



Moody's Investors Service

Credit Opinion: [Vattenfall AB](#)

Global Credit Research - 16 Dec 2009

Stockholm, Sweden

Ratings

Category	Moody's Rating
Outlook	Stable
Issuer Rating	A2
Senior Unsecured	A2
Subordinate MTN	A3
Nuon Power Generation BV	
Outlook	Rating(s) Under Review
Issuer Rating	*A3
Vattenfall Treasury AB	
Outlook	Stable
Bkd Senior Unsecured	A2
Bkd Subordinate MTN	A3
Bkd Commercial Paper	P-1

* Placed under review for possible downgrade on February 27, 2009

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Key Indicators

Vattenfall AB

	2006	2007	2008
FFO Interest Coverage	10.0x	9.3x	7.1x
FFO/ Net Debt	52.0%	53.6%	37.2%
RCF/ Net Debt	42.8%	40.7%	27.5%
FCF/Net Debt	19.1%	9.5%	-2.7%
RCF/ (Capex + Acquisitions - Divestures)	169.6%	132.6%	55.9%
EBITDA margin	30.9%	31.3%	26.7%

Note: For definitions of Moody's most common ratio terms please see the accompanying [User's Guide](#).

Opinion

Corporate Profile

Vattenfall AB (Vattenfall, A2/stable), a 100% Swedish state-owned company, is the largest utility in the Nordic sector, as well as the third-largest electricity producer in Germany. It is active in all aspects of the electricity chain, as well as district heating.

In March 2009, the company made an offer to acquire 100% of Nuon NV's generation and supply operations. The transaction involves a two-step process: first, Vattenfall acquired 49% of Nuon's generation and supply activities (for EUR4.8 billion) on 1 July 2009; second, Vattenfall will acquire the remaining 51% of the shares after two, four and six years under fixed terms for an overall consideration of EUR5.03 billion. Vattenfall consolidates Nuon as of 1 July 2009 from which date it also has operational control.

STRATEGY

Management's strategy aims to develop Vattenfall as a leading European energy company, with a top 3 position among electricity producers in terms of clean electricity generation in Europe. The acquisition of Nuon's commercial activities is consistent with this strategy. Whilst the company intends to remain vertically integrated along the value chain, its main focus remains on generation activities, with the specific long-term objective of investing primarily in sustainable energy sources.

However, in light of difficult market conditions, Vattenfall is now focused on consolidation of its recent acquisition and key capital expenditure. Vattenfall has adjusted downwards its five-year investment plan for 2009-13 in light of more difficult market conditions to SEK210 billion (including SEK40 billion for Nuon) from an original SEK190 billion (excluding Nuon). The largest portion of these investments will be used to strengthen Vattenfall's generation capacity. This will take the form of new power plants and the refurbishment of existing plants to reduce carbon dioxide (CO₂) emissions, as well as nuclear capacity upgrades and lifetime extensions of generation assets in Sweden and Germany.

Vattenfall also plans some divestments, in the German and Nordic regions which are estimated to generate around EUR1.5 billion of cash proceeds. The potential disposal of Vattenfall's German transmission grid is likely to be the biggest contributor. Moody's estimates that most of these disposals will take place in 2010.

Rating Rationale

Vattenfall is classified by Moody's as a Government Related Issuer (GRI), given its 100% ownership by the Swedish government. On application of the GRI methodology, the A2 long-term issuer ratings of Vattenfall incorporate a one-notch uplift for potential state support. The rating includes the following factors:

- Baseline Credit Assessment (BCA): 7 (on a scale of 1 to 21, where 1 represents lowest credit risk; a 7 is equivalent to an A3 rating), which is based upon Moody's application of its Methodology for Unregulated Utilities, as set out below;
- Local currency rating of the Swedish government: Aaa/stable;
- Dependence: Low in light of the high degree of geographic diversification in the revenue base and, hence, a lower linkage than is normally seen for a utility between its performance and the country's (Sweden's) overall economic performance.
- Support: Medium, reflecting its 100% ownership by the Swedish state and the strategic importance of Vattenfall within Sweden, at the same time acknowledging the state's determinedly non-interventionist stance. Moody's believes that the authorities would hesitate to intervene except in the most extreme circumstances, such as when the firm controls key strategic assets (Vattenfall controls key nuclear and hydrological generating assets as well as sizeable parts of the network infrastructure). The Swedish state exercises long-term active ownership over the company and views value creation as a paramount goal for Vattenfall. To this end, the state establishes market requirements on profits and returns based on the risk profile of the company.

Moody's applies its rating methodology for Unregulated Utilities and Power Companies (August 2009) to Vattenfall. Based on the historic financial profile, the grid output for Vattenfall indicates a BCA of 5 (equivalent to an A1 rating), as summarised and described in the grid and paragraphs below. However, Moody's assigns a BCA of 7 (equivalent to an A3 rating) because the grid is based on average three-year historic financial metrics, which were very strong due to high power prices and a lack of acquisition opportunities. The rating is, however, forward looking, reflecting the fact that, following the Nuon acquisition and in a softer power price environment, these financial metrics will weaken.

KEY RATING FACTORS

FACTOR 1 - MARKET ASSESSMENT, SCALE AND COMPETITIVE POSITION

SIZE AND SCALE

As at 30 September 2009, Vattenfall had assets of SEK649 billion (e.g. EUR59 billion). This places it in the Aa category, as a large supra-regional with its strong positions in Northern Europe. There are no other companies in this category. Vattenfall ranks after the biggest utilities in EMEA, such as E.ON (A2/stable), Enel (A2/negative), Iberdrola (A3/stable) and EDF (Aa3/stable), but before Fortum (A2/stable), EnBW (A2/Under Review for Downgrade) and EDP (A3/stable).

COMPETITIVE POSITION AND MARKET STRUCTURE

Vattenfall scores A on this factor, reflecting its strong market positions in the Nordic and North European regions (Germany in particular), but also recognising the competitive and open nature of these markets.

Vattenfall is the largest power (electricity and heat) generator in the Nordic region, with 18.6 GW of installed capacity. It has a market share of around 20% in electricity generation. In the Nordic area, four major players control around 50% of the market (Vattenfall, Fortum, Statkraft and E.ON).

Vattenfall also has a strong position in the German market, with around a 12% share, similar to EnBW; together, they rank third in terms of size, after E.ON and RWE.

Following the acquisition of Nuon, Vattenfall, in terms of installed capacity is the third largest generator in the Dutch market. In the Polish market, heat production and heat sales are the largest part of its operations, where Vattenfall has a market share of approximately 12%.

FACTOR 2 - CASH FLOW PREDICTABILITY OF BUSINESS MODEL

FUEL MIX AND STRATEGY

Vattenfall scores A on this factor, although it is expected to shift into Aa as it continues with its investment strategy focused on renewables. As of the end of 2008, around 50% of its generation was from hydro, nuclear and other non-fossil fuel sources (23% hydro, 25.3% nuclear, 1.1% wind, 0.5% biofuels and waste). However, with the addition of Nuon, with its mainly gas-fired portfolio, this contribution is likely to drop slightly. Nonetheless, Vattenfall has an overall well-balanced portfolio.

DEGREE OF INTEGRATION AND HEDGING STRATEGY

In this category, Vattenfall scores Baa. We consider Vattenfall's "long" position in generation in both the Nordic and German region vis its supply business (around 60-70% of production is sold to end-customers, the balance on the wholesale market), however noting that Vattenfall benefits from low-cost baseload generation assets in its major markets hence high load factors with access to the liquid Nord Pool and EEX electricity exchanges which are the primary outlets for wholesale generation.

Overall, supply activities remain very low-margin in the Nordic and German regions, although they provide some hedge to generation activities. A retail business has in any event more limited benefits in terms of margin protection, in a very transparent and competitive market such as the Nord Pool, than in some other European markets.

Additionally Moody's notes that Vattenfall has an active and prudent hedging programme through both the Nord Pool and EEX, which mitigates the impact of short-term price movements, in particular this is important in the somewhat volatile hydro-driven Nord Pool. As of September 2009, Vattenfall had sold forward 80% of electricity generation for 2009, 70% in 2010 and over 40% for 2011; for Central Europe, the hedges for the comparable periods were 90%, 70% and over 20%; and for Benelux, 100%, over 90% and over 50%, respectively.

CAPITAL REQUIREMENTS AND OPERATIONAL PERFORMANCE

In line with most of its European peers, Vattenfall has significant capex requirements in the next few years. However, the recent trimming of its capex budget, such that estimated annual capex is, on average, SEK42 billion (SEK210 billion over the five-year period 2009-13), or around 14% with respect to its current net property, plant and equipment (SEK 311 billion as of 30.9.2009) position, placing it in the Ba category. Further details of Vattenfall's investment plan, in line with its strategic objectives, are provided under "Strategy".

CONTRIBUTION OF HIGH/LOW RISK BUSINESSES

Vattenfall scores in the Aa category on this factor, as it has a contribution of between 25- 30% of EBITDA from regulated/low risk businesses (Moody's includes network and district heating businesses in this category), although this could decrease further over time, moving the score towards A.

Vattenfall maintains strong market positions in regulated networks and the district heating businesses. It is the second-largest network operator in the Nordic region, the third-largest transmission operator and the fourth-largest distribution system operator in Germany, while it has the largest district heating business in the region. District heating is not a regulated business, but it has quasi-monopoly characteristics given the high barriers to entry and long-term contracts.

The profit contribution from the distribution and heat businesses in Poland is still relatively small, although Moody's regards this regulatory environment as slightly more risky (compared with Western Europe), as it is still in the process of development.

FACTOR 3 - FINANCIAL POLICY

Vattenfall has demonstrated a balanced financial policy for the past several years between shareholder and bondholder interests and scores Baa, in line with the majority of the unregulated power utilities in Europe. Vattenfall's financial targets include cash flow interest coverage (after maintenance investments) between 3.5-4.5x and ROE of 15%. The dividend policy payout ratio is between 40% and 60%. For a number of years, Vattenfall has maintained the target of a long-term rating in the A category. In assigning a Baa score, Moody's also factors in Vattenfall's willingness to pursue strategic growth through capex and acquisitions, although notes that the company is now pursuing a policy of consolidation following the Nuon acquisition and in light of more difficult market conditions.

FACTOR 4 -- FINANCIAL STRENGTH METRICS

Following the Nuon acquisition, Moody's expects the company to be somewhat weakly positioned in this category as existing hedges roll off. Furthermore, the company may continue to suffer from restrained demand in the Nordic sector. Vattenfall expects the German sector to rebound more quickly.

The first nine months of 2009 reflected a much weaker financial profile than 2008, due to both the Nuon acquisition and a weaker operating environment. Vattenfall's debt increased substantially, primarily due to the acquisition of Nuon. Unadjusted total debt and net debt at the end of Q3 rose to SEK218.8 billion and SEK157.3 billion from SEK107 billion and SEK66 billion, respectively, at the end of 2008, the recent debt numbers include SEK51 billion of debt liabilities to minorities, representing the 51% of Nuon still owned by the current Dutch municipal shareholders but that will be acquired by Vattenfall in due course. Reported FFO for the first nine months of 2009 was SEK25.3 billion, with reported FFO to net debt at 23%. Investments in Q3 were SEK68.5 billion, including the Nuon acquisition, (SEK85.4 billion to date for 2009).

In recent years, Vattenfall had demonstrated very strong metrics for its rating profile (FFO/net debt and RCF/net debt of 37.2% and 27.5%, respectively, in 2008). Moody's currently sets the following parameters for the current rating category: RCF/net debt of 15-19% and FFO/net debt in the 20s. Vattenfall should ensure a solid positioning within these ranges to maintain a comfortable positioning within the rating category.

Following the Nuon acquisition, Moody's expects the company to be somewhat weakly positioned for its rating, as the company may continue to suffer from restrained demand in the Nordic sector. Vattenfall however expects the German sector to rebound more quickly.

Moody's notes, however, that the company is very aware of the fragile market conditions and is taking measures to find capex and operating efficiencies, as well as around an expected EUR1.5 billion of divestments to defend its financial profile.

Liquidity

Vattenfall has a good liquidity position due to strong cash flow and significant liquid assets, as well as ample back-up lines. At Q3

2009, Vattenfall had SEK18.7 billion (around EUR1.8 billion) of available cash and cash equivalents and SEK41.2 billion (EUR4 billion) of short-term investments, totalling SEK60 billion, of which SEK37.8 billion (EUR3.7 billion) is fully available. The company also has a EUR1 billion committed revolving credit facility, syndicated with 12 banks, which matures in 2013. Drawings under the facility are subject to representations that no adverse change in the group's financial condition has occurred. In addition, the company has a SEK100 million overdraft facility. Moody's estimates that cash from operations in the following 12 months will be around SEK40 billion. This will be applied to capex for the next 12 months which is expected to be in the region of SEK40 billion or more, debt repayments which are expected to total SEK6.9 billion in FY 2010. and dividend payments.

Rating Outlook

The outlook is stable. Moody's notes that the company is likely to be positioned at the low end of the rating category level in the near term, but notes that the company has taken measures to defend its financial profile. However, if the company fails to demonstrate that it can comfortably move back within its rating band, then negative pressure is likely to develop.

What Could Change the Rating - Up

Moody's notes that positive pressure is unlikely to develop in the near term, given Vattenfall's current financial profile, its recent Nuon acquisition, its substantial investment strategy and its long-term strategy to continue to grow its operations. Moody's notes that the company's financial flexibility has somewhat reduced following the transaction, but planned divestments should help ease the situation.

What Could Change the Rating - Down

Vattenfall is currently positioned at the low end of the current rating category. Should ratios deteriorate beyond the bands indicated for any extended period, then downward pressure could occur. This could result from sustained lower prices and volumes, or an increase in its investment plans.

In addition to the factors listed above affecting the BCA, the ratings may also be affected by changes in the ratings of the supporting government, or by changes in Moody's assessment of default dependence and support described in the rating rationale, none of which are foreseeable in the medium term.

Rating Factors

Vattenfall AB

Global Unregulated Utilities	Aaa	Aa	A	Baa	Ba	B	Caa
Factor 1: Market assessment, scale and competitive position (25%)							
a) Size and scale		x					
b) Competitive position and market structure			x				
Factor 2: Cash flow predictability of business model (25%)							
a) Fuel strategy and mix			x				
b) Degree of integration and hedging strategy				x			
c) Capital requirements and operational performance					x		
d) Contribution from low-risk/high risk businesses		x					
Factor 3: Financial policy (10%)							
Financial Policy				x			
Factor 4: Financial strength metrics (40%) *							
a) FFO / Interest			8.6x				
b) FFO / Net Debt		46.5%					
c) RCF / Net Debt		36.0%					
d) FCF /Net Debt				7.6%			
Rating:							
a) Indicated BCA from Methodology			A1				
b) Actual BCA Assigned			7				

* 3 year average historicals

Government Related Issuer	Factor
a) Baseline Credit Assessment	7
b) Government Local Currency Rating	Aaa
c) Default Dependence	Low
d) Support	Medium



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