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ATON

EQUITY RESEARCH

UTILITIES

ELECTRICITY DISTRIBUTION

Longer-Term RAB Rates of Return Clarified

Electricity distribution

Current MktCap	**$14.6bn**
12M Target MktCap	**$26.6bn**
Potential upside	**82%**

Aton top picks in utilities sector

Company	Ticker	Current price ($)	12M TP ($)	Potential Upside	Rating
MRSK Holding (ord.)	MRKH	0.128	0.248	93%	BUY
MRSK Urals	MRKU	0.0086	0.0204	138%	BUY
MRSK South	MRKY	0.0050	0.0127	151%	BUY
MRSK North Caucasus	MRKK	4.9	14.7	199%	BUY
MRSK Center and Volga	MRKP	0.0068	0.0130	90%	BUY
MOESK	MSRS	0.0446	0.0807	81%	BUY
MRSK Center	MRKC	0.037	0.064	75%	BUY

Prices as of 27 Aug 2010 (MICEX closing)

Source: Bloomberg, Aton estimates

Federal Tariff Service (FTS) proposes longer-term regulatory RAB rates. Last week the FTS published on its web site draft orders for regulatory rates of return on regulatory asset bases (RAB) until 2015. These regulatory rates of return are applied to the Federal Grid Company (FSK) and electricity distribution companies (MRSKs).

Longer-term regulatory rates of return set at 10-11%. The FTS's latest orders propose rates of return for MRSKs, which are due to introduce RAB from 1 Jan 2011, as well as for the fourth and fifth years of RAB regulation for FSK and the MRSK regional branches that adopted RAB in 2009 or 2010. The numbers provided indicate that from 2012 to 2013 the base regulatory rate of return will decline from 12% to 11% for MRSKs and from 11% to 10% for FSK (see Figure 1). Based on our discussions with sector companies, these draft proposals are very likely to be formally approved.

A largely expected move. According to RAB methodology, the regulatory rate of return is linked to government bond yields. The latter have decreased recently; therefore it seems logical that the regulatory rates of return be adjusted downwards.

Earlier decisions left unchanged however. For MRSK regional branches that switched to RAB from 2009 and 2010 as well as for FSK, the previously established regulatory rates of return for the first three years of RAB implementation, are due to remain unchanged. We consider this an important sign of the government's intention to maintain RAB regulation's main principles: commitment and predictability.

Possible target price reductions, though sector upside potential remains over 60%. We currently assume a long-term regulatory rate of return for the MRSKs of 12%. We estimate that a 1 ppt reduction in the long-term regulatory rate of return will decrease our target market capitalisation for the electricity distribution sector by 10.4%, all other things equal (see Figure 2). But even in this scenario, our estimates still suggest some 63% average upside potential for the distribution sector from current market levels.

We believe our MRSKs valuations have a substantial safety margin. We stress that our MRSKs valuations incorporate quite conservative assumptions, leaving room for target price increases. We assume 2012 as the initial year for RAB introduction at the remaining MRSK branches (vs the government-set deadline of 2011) and sizable WACCs of 15.5-17.5%. At present, we keep our target prices unchanged, pending further information from the regulator on key RAB parameters (such as initial RAB values, and the timeframe for the transition to RAB at the remaining MRSK branches).

Clarification should be positive for market sentiment. We feel that a lack of investor confidence with respect to RAB parameters and the timetable for introducing RAB are the key reasons the MRSKs trade at hefty discounts to our target prices. Our view is, therefore, the greater the clarity provided by the regulator on RAB parameters, such as in this latest announcement, the better the market sentiment. Thus, we believe that further public announcements from the regulator, assuming they do not come as a major disappointment, may become a trigger for the MRSKs' share price performances.

ILYA KOUPREYEV
ilya.koupreyev@aton.ru
ALEXEY EVSTRATENKOV
alexey.evstratenkov@aton.ru
VLAD NIGMATULLIN
vladislav.nigmatullin@aton.ru

Appendix

Note: In Figure 1, the numbers in red are those proposed by the FTS in its draft orders published last week, while the numbers in black are the previously established rates.

Figure 1: Regulatory rates of return under RAB regulation

	2009	2010	2011	2012	2013	2014	2015
Regulatory rate of return on initial asset base ("old" RAB)							
MRSK branches switched to RAB from 1 Jan 2009	6%	9%	12%	12%	11%		
MRSK branches switched to RAB from 1 Jan 2010		6%	9%	12%	11%	11%	
MRSK branches to introduce RAB from 1 Jan 2011			6%	9%	11%	11%	11%
FSK		3.9%	5.2%	6.5%	7.8%	9.1%	
Regulatory rate of return on new investments ("new" RAB)							
MRSK branches switched to RAB from 1 Jan 2009	12%	12%	12%	12%	11%		
MRSK branches switched to RAB from 1 Jan 2010		12%	12%	12%	11%	11%	
MRSK branches to introduce RAB from 1 Jan 2011			12%	12%	11%	11%	11%
FSK		11%	11%	11%	10%	10%	

Source: FTS

Figure 2: Estimated target price changes due to reduction of long-term regulatory rate of return from 12% to 11%

Company	Ticker	12M TP current ($)	12M TP new ($)	Change	Current price ($)	Potential upside to new TP	Current EV/RAB 2009E	New Fair EV/RAB 2009E
MRSK Center	MRKC	0.0643	0.0579	-9.8%	0.0368	58%	0.47	0.60
MRSK South	MRKY	0.0127	0.0111	-12.3%	0.0050	120%	0.53	0.71
MRSK North Caucasus	MRKK	14.7	13.2	-10.4%	4.93	168%	0.16	0.33
MRSK Center and Volga	MRKP	0.0130	0.0115	-10.9%	0.0068	69%	0.43	0.56
MRSK North-West	MRKZ	0.0128	0.0117	-8.6%	0.0066	76%	0.37	0.51
MRSK Siberia	MRKS	0.0141	0.0124	-11.7%	0.0087	43%	0.35	0.40
MRSK Urals	MRKU	0.0204	0.0188	-7.9%	0.0086	119%	0.38	0.61
MRSK Volga	MRKV	0.00511	0.00459	-10.2%	0.00346	33%	0.46	0.51
MOESK	MSRS	0.0807	0.0723	-10.4%	0.0446	62%	0.47	0.57
Lenenergo (ord.)	LSNG	1.066	0.923	-13.4%	0.742	24%	0.44	0.45
Lenenergo (pref.)	LSNGP	0.830	0.694	-16.4%	0.851	-18%		
Kubanenergo	KUBE	3.03	2.51	-17.1%	5.87	-57%	0.76	0.38
MRSK Holding (ord.)	MRKH	0.248	0.222	-10.2%	0.128	73%	0.42	0.51
MRSK Holding (pref.)	MRKHP	0.141	0.126	-10.2%	0.088	44%		
Sector total MktCap ($bn)		26.6	23.8	-10.4%	14.6	63%		

Source: Aton estimates, Bloomberg

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