

RESEARCH

Summary:

Vattenfall AB

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Credit Rating: A-/Stable/A-2

Rationale

The ratings on Sweden-based utility Vattenfall AB reflect its strong, vertically integrated position in the north European electricity market, competitive generation portfolio, significant monopoly utility operations, and strong cash flow generation.

Negative rating factors include Vattenfall's exposure to competition and price volatility in power generation, political risks related to nuclear and coal generation, and increasing regulatory pressure on monopoly network operations.

Standard & Poor's Ratings Services currently factors no direct support from Vattenfall's 100% owner, the Kingdom of Sweden, into the ratings. Political and taxation pressures on the company have increased, although the Swedish government appears to have no plans for restructuring or major strategy changes. In addition, there is no plan to privatize Vattenfall in the foreseeable future.

Vattenfall's capital expenditure is likely to increase over the medium term. By 2011, the company plans to invest about Swedish krona (SEK) 134 billion, mainly in new power generation capacity, reinforcement of its electricity network, and reinvestments.

Following the integration of its acquired German operations, and the acquisition of SEK12.6 billion (on a net basis) of Danish power generation assets in 2006, we expect Vattenfall to continue its growth strategy and to be acquisitive--both in its current markets and in neighboring European countries. The number of potential acquisition targets will likely be limited and any acquisitions will be highly contested, however.

Vattenfall's financial performance remains strong for the ratings, with funds from operations to adjusted debt of about 39% in 2006 (treating SEK8.9 billion in hybrid capital notes as 50% debt and 50% equity). Standard & Poor's expects Vattenfall to exploit the financial headroom in the current ratings through debt-financed acquisitions or capital expenditures. In the absence of major acquisitions or large scale capital expenditures, and in view of strong wholesale power price developments, funds from operations to adjusted debt should remain at above 30% over the medium term.

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 over the short term.

The company's adequate liquidity position is supported by the following factors:

- Cash and short-term investments at March 31, 2007 of about SEK27.9 billion, compared with SEK15.9 billion in short-term debt.
- Strong free operating cash flow (about SEK23.4 billion for the twelve months ended March 31, 2007), reflecting solid profitability and manageable capital expenditure needs in the utility operations.
- Access to unused committed credit facilities of SEK9.7 billion as of March 31, 2007. In February

2006, the company refinanced a €600 million revolving credit facility and at the same increased the amount to €1 billion. The new revolver matures in 2013, and the company has good access to public debt markets.

- The absence of rating triggers or onerous covenants in Vattenfall's financing agreements.
- Free operating cash flow is expected to remain at SEK5 billion-15 billion a year, based on sustained operating profitability.
- 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 reflects the increasing regulatory and political pressure in Vattenfall's main markets, which tempers the prospect of continued improved credit quality from its current strong level. Such pressure has resulted in increasing shareholder demands, stricter regulation, and an increased focus on environmental and energy policy objectives for the company. Further adverse political or regulatory actions cannot be ruled out.

The stable outlook also reflects our expectation that Vattenfall will continue its growth strategy, remain acquisitive, and increase capital expenditures over the medium term. This could weaken the financial profile from its current, strong, level, although we do not expect the company to jeopardize its objective of maintaining a rating in the 'A' category. In the current environment, with increased political and regulatory uncertainty, upside ratings potential is limited.

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