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Research Update:

Vattenfall AB Lowered To 'A-/A-2' On Increasingly Difficult Operating Conditions; Outlook Stable

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Overview

- In our view, Vattenfall's business risk profile has weakened slightly, owing to an increasingly difficult and volatile industry environment and ongoing pressure on profitability and operating cash flows.
- We believe these factors are also negatively affecting Vattenfall's financial risk profile, which we now view as "significant" as opposed to "intermediate" previously, as our criteria define these terms.
- We are lowering our ratings on Vattenfall to 'A-/A-2' from 'A/A-1'.
- The outlook is stable, based on our expectation that Vattenfall's key credit measures will remain commensurate with the 'A-/A-2' ratings in the near term.

Rating Action

On Dec. 9, 2011, Standard & Poor's Ratings Services lowered its long- and short-term corporate credit ratings on Sweden-based utility Vattenfall AB to 'A-/A-2' from 'A/A-1'. We also lowered the rating on Vattenfall's subordinated capital securities debt issue to 'BBB-' from 'BBB'. The outlook is stable.

Rationale

The downgrade reflects our view that Vattenfall's business risk profile has weakened slightly as a result of an increasingly difficult and volatile industry environment, ongoing pressure on the group's profitability and operating cash flows, and a gradually declining share of more stable income from regulated activities following disposals. We believe these factors are also negatively affecting Vattenfall's financial risk profile, which we have revised to "significant" from "intermediate", as our criteria define these terms. As we do not believe that Vattenfall's financial risk profile and credit measures will improve to a level commensurate with an 'a-' stand-alone credit profile (SACP) in the near to medium term, we have consequently revised the SACP to 'bbb+' from 'a-'. Our 'A-' long-term rating on Vattenfall is one notch above the SACP, based on our expectation that there is a "moderate" likelihood that the company would receive support from its owner, the Kingdom of Sweden (AAA/Stable/A-1+), in a financial stress scenario.

We believe that Vattenfall faces an increasingly complex, volatile, and uncertain operating environment, exacerbated by rising regulatory uncertainty and weakening macroeconomic conditions. We anticipate that Vattenfall's

profitability is likely to be constrained by sluggish demand and falling and increasingly volatile power prices, as seen in 2011. We also anticipate that the Nordic region could generate a possibly chronic oversupply of power over the medium term. Vattenfall furthermore continues to have low availability in its nuclear power plants, owing to prolonged outages in Sweden and the decision by the German state to close nuclear plants in Germany. These factors are likely to put pressure on the group's operating earnings and cash flows over the near and medium term, in our view, despite the group's ongoing cost rationalization program. We also assume that the completion of asset disposals, notably the Polish distribution and heat businesses, will reduce earnings in the near term.

Lower earnings are also likely to reduce the group's funds from operations (FFO) in the near term, in our view. Proceeds from divestments should support a reduction in adjusted debt in the near term, but are likely to be partly offset by continued high investments and dividend payouts. Nevertheless, we believe that investments over the next few years will be clearly lower than the 2010 outflows of Swedish krona (SEK) 40 billion (about €4.4 billion).

For the 12 months ended Sept. 30, 2011, Vattenfall's adjusted FFO to debt was about 21%, which is in line with our base-case forecasts over the near to medium term. This is based on our expectations that anticipated debt reduction is not likely to offset lower operating cash flows in the near to medium term. We believe that this level of credit measures, alongside higher volatility in earnings and a declining share of income from regulated activities, are more commensurate with a "significant" financial risk profile, rather than "intermediate".

The ratings on Vattenfall continue to reflect our view of its strong and diverse position in the northern European electricity and heat markets and competitive electricity generation portfolio in Sweden and, to some extent, in Central Europe. We consider these strengths balanced by Vattenfall's exposure to volatile wholesale power prices, its weak track record as a nuclear operator, and the high carbon intensity of the non-Nordic part of Vattenfall's electricity generation fleet. A further constraint on the ratings, in our view, is Vattenfall's "significant" financial risk profile.

Our 'A-' long-term rating on Vattenfall is based on our assessment of the company's 'bbb+' SACP, as well as our view that there is a "moderate" likelihood that the owner, the government of the Kingdom of Sweden, would provide timely and sufficient extraordinary support to Vattenfall in the event of financial distress. This is based on Vattenfall's:

- "Strong" link with the Swedish government, given the group's 100% state ownership through the Ministry of Finance, and the government's influence on high-level strategic decision-making; and
- "Limited" role, given the group's strong, but not dominant, market position in Sweden, increasing exposure to non-Nordic markets, and its operations in a fully liberalized electricity market, such that it could conceivably be replaced by a private-sector entity or another GRE.

Liquidity

The short-term rating is 'A-2'. We have revised the group's liquidity position to "strong" from "adequate". This is based on our expectations that the group will maintain liquidity sources of above 1.5x of liquidity uses in the near term. We further believe that Vattenfall has a solid relationship with banks, a high standing in credit markets, and prudent risk management.

As of Sept. 30, 2011, the group's liquidity was supported by:

- Available cash and short-term investments of SEK26.3 billion;
- Access to unused long-term committed credit facilities of about SEK33 billion, consisting of a €1 billion (about SEK9.3 billion) credit facility maturing in February 2013 and a €2.55 billion (SEK 23.6 billion) credit facility maturing January 2016. In addition, Vattenfall has signed a multi-option credit facility of €1.3 billion (SEK9.3 billion) on a rolling 12-months basis until further notice. We understand that these facilities do not contain any onerous financial covenants;
- Funds from operations of SEK39.8 billion for the last 12 months ended Sept. 30, 2011. However, we anticipate that FFO will be lower in the near term; and
- Proceeds from divestments from sale of Polish and Belgian assets, with expected proceeds of about SEK16.6 billion.

This compares with expected outflows of:

- SEK17 billion of reported short-term debt as of the same date, although part of this is related to collateral for margin calls and may not materialize;
- Expected annual capital expenditures of approximately SEK30 billion (based on company indications of SEK150 billion-SEK155 billion over a five-year period), which we believe could be scaled back or partly postponed if needed; and
- Dividend payments, which were SEK6.7 billion in 2011.

Outlook

The stable outlook reflects our expectations that Vattenfall's own efficiency measures will mitigate pressure on profitability from falling power prices. It further reflects our expectations that Vattenfall's investments will decrease in the near term and average about SEK30 billion annually over the next few years. Based on these factors, combined with proceeds from asset disposals, which we believe Vattenfall will use to reduce adjusted debt, we anticipate that Vattenfall should be able to maintain credit measures in line with the ratings, including adjusted FFO to debt of about 20%.

We could lower the ratings if Vattenfall's operating and/or financial performance significantly weakens from current levels, leading to a negative impact on credit measures, such as a sustained decline in adjusted FFO to debt below 20%. This could be a result of weaker-than-expected power price developments, internal operational underperformance related to prolonged outages in nuclear plants, a lack of further progress with cost efficiencies,

or poor returns on new investments. Should such a development also cause us to further revise the group's business risk profile, we could also review current credit measures we view as appropriate for the ratings.

We could also lower the ratings is if we see evidence of government support weakening. This would most likely be as a result of a privatization of a significant part of the government's shareholding in Vattenfall. Nevertheless, we currently deem this unlikely over the near to medium term.

We could raise the ratings if we believed that Vattenfall's financial risk profile and credit measures could improve sustainably to a level commensurate with a one notch higher SACP, for example through an sustainable increase in adjusted FFO to debt to about 25%, based on the existing business risk profile. Such an improvement could be a result of sustainably higher power prices supported by an improved demand-and-supply situation, or a significantly higher availability of nuclear plants (although this could have a reverse impact on power prices).

We could also raise the ratings by one notch if we saw evidence of strengthened government support, leading us to revise upward our assessment of the likelihood of government support for Vattenfall.

Related Criteria And Research

- Rating Government-Related Entities: Methodology And Assumptions, Dec. 9, 2010
- Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Sept. 28, 2011
- Use of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria Methodology: Business Risk/Financial Risk Matrix Expanded, May 27, 2009
- 2008 Corporate Criteria: Analytical Methodology, April 15, 2008
- 2008 Corporate Criteria: Ratios And Adjustments, April 15, 2008
- Understanding Standard & Poor's Rating Definitions, June 3, 2009
- Principles Of Credit Ratings, Feb. 16, 2011

Ratings List

Downgraded; CreditWatch/Outlook Action

| | To | From |
|-------------------------|---------------|----------------|
| Vattenfall AB | | |
| Corporate Credit Rating | A-/Stable/A-2 | A/Negative/A-1 |
| Senior Unsecured | A- | A |
| Subordinated | BBB- | BBB |
| Commercial Paper | A-2 | A-1 |

Ratings Affirmed

Vattenfall AB

Nordic scale short-term rating K-1

Additional Contact:

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Complete ratings information is available to subscribers of RatingsDirect on the Global Credit Portal at www.globalcreditportal.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following Standard & Poor's numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

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