This Analysis provides a discussion of the factors underpinning the credit rating/s and should be read in conjunction with our Credit Opinion. The most recent ratings, opinion, and other research specific to this issuer are provided on Moodys.com. Click here to link.

Analysis

SWEDEN
Europe/M.East/Africa

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Vattenfall AB

Corporate Profile

VATTENFALL IS ONE OF NORTHERN EUROPE'S LARGEST ENERGY GROUPS WITH A STRONG FINANCIAL PROFILE

With a market presence in Sweden, Finland, Germany and Poland, Vattenfall is Europe's fifth-largest power generator overall and leader in district heating. The parent company based in Sweden, Vattenfall AB (rated A2/P-1 positive outlook), has around 20% of the Nordic region's total generating capacity and is its second-largest network operator with 1.3 million customers. In Sweden it leads the supply market and in Finland it is the second-largest supplier. Total number of electricity customers amount to around 934 000. Vattenfall AB is 100% owned by the Swedish State (rated Aaa, stable outlook.)

Vattenfall Europe is now the third-largest power company in Germany, with a 17% share of the generation market, after E.ON (rated Aa3 with stable outlook) and RWE (rated A1 with stable outlook). It also has the fourth-largest distribution business in Germany, with 3.4 million customers mainly in Berlin and Hamburg. Its supply business, in turn, is third-largest with 3 million end customers, and in East Germany and Hamburg, it is the second-largest operator in transmission activities.

In Poland, Vattenfall owns 75% of Elektrocieplownie Warsawskie (EW), one of the country's largest heating generation companies with a 27% market share. Through its 75% stake in Górnoslaski Zaklad Elektroenergetyczny (GZE), it has a 3% market share of electricity generation, and, with 1.1 million customers, it is the sixth-largest network distribution company.

Moody's Investors Service
Global Credit Research

FY ended 31 December (SEK m)	Gross Revenue			Operating Profit (*)			Relative Contribution		Operating Margin	
	2003	**2004**	***Change***	**2003**	**2004**	***Change***	**2003**	**2004**	**2003**	**2004**
Nordic Generation	29,531	25,174	-15%	6,319	8,891	41%	40%	45%	21%	35%
Market Nordic	24,994	20,286	-19%	372	218	-41%	2%	1%	1%	1%
Nordic Heat	2,868	2,963	3%	345	418	21%	2%	2%	12%	14%
Nordic Distribution	7,809	8,231	5%	2,127	2,309	9%	13%	12%	27%	28%
Services	3,042	3,103	2%	98	164	67%	1%	1%	3%	5%
Other businesses	1,855	1,592	-14%	(841)	(854)	2%	n/m	n/m	-45%	-54%
Eliminations	(27,585)	(20,555)	n/m	11	0	n/m	n/m	n/m	n/m	n/m
Total Nordic	**42,514**	**40,794**	**-4%**	**8,431**	**11,146**	**32%**	**58%**	**61%**	**20%**	**27%**
Germany	**63,974**	**66,761**	**4%**	**6,160**	**7,085**	**15%**	**39%**	**36%**	**10%**	**11%**
Poland	**7,845**	**7,427**	**-5%**	**442**	**569**	**29%**	**3%**	**3%**	**6%**	**8%**
Eliminations	(2,398)	(1,616)	n/m	0	(12)	n/m	n/m	n/m	n/m	n/m
Group Total	**111,935**	**113,366**	**1%**	**15,033**	**18,788**	**25%**	**100%**	**100%**	**13%**	**17%**

(*) Excluding items affecting comparability
Source: Vattenfall

In the Nordic region,Vattenfall is the fourth-largest supplier of district heating, a relatively low risk, quasi-monopoly business,[1] and the largest supplier in Germany.

Between 40% and 50% of Vattenfall's operating profit at the group level is derived from lower risk monopoly-style networks and district heating businesses, with the balance from generation and supply activities.

LEGAL STRUCTURE

Vattenfall AB, the parent company, is based in Sweden. As of 2004 the Group is organised into Business Groups; one for the Nordic countries and one for Germany. Poland will become a Business Group as of August 2005. Vattenfall Europe AG, Germany, which was formally established in August 2002 out of the merger between HEW and VEAG, is the holding company for German operations. Prior to this, LAUBAG had been taken over by HEW while the merger of BEWAG into Vattenfall Europe was legally closed at the end of August 2003.[2] While Vattenfall Europe AG is headquartered in Berlin, several important functions are kept in Hamburg. Functionally, Vattenfall Europe is now organised in business units along the value chain for electricity and heat; similarly to the structure in the Nordic countries.

Vattenfall Treasury AB and Vattenfall Treasury Inc (the US CP issuing arm, though the programme is currently unutilised), under the guarantee of Vattenfall AB, issue all public debt instruments for the group. Vattenfall controls the cash flow of its subsidiaries, which are managed through cash pooling agreements. There are some external third-party bank loans at the German subsidiary level (excluding the affiliate loans mentioned below) within the Vattenfall Europe group, which represented around 15% of total group debt at the end of 2004. This exposure has diminished over time and Moody's expects it to be reduced still further as these loans mature and are replaced, as appropriate, by debt at the parent level. In addition, Vattenfall also includes within "group debt" loans of approximately SEK14.5 billion (as of FYE 2004) from affiliate companies that hold some of Vattenfall's nuclear assets.

Management Strategy

MANAGEMENT SEEKS PROFITABLE GROWTH IN NORTHERN AND CENTRAL EUROPE

Group management strategy is to position Vattenfall as a leading European energy company and increase market share in the overall European energy market, by concentrating on electricity and heat generation, distribution and supply.

Vattenfall's strategy for growth includes:

- Acquisitions foremost, both in markets where it is already present and in neighbouring markets including: Norway and Denmark in the Nordic sector as well as Austria, Benelux, the Czech Republic, France, and Switzerland. Acquisitions are likely to provide the group with its most significant growth opportunities.

1. Nordic ranking: Fortum, Sydkraft/E.ON, Helsinki Energia, Vattenfall.
2. By 2002, Vattenfall had completed a number of acquisitions in Germany: the East German Vereinigte Energiewerk AG (VEAG) generated energy predominantly from lignite which was supplied by Lausitzer Braunkohle AG (LAUBAG). Other operators were the utilities, Hamburgische Electricitäts-Werke AG (HEW AG) and Bewag Aktiengesellschaft (BEWAG).

– Organic investment in its core businesses, particularly to expand electricity generation and heat production. Its multi-year investment plan includes, among other goals, expansion of current generation capacity.

Management is keen to emphasise that growth should be profitable. In particular, management has – based on the owners' requirement – set profit objectives of a 15% return on equity, equivalent to 11% return on net assets.

Not surprisingly, an important aspect of Vattenfall's strategy has been attention to costs. Management has applied cost rationalisation initiatives at its German and Polish operations resulting in improved operating profit. Moody's believes that further cost savings are possible and expects the company to concentrate on capturing cross-border cost synergies, which its scale of operations should allow in the areas of procurement, maintenance, finance and administration.

The financial strategy of the group remains prudent overall. Notwithstanding a stated interest in acquisitions and a prudent dividend policy, management is committed to maintaining a rating in the single-A category and this is a target set by its owner. Moody's is not aware of any specific capital structure or financial leverage framework used by management to guide the future growth path of the group, although the state has set a 3.5x to 5x interest coverage goal for the group. Management will study new business opportunities as they arise, in line with its strategy of being a leading European player and active in the European energy market's long-term consolidation.

Key Rating Considerations

VATTENFALL'S A2/P-1 SENIOR UNSECURED RATINGS REFLECT THE APPLICATION OF MOODY'S GRI METHODOLOGY

The A2/P-1 senior unsecured ratings of Vattenfall AB reflect the application of Moody's new rating methodology for government-related issuers (GRIs).[3] In accordance with this methodology, the ratings of Vattenfall AB reflect the combination of the following factors:[4]

- Baseline credit assessment: 3 (on a scale of 1 to 6, where 1 represents lowest credit risk);
- Local currency rating of the Swedish government: Aaa;
- Dependence: Low; (see "Dependence Factors")
- Support: Medium. (see "Support Factors")

Vattenfall's baseline credit assessment of 3 reflects its strong market positions and strong financial profile, (described more fully in "Business Risk Factors" and Financial Risk Factors".) It benefits both from a strong market position as the largest Scandinavian electric utility as well as its strategic move into the German electricity sector in recent years, which positions it as a leading player in northern Europe. Vattenfall draws strength from its increased size and diversity, in particular as it reduces its exposure to the relatively volatile Scandinavian generation market.

The rating outlook is positive reflecting the significant financial flexibility that the Vattenfall group has built up at the current rating level. The outlook acknowledges Vattenfall's intention to pursue an acquisition strategy within Europe. Despite its already sizeable capex plan and the acquisition this year of Danish generation assets, Moody's expects Vattenfall to continue to generate free cash flow from 2006 onwards. If the company is unable to find further sizeable investments in the intermediate future, Moody's believes that further positive rating pressure could develop as its financial profile continues to improve. At the same time Moody's recognises that there are a number of risks associated with an ambitious expansion strategy as well as a number of pricing, regulatory and operational challenges in its core Northern European markets.

In addition to the factors affecting the baseline credit assessment, the ratings may also be impacted by changes in the ratings of the supporting government, or by changes in Moody's assessments of default dependence and support.

3. *Please refer to Moody's Special Comment ("The Application of Joint Default Analysis to Government-Related Issuers") published in April 2005, and its accompanying press release. Please also refer to Moody's Special Comment entitled "Rating Government-Related Issuers in European Corporate Finance" for a detailed discussion of the application of the GRI rating methodology to corporate issuers in Europe. GRIs are entities with full or partial government ownership or control, a special charter, or a public-policy mandate from a national or local government.*

4. ***"Support"** is the likelihood that the state shareholder will provide an extraordinary "bail-out" to a GRI on the verge of default. The baseline credit assessment of the GRI therefore measures the likelihood that the GRI will require such an extraordinary "bail-out". The baseline credit assessment also takes into account all aspects of the GRI's existing (or anticipated) business model, including benefits (such as regular subsidies or credit extension) and/or drags associated with the government relationship.*

   ***"Dependence"** captures the intrinsic economic link between the GRI's baseline default risk and the default risk of the government. For more detailed discussion of definitions please see Moody's Special Comments noted earlier.*

BUSINESS RISK FACTORS

Recent acquisition in Danish electric industry demonstrates Vattenfall's appetite for growth

In February 2005, following its bid to acquire up to 67% of Elsam, Vattenfall gained a 35.3% minority interest in the company after competing bidder, Dong, won a controlling 64.7%. The acquisition price for the minority stake amounted to DKK8.5 billion. Subsequently, in June 2005, Vattenfall agreed with Dong to acquire 24% of the generation capacity of Elsam/E2 in exchange for its 35.3% stake in Elsam. The agreement allows Vattenfall to establish a presence in the Danish market through combined heat and power (CHP) and wind power assets. Moody's believes that the acquisition of these assets will provide interesting diversification to Vattenfall's current generation portfolio mix and makes sense geographically given its positioning between Sweden and Germany.

Nordic wholesale prices are influenced by hydrological conditions and remain inherently volatile

Vattenfall's Nordic electricity generation is based on low-cost hydro and nuclear power. In 2004 hydro power represented 34% of its Nordic generation, while nuclear power comprised 65%; Vattenfall generates half of Sweden's power and around 20% of the whole Nordic market's power.

In the Nordic sector, generation mix and power prices are influenced by variations in water levels and will always be somewhat volatile. Prices have picked up from extreme lows during the wet years of the late 1990s, and an expected reduction in the reserve margin over the medium-to-long term should mitigate against repeating such a large downward movement – indeed, prices spiked significantly in late 2002 and during 2003 because of a fall in reservoir levels in Sweden and Norway but returned to more stable levels in 2004 and in the beginning of 2005 as water reserve levels recovered. Moody's notes that Vattenfall has an active hedging programme through Nord Pool, which should help mitigate the impact of short-term price movements.

German operations reduce exposure to relatively volatile Scandinavian market although being "long" generation does still increase risk

Vattenfall's generation business in Germany is primarily thermal, which accounted for 89% of production in 2004. Thermal prices, which have risen from 1998-2000 lows, are less volatile and therefore provide something of a hedge to the Nordic generation portfolio. Nonetheless, high coal prices and the emerging emissions trading business may also continue to create some volatility in German wholesale prices. The company still remains long on generation and hence is overall exposed to wholesale prices, but diversification along the value chain and a greater fuel mix[5] have reduced Vattenfall's overall exposure to the Nordic weather system.

Environmental issues will remain an important consideration for Vattenfall, and nuclear power is expected to remain an important component in the Nordic fuel mix

Nuclear power represents an important component of Vattenfall's overall generation mix, with the company owning shares in nuclear plants both in Sweden and Germany.

In December 2004, the Swedish government decided to close down the Barsebäck 2 nuclear plant by May 2005. This follows a parliamentary decision taken back in 1997 to decommission both nuclear reactors of the Barsebäck plant (Barsebäck 1 was closed at the end of 1999). Sweden's energy policy is still somewhat unclear – recent discussions with the Swedish power companies with regard to reconsidering the future of nuclear power and extending the life of a number of nuclear plants, ended somewhat unsatisfactorily. However, Moody's does not believe this represents a decisive move towards full nuclear decommissioning in Sweden in the near term, given the country's dependence on nuclear power, which currently represents circa 50% of production, and the lack of viable alternatives. In Germany, where the government is currently planning to phase out nuclear power over time, Vattenfall owns three nuclear plants which have planned closure dates between 2008 and 2019.

5. *See Figure 2*

Figure 2. Vattenfall Group Power Generation Mix.

	2003	2004
Hydro power	18.0%	20.1%
Nuclear power	36.2%	37.3%
Fossil fuel-based power	45.6%	42.2%
Wind power	0.1%	0.1%
Biofuel, waste	0.1%	0.3%
Total Electricity	100.0%	100.0%

Source: Vattenfall

Initial CO2 emission allocation has broadly neutral impact on Vattenfall

Acquisitions in Germany (particularly the lignite-based VEAG) and Poland have brought to Vattenfall operations that have new environmental profiles and risks.

The National Allocation Plans (NAPs), designed by EU governments to address the issue of emissions of greenhouse gases, came into effect in 2005 – initially covering carbon dioxide (CO2). All combustion plants over a certain size must have allowances to cover their CO2 emissions. In each country, emission allowances have been allocated to plants participating in the system. While companies look for ways to reduce emissions, the introduction of carbon dioxide emissions trading and the allocation of emission rights vs. needs will lead to the price of emission allowances being determined by their scarcity.

In Germany, Vattenfall requires emission allowances owing to its thermal exposure, which is 89% circa of its total generation in that country. In Sweden the requirements are very low, given the high proportion of hydro and nuclear generation. However, should Vattenfall construct new thermal power plant in the future, it could be short on allocations. Additionally, in Poland, there has been a substantial over-reduction *vis á vis* the Kyoto target, with the surplus allocated to the state. Here, Vattenfall is unlikely to have any deficit. Overall, and for the first allocation period (2005-2007), Moody's expects Vattenfall's allowances to be broadly in line with its requirements.

Vattenfall's operations in Poland are showing the benefits of rationalisation through improved profitability, but operating risks are still relatively high in this region

Vattenfall continues to improve the efficiency of its Polish operations, which reported an increased operating profit in 2004 over 2003, despite lower volume in both heat and electricity. The Polish market is still at an early stage of liberalisation and privatisation, with most generation and distribution activity remaining in the hands of state-owned enterprises. The privatisation process may offer acquisition opportunities to strengthen its market presence through acquisitions, although such moves to create greater critical mass and synergies may be difficult given the State Treasury's high price-expectations. Liberalisation is expected to be completed by 2007 with the liberalisation of supply to the consumer market (the corporate customers market is already liberalised). In Poland, where tariffs currently are set on an annual basis, there is a need for greater transparency in regulatory developments, which still present some risks.

There is some regulatory uncertainty in Vattenfall's markets; however, distribution is relatively low-risk business compared with generation and supply

Vattenfall has access to the well-established distribution and supply networks in the Berlin and Hamburg regions. These are monopoly businesses, and they currently contribute a significant portion of cash flows in Germany. A new law is expected to be passed later in 2005 that should lay the foundations of a more incentive-oriented *ex-post* regulatory body into what has largely been a self-regulated environment. Implementation of the model is expected to occur within two years of the introduction of the new law.

Distribution has traditionally been a relatively low-risk business in Sweden and Finland, and has traditionally been loosely regulated. However, in 2004, the Swedish regulator introduced a new *ex-post* regulatory model – i.e., the "Performance Assessment Model," which is aimed at improving efficiencies within the sector. A new regulatory model was also introduced in Finland in December 2004. These changes, particularly in Sweden, could lead to some pressure on tariffs although discussions are ongoing between companies and the Regulator.

The Polish regulatory environment is still in process of development. Tariff setting has traditionally been based on cost recovery, and further readjustments to tariffs are needed, but, over time, as tariff setting becomes more transparent and performance-based, this will lead to greater pressure on inefficient companies.

Financial Risk Factors

A STRONG FINANCIAL PROFILE ALLOWS SCOPE FOR FURTHER ACQUISITIONS AT THE CURRENT RATING LEVEL

Figure 3. Income

FY to 31 December	2001	2002	2003	2004
in SEKm				
Revenue	69,003	101,025	111,935	113,366
Change(%)	*117.7%*	*46.4%*	*10.8%*	*1.3%*
EBIT adjusted [1] [2]	9,940	14,335	14,741	19,875
Change(%)	*130.6%*	*44.2%*	*2.8%*	*34.8%*
EBIT margin	14.4%	14.2%	13.2%	17.5%
Interest Expense	(4,588)	(6,196)	(4,460)	(3,431)
Interest Income	1,880	2,363	1,162	1,030
Net Interest	(2,708)	(3,833)	(3,298)	(2,401)
Other Income/(Expenses)	770	(428)	942	(601)
Exceptionals	(56)	228	263	819
Income before Tax	7,454	9,987	12,360	17,359
Pre-Tax margin	*10.8%*	*9.9%*	*11.0%*	*15.3%*
Tax	(2,167)	(1,763)	(2,831)	(5,011)
Minority interests	(1,097)	(658)	(406)	(572)
Net Income	4,190	7,566	9,123	11,776

Source: Moody's, based on group accounts in accordance with Swedish GAAP.
[1] Not adjusted for operating lease rentals. More details in the FRA "Moody's Adjustments to Vattenfall's Accounts", May-2005.
[2] Including amortisation of negative goodwill, but excluding amortisation and impairment of positive goodwill.

FURTHER IMPROVEMENTS IN OPERATING PROFIT ARE EXPECTED, ALTHOUGH THESE WILL LIKELY BE MORE CONTAINED AFTER THE STRONG INCREASE RECORDED IN 2004

In 2004, Vattenfall reported a strong improvement in operating profit, despite a modest 1.3% rise in revenue. Weaker prices constrained revenue, but this was offset by higher generation volumes (167.1 TW, up 7.3%). After adjusting for dissolution of negative goodwill (SEK4.8 billion circa in 2004 vs. SEK3.0 billion in 2003), one-off items affecting comparability and the contribution from associates, operating profit rose SEK5.1 billion to SEK19.9 billion. A more favourable generation mix also helped, as low-cost hydro and nuclear power output rose while thermal generation decreased. In addition, operating profit benefited from a lower operating cost base as initiatives undertaken in Germany and Poland continued to bear fruit. In 2004, Vattenfall achieved savings in annualised operating expenses of SEK4.7 billion (519 million) in Germany, while headcount reduction initiatives in Poland have also produced cost savings. All of which contributed to the strong group operating profit performance. Moody's expects operating profit to remain strong also in 2005, although any improvement upon 2004 is expected to be more contained.

Q1-2005 RESULTS CONFIRM STRONG PROFIT UPTREND IN GERMANY AND POLAND

During the first quarter of 2005, Vattenfall benefited from the continuation of some of the trends that occurred in 2004. Revenue rose by circa 10% (compared to the first quarter of Q1 2004) to SEK35 billion and operating profit (excluding items affecting comparability) rose 15.8% to SEK9.2 billion. In particular, the performance in Germany was strong, driving sales (+23.6%) and operating profit growth (+43.4%) thanks to higher market prices and continued cost saving initiatives. Sales (+14.8%) and operating profit (17.6%) continued to grow strongly also in Poland helped mainly by exchange rate effects. Operating performance in the Nordic region was relatively stable with regard to sales (+1.6%) and operating profit (-0.3%) as improvements in generation and supply were offset by the costs of a storm at the beginning of January which affected the distribution business. During the first quarter, this event accounted for approximately SEK400 million of charges against Nordic profits.

Vattenfall has in place a hedging programme that should lessen the impact of adverse movements in market prices (which appeared relatively stable at the beginning of 2005), while the continued focus on cost-cutting measures should provide further support to profit margins. Moody's does not expect the closure of the Barsebäck 2 nuclear reactor to have any material adverse financial impact on either Vattenfall's profitability or cash flow, as the government is expected to fully compensate Vattenfall for costs related to the closure.

FREE CASH FLOW PERFORMANCE WILL REMAIN SOLID

The strong performance in operating profit fed through to operating cash flow, which allowed Vattenfall to improve free cash flow generation after the dividend increase (paid in 2004) and investment activity.

Over the next 2 to 3 years, capital spending requirements will be somewhat above the 2004 level as Vattenfall's multi-year investment programme gets under way. Over the 2005-2007 period, some SEK40 billion are projected for investments (excluding acquisitions) of which SEK 30 billion for maintenance capex. However, operating cash flow is expected to exceed investment and dividend requirements (assuming 1/3 dividend pay-out), resulting in solid free cash flow generation.

CREDIT PROTECTION MEASURES HAVE STRENGTHENED, GIVING INCREASING FINANCIAL FLEXIBILITY

Thanks to the debt reduction activity of the past two years, credit metrics have improved substantially.

In 2004, total financial debt declined by SEK12.5 billion to SEK73 billion as Vattenfall applied free cash flow to debt reduction. Also during Q1 2005 total financial debt continued to be reduced, with SEK71.4 billion reported at the end of March; although this is likely to rise in the second quarter following the (approximately) SEK10.2 billion payable for the acquisition in Denmark.

Recent hybrid issuance

Vattenfall Treasury AB (under the guarantee of Vattenfall AB) recently issued a €1 billion capital securities debt instrument which is rated Baa1 positive outlook by Moody's, two notches below the senior unsecured rating, given its deeply subordinated nature. This hybrid instrument has certain features which make it more equity-like, and includes amongst other things (i) a perpetual maturity with replacement language to cover all calls, (including those for regulatory, tax, and accounting purposes), which indicates Vattenfall's intent to replace this instrument with a similar or more equity-like instrument in case of a call, (ii) mandatory deferral (non-cumulative) of the coupon tied to the breach of a meaningful pre-determined financial trigger, and (iii) a ranking of most junior subordinated debt instrument in the capital structure, with limited creditor rights or events of default (Vattenfall has also indicated its intent not to issue any more junior instrument). Based on these features, this instrument is classified as basket D in terms of equity replication by Moody's. As such 25% of the instrument will be calculated as debt and 75% as equity in future calculation of financial ratios and therefore adds to this company's financial flexibility.[6]

Considering the group financial leverage at the end of 2004 and expectations of solid free cash flow generation for the next couple of years, Moody's concludes that the company's financial flexibility is increasing at the current rating level. However, Moody's notes that Vattenfall has always made clear that it would consider further acquisition opportunities in Europe. When assessing the credit profile of the group, Moody's views Vattenfall's increasing financial flexibility as a balancing factor to its acquisition strategy.

Figure 4. Cash flow

FY to 31 December in SEKm	2001	2002	2003	2004
Gross Cash from Operations [1]	14,315	25,010	24,479	29,382
Change(%)	59.5%	74.7%	-2.1%	20.0%
Interest paid	(4,468)	(5,822)	(4,467)	(3,693)
Interest received	1,827	2,239	1,423	1,256
Tax Paid	(2,905)	(1,635)	(3,244)	(2,972)
Dividend rec'd & other	1,673	311	0	0
Cash Flow from Operations [2]	10,442	20,103	18,191	23,973
Change(%)	105%	93%	-10%	32%
Dividend	(1,784)	(1,364)	(1,937)	(2,600)
Retained Cash Flow [2]	8,658	18,739	16,254	21,373
Net Capital Expenditure	(5,745)	(10,170)	(7,420)	(9,262)
Free Funds	2,913	8,569	8,834	12,111
Net Investments	(37,535)	(25,388)	(930)	(1,239)
Cash Flow before Financing	(34,622)	(16,819)	7,904	10,872

Source: Moody's
[1] Including working capital cash flows.
[2] Not adjusted for operating lease rentals and interest expense capitalised.

6. see "Refinements to Moody's Tool Kit: Evolutionary, not Revolutionary!", February 2005

Figure 5. Financial leverage [1]

FY to 31 December in SEKm	2001	2002	2003	2004
Short-term Debt	30,113	27,582	15,702	8,894
Long-term Debt	58,420	67,158	69,845	64,119
Total Financial Debt	88,533	94,740	85,547	73,013
Total Debt Adjusted [2]	104,006	113,365	103,255	92,582
Cash and Marketable Securities [3]	6,744	11,877	11,052	9,800
Net Debt Adjusted	97,261	101,488	92,203	82,781
Equity	39,578	45,128	52,506	62,316
Total Assets	259,043	276,276	264,966	256,915
EBIT Margin	10.0%	10.3%	8.9%	14.9%
Adjusted RCF / Net Adjusted Debt	9.4%	19.0%	18.1%	26.8%
Adjusted FFO Interest Coverage	3.2x	4.2x	5.0x	7.9x
Adjusted RCF / Capex+ Investments (net of disposals)	19.0%	54.8%	161.1%	182.7%
EBIT Gross Interest Coverage	1.9x	2.1x	2.4x	5.1x
Adjusted FFO/Net Adjusted Debt	11.2%	20.4%	20.2%	30.0%

[1] Leverage ratios as defined in "Moody's Basic Definitions for Credit Statistics, User's Guide, June 4, 2003".
[2] Adjusted for "debt-like" liabilities.
[3] Net of any restricted cash or securities.
Source: Moody's

Moody's uses Vattenfall's group debt capital ratio in some calculations to estimate a relevant amount of pension, nuclear and mining obligations to be included in the necessary adjustments, in addition to adjustments for operating leases. For Moody's approach, please refer to Moody's Rating Methodology entitled "Moody's Approach to Analysing Pension Obligations of Corporations," November 1998.

LIQUIDITY PROFILE REMAINS HEALTHY

The company has a healthy liquidity profile due to its strong cash flow, and strong position in cash and marketable securities (for more details, see Vattenfall's Liquidity Risk Assessment).

Dependence Factors

Vattenfall's A2 senior unsecured ratings factor a *low degree of dependence* because of the high degree of geographical diversification in the revenue base – with European operations contributing over half of revenues at the group level – and hence lower linkage than is normally seen for a utility between its performance and the country's (Sweden's) overall economic performance.

Support Factors

Vattenfall's A2 senior unsecured ratings incorporate a *medium degree of support* reflecting 100% state ownership and the strategic importance of Vattenfall within Sweden, at the same time acknowledging the state's determinedly non-interventionist stance.

OWNERSHIP BY THE STATE

Vattenfall AB is a public limited company that is 100% owned by the Swedish State (Aaa, stable outlook.) The Swedish State exercises long-term active ownership and administration over the company; nonetheless, it has value creation as a paramount goal for Vattenfall. (This objective applies to all those state-owned companies such as Vattenfall which are exposed to competition. The state distinguishes between such companies and state-owned companies which primarily have special societal interests to fulfil.)[7] To this end, the state establishes market requirements on profits and returns based on the risk profile of the company.

7. *Please also refer to the "State Ownership Policy 2004" of the Ministry of Industry, Employment and Communications in Stockholm*

Currently, there appears to be no political will to privatise Vattenfall, although the subject has been raised periodically. Given the trend towards privatisation within Europe, Moody's believes that privatisation may be a possibility over the medium-to-long term. However, no such plan has materialised in the past, nor appears likely at the moment.

Moody's believes that the Swedish Government, given its market-orientated stance, is adamantly non-interventionist, and the authorities would hesitate to intervene in support of partially or even fully state-owned companies except in the most extreme circumstances, such as when the firm controls key strategic assets. This could be applied in the case of Vattenfall, which, given its size and importance, is a "flagship company" in Sweden with control over key nuclear and hydrological generating assets as well as sizeable parts of the network infrastructure.

Related Research

Analysis:

Fortum Oyj, March 2004 (81739)

E.ON AG, May 2004 (87187)

RWE AG, June 2005 (93019)

Financial Reporting Assessment:

Moody's Adjustments to Vattenfall's Accounts, May 2005 (92687)

Industry Outlook:

European Gas, February 2004 (81160)

European Utilities, November 2003 (80100)

Rating Methodology:

Rating Methodology: Global Regulated Electric Utilities (91730)

Refinements to Moody's Tool Kit: Evolutionary, not Revolutionary!, February 2005 (91696)

Special Comment:

Rating Government-Related Issuers in European Corporate Finance (Addendum), June 2005 (93159)

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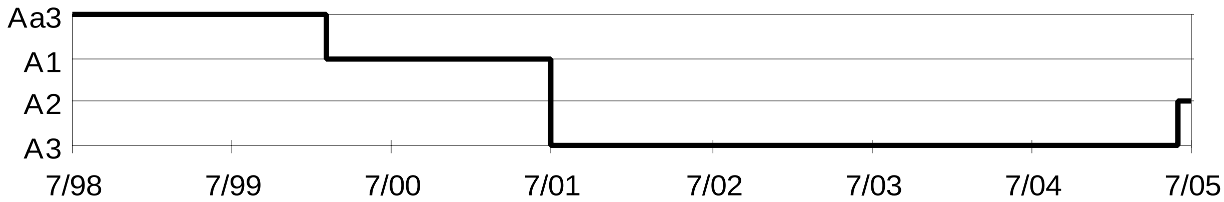

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