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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 position as the largest Nordic and third-largest German electricity utility, its competitive and modern generation portfolio, major downstream supply businesses, and significant electricity distribution and heating monopoly operations. Negative rating factors include exposure to competitive and volatile markets, generation output that exceeds retail sales volumes, and the challenges of fully integrating acquired companies in Germany and Poland. The company's financial profile is improving from a relatively weak position following the acquisitions. 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.

Vattenfall has become a leading north European utility focusing on electricity and heating operations in the Nordic region, Germany, and Poland. Although strategically positive, the challenging size of the expansion is illustrated by the tripling of Vattenfall's turnover to 101 billion Swedish krona (Skr; $12 billion), and the doubling of its asset base in 2002 compared with 2000 to Skr276 billion. The German operations have been integrated into Vattenfall Europe AG, which is now more than 90% owned by Vattenfall AB. The program targeting €400 million-€500 million of annual cost savings in the German operations by 2004 is progressing as planned.

Vattenfall has benefited in 2002-2003 from the high Nordic power prices resulting from limited hydroelectric supplies. The high prices could continue over the coming winter, but their positive impact is moderated by the group's low hydroelectric availability in the Nordic region. The tightening Nordic generation balance is expected to continue to underpin prices, although volatility will remain in this region of high hydroelectric generation and the hydrological balance is expected to return to normal in the medium term. Vattenfall's prudent hedging strategy limits both upside and, importantly, downside price risk.

In Germany, power prices have trended upwards, and although there could be further improvement, there is room for uncertainty and volatility caused by changing market rules, continuing overcapacity, and the economic slowdown. The low-risk monopoly network and heating operations should continue to underpin Vattenfall's rating despite the potential for increased regulatory pressure.

Vattenfall posted strong first-half results in 2003. These results, on the back of high power prices, increasing volumes due to cold weather, and successful cost cutting, were on the high side of Standard & Poor's expectations and improved the company's debt protection measures. Although the positive trend is expected to be less pronounced over the full year, the company appears well on the way to achieving financial recovery in the medium term. Strong cash flow and low capital expenditure contributed to a further decrease in Vattenfall's net debt from its peak in the third quarter of 2002.

Total adjusted debt at the end of June 2003 was about Skr111 billion (compared with Skr112 billion at year-end 2002), including Skr17 billion of unfunded pension liabilities and Skr2.5 billion of leasing liabilities. Adjusted debt leverage was 64% at the end of the second quarter of 2003, compared with 67% at year-end 2002. It is expected to reduce to about 60% in the medium term. Adjusted funds from operations (FFO) interest coverage (including imputed interest on pensions) improved to about 5.0x from 3.9x in 2002, ahead of the 4.0x-4.5x expected in the medium term. FFO to adjusted debt improved to 19% on a year-on-year basis, from a weak 16% in 2002. This is close to the 20% expected in the medium term.

Liquidity.

Vattenfall's liquidity position is strong. About Skr16 billion in short-term debt at the end of June 2003 is balanced by substantial cash and liquid assets of Skr19 billion, and about $1.25 billion in unused committed credit facilities at Vattenfall AB and Vattenfall Treasury AB. All of these mature within one year. The company maintains a policy of having cash, liquid assets, or committed credit lines (those undrawn and not used as back-up for outstanding commercial paper) equivalent to at least 10% of annual turnover, but levels are expected to remain significantly higher than this minimum. The medium to long-term maturity profile is fairly even, apart from a Skr18 billion peak in 2004. There are no rating triggers or onerous covenants in Vattenfall's financing agreements.

Outlook

The stable outlook is based on Standard & Poor's expectation that Vattenfall will continue to improve its financial profile in the short to medium term by dedicating free cash flow to debt reduction. The company is not expected to make significant acquisitions in the short term. The rating could be negatively affected by an unexpected event such as a shift in Vattenfall's short to medium-term investment and acquisition strategy, a return of sustained electricity price pressure in core markets, or a substantial setback in the German cost-cutting process. Some gradual reduction of German network charges is incorporated into the ratings. In the medium to longer term, the company is expected to become more acquisitive again. This is likely to constrain significant further improvement in the financial profile.

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