Credit Opinion: Statkraft AS

Global Credit Research - 14 Dec 2010

Oslo, Norway

Ratings

Category	Moody's Rating
Outlook	Stable
Issuer Rating	Baa1
Senior Unsecured	Baa1
Other Short Term	(P)P-2

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Key Indicators

Statkraft AS[1][2]

	12/31/2009	12/31/2008	12/31/2007	12/31/2006
(CFO Pre-W/C + Interest) / Interest Expense	5.1x	4.9x	4.9x	7.4x
(CFO Pre-W/C) / Net Debt	19.6%	22.8%	19.0%	24.6%
RCF / Net Debt	-6.1%	2.3%	-2.9%	8.8%
FCF / Net Debt	-3.1%	2.7%	-6.0%	-6.5%

[1] Standard adjustments in accordance with "Rating Methodology: Moody's Approach to Global Standard Adjustments in the Analysis of Financial Statements for Non-Financial Corporations, Part 1, Part 2 and Part 3." [2] Source: Moody's Financial Metrics

Note: For definitions of Moody's most common ratio terms please see the accompanying User's Guide.

Opinion

Corporate Profile

Statkraft AS (Baa1/P-2 stable outlook) is Norway's leading generator of electricity; the company's output, primarily hydro based, covers 35% of Norway's consumption. As of end 2009 the company had 15.8 GW of installed capacity; 40 TWh of reservoir capacity; with 57 TWh of production sold in 2009 - mainly into the Nordic area, albeit with around 10% now sold to Germany. In recent years it has pursued a policy of expansion into downstream activities in Norway as well as expanding into thermal and renewables production in Northern Europe in order to diversify its business risk profile.

Statkraft acquired assets of 7 TWh through an asset swap with E.On in 2008 in return for its stake in E.ON Sverige. These assets include hydropower and district heating in Sweden; hydro and gas power assets in Germany and hydropower in the UK as well as E.ON AG shares worth around EUR2 billion. Moreover, Statkraft is present in some hydropower projects in Southeast Europe, South East Asia and Latin America.

Statkraft AS is 100% owned by Statkraft SF, in turn 100% owned by the Norwegian government.

Recent Developments

In November 2010, the Norwegian Government proposed to increase its equity capital in Statkraft SF by NOK14 billion, subject to resolution by the Norwegian parliament. As a result, Statkraft has increased its targeted investment programme for the period 2010-2015 to NOK82 billion as explained more fully under "Strategy" below.

Rating Rationale

Statkraft's Baa1/P-2 ratings reflects the application of Moody's joint default analysis for Government Related Issuers (GRI) which combines the underlying strength of the company or Baseline Credit Assessment (BCA) and the credit support that the government of Norway could provide in a distress situation. Under this methodology, the rating gives 2 notches uplift from the BCA for potential government support, reflecting the following inputs:

- BCA: 10 (on a scale of 1 to 21, where 1 represents lowest credit risk; 10 is equivalent to Baa3);

- Local currency rating of the Norwegian government: Aaa, stable outlook;

- Dependence: Moderate;

- Support: Strong.

Statkraft AS has a relatively higher business risk compared to other European utilities due to its principal role as a generator, with a very limited retail supply and distribution base; electricity production and sales generated around 85% of EBITDA as of 9M 2010. Statkraft derives further cash flow from its industrial holdings as well as the consolidation of its 66% ownership in Skagerak Energi - a regional utility active in the generation, supply, networks and district heating sectors in Norway. Skagerak Energi contributed a further 13% to EBITDA in 9M 2010.

Statkraft benefits from its strong market position as Norway's leading generator of low marginal-cost and environmentally-friendly hydro production. The company controls a large number of reservoirs which can mitigate some of the significant volume and price risk as a result of the high, but variable, hydrological input in the Nordic power system.

The rating also factors an ambitious expansion plan, and a shift into higher risk activities (such as international hydro and offshore wind activities) could increase the riskiness of the business profile over time which may lead to more demanding metrics for the same rating category.

Strategy

Following the government's announcement of new equity of NOK 14 billion for the company, Statkraft have expanded their investment plan to NOK82 billion over the next five years (2010-15). The company have stated that their strategy remains focused on growth in environmentally-friendly and flexible power generation.

Moody's expects that the company will continue to develop further its already strong hydro generation capabilities in Norway and other areas of Europe. Although the Government has said the company will not invest in additional gas power plant, except for those that have already been approved by the Board, this is likely to mean the extension of the Knapsack power plant is likely to go ahead.

Further investments will include (i) wind power (UK, Norway and Sweden) as well as district heating (ii) international investments in hydropower - developments in Turkey and Albania and also (via SN Power) in South America and Asia are under way. Statkraft has previously scaled down its ambitions to increase shareholdings in regional companies in Norway as well as selling its solar power interests.

Detailed Rating Considerations

In deriving the BCA of "10" (equivalent to a "Baa3") Moody's applies the methodology for Unregulated Utilities and Power Companies (August 2009). Under this methodology, Statkraft is considered as an Unregulated Power Company and now maps to a Ba1 which is one notch below its current BCA of 10 due to a slight weakening of its average historical ratios. Nonetheless given the company's strong market position and portfolio flexibility and in recognition of the benefit of, albeit irregular, capital injections versus high dividend payments we maintain the BCA at 10.

FACTOR 1: Market Assessment, Scale, and Competitive Position

Market and Competitive Position

Statkraft scores a Baa on this factor, reflecting its strong market position but acknowledging the reality of operating in a competitive market place. It has a leading market position in Norway with a 35% market share in generation. In the relatively fragmented Nordic market, Statkraft is the third largest generator with around 12-15% of total power generation. Nord Pool is the most transparent and liquid of the European wholesale electricity markets,

Statkraft's Norwegian hydropower plants have load factors typically of around 45-50%, reflecting a relatively high installed capacity vis a vis output. Whilst companies in the Baa category, generally have higher load factors, Moody's also recognises the high level of availability this gives to Statkraft, which combined with large reservoirs, leads to increased production flexibility, enabling Statkraft to produce significant volumes when market conditions are favourable.

The Nord Pool is more volatile in terms of pricing than other European electricity pools, given the high, but variable, hydro content and high availability of nuclear power (both low marginal cost technologies). As a general rule, these prices feature as the cheapest wholesale prices in Europe, unless conditions are particularly dry. Nord Pool prices are however also influenced by central European prices given increasing interconnection and Statkraft's hydro plants will become even more valuable as CO_2 costs are further priced into European electricity prices.

Geographic Diversity

Statkraft scores Ba on this factor as the bulk of Statkraft's assets are in the Nordic sector. In terms of geographical diversity, around 70% of Statkraft installed capacity (15.8GW) is in Norway. The company is also present in Sweden, Germany, UK and Southeast Europe. Still around 90% of production in 2009 was in the Nordic countries, with the bulk of the remainder in Germany.

Statkraft also has a majority stake in SN Power (60% from January 2009), this company is used as a financial holding for Statkraft's equity investments mainly in South America and Southeast Asia. The company, together with JVs and associates, has installed capacity of 1000MW (its pro-rata share is 620MW); with 500 MW under development and a further pipeline of assets. Those international activities are higher-risk but are limited in scope. It is active in further developing projects in emerging markets via SN Power. Overall the company aims to continue the diversification away from Norway and hydro power mainly into mainland Europe and the UK, concentrating in wind and gas assets. In addition, hydropower projects in South-East Europe are under development. Nonetheless in the intermediate term the bulk of Statkraft's assets will be in the Nordic countries.

FACTOR 2: Cash Flow Predictability of Business Model

Hedging Strategy

Statkraft scores Baa on this factor, reflecting the fact that Statkraft has quite predictable cash flows for a company principally focused on generation, given the combination of spot and long term hedges that it has in place. This factor also recognises the value of its control over 40% of the reservoirs in Norway, which covers some 90% of Statkraft's own production, hence giving it a high degree of flexibility in the portfolio.

In the Nordic market around 50% of its production is pre-sold on a long-term basis. Statkraft also hedges parts of the production under term contracts through Nord Pool, practising "dynamic hedging". The remainder of the production is sold spot on the continental and Nordic exchanges. Statkraft uses the flexibility afforded it by its reservoir-based hydro production, to optimise its portfolio with regard to the timings and amount of volumes of electricity to be sold and at what price. In addition, there is a built-in hedge between production volumes and electricity prices in Nord Pool which helps reduce volatility (ie when prices are low because of high hydrological levels, the company is likely to sell greater volumes). Further new capacity build-out both in Norway and Continental Europe should also help to hedge the company's exposure to pricing volatility.

Statkraft has in place a number of long term contracts at commercial rates and also has access to end-users - primarily via its control of Fjordkraft (via Statkraft AS and Skagerak Energi) and Trondheim Energi.

Statkraft's profitability has historically been somewhat depressed by a number of politically-driven, out-of-the-money industrial and concessionary contracts (12 TWh in 2009), although the bulk of these industrial contracts will run off by the end of 2011. Many of these contracts are with power-intensive and wood-processing industries - the pricing on the industrial contracts was set by the Norwegian Parliament, and the concession agreements mean that Statkraft supplies municipalities at below-market prices. These tail off in the intermediate term (to 3.3 TWh in 2012) and Statkraft has secured new contracts to replace them at higher prices. In 2009 Statkraft entered into a 20 year contract to supply Boliden Odda for 900 GWh per annum and it has other long term agreements for around 10 TWh. Moody's believes that the company's cash flows will be boosted incrementally over the years as a result.

Fuel Strategy & Mix

As of FYE 2009, 81% of Statkraft's installed capacity is based off hydro power (14% is gas, 2% wind power, with 3% derived from district heating.) Given this concentration, Statkraft scores Ba on this category although Moody's also recognises that the company will gradually diversify its generation capacity through new investments - primarily focused on "green" energy, both within and outside of Norway.

Operational Characteristics & Capital Requirements

Moderate levels of capex are required for maintenance and for environmental-related expenditures. In 9M 2010, around NOK646 million was spent on maintenance capex given the high quality and long expected life of its assets. Statkraft scores A on this factor as most outages are expected to be short - the average outage for Statkraft's hydro power plants over the past 5 years was less than 45 days.

FACTOR 3: Financial policy

Statkraft scores Baa, as do most European utilities, in this category. This reflects the fact that the company manages its investments according to its financial flexibility. The government's policy of taking high dividends out of the company to date, has somewhat constrained the company's flexibility to invest, however the company is expected to tailor its financial investments to its financial flexibility - as reflected in its revised strategic plan .

Liquidity

Statkraft's liquidity is quite healthy although back up facilities may need to be increased in line with the newly revised capex programme. Statkraft has a policy of maintaining sufficient liquidity to cover at least a 6 month period, including the significant annual dividend extracted by its State owner.

Cash flows can be quite variable over a twelve month period given variations in production and pricing levels. Operating cash flow over the next 12 months should be largely sufficient to meet committed capex and dividends. As of 9M 2010,Statkraft had cash and liquid securities of NOK5.5 billion whilst debt maturities over the next 12 months stood at NOK4.8 billion. Statkraft has a committed long term back up bank facility of NOK5 billion maturing in 2012 and a NOK3 billion facility maturing in 2013.

Statkraft has a change of ownership control covenant in some back-up and bond facilities.

FACTOR 4: Financial metrics

Statkraft's profitability can be somewhat volatile given its high reliance on hydro levels. Nonetheless Statkraft engages in dynamic hedges to mitigate this volatility and also enters into long term sales to help mitigate such risks, also control over significant reservoirs gives it significant flexibility. Additionally there is an inverse correlation between hydro production volumes and prices, as prices tend to go down when hydro production is high and conversely go up when production is low, which has some offsetting benefits. Increasing fuel and geographic diversification will also have more of an impact over time. On the plus side, Statkraft will also increasingly benefit from its CO2-light portfolio.

9M 2010

Overall production at 39.6 TWh, was similar to the preceding year, although with a marginal increase driven by higher gas production. EBITDA saw a significant increase over the previous year (up 21% to NOK1.7 billion) primarily driven by similar levels of hydro production but at higher prices (average system price of EUR50 per MWh in first nine months vis EUR34 per MWh in the previous year). Gas power production was a negative profit contributor driven by low or negative spark spreads. Lower net financial expenses also contributed together with positive changes in unrealised value of energy contracts.

The company gained from unrealised currency gains in the NOK and SEK against the EUR but this had no cash effect on the company's accounts.

NOK2.6 billion was invested during the year.The sale of Trondheim Energi'sgrid operations amounted to proceeds of NOK1.4 billion. Dividends of NOK4.2billion were paid to the ultimate State owner in 9M 2010.

Nordic consumption rose by 5.2% over 2009, largely driven by cold temperatures. Underlying demand remains weak in Finland and Sweden (around - 5/6%) compared with the pre-crisis period.

Statkraft has demonstrated solid FFO/net debt metrics in recent years; in the high teens to early twenties. 2008 was an exceptional year both because of the transaction with E.ON, although Moody's normalises for this transaction (i.e. excludes the impact of one-off items relating to it), and high power prices. Despite the drop off both in demand, both Nordic and German, and fall in thermal spreads in 2009, Statkraft still demonstrated, somewhat lower, but still strong FFO, also helped by hedges already in place. FFO/net debt metrics in 2010 are expected to be strong, given the high prices in the Nordic market due to dry weather conditions.

In general Funds From Operations (FFO)/net debt is a key indicator of the company's core operating strength in relation to debt. Strong FFO is however tempered by the government's policy on dividends and hence the company's ability to retain cash in the company. In recent years, the government has continued to extract significant dividends out of Statkraft (generally over 90% but it has just declared 85% in the 2011 Budget on the 2010 result.) Overall this policy results in low, even negative, Retained Cash Flow/Net Debt and has an impact on the company's financial flexibility when it comes to investments.

Moody's would generally expect the company to show that it can sustain ratios, adjusted in line with Moody's methodologies, in the following ranges for the current rating category: FFO/net debt of mid-high teens and FFO/interest coverage of at least 3-4x. RCF/net debt should be positive based off dividend payouts on recurrent income.

Statkraft's future financial profile will be influenced by (i) the ongoing level of dividends extracted from the company, (ii) the level of power prices, (iii) the size and pace of its investment programme.

RELATIONSHIP WITH ITS OWNER

A White Paper on State Owned Companies was published in December 2006. This clarified the following:

(i) The dividend for Statkraft will be in the upper quartile: i.e. in the range of 75-100%.

(ii) Statkraft will remain 100% State-owned: Under the current Government there is no possibility of privatization. The government has reinforced Statkraft's vision to be Europe's leading provider of environmentally friendly energy.

(iii) The document also states that preferably, investments outside the Nordic area should be made with other partners. This approach suggests that the company can invest without necessarily involving other companies, as was previously required.

(iv) There is a general comment in the paper (not specifically directed at Statkraft) that "wholly owned companies may get equity injections if needed if projects are interesting and profitable".

CORPORATE STRUCTURE

With effect from 1October 2004, the Statkraft group was reorganised. The bulk of the operating activities of Statkraft SF (now the ultimate holding company) were reorganised into a limited liability company, Statkraft AS and its subsidiaries. The aim of this incorporation was among other factors to improve Statkraft's competitiveness. Statkraft AS is now the financial holding company of the group where external debt is issued.

Statkraft SF continues to hold only some domestic power plants subject to state ownership and overseas plants in Laos. Outstanding obligations of Statkraft SF incurred before 1.1.2003, remain at the level of Statkraft SF. Corresponding back-to-back loans are in place with Statkraft AS. All Statkraft's loans have pari passu clauses, with the inter-company loans mirroring the terms of the State backed loans and hence the debt at SF ranks pari passu with all external non-guaranteed debt at AS (as well as with intercompany debt).

OTHER GRI FACTORS

Support is strong. This reflects a strong indication of support from the current Labour-led government, re-elected in 2009, for Statkraft. The December 2006 White Paper reinforced the strategic importance of Statkraft which the Government has said will not be privatised. Additionally the strength of the government's commitment to the company has been demonstrated by the recent capital injection, although it continues to extract high dividends. Moody's also notes that under the Norwegian Industrial Licencing Act, only majority (two-thirds), publicly-owned companies can own power plants or waterfall rights and hold their licence in perpetuity, in keeping with the notion that "the country's hydropower resources belong to, and shall be managed for, the benefit of the general public."

Moderate dependence reflects the strong contribution from Statkraft's domestic operations to its profitability.

Rating Outlook

The outlook is stable. The company is expected to demonstrate ratios with the range indicated for the rating category - maintaining FFO/interest of at least 3-4x, FFO/net debt of mid-high teens and positive RCF/net debt. The equity injection from the government will boost the company's capital structure. However, the investment programme is challenging, future dividend levels uncertain and were power prices to soften, these ratios may be challenged.

What Could Change the Rating - Up

The company would need to be able to achieve and sustain RCF/net debt in the double digits, FFO/net debt of high teens/twenties, and FFO/interest of 4-5x or over for a notch upgrade.

Otherwise, a significant shift upward in support would be needed to move the rating upwards, which seems unlikely in the foreseeable future. The rating is not very sensitive to shifts in dependence.

What Could Change the Rating - Down

Downward pressure could result if the company failed to maintain its financial profile in line with the current guidance. A reduction in the perceived level of support from the government, particularly if that was accompanied by a still very high, or unpredictable, dividend policy could also have a negative impact, although this is not expected.

Rating Factors

Statkraft AS

Power Companies	Aaa	Aa	A	Baa	Ba	B	Caa
Factor 1: Market Assessment, Scale and Competitive Position (20%)							
a) Market and Competitive Position				X			
b) Geographic Diversity					X		
Factor 2: Cash Flow Predictability of Business Model (20%)							
a) Effectiveness of Hedging Strategy				X			
b) Fuel Strategy and Mix					X		
c) Capital Requirements & Operational Performance			X				
Factor 3: Financial Policy (10%)							
a) Financial Policy				X			
Factor 4: Financial Strength Metrics (50%) [1][2]							
a) (CFO Pre-W/C + Interest) / Interest Expense (3 year Avg)				5.0x			
b) (CFO Pre-W/C) / Net Debt (3 year Avg)					20.5%		
c) RCF / Net Debt (3 year Avg)							-2.0%
d) FCF / Net Debt (3 year Avg)						-2.0%	
Rating:							
a) Indicated BCA from Methodology Grid					Ba1		
b) Actual BCA Assigned				10=Baa3			

Government-Related Issuer	Factor
a) Baseline Credit Assessment	10=Baa3
b) Government Local Currency Rating	Aaa
c) Default Dependence	Moderate
d) Support	Strong

[1] Standard adjustments in accordance with "Rating Methodology: Moody's Approach to Global Standard Adjustments in the Analysis of Financial Statements for Non-Financial Corporations, Part 1, Part 2 and Part 3." In addition, Moody's adjusts for one-time items. [2] 3-year average metrics (2007-2009); Source: Moody's Financial MetricsTM

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