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Summary: Vattenfall AB

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Credit Rating: A-/Stable/A-2

Rationale

The ratings on Sweden-based Vattenfall AB reflect the group's strong position as a major North European electricity utility, its competitive generation portfolio, major supply businesses, and significant energy utility monopoly operations that continue to underpin the rating, despite likely increased regulatory pressure.

Negative rating factors include exposure to competitive and volatile markets in its key power generation business, exacerbated by generation output that exceeds end-user sales volumes, and challenges of integrating acquired companies. The ratings do not factor in any support from Vattenfall's 100% owner, the Kingdom of Sweden (AAA/Stable/A-1+). Although there have been signs of increased political scrutiny of the company's activities, the owner appears to have no plans for a restructuring or change in the group's strategy.

Vattenfall focuses on the Nordic region, Germany, and Poland. The group's cost-cutting program in Germany is close to achieving the targeted €400 million-€500 million of savings per year by the end of 2004.

Vattenfall has benefited from rising power prices in its core markets in recent years, resulting from tightening capacity balance, high fuel prices, and low hydroelectricity supplies. Nordic wholesale power prices are expected to normalize in line with the hydropower situation at about €25-€29 per megawatt-hour (MWh), but volatility will remain. German power prices could increase further to more than €30/MWh. Some uncertainty is created by fuel prices, changing market rules, remaining overcapacity, and the introduction of carbon-dioxide emissions trading. Vattenfall's prudent hedging strategy limits its exposure to price volatility risk. Some increased regulatory pressure in monopoly activities in Sweden and Germany is factored into the ratings.

Vattenfall's financial performance continued to meet Standard & Poor's expectations in the first six months of 2004. This was aided by high electricity prices, successful hedging, cost cutting, improved operational performance of nuclear units, and a reduction of interest costs.

The company's financial profile has improved continually over the past few years to become adequate, bordering on strong, for the rating level, especially as key ratios are stronger on a net basis. Coverage of gross interest by adjusted funds from operations (FFO) (including interest on pensions and leasing adjustments) improved to about 5.5x at June 30, 2004 (rolling 12-month figures) from 4.5x in 2003. FFO to adjusted gross debt improved to 21.5% at June 30, 2004 (rolling 12-month figure) from 18% in 2003. These key ratio levels are expected to be maintained in the medium term. Total adjusted debt at June 30, 2004, was about Swedish krona (Skr) 101 billion (€10.9 billion; Skr104 billion at year-end 2003), including Skr16.4 billion of unfunded pension liabilities and Skr2.3 billion of leasing liabilities.

Short-term credit 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, as well as significant access to alternative sources of liquidity. Although Vattenfall's operations are influenced by 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. There are, however, significant provisions (including nonpension personnel-related provisions, and mining and other environmental liabilities) that could consume cash in the short to medium term.

The adequate liquidity position is supported by:

- Cash and short-term investments of about Skr16 billion, compared with Skr16 billion of short-term debt and Skr82 billion of total unadjusted debt at June 30, 2004.
- Strong free operating cash flow (about Skr11.5 billion on a rolling 12-month basis at June 30, 2004), reflecting the solid profitability and moderate capital expenditure needs in the utility operations.
- Access to unused committed credit facilities of Skr5.5 billion (maturing in 2008), and Skr5.9 billion in unused uncommitted facilities at the end of June 2004, as well as good access to public debt markets.
- No rating triggers or onerous covenants in Vattenfall's financing agreements.
- Free cash flow is expected to remain well above Skr10 billion per year, based on sustained operating profitability and about Skr8 billion of annual capital expenditure. The 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 is based on Standard & Poor's expectation that Vattenfall will maintain its current financial profile and refrain from major acquisitions in the short term. The expectation that the company will become more acquisitive in the medium term could limit further significant improvement in financial and credit quality. Barring acquisitions, the credit quality could improve in the medium term. A large-scale return to investment mode could have a negative effect on Vattenfall's credit quality, depending on the risk-profile of the acquisition targets, the acquisition amounts, and the financing strategy adopted. A gradual reduction in network charges is incorporated into the ratings. The company should be able to withstand temporary lower electricity margins, but any prolonged period of low electricity margins could have a detrimental impact on credit quality.

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