

Credit Opinion: [Vattenfall AB](#)

## Vattenfall AB

*Stockholm, Sweden*

### Ratings

Category	Moody's Rating
Outlook	Stable
Issuer Rating	A2
Senior Unsecured MTN	A2
Subordinate MTN	A3

### Vattenfall Treasury AB

Outlook	Stable
Bkd Senior Unsecured	A2
Bkd Subordinate MTN	A3
Bkd Commercial Paper	P-1

### Contacts

Analyst	Phone
Helen Francis/London	44.20.7772.5454
Andrew Madge/London	
Stuart Lawton/London	
John Diaz/New York	1.212.553.1653

### Key Indicators

[1]

Vattenfall AB	31/12/2005	31/12/2006
Adjusted FFO Interest Coverage [2]	8.8x	10.1x
Adjusted FFO / Net Adjusted Debt [3]	33.7%	52.5%
Adjusted RCF / Net Adjusted Debt [4]	26.4%	43.3%

Adjusted RCF / Capex [5]	85.9%	171.6%
EBITA Margin Adjusted [6]	18.3%	21.2%

[1] Based on "As Adjusted" financial statements. Details in "Moody's Approach to Global Standard Adjustments in the Analysis of Financial Statements for Non-Financial Corporations - Part II, Rating Methodology, Feb-06 (#96729). [2] (Cash flow from operations (CFO) pre-Working Capital + Interest Expense) / Interest Expense [3] CFO pre-Working Capital / Net Debt Adjusted [4] (CFO pre-Working Capital - Dividends Paid) / Net Debt Adjusted [5] (CFO pre-Working Capital - Dividends Paid) / Capex [6] (Pretax Income + Interest Expense + Other Non-Recurring Expenses + Amortization) / Revenues

*Note: For definitions of Moody's most common ratio terms please see the accompanying [User's Guide](#).*

## Opinion

### Credit Strengths

Credit strengths for Vattenfall are:

- Strong market position as Scandinavia's largest electric utility and a leading player in Northern Europe
- Diversified business mix including regulated network and district heating business
- Significant financial flexibility.

### Credit Challenges

Credit challenges for Vattenfall are:

- Event risk related to growth-oriented management strategy
- Commodity risk exposure, as Vattenfall remains long in generation in both Sweden and Germany
- Regulatory, environmental and political risks in a number of markets.

### Company Profile

Vattenfall is the largest utility in the Nordic sector as well as the third largest electricity producer in Germany. It is active in all aspects of the electricity chain as well as district heating.

### Rating Rationale

The A2 senior unsecured ratings of Vattenfall AB reflect the baseline credit assessment (BCA) of the group and the credit enhancement (one notch) resulting from the 100% ownership by the Kingdom of Sweden.

When assessing Vattenfall's BCA, Moody's applies its Rating Methodology for Global Regulated Electric Utilities. The following factors represent key drivers in determining the rating:

#### ASSESSMENT OF BUSINESS RISK FACTORS

The BCA of 7 (on a scale from 1 to 21, with 7 mapping to an A3) reflects Vattenfall's overall medium risk business profile. Regulated network and low risk district heating activities contribute between 15% and 16% of EBIT (2006) respectively at the group level, with the most significant proportion of profitability coming from generation. Moody's normally considers regulated network activities as lower risk than more volatile generation and supply as they are monopoly businesses that normally offer greater predictability of cashflow. Nonetheless, Moody's recognises that in Vattenfall's two key markets, Sweden and in particular, Germany, there is a significant degree of pressure on regulated tariffs which has and will continue to have a negative impact on earnings.

Vattenfall's medium business risk is reinforced by its strength and diversity - it is the

largest Scandinavian electric utility, Germany's third largest power generation company and the second largest transmission operator; in addition, it has a sizeable supply business. This positions it as a leading Northern European utility. Its exposure is rather well-spread: whilst deriving strong cash flows from the volatile, more hydro and nuclear-based Scandinavian generation market, these risks are mitigated by its exposure to the more thermal-based German market. Vattenfall's geographic and fuel mix was further diversified in 2006 when it acquired around 20% of the generation capacity in the Danish market. These assets add more thermal generation to its Nordic mix, although remain a relatively small component. A prudent hedging strategy, and ownership of some upstream assets (such as lignite mines in Germany) also reduce some of the generation risk, contributing to our assessment of a medium risk exposure for generation. Vattenfall could nonetheless be affected by a number of risks from a political, pricing and environmental perspective in its core Northern European markets.

Generation is the most significant contributor to profitability, and this is expected to increase over time given (i) strong cash flows off the back of strong power prices (ii) increasing investments in these areas, (iii) lower earnings from network and possibly district heating businesses.

Therefore, in the longer term, Vattenfall's business risk profile is expected to gradually weaken, as the earnings contributions from more volatile unregulated activities, generation and supply, is anticipated to grow.

#### ASSESSMENT OF FINANCIAL RISK FACTORS

Currently, Vattenfall's financial profile is very strong for its A2 rating category, for which Moody's would expect a ratio of Retained Cash Flow (RCF)-to-Net Adjusted Debt in the mid-to-high teens on a sustainable basis.

However, the stable rating of A2 reflects the fact that external acquisitions remain an important element of Vattenfall's growth strategy and Moody's would expect that if substantial M & A activity took place, this could reduce the RCF-to-Net Adjusted Debt ratio from its current very high levels back to those for the current rating. Moody's also notes that as a wholly owned subsidiary of the State, Vattenfall is unlikely to have access to additional equity if it did want to make an acquisition. Additionally, Vattenfall has expressed publicly that it targets maintaining a single-A credit rating.

Furthermore, some of Vattenfall's financial flexibility at its current rating level will likely be absorbed by its substantial SEK134 billion investment programme over the 2007-11 period (an increase on the prior year's already large SEK104 billion plan). The bulk of Vattenfall's investment plans are aimed at upgrading and expanding existing generation capacity as well as adding some new plants in a number of areas. Additionally, Vattenfall is focused on expanding its renewables capability in Germany and Sweden. Vattenfall also intends to invest in networks upgrade. Lower network tariffs, particularly in Germany, and some likely pressure on district heating margins as a result of higher fuel costs are also likely to have some impact on profitability. Generation spot prices, especially in the Nordic region are expected to remain volatile, and lower CO2 limits in Germany will have some impact on prices. Vattenfall also expects to pay larger dividends - the target has been raised from 30% of net profit after tax to 40-60%, which will absorb some free cash flow. These factors, taken together, could well mean that the company's debt protections will weaken from current high 2006 levels. Nonetheless despite a likely weakening, absent any large acquisitions, Moody's anticipates that Vattenfall's financial profile will stay strong for the current rating category.

To offset the migration of Vattenfall's business risk profile, as the company gradually moves its business risk mix towards a higher contribution from more volatile generation and supply, as described earlier, Moody's notes that the target ratio range of Retained

Cash Flow-to-Net Adjusted Debt has shifted from around 13% to 17% to around 15% to 19% for its current rating category.

### **Liquidity**

Vattenfall AB (A2/P-1) is the guarantor of Vattenfall Treasury AB (its treasury management arm). Vattenfall has a healthy liquidity position due to strong cash flow, significant liquid assets as well as ample back up lines. Over the next 12 months, Moody's expects Vattenfall to generate cash from operations in the region of around EUR 3.8 billion. In addition the company had approximately EUR 1.9 billion of cash and liquid funds available as at 1H 2007 - not including a minimum EUR 0.35 billion (SEK3.1bn) which must be held at Vattenfall Europe to cover its nuclear operations (under the so called "Solidarity Agreement"). This together with availability under committed credit facilities as noted below, should be sufficient to meet committed capex and dividends and maturing debt over the next 12 months. Vattenfall's general policy is to keep no less than 10% of group turnover in cash or committed back up lines (currently this would mean a minimum of around EUR 1.5 billion). Should the next 90 days' debt maturities exceed this amount, then this sets the minimum level of cash and committed lines.

Vattenfall has two CP programmes, a Euro CP programme of US\$2 billion and a domestic programme of SEK15 billion - usage of the programmes varies, depending largely on pricing and need. External sources of liquidity include mainly a 7-year committed EUR 1 billion revolving credit facility, syndicated with 12 banks which matures in February 2013. Drawings under the facility are subject to representations that no adverse change in the group financial condition has occurred.

### **OTHER GRI FACTORS**

In accordance with Moody's GRI rating methodology, the A2 senior unsecured ratings of Vattenfall AB reflect the impact of the following factors on its BCA:

- Local currency rating of the Kingdom of Sweden: Aaa.
- Dependence is Low taking into account the high degree of geographical diversification in the revenue base, with European operations contributing over half of revenues at the group level.
- Support is Medium reflecting the 100% state ownership and the strategic importance of Vattenfall within Sweden. However, Moody's believes that the Swedish government has a high degree of market orientation, and the authorities would hesitate to intervene in support of partially or even fully state-owned companies except in the most extreme circumstances such as when the firm controls substantial utility infrastructure and nuclear and hydro assets as is the case with Vattenfall. Moody's does not believe that there is any near-term likelihood of privatization, despite the change to a conservative-led Government in 2006 which resulted in a number of less strategic state-owned companies being considered for privatisation.

### **Rating Outlook**

The outlook is stable. This reflects the strong financial profile of the company but also recognises the challenge of a large investment programme and some regulatory, environmental and political challenges. The rating also builds in flexibility to make further acquisitions in line with Vattenfall's growth intentions. In this regard, Moody's also notes that any large scale acquisition would in all probability be debt-financed as given its current 100% share ownership, it is unlikely that the company could rely on any fresh equity.

### **What Could Change the Rating - Up**

Moody's notes that nonetheless the company's financial profile is expected to continue to stay strongly positioned for its rating category absent any large acquisition or series of acquisitions. According to Moody's, positive pressure could therefore develop, if the risk of dilution of the group's financial profile diminishes due to the lack of acquisitions over the next 12 - 18 months.

### **What Could Change the Rating - Down**

Negative rating pressure could materialise in the event of a significant debt-funded acquisition, in combination with a severe downturn in operating, regulatory or political environment beyond the assumed financial flexibility. However, Moody's does not see this as likely and expects acquisitions or investments to be subject to Vattenfall's investment criteria, including that of maintaining a single-A rating.

In addition to the factors listed above affecting the baseline credit assessment, the ratings may also be impacted by changes in the ratings of the supporting government, or by changes in Moody's assessment of default dependence and support described in the rating rationale.



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