

### Summary:

## Vattenfall AB

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# Vattenfall AB

**Credit Rating:** A/Negative/A-1

## Rationale

The ratings on Swedish-based power utility Vattenfall AB reflect its strong position in the northern European electricity market, large and diverse operations, and competitive generation portfolio. In addition, Vattenfall generates stable cash flow from electricity distribution and district heating operations. Standard & Poor's Ratings Services considers these strengths to be balanced by Vattenfall's exposure to wholesale power prices and the high carbon intensity of the non-Nordic part of Vattenfall's electricity generation fleet, the latter of which results in exposure to rising costs from a tightening cap on carbon emissions in the EU (especially from 2013). A further constraint on the ratings, in our view, is Vattenfall's weakened financial risk profile following a €9.8 billion acquisition of N.V. Nuon Energy (Nuon; not rated) in 2009. In addition, we consider Vattenfall's Swedish krona (SEK) 165 billion (about €17.8 billion) capital-expenditure program (2011-2015)--which will be partly debt funded--to be aggressive.

Our 'A' long-term rating is based on Vattenfall's stand-alone credit profile, which we assess at 'a-', as well as on our opinion that there is a "moderate" likelihood that the government of the Kingdom of Sweden (AAA/Stable/A-1+) will provide timely and sufficient extraordinary support to Vattenfall in the event of financial distress.

In accordance with our criteria for government-related entities, our view of a "moderate" likelihood of extraordinary government support is based on our assessment of Vattenfall's:

- "Strong" link with the Swedish government, given the company's 100% state ownership and the government's influence on high-level strategic decision-making; and
- "Limited" role, given the company's strong, but not dominant, market position in Sweden, increasing exposure to non-Nordic markets, and its operations in a fully liberalized electricity market.

## Key business and profitability developments

Vattenfall's earnings in the first three quarters of 2010 were supported by higher production volumes, lower operating costs, a full contribution from Nuon, and the effect of higher average electricity prices in the Nordic region. However, lower dark and spark spreads (the theoretical gross margin in coal-fired and gas-fired electricity generation, respectively) in the group's European continent operations cancelled out these gains. Furthermore, operating availability in the group's otherwise profitable nuclear generation fleet remained poor in 2010--although we note that availability and, hence, production in its Swedish nuclear plants has increased in recent months.

We think Vattenfall's exposure to volatile wholesale power prices is mitigated by the group's prudent strategy of selling forward the bulk of its output. According to Vattenfall's interim third-quarter 2010 report, the group had sold forward 73% and 83%, respectively, of its 2011 expected Nordic and European continent output. And for 2012, it had sold forward 54% (Nordic output) and 40% (European continent output). However, locked-in prices that are lower than hedges currently expiring are likely to pressure Vattenfall's profitability over the medium term, in our view. Furthermore, from 2013, under Phase III of the ETS (European Trading System), all CO2 emission

allowances will be auctioned, which we think could weigh on Vattenfall's large electricity generation operations on the European continent. These generation assets are largely fossil-fuel based.

We will monitor the extent to which Vattenfall's management can offset the combined effects of spread compression, a sluggish recovery in demand, and rising CO<sub>2</sub> costs with the implementation of cost savings and efficiency improvements. For example, we note that Vattenfall recently launched a cost-cutting program aimed at reducing operating expenses by SEK6 billion annually. In addition, the company has indicated its intention to divest less-profitable assets in non-core markets.

### **Key cash flow and capital-structure developments**

The acquisition of Nuon significantly added to Vattenfall's debt burden, which, combined with continued weak profitability, has weakened the company's financial risk profile. Vattenfall paid about SEK52 billion to acquire an initial 49% stake in Nuon. It also consolidated about SEK49 billion, for the remaining 51%, as interest-bearing debt.

Although the adjusted funds from operations (FFO)-to-debt ratio recovered to about 21% in the 12-months ended Sept. 30, 2010 (compared with about 18% in the previous corresponding period), we believe that cash flow credit metrics will be pressured over the near term. This is likely to result from debt incurred as a result of high investment levels and pressure on profitability from falling generation margins. However, we understand that Vattenfall is looking to bolster cash flow further by reducing capital spending, improving operational effectiveness, and executing asset disposals such as the phased divestment of assets in noncore markets. These measures, we believe, will be critical to support Vattenfall's efforts to reduce debt and strengthen cash flow credit measures on a sustainable basis.

### **Short-term credit factors**

The short-term rating is 'A-1'. Our assessment of Vattenfall's "adequate" liquidity position is supported by available cash and short-term investments of SEK37.3 billion, as of Sept. 30, 2010. Vattenfall also had access to an unused €1 billion committed credit facility maturing in February 2013, which contains no rating triggers or onerous covenants. This compares with SEK15.8 billion of reported short-term debt and interest-bearing provisions, as of the same date.

Vattenfall has a policy of maintaining the equivalent of 10% of the company's turnover in cash or committed credit lines (currently equates to about SEK20 billion-SEK25 billion) or the equivalent of the next 90 days' debt maturities, whichever is greater. The company faces significant debt payments--including two SEK15 billion installments for Nuon--in 2011, totaling about SEK24 billion, and in 2013, totaling about SEK32 billion. Consequently, we believe these payments will need to be addressed in the coming years to reduce funding and refinancing risk. This is in addition to about SEK165 billion of planned investments in 2011-2015, which we understand are front loaded. The company expects to invest SEK45 billion in full-year 2010, SEK44 billion in 2011, and SEK33 billion in 2012. A portion of the investments in 2010 and 2011 are likely to be debt funded and will add to Vattenfall's already significant debt burden.

## **Outlook**

The negative outlook reflects Vattenfall's key credit measures, which are currently below our expectations for the ratings, and also our concern that the company could struggle to restore cash flow credit metrics over the near term. Our concern is based on a number of factors, including a high debt burden following the Nuon acquisition, a negative medium-term trend for forward power prices in key markets, margin pressure from rising environmental

costs, uncertainty with regards to the success and timeliness of disposals, and ongoing high investment levels.

We currently expect the FFO-to-debt ratio to gradually recover to almost 20% in 2011, after which it could strengthen to levels above our 20% threshold in 2012. We note, however, that execution risks--relating to cost cutting efforts, disposal programs, and improving nuclear availability--and general market uncertainty remain factors that could prevent a recovery in the company's key credit metrics.

We could lower the ratings by one notch if we believe Vattenfall is unlikely to make sufficient progress in 2011 toward a ratio of FFO to debt (adjusted) of more than 20%, and if it is unable to maintain that level on a sustainable basis afterwards. The ratings could come under further pressure if we see evidence of government support weakening. Similarly, if Vattenfall unexpectedly undertakes a material debt-financed acquisition, or expands its investment program from current levels, ratings downside could result.

Conversely, we could revise the outlook to stable if Vattenfall were to successfully implement its measures to restore its financial profile to a level that we consider commensurate with an 'a-' stand-alone credit profile.

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