

RESEARCH

Research Update:

Vattenfall AB Outlook Revised To Stable On Growing Regulatory And Political Pressure

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Rationale

On Sept. 6, 2006, Standard & Poor's Ratings Services revised its outlook on Sweden-based integrated power utility Vattenfall AB to stable from positive. At the same time, the 'A-' long-term and 'A-2' short-term corporate credit ratings on Vattenfall were affirmed.

The outlook revision reflects the increasing regulatory and political pressure in Vattenfall's main markets of Sweden and Germany. The company is also significantly stepping up its capital expenditure program over the medium term. At June 30, 2006, Vattenfall had Swedish krona (Skr) 69 billion (\$9.5 billion) in interest-bearing debt outstanding (including Skr9.1 billion in hybrid capital notes as debt).

Over the past year, several adverse regulatory and fiscal actions have affected Vattenfall. In Sweden, taxation on power generation has increased and electricity network distribution regulations have also become stricter. In 2006, the German network regulator imposed a decrease in transmission tariffs by almost 18%. Further adverse measures cannot be ruled out. As a fully state-owned utility, Vattenfall could also become subject to political actions such as potential restructuring of the company or major changes in strategy, or potential privatization.

Capital expenditures are also expected to increase over the medium term. By 2010, the company is planning to invest about Skr100 billion, mainly in new power generation capacity, reinforcement of its electricity network, and reinvestments.

Following the integration of its acquired German operations and the acquisition of Skr10 billion worth of Danish power generation assets in 2006, Vattenfall is expected to continue its growth strategy and to be acquisitive in its current markets and in neighboring Western European countries. The number of potential acquisition targets is likely to be limited and highly contested, however.

The ratings on Vattenfall reflect its strong vertically integrated position in the North European electricity market; a competitive generation portfolio; significant energy utility monopoly operations; and strong cash flow generation.

Negative factors include exposure to competition and price volatility in power generation; political risks related to nuclear and coal generation; and increasing regulatory pressure on monopoly network operations. The ratings do not factor in any support from Vattenfall's 100% owner, the Kingdom of Sweden.

Vattenfall's financial performance continues to be strong, with funds from operations to adjusted debt (treating Skr9.1 billion in hybrid capital notes as 50% debt and 50% equity) above 30% in 2005 and 2006. In the absence of major acquisitions and a continued strong wholesale power price development, this ratio is likely to stay above 30% over the medium term.

Short-term rating factors

Vattenfall's short-term rating is 'A-2'. The company is expected to have adequate internal liquidity over the short term, reflecting strong operating cash flow protected by hedging arrangements, and significant access to alternative sources of liquidity. Although much of Vattenfall's operations are in highly competitive and volatile markets, movements in sales prices and volumes are not expected to have a material negative impact on the company's liquidity and financial performance in the short term.

The adequate liquidity position is supported by:

- Cash and short-term investments at June 30, 2006 of about Skr14.7 billion, compared with Skr7.3 billion of short-term debt.

- Strong free operating cash flow (about Skr14.3 billion for 2005), reflecting solid profitability and moderate capital expenditure needs in the utility operations.
- Access to unused committed credit facilities of Skr9.4 billion at mid-year 2006. In February 2006, the company refinanced its €600 million revolving credit facility, at the same time increasing the amount to €1 billion. The new revolver matures in 2013, and the company has good access to public debt markets.
- The absence of rating triggers or onerous covenants in Vattenfall's financing agreements.
- Free operating cash flow is expected to remain at more than Skr10 billion per year, based on sustained operating profitability. Company policy is to maintain the equivalent of 10% of group 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 the increasing regulatory and political pressure in Vattenfall's main markets, which tempers prospects of continued improved credit quality from the current strong level. Such pressure has resulted in increasing demands by the shareholder, stricter regulation, and increased focus on environmental and energy policy objectives for the company. Further adverse political or regulatory actions cannot be ruled out at this stage.

The stable outlook also reflects Standard & Poor's expectation that Vattenfall will continue its growth strategy and to be acquisitive and to increase capital expenditures over the medium term. This could weaken the financial profile from its current strong level, but management is expected to avoid jeopardizing the company's objective of maintaining a credit rating in the 'A' category.

Ratings List

	To	From
Vattenfall AB		
Corporate credit rating	A-/Stable/A-2	A-/Positive/A-2
Senior unsecured debt	A-	

Vattenfall Treasury AB		
Senior unsecured debt*	A-	
CP*	A-2	
CP, Nordic national scale*	K-1	
*Guaranteed by Vattenfall AB		

NB: This list does not include all ratings affected.

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