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Vattenfall AB

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MOODY'S CONFIRMS VATTENFALL'S A3 SENIOR UNSECURED RATING; OUTLOOK NEGATIVE

Moody's Investors Service has today confirmed the long-term senior unsecured A3 rating of Vattenfall AB and its guaranteed subsidiaries. The rating outlook is negative. Moody's has also confirmed the senior subordinated rating at Baa1.The short-term rating, which was not under review, is P-2. This completes the ratings review that was initiated in December 2001 upon the acquisition by Vattenfall of Mirant's 44.7% stake in BEWAG for US$1.63 billion.

Moody's rating confirmation reflects the fact that Vattenfall's debt protection measures should not be materially impacted by the acquisition, which will be funded through a combination of free cash flow, the use of cash balances within Vattenfall's German subsidiaries as well as an increase in overall debt levels. Access to the relatively unleveraged cash flows of BEWAG, as well as improved cash flow projections as a result of higher expected generation prices in Germany and the Nordic sector should mean that overall debt protection measures - whilst currently somewhat weak (FFO/ gross interest cover of around 3.5x expected for 2001) - should improve from 2002 onwards to be more in line with this A3 rating category.

Moody's rating also factors the possible acquisition of the remaining 25% stake in Hamburgische Elektrizitaetswerke (HEW) from the City of Hamburg should the City decide to exercise its put option, as well as a further increase in stakes in its existing Polish subsidiaries. Moody's does not expect Vattenfall to make other significant acquisitions during the consolidation period (2002-04) in line with its business plan.

Moody's negative rating outlook reflects the persistent large execution and integration risks in Germany, despite the progress made to date, given the size and scope of Vattenfall's acquisitions. Assuming integration and acquisitions proceed as planned, the rating agency expects Vattenfall to apply free cash flow to reduce debt levels from 2003 onwards (current leverage is around 60%.) Moody's cautions that any further significant acquisitions by Vattenfall, although not currently expected, could bring further negative pressure to bear on the rating. However, assuming integration proceeds as expected and, in the absence of a material downturn in generation prices or significant regulatory pressure, Moody's expects that this rating could stabilise within 12-18 months.

The A3 rating also factors Vattenfall's strength as the largest Scandinavian electric utility and its move into Germany, which positions it as a leading player within northern Europe. Moody's believes that gaining control of BEWAG is a positive strategic step that should allow a faster integration of the German operations and strengthen its presence in the German retail and distribution market. Vattenfall currently owns a 73.8% stake in HEW, 81.25% of the generator and transmission grid, VEAG and 92% of LAUBAG, its captive lignite mine, as well as 89.5% of BEWAG, the Berlin-based utility.

Moody's notes that Vattenfall has established a new managerial structure and outlined a targeted operational and legal structure for the new group in Germany, to be called Vattenfall Europe, which should be implemented during 2002. Vattenfall aims to put in place a holding company for operating units focusing on separate business activities along the value chain to allow greater transparency of cost and profitability. While Moody's believes that the company has made steady progress towards integration, the rating agency notes that this process will remain challenging from a managerial and operational perspective and is therefore not likely to be completed before 2004. Despite the greater than expected upfront costs, Vattenfall now expects to reap the benefit of cost savings and synergies from 2004 onwards - but Moody's maintains that achieving the targeted returns on capital may be difficult within this period.

Vattenfall anticipates that cash flows from 2002 onwards will be positively affected by improvements in generation prices in both Scandinavia and Germany. Whilst Scandinavian prices have recovered following greater normalisation of weather conditions, these prices remain somewhat volatile given the high level of hydro in the generation fuel mix. In Germany, Vattenfall should benefit from the relatively low marginal costs at VEAG's modern lignite plants. However, in Moody's view, all-in costs are still somewhat high given the ongoing high capital expenditures within its lignite-based production unit. Moody's anticipates that Vattenfall will continue to remain long in generation and will inevitably be exposed to competitive and somewhat volatile pricing levels. Supply margins are expected to remain very tight in both Scandinavian and German markets.

About half of the Vattenfall group's EBITDA is expected to come from monopoly (distribution/ transmission) or near-monopoly activities (district heating), which should allow stable cash flows. However, Moody's cautions that the increasing regulatory focus in the German or Swedish markets may put some pressure on these margins.

Vattenfall has fairly significant cash and liquid assets position of over SEK 25 billion. These are normally held partially as coverage for nuclear, pension and mining provisions in Germany but are not legally tied and Vattenfall believes them to be conservatively provisioned. (HEW is obliged to maintain EUR370 million to cover the operation of its nuclear assets.) Vattenfall expects to use a proportion of these cash and liquid assets within Germany to fund its acquisitions. As a result, Moody's expects net debt levels to rise proportionally more than gross debt levels in 2002, while net debt protection measures will be correspondingly affected.

Although the Swedish State owns 100% of Vattenfall, no direct support is factored into the rating. Nevertheless, Moody's believes that the State would ensure that Vattenfall stayed within investment grade. Privatisation is not currently considered politically acceptable, but this climate may change after the September 2002 elections. Additional capital, via an IPO, could give Vattenfall greater financial flexibility.

Vattenfall is the parent company of one of the largest energy groups in the northern European region and is headquartered in Stockholm, Sweden. Its principal businesses are the generation, distribution and supply of electricity. The group is expected to have revenues of just under SEK 70 billion at FYE 2001.