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# Moody's Adjustments to Vattenfall's Accounts[1]

## ACCOUNTING FRAMEWORK AND KEY FINANCIAL DATA

Vattenfall AB (rated A3/Prime-2/stable) prepared its accounts for 2004 and 2003 in accordance with Swedish GAAP. Conversion to IFRS in 2005 changes the accounting treatment adopted for positive and negative goodwill, financial instruments (including derivatives), Swedish nuclear waste liabilities and payments to the Swedish Nuclear Waste Fund, land restoration and other provisions, development costs and minority interests. Some of these changes are already adjusted for by Moody's and the others do not have a material impact on the more important credit metrics used by the rating agency.

**Key Financial Data**

| | As reported by Vattenfall | | As adjusted[a] by Moody's | |
|---|---|---|---|---|
| **SEK billion** | **2004** | **2003** | **2004** | **2003** |
| Sales | 113.4 | 111.9 | 113.4 | 111.9 |
| Operating profit | 19.6 | 15.3 | [c]20.1 | [c]14.8 |
| Interest income | 1.0 | 1.2 | 1.0 | 1.2 |
| Interest expense | 3.4 | 4.5 | 3.7 | 4.7 |
| CFO | 24.0 | 18.2 | 24.3 | 18.3 |
| Dividends paid | 2.6 | 1.9 | 2.6 | 1.9 |
| RCF (after working capital)[b] | 21.4 | 16.3 | 21.7 | 16.4 |
| Gross debt | 73.0 | 85.6 | 92.6 | 103.2 |
| Net debt | 55.4 | 66.9 | 82.7 | 92.1 |

*a. For Moody's methodologies, see Related Research at the end of this report.*
*b. RCF (after working capital) equals CFO less dividends paid.*
*c. Excludes restructuring costs in Germany totalling SEK 3.0bn in 2004 and SEK 4.8bn in 2003.*

1. *This commentary is confined to publicly available information, focusing on the key financial data reported by the issuer and the adjustments made to convert it into a format that is most helpful for analytical purposes. The factors identified are already incorporated in the rating and the commentary is intended to improve transparency and provide added insight. Moody's does not perform forensic or audit procedures and this commentary does not address whether the financial reporting complies with relevant laws or regulations.*

## ADJUSTMENTS MADE BY MOODY'S IN ASSESSING EARNING POWER

| SEK billion | 2004 | 2003 |
|---|---|---|
| **Operating profit as reported** | **19.6** | **15.3** |
| Amortisation of negative goodwill | -3.0 | -4.8 |
| Amortisation and impairment of positive goodwill | 0.3 | 0.3 |
| One-off items affecting comparability | -0.8 | -0.3 |
| Equity accounted entities reclassified by Moody's | 0.8 | -0.6 |
| Interest element in lease rental expense (see explanation on page 3) | 0.2 | 0.1 |
| **Operating profit as adjusted – after restructuring costs in Germany** | **17.1** | **10.0** |
| **Operating profit as adjusted – before restructuring costs in Germany** | **20.1** | **14.8** |

***Goodwill amortisation is reversed by Moody's***

Moody's routinely reverses the amortisation of goodwill, an accounting practice that is discontinued under IFRS. This adjustment has an adverse impact on Vattenfall's profitability because it changes the treatment of negative goodwill totalling SEK 22bn relating to the operations in Germany which Vattenfall purchased at a discount. Under Swedish GAAP, negative goodwill is credited to income to offset the losses and restructuring costs anticipated when the businesses were acquired. The losses and restructuring costs are not separately disclosed but it would appear that the amount of negative goodwill credited to income each year is intended to remove the adverse impact of these costs. Although negative goodwill still to be amortised totalled SEK 6.9bn at 31 December 2004, the German cost-cutting programme was formally completed at that date and no restructuring costs have been charged in the first quarter of 2005. The cash outflow related to the German restructuring costs, which is not disclosed separately, has an adverse impact on CFO.

***One-off items affecting comparability are stripped out***

Vattenfall has helpfully identified "items affecting comparability" (mainly net capital gains) totalling SEK 819m in 2004 and SEK 263m in 2003 which Moody's has stripped out from operating profit. Further details are not provided in the accounts, but it seems that write-downs of tangible fixed assets and investment properties (SEK 392m in 2004 and SEK 162m in 2003) are not regarded as one-off or exceptional. Moody's regards these charges as equivalent to recurring depreciation adjustments. However, the rating agency has added back a goodwill impairment charge of SEK 211m made in 2004. Vattenfall does not include unused provisions reversed to income in the category of items affecting comparability. The amount has remained fairly constant at about SEK 2.5bn in 2004 and 2003 – see the table below.

In order to calculate a meaningful operating margin, Moody's has excluded Vattenfall's share of the profit of equity accounted entities from operating profit as reported.

***Provisioning has a significant impact on profit***

Provisions made by Vattenfall to cover future cash outlays for nuclear waste management, restoring mining sites and other environmental measures, severance pay and other restructuring-related matters, tax issues, legal disputes, losses on contracts and other exposures (excluding pensions) amount to SEK 28.8bn at the end of 2004 (2003, SEK 32.0bn; 2002, SEK 31.0bn). Some of these liabilities are difficult to estimate. The table below shows how profit has been affected by amounts added to and reversed from these provisions, as well as their cash impact:

| SEK billion | 2004 | 2003 |
|---|---|---|
| Amounts added (including the impact of discounting) | 3.7 | 6.5 |
| Amounts reversed | -2.6 | -2.5 |
| Net charge to profit (amounts added less amounts reversed) | 1.1 | 4.0 |
| Cash impact – amounts disbursed | 3.8 | 5.2 |

In 2004, provisions reversed included SEK 1.4bn related to lignite mining operations and other environmental measures (2003, SEK 1.6bn). The difference between provisions charged against profit and their related cash impact widened to SEK 2.7bn in 2004. This contributed to the cash flow from operations being slightly below expectations in 2004, as shown on the next page.

The difference between provisions charged against profit and their related cash impact could also have contributed to the lower than expected cash outflow for tax in 2004. Provisions are often deductible for tax purposes when spent, rather than when charged in the accounts. Tax paid by Vattenfall in 2004 totalled SEK 3.0bn. This represents 21% of Moody's adjusted operating profit after restructuring costs in Germany (SEK 17.1bn) less adjusted net interest expense (SEK 2.7bn). In 2003, tax paid was unusually high at 49% of Moody's adjusted profit after restructuring costs in Germany due to exceptional outflows in Germany arising from certain tax proceedings.

***Cash flow from operations is slightly lower than expected in 2004***

| SEK billion | 2004 | 2003 |
|---|---|---|
| Operating profit as adjusted – after restructuring costs in Germany (see page 2) | 17.1 | 10.0 |
| Amortisation of intangible fixed assets (excluding goodwill) | 0.5 | 0.6 |
| Depreciation and write-downs of tangible fixed assets | 13.7 | 13.5 |
| Depreciation and write-downs of investment properties | 0.3 | – |
| Non-interest element in lease rental expense (see explanation below) | 0.4 | 0.2 |
| Interest income | 1.0 | 1.2 |
| Interest expense (as adjusted – see the table below) | -3.7 | -4.7 |
| Tax paid | -3.0 | -3.2 |
| Expected cash inflow based on operating profit as adjusted by Moody's | 26.3 | 17.6 |
| Actual cash inflow (CFO as adjusted – see table below) | 24.3 | 18.3 |

***Interest expense is adjusted for capitalised interest and lease rental interest***

| SEK billion | 2004 | 2003 |
|---|---|---|
| **Interest expense as reported** | **3.4** | **4.5** |
| Interest capitalised | 0.1 | 0.1 |
| Interest element in lease rental expense (see explanation below) | 0.2 | 0.1 |
| **Interest expense as adjusted** | **3.7** | **4.7** |

***CFO is adjusted for the reversal of capitalised interest and lease rental principal***

| SEK billion | 2004 | 2003 |
|---|---|---|
| **CFO as reported** | **24.0** | **18.2** |
| Interest capitalised reclassified by Moody's | -0.1 | -0.1 |
| Non-interest element in lease rental expense (see explanation below) | 0.4 | 0.2 |
| **CFO as adjusted** | **24.3** | **18.3** |

## ADJUSTMENTS MADE BY MOODY'S IN ASSESSING FINANCIAL OBLIGATIONS

| SEK billion | 2004 | 2003 |
|---|---|---|
| **Gross debt as reported** | **73.0** | **85.6** |
| Operating leases | 4.8 | 2.8 |
| Pre-funded pension obligations | 0.3 | 0.3 |
| Unfunded pension obligations | 8.5 | 7.9 |
| Lignite mining and other environmental obligations | 4.1 | 5.1 |
| Swedish Nuclear Waste Fund – contingent liability | 1.9 | 1.5 |
| **Gross debt as adjusted** | **92.6** | **103.2** |

***Operating leases are capitalised by Moody's***

Moody's adjusts debt to include assets used by Vattenfall under operating leases. The rating agency estimates the cost of these assets by applying a standard multiple of eight to the lease rental expense of SEK 594m (2003, SEK 353m). Having capitalised the assets at their estimated cost, Moody's reclassifies the lease rental expense in order to adjust operating profit, interest expense and CFO.

***German pension obligations are included in adjusted debt***

Moody's methodology for pensions distinguishes between unfunded and pre-funded plans. The present value of Vattenfall's unfunded obligation (measured under RR 29, the Swedish accounting standard which is similar to IAS 19) is SEK 17bn. Moody's has factored in an equity credit of 50% as part of a simulated pre-funding – debt has accordingly been adjusted by SEK 8.5bn. For the pre-funded plans, Moody's takes into account the entire SEK 289m excess of the obligation over the fair value of the plan assets. RR 29 was implemented in 2004. Detailed figures are not available for 2003 but the total obligation exceeded the fair value of the assets by SEK 16.2bn. Moody's has assumed a broadly unchanged SEK 300m deficit in the pre-funded plans. Debt has therefore been adjusted by 50% of the residual SEK 15.9bn attributed to the unfunded plans.

Under RR 29, Vattenfall's pension commitment to Swedish employees is accounted for as a defined contribution arrangement. This is because several employers are involved and it has not been possible to identify Vattenfall's share of the surplus or deficit.

***Under IFRS, the Swedish nuclear waste management obligation is on balance sheet***

In Sweden, the operators of nuclear power plants pay a fee to the Swedish Nuclear Waste Fund ('SNWF') for the future management of nuclear waste and the decommissioning of the facilities. Under Swedish GAAP, this fee is reported as an operating expense every year and no provision is made in the balance sheet. Under IFRS, the payment of the fee is treated as an investment because ultimate responsibility for managing the nuclear waste resides with the operators of the plants. Vattenfall's share of this obligation is approximately SEK 22bn at the end of 2003 – this is recorded on the balance sheet under IFRS. However, the liability is more than offset by Vattenfall's share of the assets in the SNWF. Moody's has consequently not added the liability to debt in the table above. Instead, the rating agency has factored in 50% of the SEK 3.8bn guarantee given to the SNWF. This amount is recalculated every year and is designed to cover the risk of early reactor shutdown and the possibility of a shortfall in the SNWF arising from higher than expected costs or lower than planned investment returns.

***German nuclear waste management provisions and mining obligations are factored in***

Vattenfall is the co-owner with E.ON AG of four nuclear power plants in Germany, although one (Stade) is no longer operational. The output from these plants is sold by a GmbH limited liability company that owns each plant to the co-owners on a full cost basis. This ensures that the cost of operating each facility is borne by the co-owners in proportion to their share of the output. Surplus cash in the GmbH company is loaned out to the co-owners on a pro-rata basis. If proportionate consolidation had been used to account for these arrangements, Vattenfall's balance sheet would reflect its pro-rata share of the cost of each plant, together with its share of the liability for managing the nuclear waste. However, under Swedish GAAP, Vattenfall has fully consolidated one of the companies (Brunsbüttel) where its share of the output is 66.7%, but equity accounting is used for the other three where Vattenfall's share varies from 20% to 50%. Consequently, Vattenfall's gross debt figure includes loans totalling SEK 14.5bn (2003, SEK 15.0bn) owed to the three equity accounted nuclear power companies which would be replaced by Vattenfall's share of the underlying liabilities under proportional consolidation. Moody's understands that Vattenfall's pro-rata share of the provision for nuclear waste management for all four plants, calculated on an IFRS basis, is lower than the loans payable to the three equity accounted companies. No adjustment to debt has therefore been made for the nuclear waste management obligations in Germany. However, Moody's has adjusted debt to include 50% of Vattenfall's liability relating to lignite mining operations in Germany. Restoring these sites and dealing with other environmental obligations has a delayed cash impact similar to unfunded pensions.

***Moody's net debt calculation excludes loans to minority shareholders and blocked funds***

The net debt figure calculated by Vattenfall includes deductions for liquid assets (SEK 13.6bn in 2004 and SEK 14.6bn in 2003) and loans made to minority shareholders in foreign companies. Moody's has excluded the latter item in calculating net debt because the funds are not immediately available to pay down debt. The rating agency has consequently also excluded blocked liquid assets like Vattenfall's share of the liability insurance agreement between the German nuclear power operators (SEK 3.5bn in both years) and funds set aside as security for trading on energy exchanges (SEK 220m in 2004 and SEK 8m in 2003).

| SEK billion | 2004 | 2003 |
|---|---|---|
| **Net debt as reported** | **55.4** | **66.9** |
| Moody's upward adjustment to gross debt – see the table above | 19.6 | 17.6 |
| Loans to minority shareholders not deducted from gross debt by Moody's | 4.0 | 4.1 |
| Blocked funds | 3.7 | 3.5 |
| **Net debt as adjusted** | **82.7** | **92.1** |

## RELATED RESEARCH

**Rating Methodologies**

Moody's Approach to Analyzing Pension Obligations of Corporations, November 1998 (#39330)

Off-Balance Sheet Leases: Capitalization and Ratings Implications, October 1999 (#48591)

Analytical Implications of Employee Stock-Based Compensation, December 2002 (#76852)

Hybrid Securities Analysis – New Criteria for Adjustment of Financial Ratios to Reflect the Issuance of Hybrid Securities, Product of the New Instruments Committee, November 2003 (#79991)

The Analysis of Off-Balance Sheet Exposures – A Global Perspective, July 2004 (#87408)

Other Postretirement Benefits – Moody's Analytical Approach, December 2004 (#90378)

Refinements to Moody's Tool Kit: Evolutionary, not Revolutionary! A Product of the New Instruments Standing Committee, February 2005 (#91696)

**Special Comments**

Demystifying Securitization for Unsecured Investors, January 2003 (#77213)

Analytical Observations Related to "Underfunded" Pension Obligations when using UK and IAS GAAP, May 2003 (#78060)

The Impact of Moody's Financial Reporting Initiative on European Corporates, March 2004 (#81673)

**Special Report**

Moody's Basic Definitions for Credit Statistics, User's Guide, June 2003 (#78480)

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