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Summary: Vattenfall AB

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Credit Analyst: Andreas Zsiga, Stockholm (46) 8-440-5936; Magnus Pettersson, Stockholm (46) 8-440-5929

Credit Rating: A-/Negative/A-2

■ Rationale

The ratings on Vattenfall AB are based on the group's:

- Strong position as the largest Scandinavian and third-largest German electricity utility;
- Access to a competitive and generally modern generation portfolio;
- Major downstream supply businesses;
- Significant electricity distribution and heating monopoly operations; and
- Increased geographical diversity.

Negative rating factors are:

- Generation output that significantly exceeds downstream supply volumes in competitive markets;
- Policy risks related to nuclear and coal-fired generation;
- High total costs in the German generation portfolio and lignite mining operations; and
- Challenges in integrating acquired companies in Germany and Poland.

The financial profile is relatively weak following aggressive growth in recent years, but is sustainable at the rating. No support from Vattenfall's 100% owner, the Kingdom of Sweden (local currency AAA/Stable/A-1+; foreign currency AA+/Positive/A-1+), is factored into the rating. Standard & Poor's does not exclude a potential privatization in the medium to long term.

Vattenfall has become a leading Northern European utility, focusing on electricity and heating operations in the Nordic region, Germany, and Poland. The expansion achieved is expected to triple Vattenfall's turnover to more than Swedish krona (Skr) 100 billion (\$10.6 billion), and to more than double its asset base compared with 2000 to about Skr290 billion. The group's German operation, Vattenfall Europe (formerly known as Neue Kraft), includes Hamburg-based HEW, Berlin-based Bewag, the electricity generator Veag, and its coal supplier Laubag. The acquisition of U.S.-based Mirant Corp.'s 45% stake in Berlin-based utility Bewag in 2002 enhances Vattenfall's control over Vattenfall Europe, including importantly, its cash flow and liquidity, and allows Vattenfall to accelerate the integration process. The company is targeting annual cost savings in Germany of up to Skr4.5 billion in the medium term.

Vattenfall has benefited from a sustainable recovery of Nordic and German power prices in 2001, but price volatility remains a risk (the slight reduction in prices in 2002 is manageable). Low-risk monopoly network and heating operations are expected to provide stable cash flows even in the event of stricter regulation, which is expected in Sweden and, over time, in Germany. Significantly stricter monopoly regulation is not, however, factored into the rating.

The Skr17.0 billion Bewag acquisition, completed in February 2002, increased Vattenfall's gross debt to about Skr101.5 billion at the end of June 2002 (excluding Skr17.1 billion in pension liabilities). In addition to committed acquisitions, including the Skr8 billion buyout of HEW's 25% minority owner, short and medium-term development of gross debt will depend largely on the planned use of liquidity (reported at Skr25.3 billion) for financing purposes. Standard & Poor's expects gross debt leverage to decrease in the medium term to less than 60% from a peak of about 65% in the short term (62% at the end of June 2002), as free cash flow is intended for debt reduction rather than acquisitions.

In view of the current price outlook in the Nordic region and Germany, funds from operations (FFO) in 2002-2003 should be close to the approximately Skr17 billion generated by Vattenfall and the German companies independently in 2000, despite higher net interest expenses. FFO gross interest coverage is expected to be weak but adequate for the rating level in the short term, sustained at more than 3.5 times (x; 3.5x in 2001) with the potential for improvement in the medium to long term. Internal funding of the expected Skr7.0 billion-Skr8.0 billion of annual reinvestments is very strong at about 200% on average, but the committed acquisition investments reduce internal funding ratios in the short term.

■ Outlook

The outlook reflects the potential negative impact on Vattenfall's financial profile should electricity price pressure reoccur in Scandinavia and Germany, or should expected synergies and cost savings in Germany fail. The outlook could be revised to stable in about 6-12 months if Standard & Poor's considers integration and cost reductions to be progressing according to plan, and there is no negative shift in prices and price expectations. The rating does not factor in further acquisitions or continued investments in non-core businesses by Vattenfall, which would be contrary to the company's strategy and medium-term acquisition and investment policy.

■ Analytical E-Mail Addresses

andreas_zsiga@standardandpoors.com

magnus_pettersson@standardandpoors.com

infrastructureeurope@standardandpoors.com