Phase 2 and 3 EUA auctioning

Carbon Expo, 1 June 2011

Current experiences of phase 2 EUA auctions

German government EEX phase 2 auctions:

•Morgan Stanley regularly participates in these auctions.

•Very straightforward and efficient process.

UK Government OTC phase 2 auctions:

•Morgan Stanley was the first primary participant to be approved by UK Government.

•We participate in every single auction on behalf of clients.

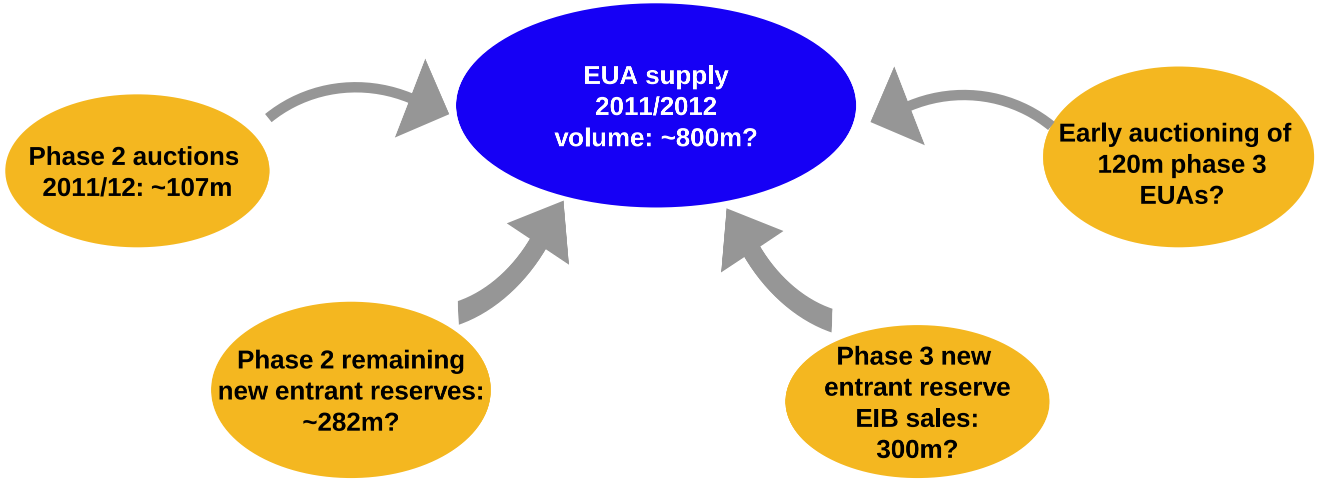
•Both approaches are very efficient, based on comparing platforms, and assessing coverage ratios and clearing prices vs market prices.

•One advantage of UK Government approach over German government approach:

•If you win volumes through an OTC auction, you maintain full flexibility as to where you hold your trading position in the market.

•If an exchange wins an auction contract, it could take some time before liquidity shifts to this exchange, and makes it easier to manage trading positions.

2011 and 2012 EUA supply vs demand balance



2011/12 demand factors

Industrials: a substantial part of their phase 3 short position will simply be covered by banking their phase 2 length. Some demand will come from facilities newly included in the EU ETS from 2013 hedging their short positions.

Aviation: Flight levels have been taking time to recover post-recession, and oil at >$100/bbl presents an additional hurdle for demand growth. Aviation buying in 2012 will be directed towards aviation EUA auctions (~30m of supply per annum).

Power sector: pre-2013 hedging of:

1) 2011/12 power going into delivery;

2) 2013 onwards forward power sales.

Situation in March 2011: power sector EUA demand

1) 2011/12 power going into delivery:

•Power sector roughly 20-25% short in phase 2.

•Have been buying EUAs in the lows throughout the past 2 years: is remaining phase 2 demand already covered?

2) 2013 onwards forward power sales:

•Profit margins in the power sector very low caused by oversupply of electricity.

•Oversupply due to new builds planned pre-recession coming online (e.g. CCGT in the Netherlands) and new wind and solar installations (e.g. in Germany, Spain, Italy and Czech Republic).

•This new supply has outpaced post-recession demand recovery.

•Only power plants categories generally in the money are: lignite, wind/solar (where on renewable subsidies programmes), and nuclear (though with increased regulatory risk and maintenance obligations).

•Assuming a 3 year evenly paced rolling hedging programme for lignite: 2011/12 demand for EUAs ~370m.

•Some additional demand will come from the most efficient CCGTs and hard coal plants on the margin meeting peak demand.

•Is it enough to fill the remaining 800m – 370m gap?

What has changed over the last few months? (1)

•The German government decision to review nuclear policy in the wake of the Fukushima Daiichi disaster immediately had an impact on EU power, gas and carbon markets.

•This weekend's policy decision to phase out nuclear by 2022 was generally in line with market expectations.

•However, in terms of fundamentals, not a huge amount has changed.

•~12 GW of nuclear capacity will be required to close by 2022, and ~8 GW has already closed.

•This is a return to the pre-nuclear extension status quo.

•New capacity is still coming online, and the nuclear phase out is not sufficient to remove near-term oversupply.

•Given that EUA free allocation roughly covers a power plant's fixed costs, mothballing of older, less efficient power plants will not occur until free allocation ends.

•So mothballing will not begin until March 2012 at the earliest. January 2013 is a more likely target date for closures for utilities not wanting to risk forfeiture of EUAs under national facility closure rules.

•Additionally, each utility will want to hold out the longest to see if other utilities mothball plants first.

What has changed over the last few months? (2)

EIB sale of 300m phase 3 EUAs:

•Registries regulation amendment proposes NER300 EUAs issued into Community registry account.

•This issuance could take place as soon as amendment agreed with Member States and enters into force.

•So the EIB can begin selling in Q4 2011 and does not need to wait for the Union registry to begin operating.

•But under the EC-EIB cooperation agreement, the EIB also has flexibility on the volume of EUAs sold in 2012 vs later on "to minimise any impact on the secondary market".

Auctioning of remaining phase 2 new entrant reserve EUAs:

•Do Member States have any deadlines in national implementing law for auctioning off these EUAs?

•Not evident that national allocation plans and EC decisions contain this level of detail.

•If they have flexibility, they could choose to delay sales into phase 3 depending on attractiveness of EUA prices and the immediacy of national budget pressures (which in some cases, are alleviated by AAU sales).

What has changed over the last few months? (3)

Early auctioning of 120m phase 3 EUAs:

•Official journal procurement process needed for selecting early auction platform: typically takes ~8 months.

•If each decision needs to be agreed with Member States, will likely take longer.

•Presently, technical specifications for launching the process are still being discussed.

•Winning platform then needs to buy/adapt auction software and set up new participants.

•As a result, many assuming early auctioning will only start mid-2012.

•Member States not using common platform have additional hurdle of chosen platform being approved as part of an auction regulation amendment (annex III).

•However, EC proposal to early auction 120m EUAs comes in the form of an auction regulation amendment (annex I).

•Member State enthusiasm for early auctioning seems limited.

•Therefore, volumes could still change, as well as the requirements for early auction platforms.

Morgan Stanley Commodities

CONTACTS AND DISCLAIMERS

Contacts

Olivia Hartridge, Vice-President

Phone: +44 20 7677 9936
Mobile: +44 7770 315 277
Olivia.Hartridge@morganstanley.com

Morgan Stanley | Fixed Income
20 Bank Street | Canary Wharf | Floor 02
London, E14 4AD

Morgan Stanley

Disclaimer

This material was prepared by sales, trading, banking or other non-research personnel of one of the following: Morgan Stanley & Co. Incorporated, Morgan Stanley & Co. International plc, Morgan Stanley MUFG Securities Co., Ltd., Morgan Stanley Capital Group Inc. and/or Morgan Stanley Asia Limited (together with their affiliates, hereinafter "Morgan Stanley"). Unless otherwise indicated, the views herein (if any) are the author's and may differ from those of the Morgan Stanley Research Department or others in the Firm. This information should be treated as confidential and is being delivered to sophisticated prospective investors in order to assist them in determining whether they have an interest in the type of instruments described herein and is solely for internal use.

This material does not provide investment advice or offer tax, regulatory, accounting or legal advice. By submitting this document to you, Morgan Stanley is not advising you to take any particular action based on the information, opinions or views contained in this document, and acceptance of such document will be deemed by you acceptance of these conclusions. You should consult with your own municipal, financial, accounting and legal advisors regarding the information, opinions or views contained in this document. Unless stated otherwise, the material contained herein has not been based on a consideration of any individual client circumstances and as such should not be considered to be a personal recommendation. This material was not intended or written to be used, and it cannot be used by any taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer under U.S. federal tax laws. Each taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

This material has been prepared for information purposes only and is not a solicitation of any offer to buy or sell any security, commodity, futures contract or instrument or related derivative (hereinafter "instrument") or to participate in any trading strategy. Any such offer would be made only after a prospective participant had completed its own independent investigation of the instrument or trading strategy and received all information it required to make its own investment decision, including, where applicable, a review of any prospectus, prospectus supplement, offering circular or memorandum describing such instrument or trading strategy. That information would supersede this material and contain information not contained herein and to which prospective participants are referred. If this material is being distributed in connection with or in advance of the issuance of asset backed securities, information herein regarding any assets backing any such securities supersedes all prior information regarding such assets. Unless otherwise specifically indicated, all information in these materials with respect to any third party entity not affiliated with Morgan Stanley has been provided by, and is the sole responsibility of, such third party and has not been independently verified by Morgan Stanley or its affiliates or any other independent third party. We have no obligation to tell you when information herein is stale or may change. We make no express or implied representation or warranty with respect to the accuracy or completeness of this material, nor are we obligated to provide updated information on the instruments mentioned herein. Further, we disclaim any and all liability relating to this material.

To the extent any prices or price levels are noted, they are for informational purposes only and are not intended for use by third parties, and are indicative as of the date shown and are not a commitment by Morgan Stanley to trade at any price.

This material may have been prepared by or in conjunction with Morgan Stanley trading desks that may deal as principal in or own or act as market maker or liquidity provider for the instruments or issuers mentioned herein and may also seek to advise issuers of such instruments. Where you provide us with information relating to your order or proposed transaction ("Information"), we may use that Information to facilitate the execution of your orders or transactions, in managing our market making, other counterparty facilitation activities or otherwise in carrying out our legitimate business (which may include, but is not limited to, hedging a risk or otherwise limiting the risks to which we are exposed). Counterparty facilitation activities may include, without limitation, us taking a principal position in relation to providing counterparties with quotes or as part of the ongoing management of inventories used to facilitate counterparties. Where we commit our capital in relation to either ongoing management of inventories used to facilitate clients, or in relation to providing you with quotes we may make use of that information to enter into transactions that subsequently enable us to facilitate clients on terms that are competitive in the prevailing market conditions. Trading desk materials are not independent of the proprietary interests of Morgan Stanley, which may conflict with your interests. Morgan Stanley may also perform or seek to perform investment banking services for the issuers of instruments mentioned herein.

Any securities referred to in this material may not have been registered under the U.S. Securities Act of 1933, as amended, and, if not, may not be offered or sold absent an exemption therefrom. In relation to any member state of the European Economic Area, a prospectus may not have been published pursuant to measures implementing the Prospectus Directive (2003/71/EC) and any securities referred to herein may not be offered in circumstances that would require such publication. Recipients are required to comply with any legal or contractual restrictions on their purchase, holding, sale, exercise of rights or performance of obligations under any instrument or otherwise applicable to any transaction. In addition, a secondary market may not exist for certain of the instruments referenced herein.

The securities, commodities, futures or other instruments (or related derivatives) discussed in this material may not be suitable or appropriate for all investors. This material has been prepared and issued by Morgan Stanley for distribution to market professionals and institutional investor clients only. This material does not provide individually tailored investment advice or offer tax, regulatory, accounting or legal advice. Prior to entering into any proposed transaction, recipients should determine, in consultation with their own investment, legal, tax, regulatory and accounting advisors, the economic risks and merits, as well as the legal, tax, regulatory and accounting characteristics and consequences, of the transaction. You should consider this material among other factors in making an investment decision.

Options and futures are not for everyone. Before purchasing or writing options, investors should understand the nature and extent of their rights and obligations and be aware of the risks involved, including the risks pertaining to the business and financial condition of the issuer and the underlying instrument. For Morgan Stanley customers who are purchasing or writing exchange-traded options, please review the publication 'Characteristics and Risks of Standardized Options,' which is available from your account representative.

The value of and income from investments may vary because of changes in interest rates, foreign exchange rates, default rates, prepayment rates, securities, prices of instruments or securities, market indexes, operational or financial conditions of companies or other factors. There may be time limitations on the exercise of options or other rights in instruments (or related derivatives) transactions. Past performance is not necessarily a guide to future performance. Estimates of future performance are based on assumptions that may not be realized. Actual events may differ from those assumed and changes to any assumptions may have a material impact on any projections or estimates. Other events not taken into account may occur and may significantly affect the projections or estimates. Certain assumptions may have been made for modeling purposes only to simplify the presentation and/or calculation of any projections or estimates, and Morgan Stanley does not represent that any such assumptions will reflect actual future events or that all assumptions have been considered or stated. Accordingly, there can be no assurance that estimated returns or projections will be realized or that actual returns or performance results will not materially differ from those estimated herein. Some of the information contained in this document may be aggregated data of transactions executed by Morgan Stanley that has been compiled so as not to identify the underlying transactions of any particular customer.

Notwithstanding anything herein to the contrary, Morgan Stanley and each recipient hereof agree that they (and their employees, representatives, and other agents) may disclose to any and all persons, without limitation of any kind from the commencement of discussions, the U.S. federal and state income tax treatment and tax structure of the transaction and all materials of any kind (including opinions or other tax analyses) that are provided to it relating to the tax treatment and tax structure. For this purpose, "tax structure" is limited to facts relevant to the U.S. federal and state income tax treatment of the transaction and does not include information relating to the identity of the parties, their affiliates, agents or advisors

This information is not intended to be provided to and may not be used by any person or entity in any jurisdiction where the provision or use thereof would be contrary to applicable laws, rules or regulations.

This communication is directed in the UK to those persons who are eligible counterparties or professional clients and must not be acted on or relied upon by retail clients (each as defined in the UK Financial Services Authority's rules).

This information is being disseminated in Hong Kong by Morgan Stanley Asia Limited and is intended for professional investors (as defined in the Securities and Futures Ordinance) and is not directed at the public of Hong Kong.

This information is being disseminated in Singapore by Morgan Stanley Asia (Singapore) Pte. This information has not been registered as a prospectus with the Monetary Authority of Singapore. Accordingly, this information and any other document or material in connection with the offer or sale, or invitation for subscription or purchase, of this security may not be circulated or distributed, nor may this security be offered or sold, or be made the subject of an invitation for subscription or purchase, whether directly or indirectly, to persons in Singapore other than (i) to an institutional investor under Section 274 of the Securities and Futures Act, Chapter 289 of Singapore (the "SFA"), (ii) to a relevant person pursuant to Section 275(1) of the SFA, or any person pursuant to Section 275(1A) of the SFA, and in accordance with the conditions, specified in Section 275 of the SFA or (iii) otherwise pursuant to, and in accordance with the conditions of, any other applicable provision of the SFA. Any offering of this security in Singapore would be through Morgan Stanley Asia (Singapore) Pte, an entity regulated by the Monetary Authority of Singapore.

This information is being disseminated in Japan by Morgan Stanley MUFG Securities Co., Ltd., Any securities referred to herein may not have been and/or will not be registered under the Financial Instruments Exchange Law of Japan (Law No. 25 of 1948, as amended, hereinafter referred to as the "Financial Instruments Exchange Law of Japan"). Such securities may not be offered, sold or transferred, directly or indirectly, to or for the benefit of any resident of Japan unless pursuant to an exemption from the registration requirements of, and otherwise in compliance with the Financial Instruments Exchange Law and other relevant laws and regulations of Japan. As used in this paragraph, "resident of Japan" means any person resident in Japan, including any corporation or other entity organized or engaged in business under the laws of Japan. If you reside in Japan, please contact Morgan Stanley MUFG Securities for further details at +613-5424-5000.

This information is distributed in Australia by Morgan Stanley Australia Limited A.B.N. 67 003 734 576, holder of Australian financial services license No. 233742, which accepts responsibility for its contents, and arranges for it to be provided to potential clients. In Australia, this report, and any access to it, is intended only for "wholesale clients" within the meaning of the Australian Corporations Act.

For additional information, research reports and important disclosures see https://secure.ms.com/servlet/cls. The trademarks and service marks contained herein are the property of their respective owners. Third-party data providers make no warranties or representations of any kind relating to the accuracy, completeness, or timeliness of the data they provide and shall not have liability for any damages of any kind relating to such data.

This material may not be redistributed without the prior written consent of Morgan Stanley.