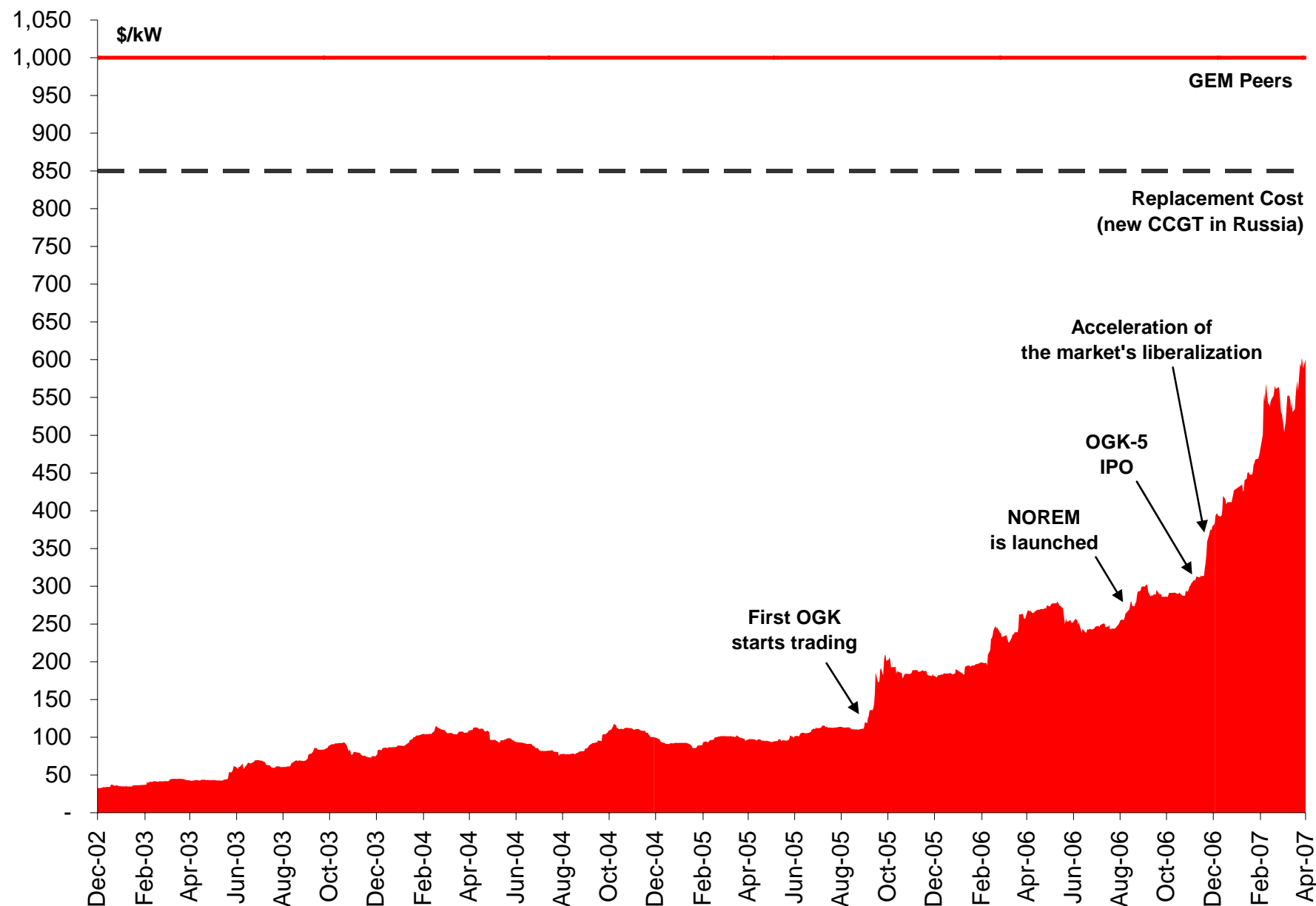


- M&A deals in Russian generating assets showed decent premiums paid by the buyers.
- The largest premium – 70% to the initial price of the auction – was paid by Mechel for Yuzhno-Kuzbasskaya GRES, which was partially due to the low valuation of the asset.
- Such premiums highlight strategic investors' confidence in the future prospects of electricity generation in Russia.

| Company | Date | Seller | Buyer | Stake % | Price \$ mln | Implied EV/IC \$/kW |
|--------------------------|--------|--------------------------|----------------|------------|-----------------|------------------------|
| TGK-1 (Petersburg GenCo) | Oct-06 | Lenenergo | Fortum | 12.5% | 148 | 375 |
| OGK-5 | Nov-06 | | IPO | 14.4% | 459 | 320 |
| OGK-3 | Mar-07 | Additional share issue | Norilsk Nickel | 37.9% | 3,100 | 602 |
| Zapadno-Sibirskaya CHP | Mar-07 | UES, SUEK, Kuzbassenergo | Evrast | 93.4% | 228 | 407 |
| Yuzhno-Kuzbasskaya GRES | Mar-07 | UES, SUEK, Kuzbassenergo | Mechel | 93.4% | 265 | 514 |

Source: Bloomberg, company data, Alfa Bank Research

Does the train move faster than the track is laid?



Note: Mosenergo (TGK-3) is incorporated since Jan-07
Source: Bloomberg, company data, Alfa Bank Research

Generation: Risks for investors

- **Political risk:** The possible slowdown of electricity market liberalization in the post-election period. However, the government has no incentives to delay this process given the looming large-scale capacity shortages in Russia.
- **Capacity market rules are still unclear.** It makes investment in generation risky due to higher uncertainty on future electricity prices.
- **Risk of oversupply of generating capacity.** UES's investment plans rely on a 5% CAGR for electricity demand through 2010, while the real growth may appear more modest given the ample room for energy savings.
- **Risk of increase of payback periods and decrease of IRR with construction of new power plants.** Follows from the previous point through lower-than-expected load factors.
- **Risk of opportunistic behaviour by the new owners of GenCos.** There are no strong guarantees that they will stick to UES's investment plans.
- **Risk of delay in construction of new capacity.** There is no guarantee that all related industries will be able to carry out UES's investment plans within such a tight timeframe (2007-2010).
- **Risk of appearance of unfriendly investor among the strategic shareholders:** e.g. aluminium smelters, which are mostly interested in development of their core business, possibly at the expense of generating assets' margins .

Distribution: DisCo inferno!



Still much cheaper than foreign peers on an asset basis, Russian DisCos still look very attractive. Key catalysts:

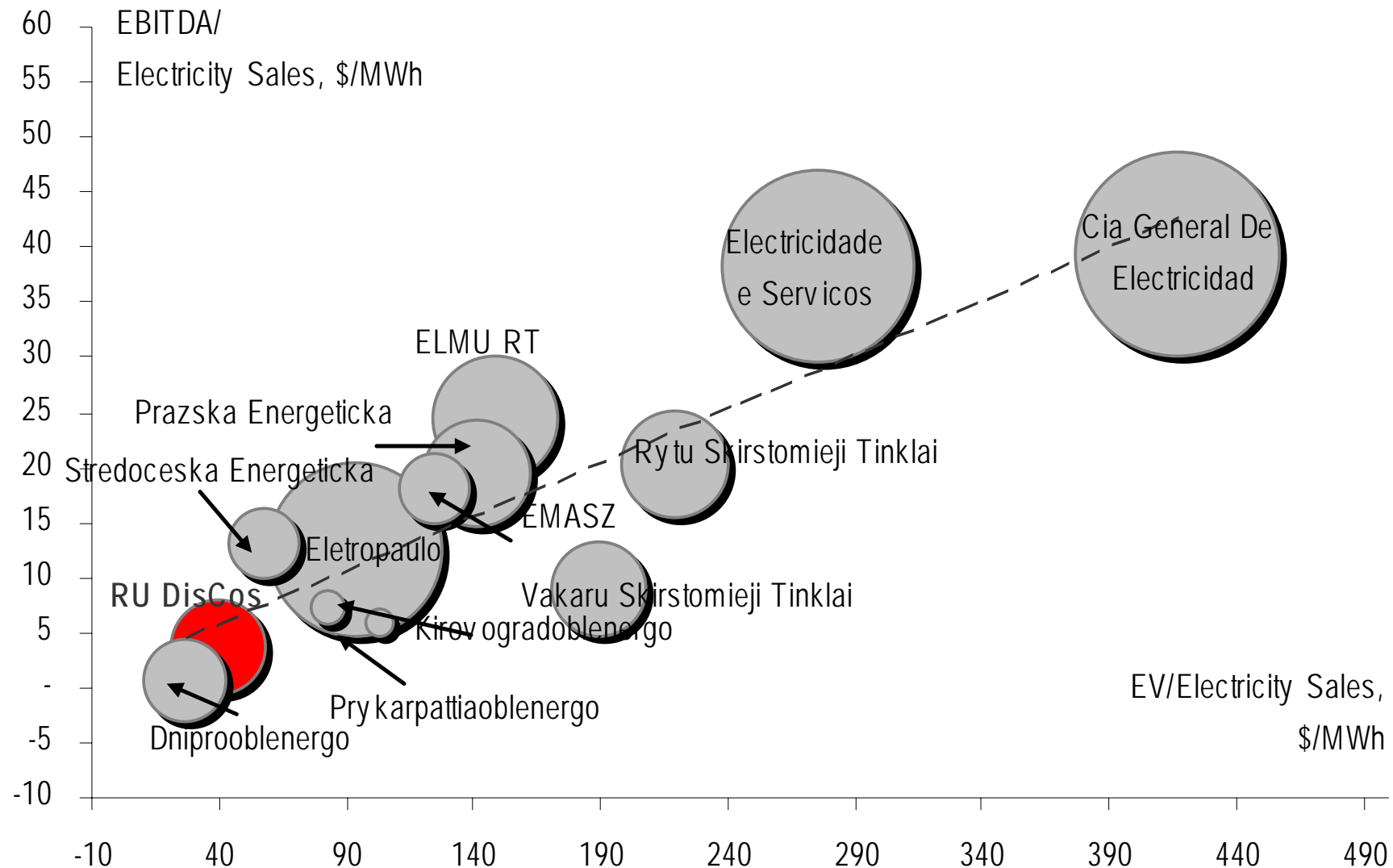
- Consolidation into enlarged MRSKs with transition to a single share starting in 2007
- Launch of new customer connections within the framework of the connection fee mechanism, resulting in growth of electricity deliveries
- Upcoming transition to more progressive RAB tariff-setting, which is likely to be clarified in 2007. This will result in more active borrowing for large CAPEX financing as well as encouragement of cost-saving among the DisCos.

| | EV/Sales 2005 | EV/EBITDA 2005 | P/E 2005 | P/BV 2005 | EV/Electricity Sales, \$/MWh | EV/Length, '000\$/km |
|-----------------------------------|------------------|-------------------|-------------|--------------|---------------------------------|----------------------|
| Russian DisCos average | 2.7 | 14.0 | 85.5 | 2.0 | 44.9 | 12.3 |
| GEM average | 1.9 | 20.0 | 67.2 | 2.8 | 105.7 | 17.6 |
| RU DisCos premium/discount to GEM | 40% | -30% | 27% | -28% | -58% | -30% |

Source: Bloomberg, company data, Alfa Bank Research

Cash productivity is much weaker than foreign peers'

EV/MWh vs. EBITDA/MWh



Note: size of bubbles reflects MCAPs
Source: Bloomberg, company data, Alfa Bank Research

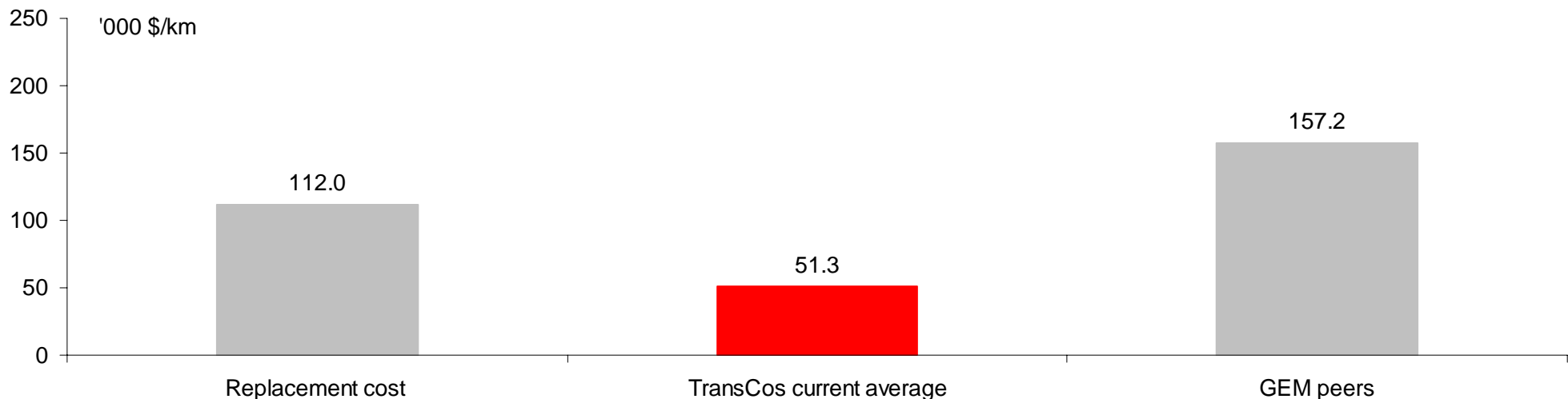
- **The key milestones of the future tariff regulation still remain unclear.** Although the state has already announced its plans to implement RAB regulation similar to that in foreign countries, there is still no the final definition of the regulatory asset base (RAB) itself. Plus there is no understanding of the rate-of-return level.
- **Risk of lower proceeds through connection fees could reduce funds necessary for making new connections.** The lion's share of DisCos' investment programs refers to CAPEX necessary for switching new customers to networks, while cash proceeds from connection fees are set as the main source of these investments. However, the companies' expectations of claims on new connections may potentially appear overestimated leading to lower connection fee revenues. In particular, Moscow City DisCo (MGESK) already expressed worries over its ability to meet cash proceed expectations for 2007 based on poor results in 1Q07.
- **Risk of unfair swap ratios for minorities within the consolidation process.** This could result in blocking of the consolidation by some disgruntled DisCo strategic minorities, as it was the case with the GenCos (e.g. TGK-6 and Integrated Energy Systems). This situation would ultimately delay the process of transition to a single share.

Transmission: Another consolidation story

The recently approved new scheme of transmission asset consolidation assumes the direct merger of the regional TransCos (MSKs) into the Federal Grid Company.

We highlight two main catalysts for TransCos:

- Consolidation under the umbrella of the Federal Grid Company, which should be completed upon UES's breakup
- Future implementation of RAB-based transmission tariff regulation for Federal Grid Company



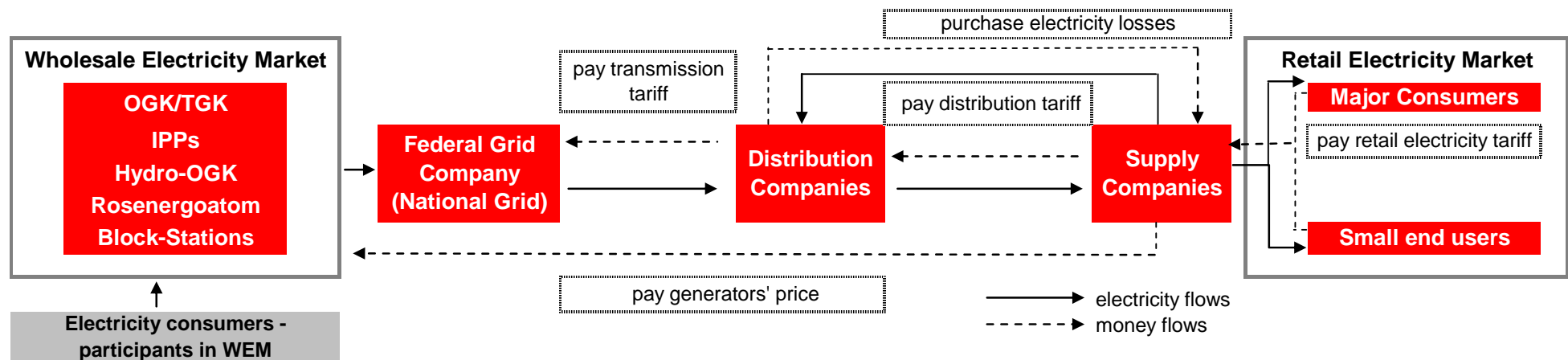
Source: FGC, companies data, Alfa Bank Research

- **Similar to the DisCos, the key milestones of future tariff regulation still remain unclear.** Although the state has already announced its plans to implement RAB regulation similar to that in foreign countries, there is still no the final definition of the regulatory asset base (RAB) itself. Plus there is no understanding of the rate-of-return level.
- **Risk of unfair swap ratios for the minorities within the consolidation process.** This might result in blocking of the consolidation by some disgruntled TransCo strategic minorities.
- **Possible delays with implementation of RAB regulation.** Looks very likely given that any reference legislation has not developed so far.
- **The settlement of RAB tariffs** for new networks only while the old networks will continue to be “cost plus” regulated until they have been depreciated at all. Such alternative is being discussed among other ones.

Supply Companies: Less clear but look promising

•The forthcoming sale of UES's stakes in all supply companies makes this business very attractive, especially given the high interest shown by different strategic investors, basically independent re-sellers, in these companies. The first auctions for 8 companies are set for May 2007.

•Today this business concentrates on the resale of electricity purchased on the wholesale market to industrial non-members of the wholesale market and residential customers. The future business model is likely to include complementary business areas such as gas supply, water supply and others that can maximize the economic benefits of ownership of local customer franchises.



Supply: Risks for investors



- **Low entry barriers.** Expected tough competition between different supply companies will lead to downward pressure on margins.
- **Possible exit by some large customers.** There are two ways to leave: going to another independent supply company on the retail market or directly to the wholesale electricity market.
- **Unclear mechanism of regulation on guaranteeing suppliers.** The majority of UES's supply companies will gain "guaranteeing supplier" status, which means that they will be obliged to supply electricity to any claimed customer. However, the mechanism of regulation of "supply margin" is still not clear enough.
- **Exposure to cross-subsidization and regulated tariffs for residential customers.** According to the Russian government, residential customers should remain untouched by the liberalization of the wholesale electricity market for the next 5 years at least, *i.e.* residential retail tariffs must be regulated within this period. Accompanied by cross-subsidization, this is likely to negatively impact the supply business' margins.
- **The future deregulation of retail electricity market is still under question.**

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