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Summary:
Vattenfall AB

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Table Of Contents

Rationale

Outlook

Summary:

Vattenfall AB

Credit Rating: A-/Stable/A-2

Rationale

The ratings on Sweden-based utility Vattenfall AB reflect its strong, vertically integrated position in the north European electricity market, competitive generation portfolio, monopoly utility operations, and strong cash flow generation.

Negative rating factors include Vattenfall's exposure to competition and price volatility in power generation and risks related to nuclear and coal generation.

We do not currently factor any extraordinary support from Vattenfall's 100% owner, the Kingdom of Sweden, into the ratings. The Swedish government appears to have no plans for restructuring or major strategy changes. Taxation pressures on the company increased in 2008, however, to address windfall gains from carbon dioxide-free production sources, including nuclear and hydro power.

Vattenfall plans to invest about Swedish krona (SEK) 173 billion in the period 2008-2012, mainly in new power generation capacity, reinforcement of its electricity network, and life-time extensions of generation assets in Germany and the Nordic countries. Moreover, the company has embarked on significant renewables investments, mainly in wind power.

Vattenfall is expected to grow organically and through acquisitions--both in existing markets and in nearby geographic markets. By 2030, the company targets annual production of 390 terawatt-hours, corresponding to a market share of about 10% within the EU-27. More recently, the company has sought to establish a presence within the U.K. wind power market, by making selected acquisitions. In addition, Vattenfall has announced its intention (subject to certain conditions) to divest its German high-voltage power grid, which may reduce the company's overall regulatory risk.

Vattenfall reported strong earnings for the third quarter of 2008, reflecting good performance in its Nordic generation business, mainly based on higher achieved prices. Conversely, earnings in the company's Central Europe operations weakened compared with the previous year on higher prices for carbon dioxide allowances, reduced availability of coal-fired plants and continued standstill at two of the company's German nuclear power plants.

Vattenfall's credit protection measures remain strong, with funds from operations to debt (not fully adjusted) at about 31% for the 12 months ended Sept. 30, 2008. In the absence of major acquisitions and output shocks, this ratio should remain well above 20%, which is consistent with the 'A-' rating.

Short-term credit factors

The short-term rating is 'A-2'. We expect Vattenfall to have adequate internal liquidity over the short term, reflecting strong operating cash flows protected by hedging arrangements and significant access to alternative sources of liquidity. Although a significant proportion of Vattenfall's operations is in highly competitive and volatile markets, movements in spot power prices are unlikely to have a material negative effect on the company's liquidity

and financial performance over the short term as a result of hedging arrangements.

The company's adequate liquidity position is supported by:

- Reported cash and short-term investments of SEK27.9 billion, as at Sept. 30, 2008, of which SEK18.3 billion were available; compared with SEK30.7 billion of reported short-term debt and interest-bearing provisions;
- Access to unused committed credit facilities of SEK13.8 billion as at Sept. 30, 2008;
- Free operating cash flow of about SEK11.4 billion for the 12 months ended Sept. 30, 2008;
- Good access to public debt markets;
- An absence of rating triggers or onerous covenants in financing agreements; and
- A policy of maintaining the equivalent of 10% of turnover in cash or committed credit lines, or the equivalent of the next 90 days' debt maturities--whichever is greater.

Outlook

The stable outlook reflects our expectation that Vattenfall will continue its growth strategy, possibly through acquisitions, and increase capital expenditure over the medium term. This could weaken the financial profile from its current, strong level. However, we do not expect the company's ratio of funds from operations to debt to fall below 20%, a level consistent with the current rating, in the event of any large, debt-funded acquisitions. We expect Vattenfall to manage satisfactorily during a period of declining spot prices due to its hedging arrangements and its adequate financial profile.

Upside ratings potential is limited, given the company's growth objectives, which may result in financial headroom under the current rating being partly, or fully, exploited.

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