

CONTACTS

Helen Francis/London 44.20.7772.5454
 Stefano de Santis/London
 Stuart Lawton/London
 Trevor Pijper/London

Moody's Adjustments to Vattenfall's Accounts

OBJECTIVE

Moody's makes a number of standard analytical adjustments to the accounts of non-financial corporate debt issuers.¹ Our objective is to better reflect – for analytical purposes – the underlying economics of transactions and events, and to improve the comparability of a company's accounts with those of its peers. Moody's does not perform forensic or audit procedures and these adjustments do not imply that the accounts fail to comply with accounting standards. Indeed, many of Moody's adjustments are inconsistent with IFRS. Our goal is to enhance the analytical value of financial data rather than to assess compliance with laws or regulations governing financial reporting.

This report, which is confined to publicly available information, shows how the adjustments made by Moody's have affected certain key credit metrics for Vattenfall AB (rated A2/P-1/stable). The adjustments detailed in this report are already incorporated in our rating analysis for the company.

Figure 1: Summary Table

SEK billion	As reported by Vattenfall		As adjusted by Moody's	
	2005	2004	2005	2004
Interest expense	2.96	3.43	3.49	4.09
Gross debt	78.66	73.01	89.71	88.63
Net debt	64.34	55.41	81.09	78.75
Funds from operations (FFO)	31.39	24.30	27.35	22.72
Dividends paid	5.78	2.60	5.96	2.60
Retained cash flow (RCF) (note 1)	25.61	21.70	21.39	20.12

*Note 1: RCF equals FFO minus dividends paid.
 Source: Vattenfall Annual Report 2005 and Moody's Adjustments.*

1. *Moody's Approach to Global Standard Adjustments in the Analysis of Financial Statements for Non-Financial Corporations – Part II, Rating Methodology published in February 2006 (#96729).*

ANALYTICAL ADJUSTMENTS MADE BY MOODY'S

Pension obligations are treated as debt-like

For Vattenfall's pre-funded pensions, Moody's adds the SEK 2.32bn difference between the defined benefit pension obligation and the fair value of the pension plan assets to debt (2004, SEK 289m). When cash contributed to pre-funded pension plans exceeds the related service cost, the difference is added back to FFO because this portion of the cash outflow is treated as a repayment of the pension-related debt. However, it is not possible to determine whether this adjustment is appropriate for Vattenfall because the necessary information was not required to be disclosed in the accounts.

For Vattenfall's unfunded pensions, the gross obligation (SEK 19.05bn in 2005 and SEK 17.05bn in 2004) which would otherwise be added to debt is reduced by the recognition of an "equity credit" amounting to SEK 7.15bn (2004, SEK 5.28bn). The "equity credit" is based on a target "equity to debt plus equity" ratio of 50%, after deducting SEK 4.75bn (2004, SEK 6.49bn) to recognise the existence of excess cash that could potentially be used to pre-fund this obligation.

Moody's attributes interest expense to the amount added to Vattenfall's debt for pensions, using a borrowing rate of 3.49% (2004, 3.78%).

Operating leases are capitalised

Moody's capitalises operating leases and recognises a related debt obligation. For Vattenfall, the lease rental expense (SEK 630m in 2005 and SEK 594m in 2004) has been multiplied by six.² A "one-third: two-thirds" ratio has been used to split the lease rental expense into interest and depreciation, respectively.

Capitalised interest is reversed if material

Moody's reverses interest expense capitalised during the year and the related cash outflow is consequently reclassified from an investing cash outflow to an operating cash outflow. However, no adjustment has been made for Vattenfall because the amounts involved are not significant.

Capitalised development costs are reversed if material

Moody's reverses product development costs capitalised under IFRS. This expenditure is instead charged to income as incurred. The related cash outflow is consequently reclassified from an investing cash outflow to an operating cash outflow. However, no adjustment has been made for Vattenfall because the amounts involved are not material.

Financial expense related to the discounting of provisions is reclassified

Moody's adjusts Vattenfall's financial expense to remove the accretion of discounted provisions. The cost of unwinding the discount is instead treated as an operating expense and the rating agency has excluded it entirely from the column headed "interest expense" in Figure 2 below.

Hybrid securities are adjusted to reflect Moody's debt-equity continuum

Moody's classifies securities with characteristics of both debt and equity using the rating agency's classification scheme which sometimes differs from the treatment in the accounts. Interest expense, dividends and the related cash outflows are consequently adjusted to be consistent with our classification of the hybrid security.

Unusual and non-recurring items are stripped out

Moody's strips out the effects of unusual and non-recurring items in order to better assess the results of ongoing, recurring and sustainable activities.

Additional adjustments are made where appropriate

Moody's may also make non-standard adjustments for matters not covered by the standard adjustments described above to better reflect the underlying economics and improve comparability with peer companies. These adjustments are explained in the footnotes in Figure 2.

2. *Guideline Rent Expense Multiples for Use with Moody's Global Standard Adjustment to Capitalize Operating Leases, Special Comment published in February 2006, revised March 2006 (#96830).*

Figure 2: Moody's Adjustments

SEK billion

	Interest expense	Dividends paid	Gross debt	Net debt
2005				
As reported (note 1)	2.96	5.78	78.66	64.34
Pensions	0.50	-	14.22	14.22
Operating leases	0.21	-	3.78	3.78
Hybrid securities (note 2)	-0.18	0.18	-6.95	-6.95
Loans to minority owners in foreign subsidiaries (note 3)	-	-	-	0.25
Funds blocked as security for trading on energy exchanges	-	-	-	2.25
Funds set aside as security for nuclear accidents	-	-	-	3.20
As adjusted (note 4)	3.49	5.96	89.71	81.09
2004				
As reported (note 1)	3.43	2.60	73.01	55.41
Pensions	0.46	-	12.06	12.06
Operating leases	0.20	-	3.56	3.56
Loans to minority owners in foreign subsidiaries (note 3)	-	-	-	3.99
Funds blocked as security for trading on energy exchanges	-	-	-	0.22
Funds set aside as security for nuclear accidents	-	-	-	3.51
As adjusted	4.09	2.60	88.63	78.75

Note 1: Gross debt as reported includes loans from minority-owned German power companies totalling SEK 13.73bn (2004, SEK 14.46bn). Moody's understands that this liability effectively equals Vattenfall's share of the total nuclear waste management obligation in Germany, after taking into account the company's share of the cash held by the German companies. There is consequently no adjustment to debt for nuclear waste management in Germany.

Note 2: Basket D (75% equity) treatment by Moody's for €1bn (SEK 9.268bn) of Capital Securities issued in June 2005 (5.25% coupon fixed until 2015, three month Euribor plus 2.95% thereafter).

Note 3: Included in net debt by Vattenfall, but excluded by Moody's because the funds are not immediately available to pay down debt.

Note 4: In 2005, derivative assets and liabilities are reported within "trade and other receivables" and "trade and other liabilities", respectively. Moody's would normally adjust debt by reallocating derivatives accounted for as fair value hedges of debt, but the necessary information is not disclosed.

Source: Vattenfall Annual Report 2005 and Moody's Adjustments.

HOW MOODY'S CALCULATES FFO

FFO equals Cash Flow from Operations (CFO) before Changes in Working Capital

Movements in working capital can have a distorting impact on CFO and Moody's consequently excludes the change in working capital from CFO in calculating FFO.

Moody's includes inventories, trade and other receivables (including those relating to interest and taxes), and trade and other payables (including those relating to interest and taxes) in working capital. In contrast to this approach, Vattenfall excludes the change in assets and liabilities relating to interest and tax from other working capital movements. Moody's has consequently reallocated these asset and liability movements to working capital (see Figure 3 below).

Provisions (liabilities of uncertain timing and amount such as pension, environmental, asset decommissioning, product warranty, and restructuring obligations) are excluded from working capital as defined by Moody's.

Moody's Analytical Adjustments are applied to standardised FFO

Having standardised the calculation of FFO, Moody's makes the additional Analytical Adjustments described on page 2 of this report. Their impact is shown in Figure 3 below.

Figure 3: Calculation of FFO

SEK billion	2005	2004
CFO as reported	24.42	24.10
Working capital outflow as reported	6.97	0.20
FFO as reported (CFO before working capital outflow)	31.39	24.30
Working capital movement relating to interest and taxes (note 1)	-0.54	-1.98
FFO as standardised by Moody's	30.85	22.32
Two-thirds of lease rental expense reclassified as depreciation	0.42	0.40
Hybrid securities financing cost reclassified (note 2)	0.18	-
One-off compensation due on closure of Barsebäck 2 (tax-free in 2005)	-4.10	-
FFO as adjusted by Moody's	27.35	22.72

Note 1: Included in FFO by Vattenfall, but treated as a movement in working capital by Moody's.

Note 2: Moody's re-allocates 75% of interest expense to preferred dividends (see footnote 2 in Figure 2).

Source: Vattenfall Annual Report 2005 and Moody's Adjustments.

MATTERS ARISING ON CONVERSION TO IFRS

Vattenfall converted to IFRS from Swedish GAAP in 2005. Moody's notes that:

- Under IFRS, Vattenfall's share in the Swedish Nuclear Waste Fund is reported as a separate, non-current asset on the balance sheet. The related obligation (for decommissioning the power plants and processing radioactive materials) is also shown separately as a liability. Under Swedish GAAP, the asset and liability were both off balance sheet because the fee paid to the Fund, which is determined by the Swedish government, was accounted for as an expense. Vattenfall's payments to, and disbursements received from, the Fund continue to be included in FFO. Given that the fair value of Vattenfall's share in the Fund exceeds the liability for nuclear waste management, Moody's has made no adjustment to debt for the nuclear waste management obligation in Sweden.
- On 31 January 2006, Vattenfall decided to extend the depreciation period for the Swedish nuclear power plants from 25 to 40 years. The reduction in the depreciation charge will be accounted for prospectively (from 2006 onwards), but the liability for decommissioning the power plants, calculated on conversion to IFRS at the transition date (1 January 2004), is based on the extended 40 year life.

To order reprints of this report (100 copies minimum), please call 1.212.553.1658.

Report Number: 98576

Author

Trevor Pijper

Senior Production Associate

Nita Desai

© Copyright 2006, Moody's Investors Service, Inc. and/or its licensors and affiliates including Moody's Assurance Company, Inc. (together, "MOODY'S"). All rights reserved. **ALL INFORMATION CONTAINED HEREIN IS PROTECTED BY COPYRIGHT LAW AND NONE OF SUCH INFORMATION MAY BE COPIED OR OTHERWISE REPRODUCED, REPACKAGED, FURTHER TRANSMITTED, TRANSFERRED, DISSEMINATED, REDISTRIBUTED OR RESOLD, OR STORED FOR SUBSEQUENT USE FOR ANY SUCH PURPOSE, IN WHOLE OR IN PART, IN ANY FORM OR MANNER OR BY ANY MEANS WHATSOEVER, BY ANY PERSON WITHOUT MOODY'S PRIOR WRITTEN CONSENT.** All information contained herein is obtained by MOODY'S from sources believed by it to be accurate and reliable. Because of the possibility of human or mechanical error as well as other factors, however, such information is provided "as is" without warranty of any kind and MOODY'S, in particular, makes no representation or warranty, express or implied, as to the accuracy, timeliness, completeness, merchantability or fitness for any particular purpose of any such information. Under no circumstances shall MOODY'S have any liability to any person or entity for (a) any loss or damage in whole or in part caused by, resulting from, or relating to, any error (negligent or otherwise) or other circumstance or contingency within or outside the control of MOODY'S or any of its directors, officers, employees or agents in connection with the procurement, collection, compilation, analysis, interpretation, communication, publication or delivery of any such information, or (b) any direct, indirect, special, consequential, compensatory or incidental damages whatsoever (including without limitation, lost profits), even if MOODY'S is advised in advance of the possibility of such damages, resulting from the use of or inability to use, any such information. The credit ratings and financial reporting analysis observations, if any, constituting part of the information contained herein are, and must be construed solely as, statements of opinion and not statements of fact or recommendations to purchase, sell or hold any securities. **NO WARRANTY, EXPRESS OR IMPLIED, AS TO THE ACCURACY, TIMELINESS, COMPLETENESS, MERCHANTABILITY OR FITNESS FOR ANY PARTICULAR PURPOSE OF ANY SUCH RATING OR OTHER OPINION OR INFORMATION IS GIVEN OR MADE BY MOODY'S IN ANY FORM OR MANNER WHATSOEVER.** Each rating or other opinion must be weighed solely as one factor in any investment decision made by or on behalf of any user of the information contained herein, and each such user must accordingly make its own study and evaluation of each security and of each issuer and guarantor of, and each provider of credit support for, each security that it may consider purchasing, holding or selling.

MOODY'S hereby discloses that most issuers of debt securities (including corporate and municipal bonds, debentures, notes and commercial paper) and preferred stock rated by MOODY'S have, prior to assignment of any rating, agreed to pay to MOODY'S for appraisal and rating services rendered by it fees ranging from \$1,500 to \$2,400,000. Moody's Corporation (MCO) and its wholly-owned credit rating agency subsidiary, Moody's Investors Service (MIS), also maintain policies and procedures to address the independence of MIS's ratings and rating processes. Information regarding certain affiliations that may exist between directors of MCO and rated entities, and between entities who hold ratings from MIS and have also publicly reported to the SEC an ownership interest in MCO of more than 5%, is posted annually on Moody's website at www.moody.com under the heading "Shareholder Relations — Corporate Governance — Director and Shareholder Affiliation Policy."

This credit rating opinion has been prepared without taking into account any of your objectives, financial situation or needs. You should, before acting on the opinion, consider the appropriateness of the opinion having regard to your own objectives, financial situation and needs.