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- Q3 2016 Vattenfall AB Earnings Call

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Andrew Moulder *CreditSights - Senior Analyst*

PRESENTATION

Karin Lepasoon - *Vattenfall - SVP Communications*

Good morning, and welcome to this presentation of Vattenfall's nine month report 2016. As usual, this is a live meeting here in Solna, combined with a webcast and a telephone meeting.

In a moment, we'll hear from our President, CEO, Magnus Hall, and our CFO, Ingrid Bonde. Afterwards, we'll open up for questions. And after this conference meeting is over, there's also possibilities to have personal interviews with Ingrid and Magnus.

With that, Magnus, over to you.

Magnus Hall - *Vattenfall - President, CEO*

Thank you very much for that introduction. And also from my side a warm welcome to all of you in this room, and, of course, also to all of you on the web and on the telephone on the presentation of the nine month results 2016 for Vattenfall.

We'll go straight into the figures. You will see from this first slide that we are looking at two different ways of reporting the results. The one that we will concentrate on would be the continuing operations, which means that we are excluding the Lignite business that we divested at the last of September. But also on the right side you can see the total Vattenfall figures, including the Lignite operations.

And of course, it's an important quarter for Vattenfall as we have closed the Lignite divestment. We are now focusing Vattenfall more towards the future where we believe Vattenfall has a lot more to do in terms of being a player in the new energy landscape being much closer to the customers, making much more in terms of renewable production. And there are lots of business opportunities there; that's quite obvious.

We will come back to that. Just a few highlights during the quarter, we have won the bid on the Danish Near Shore, I will come back to that also. We are continuing to reduce our CO2 emissions. We have some proof points to that. And of course, the regulatory environments surrounding the nuclear business is hopefully coming to a much more clear position as we go along towards the future.

Vattenfall has changed its strategic directions since about a year now. We're having our strategy around four strategic objectives; that's to be closer to the customers and have them become more sustainable. That's to also develop the production in terms of sustainable and climate neutral production, and we also of course have very high demands on a high performance culture and then also driven by a very strong and empowered organization.

You can see to the right some of our targets that we have put up in relation to those four strategic objectives. We want to come close to our customer engagements, we want to commission renewable capacity, we want to reduce the CO2 emissions. We have a clear target for ROCE even though you can see for the first quarter; I need to go back one picture. Where you see the result for the first nine months is actually 14.6 -- the



underlying EBIT is SEK14.6 billion versus the EBIT is SEK4.2 billion. We took around a SEK10 billion impairment; not only the Lignite business has been impaired but also the business that's on a continuing basis for Vattenfall. That resulted in a ROCE of only 3%.

Of course, our aim is to reach the 9% as years go, but we are not there right now. We also have safety and we have employer engagement as two important targets when it comes to driving our organization in the right direction. Our customer-base is growing, we can see that now. We have that in all three parts where we have customer engagements; it's in the customers solutions, it's the sale side where we have increased our customer-base by 70,000 customers the first nine months of this year.

We have a strong what's called a net promoter score, which means that our customers are actually recommending Vattenfall also to their neighbors, which is an emotional way of measuring their relation to the Vattenfall brand and what they think we stand for.

We have managed to lower our cost to serve and we also introduced innovative new products in that direction. If we talk about the heat, which is also consisting of many customers for Vattenfall, we had an increase of close to 30,000 customer's year-to-date. This is a business with a low churn rate; of course, you are connected to the heat system once you invest in that and you stick to that. We have a very strong political support where we are operating, and in general, this is seen as a clear path of the sustainable development for the energy supply for the future.

And we see more growth potential both in the actual district heating business, but then also in decentralized solutions where you have from Vattenfall the offer also to find other solutions for your heat needs. And in the distribution, we are happy to have two positions, these are geographic of course, and you can't expand outside the geographic positions unless you do buy some companies or buy areas. We are around the Stockholm area and we're also in the Berlin area. Of course, we can see quite good growth; 20,000 customers so far has been connected to our grids. And here, we have a very high quality focus; we invest a lot of money, increased quality and their lower interruptions. That's a very important thing for us going forward to make sure that our customers have the best available availability in terms of electricity.

But we can also see that the growth is driven by the fact that we have positions in the big cities. And we will see in the future much more digital grids and we will also need to invest not only to connect new customers, but also to connect much more renewable energy into the system. And therefore, investments into the distribution business are necessary for the future.

Stable electricity generation in the quarter; in the first nine months you can see from this picture no big change from last year. We had a little bit better availability on the nuclear side but still Ringhals number two reactor is in a standstill position, whereas we now have the go ahead from the Swedish regulatory authorities to start it up by December. And of course, that's an important thing for us also to move in that direction.

The market situation for electricity prices continues to be under pressure. In the immediate term, we see some increases in the Nordics because we have a slightly lower hydrologic, a little less water in the system. We can also see it in the continental side where there are some issues around nuclear availability in France, putting some additional pressure on the German situation when it comes to the available capacity to supply electricity.

And that also, in its turn, puts pressure on coal prices. So you can see what is happening just now is that you can see to the right, even though it's not so clear from the picture, that coal prices are going up and they are now starting also to push gas prices upwards a little bit.

If we look to the long term, so short term, we see slight uptick, but if we look to the long term we really see more or less prices being on a very low level which means that of course, the price pressure on our operations will continue, and from that aspect, we have to continue our cost savings in the Vattenfall group in order to handle this. And we have some clear programs for that going on.

We have as part of our increase to be a player towards renewable and sustainable production of electricity and heat. We have a proven competitiveness in wind according to what we can see. We have been able to win auctions in a very competitive environment. This last one is the Danish Near Shore. It's not yet approved by the Danish government and we have to say that, but its two offshore wind parks outside the west coast of Denmark, totaling of 350 megawatts. And yes; right now this seems to be the most competitive costs we have been able to present in terms of in the wind area. Not only for Vattenfall, but in general.



We have one big park that we're building together with a German -- the Munchen Stadtwerke outside the German Danish coast, and there we have been able to actually produce electricity earlier even before we have commissioned the whole park, which is a good sign. We can see that we could use that in future projects, which means that we can also reduce costs from that perspective, improve the projects that we have in front of us.

And then you can also see that we are acquiring projects in terms of building the pipeline for the future, where we want to expand in this area. That's quite clear. Not only in offshore wind; this is offshore wind, but also in onshore wind. But here we have a wind development site outside the northwest coast of Germany, and it's around 600 megawatts, which we'll be able to participate in two auctions in Germany in 2017 and 2018.

For us to continue to deliver on reduction of CO₂, of course, the significant change we have had now with the divestment of the Lignite business, that's quite clear. That's close to 60 million tons a year. That's being reduced by the fact that we are taking that out. So as you can see, we go from 84 to 24 if you adjust for that alone. But then we also have a target scenario for 2050 where we want to be climate neutral. But you can see on this picture, we're not yet fully climate neutral because of the fact that we still have gas in the system in our continental business.

But what you will see here is the phase out of coal, which will go to gas, and eventually we will have to look at other solutions to take the last part, because you can - in a district heating system, you can store quite a lot of heat when you have cheap electricity prices from all renewables. And so we will see this development, most probably also taking out the last five million tons.

And we are working on that. We can also show some proof points of this. We have just announced that one of our coal power plants in Berlin has changed from coal to gas in May next year. That's 600,000 tons a year we take away. Moorburg is going towards a CHP, which means that we can actually use the waste heat, which we are now not using to a full extent. And of course, that's mostly an economical rather than an environmental clear issue for us. And then we have just announced not so long ago a city partnership with Uppsala where we will invest in a bio-based boiler for the Uppsala heat system. So, we are moving clearly in that direction with lower CO₂ reduction.

And the last point, also, the nuclear regulatory developments are favorable in the sense that we have of course the improvements in conditions - if you look to the right in the Swedish system for the Swedish nuclear. And the tax will now be abolished the first 90% by the 1st of July next year and then fully from the 1st of January, 2018. And that's a significant change for Vattenfall. What is also being announced not so long ago is that the authority, together with the government, will now be looking at a longer period for financing the waste fee, which is also favorable for us. We believe as we will run the nuclear power plants for a longer period of time, it makes sense to also have the financing taken out for a longer period of time. But we shouldn't forget that we are, as an operator, still fully responsible for the final cost of the waste fee. It's not that we get away with only the fund.

The German development, as you know, there is a discussion and now it's turned into a [draft] law; a proposal from the German government that will mean that they will create the fund. The operators will pay into this fund, their provisions for the medium and long-term storage. And they will add the 35% top-up on that in order to secure for the state that there is enough money to handle this. And we see this as a very positive development. There are still things that need to be negotiated so that this is quite clear what is actually included when you have the turnover into how it looks when you turn the waste over, and some other issues that are being negotiated right now. But it's now turned into legal process in Germany. And we hope that during Q1 next year we will be able to have a law that can actually release us, even though we will pay into this fund of course, but will also release us from this risk that we have with the long-term obligations in Germany.

So, several positive developments in terms of the future, clear, new electricity price still being under pressure. So from that aspect, we have also a tough situation even though we see growth in lots of areas which are important apart from the electricity business.

With that, I would like to leave the word to Ingrid Bonde. Ingrid, you can stay for a second. I would just say that it's Ingrid's last quarterly report. And Ingrid Bonde has been instrumental, I believe, in the way Vattenfall has changed in being able to turn this business around in terms of cost savings, and now also moving into a new strategic direction. So from that aspect, Ingrid, I think you have a lot to be proud of. But what will happen to you and what you will do in the future is up to you. But now, you will have to show us what the Q3 and nine month results for Vattenfall look like in more detail. Welcome.

Ingrid Bonde - *Vattenfall - CFO*

Thank you very much, Magnus. Yes, it is a bit sentimental to be here today, the last quarter result is actually number 23 since I joined Vattenfall as a board member in 2011. And it's been a fantastic time and I will see what happens for the future, as always.

The results that we are showing today, as Magnus explained, we have tried to make it as transparent as possible on what is the remaining operations after the divestment of Lignite and what is the total result, including the Lignite operations that we had in our family until the end of September. As you might recall, when we announced the divestment in the Q2 result, we tried with coloring to show the difference and to ensure that you could monitor the effects of the Lignite divestment. And now we're doing it in the form of continuing operations and total Vattenfall. So, please be aware of that is actually our aim to be as transparent as possible, even though it becomes a bit more complex, of course.

The four trends we have for today's results; we have, we believe, solid financial results despite the challenging energy landscape. We have, as you might remember, improved the financial situation gradually. And we have today, we believe, a very resilient financial position, even though the market prices are still very weak.

We have a strong liquidity position. We don't expect any funding needs immediately unless we decide for other types of reasons to do some restructuring. We have a reduction in adjusted net debt, we have positive cash flow, and we also have the adjusted net debt reduction due to the provisions for the Lignite operations now handed over to the new owner. We've also decided to do some changes in our hedging strategy, and I'll come back to that in a few minutes.

Just a graph showing then the development of the financial ratios. We have a positive development of the underlying EBIT. As you can see, this is rolling 12 months for each year. The EBIT, though, has of course been affected by the items affecting comparability that has affected us. And as Magnus pointed out, in the remaining operations we did do an impairment in Q2 relating to the sort of valuation of our assets according to our established methodology based on our forecast of future market prices.

But then for total Vattenfall, we then have also the effect of the write down for the Lignite operations that we also did in Q2. We have no major changes in the impairments or the items affecting comparability between Q2 and Q3. So these are the numbers that you have already been able to digest. The debt reduction is then a function of the actual closing now of the divestment, and so is also the positive cash flow. We also have some tax refunds on the positive cash flow that is improving the results.

So going through the financial highlights; net sales being sort of lower than last year, but underlying EBIT is actually improving. And that is then thanks to strong efforts to reduce operating costs within the Company, and that goes across all the business areas. But then of course we also have lower depreciation since we have a lower asset-base after the impairments having been done.

We have a profit after tax of the continuing operations of 1.8. That includes the SEK10 billion, roughly, impairment as we talked about which is then related, again, to our forecasted price curves on the remaining operations and the difference then towards the Lignite divestment effect.

And you can also see here then that the adjusted net debt is significantly improving and we also have a very satisfactory FFO over adjusted net debt, and that means that we are now, after these activities and after these measures we have made, including of course the positive effect of the abolition of the nuclear tax in Sweden and the reduction of the hydro tax. We are now having an FFO over adjusted net debt in line with our financial targets.

As you can see on this bridge, you can see that the production volume on the underlying EBIT -- effect on the underlying EBIT on the continuing operations is relatively unchanged. We have some negative price effects, and as I just said, we have mitigating factors with lower operating expenses, partly the automatic ones of lower depreciation from written down assets, but also very significant contributions on the cost saving programs that is ongoing in the whole Company. And I think we said before that we've actually so far since we started this cost saving programs in 2010, we have reduced the external operating expenses; we're now in excess of 30%. So we're quite satisfied with that. It doesn't mean that we are home safe. We have to keep on focusing very strongly on adjusting our cost structure to the very competitive energy landscape, but we are so far so good, quite satisfied with the efforts that have been made.

You can see then that the underlying EBIT by operating segment is stable and positive for most of the business areas. Power generation have, of course, been affected by the lower energy prices. That is today the area that is of course most exposed to energy only while the other areas are doing quite well. The wind operation had a low result for the period primarily due to poor wind conditions, in particular in quarter three. The other areas are doing well, and all in all then, we have an underlying EBIT in excess of the similar period of last year.

The cash flow development is also quite satisfactory. We have, as you might recall, made strong efforts to reduce the sort of investment program in existing assets in favor of investments in new assets in the transition towards the more renewable energy landscape and our sort of sustainable production. And as you can see, now we've now come to the point where our growth investments, in particular wind, are actually in excess of our maintenance investments. And that is then, I would say, the evidence of the shift that we've been working quite hard on for a number of years is now showing very strong results. Divestments SEK4 billion, and thereby, we have a cash flow before financing activities of SEK7.2 billion. The divestments, all of them, announced already in Q2.

So, on the financial targets then, we have a return on capital employed if you then exclude items affecting comparability of 8.4; so close to the target. We have for total Vattenfall, 8.5. But of course affected by the impairments; the actual result for the period both for remaining and total is then lower. You can see here now then that the FFO over adjusted net debt for continuing operations is 23.9 and for total 24.5. You might then wonder why we have a better FFO on total than in remaining, but that is technical due to the fact that the FFO is based on -- the ratio is of course based then on the adjusted net debt. And as I just said, the adjusted net debt has been significantly reduced, with the Lignite divestment. Accordingly, the ratio technically becomes better for total Vattenfall than for the continuing operation. But most importantly, both ratios irrespective are actually now in line with our targets, which is something that we worked quite hard with for quite some time. Debt over equity is within the range and has been for quite some time, so it's more the FFO with adjusted net debt that has been in focus for us.

Finally, I'd last like to just explain to you a little bit our change in our hedging strategy. We have as most energy companies for quite some time hedged a major part of our production to reduce the financial volatility on our gross margins. We actually increased, as the energy price volatility increased the last years, we have increased the volumes hedged, as you might have followed. And now we've decided that we have a much stable financial position and also a much less exposure to energy only with a much better business risk mix, we believe. And thereby, we have decided that we can go back to the situation we had some few years back, and thereby also reduce the amount of volume hedged from now on.

And we would also focus more on the hedges on the Nordic side and on the hedges closer to delivery. So, it means that we will gradually shift over to this new hedge strategy as we sort of go into the next year because, as you know, and have already appreciated, we have already hedged the very early years, and thereby, the effect becomes gradual as we move into the realization of the existing hedges.

That's what I was planning to present today, and then we will go for the Q&A.

QUESTIONS AND ANSWERS

Karin Lepasoon - *Vattenfall - SVP Communications*

So please, Magnus and Ingrid, and [Robert] will join me here on stage because you will monitor the webcast, the questions we have there.

But we will start by taking questions here in the audience in Solna. Anybody who wants to ask a question to Magnus or Ingrid? Not this time either, but I think we do have a couple of questions on the webcast and possibly on the telephone as well. We start with the webcast, Robert.

Robert Pletzin - *Vattenfall - Communications*

Yes. We have a first question from Andrew Moulder from CreditSights. It's relating to Sandbank.



Andrew Moulder - *CreditSights - Senior Analyst*

Is the fact that you have been able to produce wind power from Sandbank before the full project commissioning due to the unique specifics of this particular field? That is, the way the turbines are connected to the grid, or is this something you could do on a regular basis for all your new fields?

Magnus Hall - *Vattenfall - President, CEO*

I'm not a super technician, but as I understand it, this is something where you can, under certain circumstances, use for most of the fields that we look forward. And it's a real improvement that we could use not only for this project, but also for most future projects.

Karin Lepasoon - *Vattenfall - SVP Communications*

You have another question, Robert?

Robert Pletzin - *Vattenfall - Communications*

We have another question from Andrew Moulder, again CreditSights, relating to the German Nuclear.

Andrew Moulder - *CreditSights - Senior Analyst*

On the German Nuclear storage, you stated that you do not expect parliamentary approval until Q1 2017. But I thought the first 20% payment needed to be made on January 1, 2017. Is this right, and if so, would you make a payment before you know the exact details of the law as it will be passed by the Parliament?

Magnus Hall - *Vattenfall - President, CEO*

This is actually one of the points that is unclear that we need to negotiate around to make sure how it will actually work. We will, of course, not pay any money until we have the full picture of what it will look like so that we get the release of the risks. Otherwise, there is no use in paying. So there will be a process now, of course, in the parliamentary process where we will also participate and see where we will land.

Ingrid Bonde - *Vattenfall - CFO*

I mean, in our liquidity planning today we are assuming that this will materialize, and thereby, prepare ourselves for that payment.

Karin Lepasoon - *Vattenfall - SVP Communications*

We don't have questions from the telephone conference. Any further questions on the webcast?

Robert Pletzin - *Vattenfall - Communications*

Not at this point.

Karin Lepasoon - *Vattenfall - SVP Communications*

All right. That actually closes this meeting here in Solna. Thank you very much, everybody, for listening in and participating.

Ingrid Bonde - *Vattenfall - CFO*

Thank you.

Magnus Hall - *Vattenfall - President, CEO*

Thank you.

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