

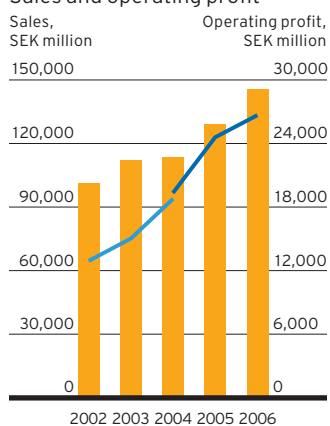
ANNUAL REPORT 2006

CREATING VALUE FOR THE FUTURE

# VATTENFALL AT A GLANCE

Vattenfall is Europe's fourth largest generator of electricity and the largest producer of heat. Consolidated sales in 2006 amounted to SEK 145,815 million. Vattenfall's vision is to be a leading European energy company. Operations today are conducted in Sweden, Denmark, Finland, Germany and Poland. Vattenfall works in all parts of the electricity value chain: generation, transmission, distribution and sales. Vattenfall also conducts energy trading and lignite mining, and produces, distributes and sells heat. The Group has slightly more than 32,000 employees, and the Parent Company, Vattenfall AB, is 100%-owned by the Swedish state.

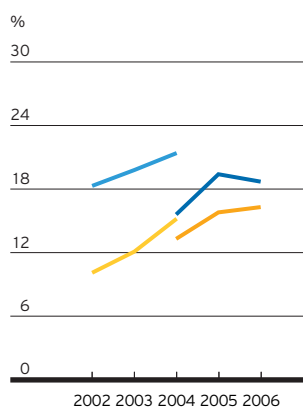
Sales and operating profit



■ Sales (IFRS)  
 ■ Operating profit<sup>1</sup> (Sw. GAAP)  
 ■ Operating profit<sup>1</sup> (IFRS)

1) Excl. items affecting comparability.

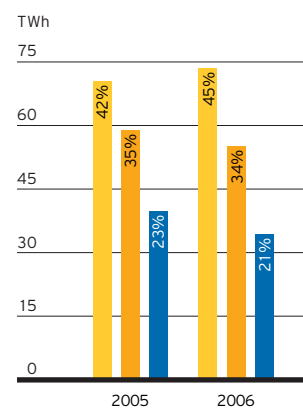
Profitability



■ Return on equity<sup>1</sup> (Sw. GAAP)  
 ■ Return on equity<sup>1</sup> (IFRS)  
 ■ Return on net assets<sup>1</sup> (Sw. GAAP)  
 ■ Return on net assets<sup>1</sup> (IFRS)

1) Excl. items affecting comparability.

Total electricity generation<sup>1</sup>



■ Fossil-based power  
 ■ Nuclear power  
 ■ Hydro power

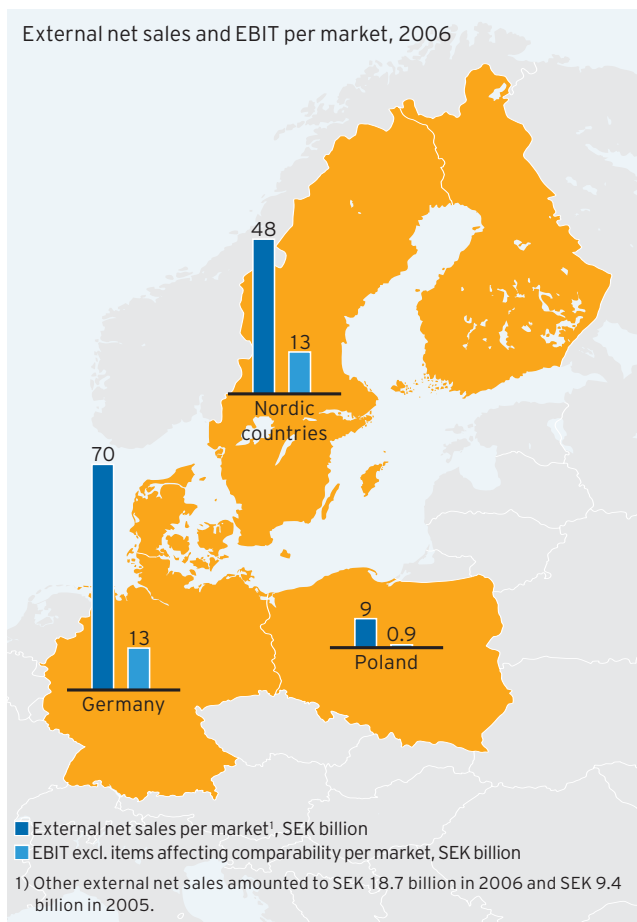
1) Wind power, biofuel and waste are included in these volumes at a total of 1.3 TWh for 2006 and 0.5 TWh for 2005.

## Key data

	2006	2005	Change, %	2006 (EUR) <sup>1</sup>
Net sales, SEK million	▲ 145,815	129,158	12.9	16,112
Operating profit, SEK million	▼ 27,049	27,571	-1.9	2,989
Operating profit (EBIT) excl. items affecting comparability, SEK million	▲ 26,676	24,585	8.5	2,948
Profit before tax, SEK million	▼ 25,525	26,160	-2.4	2,820
Profit for the year, SEK million	▼ 19,858	20,518	-3.2	2,194
Earnings per share, SEK	▼ 142.21	146.05	-2.6	15.71
Return on equity excl. items affecting comparability, %	▼ 18.7	19.4		
Return on net assets excl. items affecting comparability, %	▲ 16.3	15.8		
Total assets, SEK million	▼ 323,166	325,068	-0.6	35,709
Equity/assets ratio, %	▲ 33.3	28.0		
Funds from operations (FFO), SEK million	▲ 35,673	31,386	13.7	3,942
Investments, SEK million	▼ 17,220	24,497	-29.7	1,903
Electricity generation, TWh	▼ 164.5	169.1	-2.7	
Heat production, TWh	▲ 35.2	34.1	3.2	
Average number of employees in the Group (full time equivalents)	▲ 32,308	32,231	0.2	

1) Exchange rate SEK 9.05=EUR 1.

External net sales and EBIT per market, 2006



## Vattenfall's markets

### Nordic countries

Vattenfall generates slightly more than 20% of the electricity that is used in the Nordic countries. Electricity generation consists primarily of nuclear and hydro power. Electricity is sold to approximately 950,000 customers in the Nordic countries. Vattenfall is also a major producer of heat, mainly based on biofuels, and sells district heating and thermal heat. The Distribution unit owns and operates electricity networks and distributes electricity to some 1.3 million network customers. Vattenfall also conducts consulting, contracting and R&D activities, mainly in the energy sector.

### Germany

Vattenfall generates nearly 14% of the electricity that is used in Germany and is thereby the country's third largest electricity generator. Approximately 87% of generation is based on fossil fuels, mainly from Vattenfall's own lignite mines. Vattenfall's coal-fired plants are among the most modern in the world. Vattenfall also produces heat and has substantial district heating sales, primarily in Berlin and Hamburg. In electricity networks, Vattenfall owns and operates high-voltage as well as regional and local networks. Vattenfall has a total of approximately 3.3 million network customers and approximately 2.9 million electricity customers.

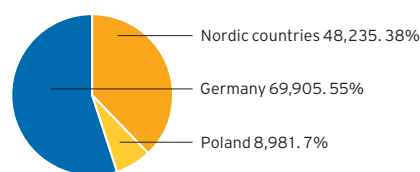
### Poland

Heat production and sales make up the majority of operations, and Vattenfall has a market share of approximately 27%. Electricity is also generated on a small scale. The Distribution unit owns and operates electricity networks and distributes electricity to 1.1 million network customers, mainly in the south-west part of the country. Vattenfall has approximately 1.1 million electricity customers in Poland.

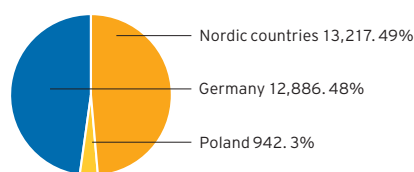
### Joint-Group operations

Vattenfall Trading Services, Vattenfall Treasury, Vattenfall Insurance and Vattenfall Research and Development are central support functions which manage the Group's risks, funding, provide market access and work with research and development.

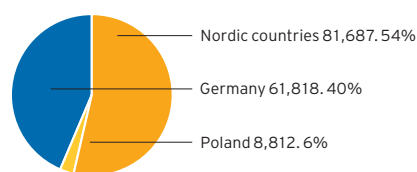
External net sales<sup>1</sup> per market, SEK million



EBIT excl. items affecting comparability per market, SEK million



Net assets per market, SEK million



1) Other net sales amounted to SEK 18,694 million (9,352). The Other segment includes Energy Trading, Finance and Other Group functions.

# CONTENTS

Financial targets and outcomes	2-3
Important events	4-5
CEO's message	6-9
Operating environment, strategies and activities	10-11
Economic value creation	12-13
Driving forces, risks and strategies	14-15
Investing in growth	16-19
Europe's energy markets	22-25
Competitive situation	26-29
Renewable energy and energy efficiency improvement	30-32
Corporate social responsibility report	33
Vattenfall's markets	
Nordic countries	36-38
Germany	39-41
Poland	42-43
Employees and competence	46-47
Corporate governance report	48-55
Board of Directors and Executive Group Management	56-59

## Financial statements

Administration report incl. Risk Management	60-69
Consolidated accounts	70-77
Notes to the consolidated accounts	77-101
Parent Company accounts, incl. Notes	102-109
Proposed distribution of profit	110
Audit Report	110
Definitions and calculations of key ratios	111
Nine-year and quarterly review	112-113
Facts about Vattenfall's markets	114-115
Glossary	116
Vattenfall's history	117

## Financial calendar 2007

8 February	Year-end report
19 March	Annual Report 2006
26 April	Interim report January-March
26 April	Annual General Meeting
26 July	Interim report January-June
31 October	Interim report January-September

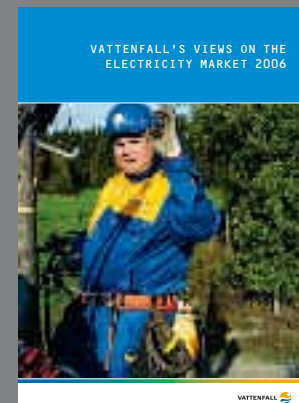
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## Other publications



Vattenfall's CSR report describes Vattenfall's operations from a sustainability perspective.



Vattenfall describes its views on the electricity market in a yearly report.

All reports can be ordered from  
 Vattenfall AB, SE-162 87 Stockholm, Sweden  
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## Further information about Vattenfall can be found on Vattenfall's websites:

www.vattenfall.com (English)  
 www.vattenfall.se (Swedish)

## VALUE CREATION IS A PREREQUISITE FOR ACHIEVING OUR VISION TO BE A LEADING EUROPEAN ENERGY COMPANY



To achieve our vision, we have embraced five strategic ambitions: Profitable Growth, Number One for the Customer, Number One for the Environment, Benchmark for the Industry and Employer of Choice.

Achieving this vision requires that we continuously create economic value in our operations. These five strategic ambitions make up the core of Vattenfall's work on realising this value. At the same time, value creation is essential for Vattenfall's long-term ability to invest in new, sustainable energy production.

In 2006 we continued to improve our earnings and are now focusing even more clearly on achieving our vision: to be a leading European energy company.

# FINANCIAL TARGETS AND OUTCOMES

Vattenfall's aspiration to be a leading European energy company has involved an emphasis on economic value creation and profitable growth. This overarching ambition forms the platform for Vattenfall's four financial targets, which have been set by the owner at the Annual General Meeting. These targets are long-term and thus are evaluated as averages over a business cycle (approx. 5–7 years).

## Main target: value creation/profitable growth

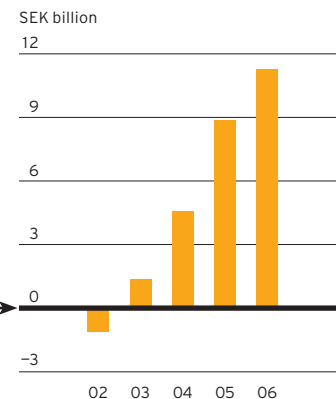
Vattenfall measures value creation over time by measuring the achieved return on net assets against the cost of capital, which is based on the owner's required rate of return (15% return on average equity). The difference between the achieved and target returns is then multiplied by net assets to arrive at an estimated economic value that is generated by the operations every year, before tax. The business units that create economic value can seek opportunities for profitable growth, either organically or through acquisitions. Definitive investment decisions are made at the Group level.

### Value creation

The difference between the achieved return on net assets and the required rate of return is multiplied by net assets to arrive at an estimated economic value that is generated by the operations every year, before tax.

\*) Figures for 2004 and onward are calculated according to IFRS.

The Group's required rate of return on net assets = 11%



## Financial targets

### Profitability

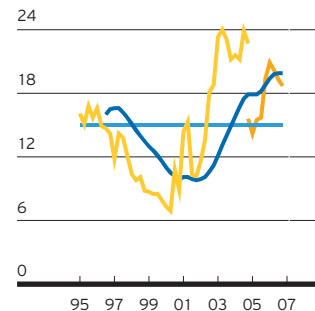
The owner's long-term profitability target is that profit after tax should amount to 15% of average equity. Recalculated to the Group's long-term profitability requirement, expressed as the return on net assets, this corresponds to a return of approximately 11% before tax.

## Outcome

- Return on equity<sup>1</sup> after tax was 18.7% (19.4%) in 2006.
- Return on net assets<sup>1</sup> was 16.3% (15.8%).
- Return on equity after tax<sup>1</sup>, last 12 months (Sw. GAAP)
- Return on equity after tax<sup>1</sup>, last 12 months (IFRS)
- Return on equity after tax<sup>1</sup>, last 4 years (Sw. GAAP through Q3 2004)
- Return target, 15%

1) Excl. items affecting comparability.

### Return, %

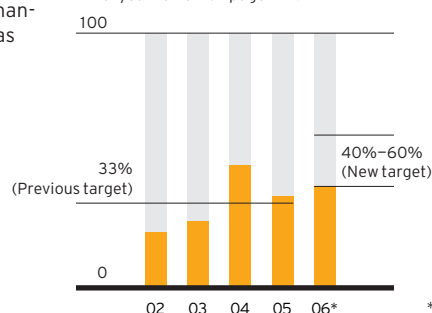


## Dividend policy

The aim is that the dividend over the long term should amount to 40%–60% of profit after tax. However, in yearly dividend decisions the Company's strategy implementation, financial position and other financial targets shall be taken into consideration. The dividend target was changed in April 2006. The previous target was 33%.

### Long-term dividend target, %

Per cent of profit for the year. Exact dividend amounts are shown in the Nine-year review on page 112.



\*) Proposed dividend.

### Return targets

Vattenfall's owner believes that the return on average equity is the most relevant measure of profitability from an ownership perspective. The target is that profit after tax should amount to 15% of average equity. Compared with many of Vattenfall's Nordic competitors, this is an ambitious goal. Direct comparisons are difficult, however, especially in view of the fact that the companies differ with respect to the age of their assets and depreciation. Vattenfall has considerable hidden assets on its balance sheet, especially concerning hydro power assets.

### Dividend policy

In view of Vattenfall's strong balance sheet and the conservative dividend policy the company has had in comparison with several competitors in recent years, the dividend goal has been changed so that the dividend should amount to 40%–60% of profit for the year. A more generous dividend policy is viewed to be compatible with Vattenfall's growth strategy.

### Financial risk level

The goal for Vattenfall's risk level consists of an ambition to maintain a credit rating in the single A category and a "cash

flow interest coverage ratio after maintenance investments" of 3.5–4.5. A credit rating takes into account a number of quantitative and qualitative variables which together make up an estimate of a company's ability to meet its credit obligations. The current ratings assigned by Moody's and Standard & Poor's take into account the extra risk component inherent in Vattenfall's acquisition strategy.

As an accounting concept, the traditional key ratio of interest coverage based on operating profit has the disadvantage that it does not take actual cash flows into account. For this reason, Vattenfall has changed over to measuring the cash flow interest coverage ratio, which shows how much of cash flow generated by operations during the year is available for new investment and the dividend, in relation to interest expenses. The highest returns in a capital-intensive industry such as Vattenfall's are often generated through reinvestment in existing facilities. Due to the relatively low operating risk associated with this type of investment, the interval has been narrowed slightly to 3.5–4.5. Previously the interval was 3.5–5.0.

Vattenfall's current four financial targets and target achievement are summarised below.

## Financial targets

### Ratings

Vattenfall's aim is to maintain a credit rating in the single A category from both Moody's and Standard & Poor's.

Vattenfall currently has ratings of A-/A-2 from Standard & Poor's and A2/P-1 from Moody's. Both Moody's and Standard & Poor's changed their outlook from positive to stable during the third quarter of 2006. Among other things, the agencies cited Vattenfall's ambitious investment plans, more stringent requirements from network regulators and greater political risk. During the year, the rating agency Fitch published its own rating for Vattenfall. This was not initiated by Vattenfall and is thus based only on openly available public information about Vattenfall.

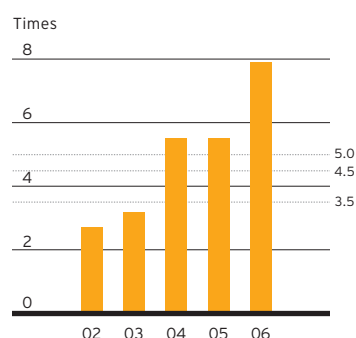
## Outcome

	Long-term Moody's	Long-term S&P	Short-term Moody's	Short-term S&P
2006	A2	A-	P-1	A-2
2005	A2	A-	P-1	A-2
2004	A3	A-	P-2	A-2
2003	A3	A-	P-2	A-2
2002	A3	A-	P-2	A-2
2001	A3	A-	P-2	A-2
2000	A1	A+	P-1	A-1

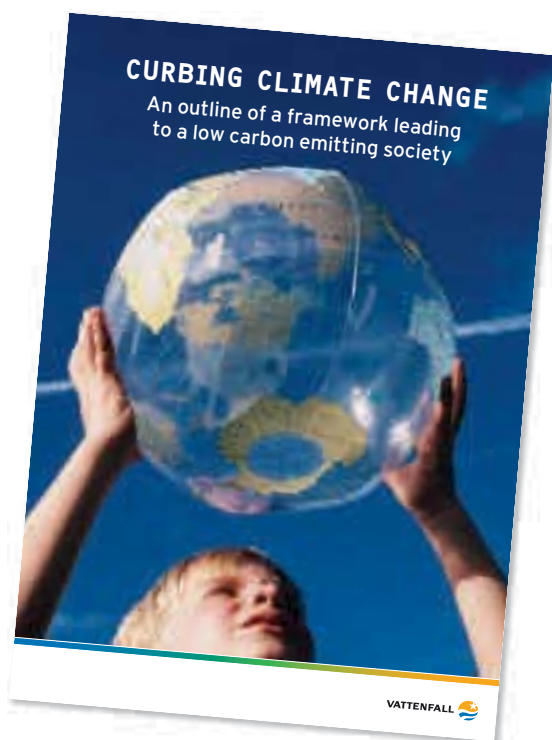
### Cash flow interest coverage ratio

This target was redefined in April 2006. The owner's previous requirement that the interest coverage ratio based on operating profit should amount to a multiple of 3.5–5.0 was replaced by a target that the "cash flow interest coverage ratio" should amount to 3.5–4.5. For a complete definition, see page 111.

### Cash flow interest coverage ratio after maintenance investments



# IMPORTANT EVENTS IN 2006



## MAJOR INITIATIVES TO CURB CLIMATE CHANGE

Since a large part of Vattenfall's electricity and heat generation is based on fossil fuels, it is important that we invest in technologies that reduce emissions of carbon dioxide. In early 2006 Vattenfall published a report entitled "Curbing Climate Change", which presents proposals for a model on how to reduce CO<sub>2</sub> emissions globally and at the same time maintain favourable conditions for investment in cost-effective and environmentally friendly technologies.

In May, Vattenfall presented a plan for greater investment in renewable electricity generation in the Nordic countries. The goal is to increase annual generation of renewable energy by 10TWh by 2016.

Also in May, construction was begun on Vattenfall's pilot CO<sub>2</sub> emission-free lignite power plant. The plant is based on oxyfuel technology<sup>1</sup> and is the first of its kind in the world. The facility, which is being built adjacent to the Schwarze Pumpe power station in eastern Germany, represents a milestone in the development of new technology for developing lignite-based electricity generation without carbon dioxide emissions. Vattenfall is investing EUR 65–70 million (approx. SEK 588–633 million) in the pilot plant, which will be commissioned in 2008. Through this new technology, Vattenfall aims over the long term to safeguard lignite-based electricity generation in Germany and at the same time make a strong contribution to a global solution to the climate issue.

1) The carbon dioxide emitted from combustion is separated and liquefied for subsequent storage in bedrock.

## REDUCED NETWORK TARIFFS FOLLOWING DECISION BY GERMANY'S NETWORK REGULATOR

In June Vattenfall was handed a decision by Bundesnetzagentur, the German network regulator, demanding sharp reductions in tariffs for the transmission operations. After Vattenfall appealed the decision, a German court overruled the regulator's demands for retroactive tariff reductions. In September and October, Bundesnetzagentur announced its decision regarding Vattenfall's distribution networks in Berlin and Hamburg, and for the subsidiary Wemag's network in northern Germany. As a result of the new rules for electricity network operations and Bundesnetzagentur's decision to lower Vattenfall's tariffs, following an impairment test, Vattenfall's distribution network assets were written down by SEK 1,019 million (EUR 110 million).



## COMPLETION OF DEAL BETWEEN VATTENFALL AND DONG IN DENMARK

Following intensive work, the asset swap between Vattenfall and the Danish energy company DONG was completed on 1 July, when approximately 24% of the combined production capacity of the Danish companies Elsam A/S and Energi E2 A/S was transferred to Vattenfall in exchange for Vattenfall's 35.3% shareholding in Elsam A/S and participation in I/S Avedøre 2. The assets taken over consist primarily of combined heat and power plants and wind power plants. The takeover increases Vattenfall's annual production volume by approximately 6 TWh of electricity and 6 TWh of heat.



## POSITIVE CUSTOMER RESPONSE TO VATTENFALL'S "TRYGGHETSAVTAL"

In June Vattenfall launched a three-year fixed-price contract with an accompanying renewal right in Sweden. The contract shelters customers against rising electricity prices for three years at the same time that it gives them the right to sign a new three-year contract at a lower price if the price of electricity falls. Demand for the new product has been very high.

## SUBSTANTIAL PROBLEMS IN NUCLEAR POWER GENERATION

On 25 July a short circuit in a switchyard outside of the Forsmark 1 nuclear power plant caused an emergency shutdown of the plant (a "scram").

The reactor was shut down automatically, at which time two of the four diesel-powered reserve systems were started and maintained adequate cooling of the fuel. The incident was classified as a 2 on the 7-degree INES scale, where 1–3 represent incidents without off-site risk, and 4 or higher signifies a discharge with impact on the environment and people. In September the Swedish Nuclear Power Inspectorate (SKI) issued a statement clarifying that the incident did not cause any damage to the reactor. According to SKI, the control room personnel acted according to instructions. Cooling of the reactor was present at all times and there was never any risk of radioactive discharge.

Before allowing a restart, SKI demanded that a number of safety measures be performed at Forsmark 1 and also at Forsmark 2, which was closed for an annual overhaul when the incident occurred. On 28 September, SKI gave its clearance for the restart of both reactors. However, at the same time, SKI stated its assessment that "Forsmarks Kraftgrupp AB has shown defects in its safety management and control of operations." The restart of the Forsmark 2 reactor was delayed by a leakage in the reactor containment and shortcomings in control



documentation. Following repairs and a review of the documentation of the repair work, SKI granted clearance for a restart on 24 October. As a principal owner of Forsmark, Vattenfall has taken the events at Forsmark with the utmost gravity. As a result of these events, a thorough review has been conducted at all of Vattenfall's nuclear power plants and safety routines are being strengthened. The incident caused a 2.3 TWh loss in generation, and the total loss of income amounted to approximately SEK 1.4 billion, of which Vattenfall's share (66%) was approximately SEK 0.9 billion.