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Research Update: Sweden-Based Vattenfall AB's Outlook Revised To Positive On Strong Financials; Rating Affirmed

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Credit Rating: A-/Positive/A-2

■ Rationale

On June 21, 2005, Standard & Poor's Ratings Services revised its outlook on Sweden-based electricity utility Vattenfall AB to positive from stable. 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 prospects for further credit improvement in the absence of any credit-dilutive acquisitions or dividend payments.

Vattenfall's financial profile has improved over the past few years to become strong for the rating level, especially as key ratios are stronger on a net basis. Total adjusted debt at the end of the first quarter of 2005 was about Swedish krona (Skr) 91.2 billion (about \$12 billion), including Skr16.7 billion of unfunded pension liabilities and Skr3.1 billion of leasing liabilities.

Coverage of gross interest by adjusted funds from operations (FFO; including interest on pension provisions and leasing adjustments) continued to improve in 2004 to about 6.3x (4.5x in 2003). Rolling 12-month FFO to adjusted average gross debt was 26% at March 31, 2005 (25% for the first quarter of 2004). These key ratio levels are expected to be maintained at about 4.5x and 20% at the current rating level, leaving significant headroom for acquisitions.

The execution risks of Vattenfall's expansion in recent years have reduced as the integration process is complete. The company is now expected to become more acquisitive again. The asset-swap involving the 35% stake in Elsam A/S (BBB+/Stable/A-2) gives Vattenfall a strong generation position in Denmark. Standard & Poor's expects Vattenfall to pursue further growth opportunities in its current markets and in neighboring Western European countries, but assesses that the number of potential acquisition targets is limited and that they are likely to be highly contested.

The volatile Nordic wholesale power prices have normalized at about €25-€30 per megawatt-hour (MWh) following a period of high prices due to poor hydroelectricity supplies. German power prices remain above €35/MWh, but there is uncertainty over fuel prices, changing market rules, capacity development, and carbon-dioxide emissions trading. Vattenfall's prudent hedging strategy limits its exposure to price volatility risk.

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

Negative factors include exposure to competition and price volatility in the company's power generation business, political risks related to its nuclear and coal generation, and increasing regulatory pressure on its monopoly business. The ratings do not factor in any support from Vattenfall's 100% owner, the Kingdom of Sweden (AAA/Stable/A-1+). Political pressure on the company has increased, but the government appears to have no plans for restructuring or major changes in the group's strategy.

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, 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 mid-June 2005) of about Skr9.5 billion, compared with Skr11.7 billion of short-term debt;
- Strong free operating cash flow (about Skr14.3 billion on a rolling 12-month basis in the first quarter of 2005), reflecting solid profitability and moderate capital expenditure needs in the utility operations;
- Access to unused committed credit facilities of €1.86 billion (of which €600 million matures in 2009), and good access to public debt markets; and
- The absence of rating triggers or onerous covenants in Vattenfall's financing agreements.

Free operating cash flow is expected to remain at about or above Skr15 billion per year, based on sustained operating profitability and annual capital expenditures of about Skr10 billion in the current Vattenfall group.

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 positive outlook reflects the potential for further credit improvement if Vattenfall continues to produce strong operational performance and free cash flow after dividends, and does not use the headroom under its ratings to make acquisitions. A significant credit-dilutive acquisition could weaken the risk profile from its current strong level, and result in the outlook returning to stable. However, management has developed a strong track record, and is not expected to undertake any deals that could threaten the company's objective of maintaining a rating in the 'A' category.

Some increased regulatory pressure in monopoly activities in Sweden and Germany is factored into the ratings.

■ Ratings List

	To	From
Corporate credit rating	A-/Positive/A-2	A-/Stable/A-2

NB: This list does not include all ratings affected.

Ratings information is available to subscribers of RatingsDirect, Standard & Poor's Web-based credit analysis system, at www.ratingsdirect.com. It can also be found on Standard & Poor's public Web site at www.standardandpoors.com; under Credit Ratings in the left navigation bar, select Find a Rating, then Credit Ratings Search. Alternatively, call one of the following Standard & Poor's numbers: London Ratings Desk (44) 20-7176-7400; London Press Office Hotline (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5916; or Moscow (7) 095-783-4017. Members of the media may also contact the European Press Office via e-mail on: media_europe@standardandpoors.com.

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