

Five Reasons Why Austrian Utility Ratings Are Proving More Resilient Than Their European Peers

Primary Credit Analyst:

Tuomas E Ekholm, Frankfurt (49) 69-33-999-123; tuomas_ekholm@standardandpoors.com

Secondary Contact:

Andreas Kindahl, Stockholm (46) 8-440-5907; andreas_kindahl@standardandpoors.com

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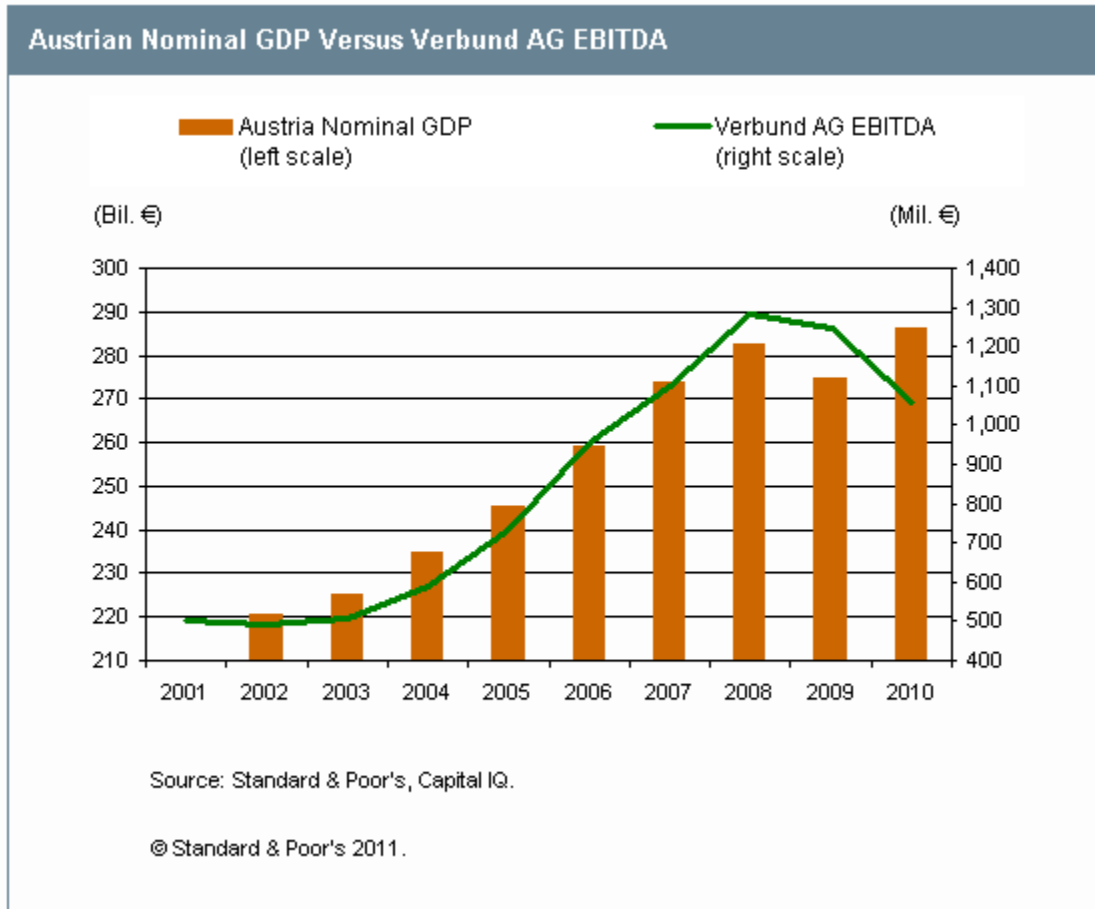
The operating environment is becoming harsher for European utilities. The growing specter of a double-dip recession in Europe suggests slower economic activity could continue cutting energy demand, while volatile commodities markets are raising companies' input costs, especially for gas. Meanwhile, forecasts show that the cost of meeting EU carbon emission targets will increasingly weigh on many companies' earnings. The debt crisis, primarily in Southern European countries, is also putting pressure on the ratings of many utilities that are fully or partially government-owned, and political risks are also materializing, most notably in Germany through the move away from nuclear generation. This is taking its toll on the credit quality of utility companies in Europe, the Middle East, and Africa (EMEA). Alone over the past four quarters, downgrades have greatly exceeded upgrades by 23 to 14 in a group of total 158 rated entities, but the trend has been ongoing since the financial crisis onset in 2008.

Yet amid these adverse conditions, the credit quality of Austria's rated utilities, which operate in mostly liberalized markets, appears largely immune to these pressures, even though they are smaller and less diversified than many of their European peers. The last downgrade of an Austrian utility rated by Standard & Poor's Ratings Services was in May 2009. We see five key factors supporting the ratings on the five Austrian utilities we rate: Verbund AG (A-/Stable/--), EVN AG (A-/Negative/--), Energie AG Oberoesterreich (A/Stable/--), KELAG (A/Stable/--), and Energie Steiermark AG (A/Stable/--). These are as follows:

1. They Operate In A Stable Economic Environment

In a liberalized energy market, such as Austria, one of the most important success factors for utility companies is the economic environment in which they operate. This is because the demand for electricity and gas closely tracks economic activity. In liberalized markets where energy pricing is based on supply and demand, industrial production levels also significantly affect wholesale energy prices. The correlation between the development of Austrian GDP and Verbund's EBITDA illustrates this interaction between the economy and financial performance of its largest utility (see chart 1).

Chart 1



Austrian utilities can rely not just on the strength of the Austrian economy, but also benefit from their proximity to neighboring Germany. The Austrian electricity market is closely connected to the German market, and the two countries in effect form one pricing zone for wholesale of electricity, which directly affects the value of the output of the Austrian power generators.

Standard & Poor's rates both the Republic of Austria and the Federal Republic of Germany at its highest rating level (AAA/Stable/A-1+; ratings on both countries are unsolicited). We view both economies as modern, highly diversified, and competitive.

2. Their Competitive Environment Is Not Too Burdensome

Even though it is a fully liberalized market, we consider Austria's market environment for utilities more credit-supportive than other liberalized energy markets in Europe. The Austrian authorities fully opened the electricity market to competition in 2001, and the gas market one year later. Yet the former regional monopolies, the majority of them fully integrated operators, have kept their very high market shares. In some regions, such as the states of Carinthia (NR; where KELAG operates), Upper Austria (AAA/Stable/A-1+; Energie AG), and Styria (AA+/Stable/A-1+; Energie Steiermark), these companies still hold a market share of above 90% of the household and SME customer segment. In other regions, too, the share of the market held by incumbents is very high. In fact,

the market has become more concentrated in recent years, despite the entry of alternative suppliers to both the electricity and gas markets, after a series of mergers and joint ventures. This has cut competition rather than increased it.

The Austrian electricity supply market is less subject to competitive forces than other liberalized European markets, in our view. According to Austrian power and gas market regulator E-Control, the three largest power suppliers of household customers hold about 60% of the market, and the five largest suppliers hold about 70%. Market shares of suppliers to small and midsize enterprises are similarly concentrated. In this environment, customers have little incentive to switch their electricity or gas suppliers, even though they have the right to do so. Switching rates among household customers are also on the decline. E-Control figures show that a mere 1.8% of households switched suppliers in 2010 and only 1% during the first half of 2011, which is significantly less than in other Western European countries with liberalized electricity markets. While in Germany the annual switching rate is increasing only slowly, and is still in the single-digit range, in the U.K. 15% of electricity customers and 17% of gas customers switched suppliers in 2010.

Austria's gas market is also highly concentrated. The country depends heavily on gas imports from Russia, with nearly 70% of the gas procured from Gazprom Export by oil-indexed long-term contracts. Only a few operators have closed import contracts with Russian, Norwegian, and German suppliers, and they dominate the wholesale market. The retail market is also highly concentrated, with the three largest suppliers together holding about 80%, according to E-Control, while the five largest suppliers hold 90%, and the 10 largest 97% of the small consumer market. EnergieAllianz, a joint venture of three regional providers, has the highest market share in this segment, at more than 60%, through its sales companies. In 2010, less than 1% of all Austrian gas consumers changed their supplier.

Austria's power and gas supply market is fairly small compared with neighboring countries, with prices at about the EU average. It is therefore unlikely to attract major foreign competition, at least in the household and small customer segments. A market entry by a foreign player through an acquisition is blocked by majority public ownership of all regional and national utility companies, which is anchored in national and state legislation. We do not expect this to change in medium term.

3. Their High Share Of Hydropower Offers Environment And Economic Advantages

We see the high share of hydropower assets in Austrian power generation as a clear competitive advantage for Austrian utilities over their European peers because this type of generation is not affected by EU carbon dioxide regulation. What's more, hydropower plants benefit from low marginal production costs and high utilization. In 2010, about 53% of Austrian electricity generation was sourced from hydropower, whereas the majority share of German power generation was thermal, which has higher marginal costs and lower utilization rates for the generation assets. Furthermore, none of the Austrian generators have nuclear capacity, and therefore do not face political risks related to operating this type of asset.

The German government's decision earlier this year to shut down part of the German nuclear fleet has also directly benefited Austrian hydropower producers. The closure of nuclear power plants has increased wholesale prices in the German-Austrian pricing zone by about 10%. This increases the value of outright production of Austrian

hydropower generators without increasing production costs. Furthermore, the hydropower assets are not affected by the full auctioning of carbon dioxide (CO₂) emissions rights, which is set to start in 2013. This will significantly increase the cost of thermal production, and thus curb the profitability of companies with a high share of thermal capacity in their generation portfolio.

We forecast the German reserve margin in power generation will stay much lower in the foreseeable future than historically because of recent plant closures and scheduled decommissioning of existing power plants reaching the end of their economic lives. In our opinion, this decrease in overall power supply in the German/Austrian pricing zone should increase wholesale power prices in the medium to long term, provided the economy doesn't contract. Furthermore, the lower reserve margin and growing use of volatile solar and wind power generation increases the demand for grid-balancing power. Austrian hydropower generators with flexible pump storage capacity look to be well placed to serve this high-priced demand, and are currently investing to expand their existing pump-storage facilities.

4. Vertical Integration And High Share Of Regulated Activities Stabilizes Their Cash Flows

All Austrian utility companies we rate offer a full range of energy-related services, and some are also engaged in water and waste activities. We see this vertical integration as positive for their business risk profiles because it spreads the risk over various parts of the utility supply chain.

In general, we view the monopolistic power and gas network operations to have the lowest business risk, followed by integrated operators. We view as higher risk companies that focus purely on the downstream or upstream side of the business or trading (see table 1). In electricity, all our rated Austrian utility companies are fully integrated (except for Energie Steiermark, which lacks significant own generation capacity). Their activities span generation, supply, and operation of networks. In the gas segment, companies' activities range from gas imports to supply of gas and operation of gas grids.

Furthermore, Austrian utilities typically have a sizable share of regulated activities in their portfolio, which adds a stable and predictable component to their earnings and cash flows. The regional utilities operate regional electricity and gas distribution networks, as well as gas transit pipelines in some cases, in addition to energy generation and supply-related activities. Verbund, as the only nationally operating utility, operates the national high voltage transmission grid. We believe that a meaningful portion of regulated utility activities as part of a group structure contributes positively to a company's capacity to carry debt. We also view the Austrian regulatory framework as transparent and predictable, which is credit supportive.

Table 1

Standard & Poor's View Of Business Risk For Utility Activities

Activity	Risk indication
Transmission	Very low
Distribution	Very low
Large integrated	Low / average
Medium-sized integrated	Average
Merchant generation	Fair
Retail supply	Fair / high

Table 1

Standard & Poor's View Of Business Risk For Utility Activities (cont.)	
Exploration and production activities	High
Trading	High / very high

5. Majority Government Ownership Supports The Ratings

According to Austrian national and state laws, utilities must be majority owned by the state or the central government. The public also views utilities as a basic public service. Local or national governments typically hold stakes of between 50% and 100% in the utility companies. This enhances the utilities' credit quality, in our view, because for most utilities we rate in Austria we consider there is a "moderate" likelihood that these government owners would provide extraordinary support for utilities in case of financial distress. This, together with the high credit ratings of the states, enhances the utilities' credit quality, according to Standard & Poor's criteria on rating government-related entities (GRE). For further information see the article "Rating Government-Related Entities: Methodology And Assumptions," published on Dec. 9, 2010, on RatingsDirect on the Global Credit Portal. The only exception to this is KELAG, whose main shareholder, Carinthia, is less financially strong than the other states.

We've seen plenty of evidence of support for Austrian utilities by their majority shareholders in the recent past, even though the form of support has been ongoing rather than extraordinary in nature, according to our criteria. In 2010, the Republic of Austria participated in Verbund AG's capital increase, and the State of Lower Austria (AA+/Stable/A-1+) in the capital increase of EVN, according to their share of ownership. Both cases underline the commitment of governments toward utility companies at national and regional level, in our view.

Majority state ownership is not by definition a credit-enhancing factor. Indeed, it can also have a negative impact on a company rating. We have recently seen this development in Greece and Portugal, where state-owned utility companies Public Power Corp. S.A. (B-/Watch Neg/--) and EDP - Energias de Portugal S.A. (BBB/Negative/A-2) have been negatively affected by the less beneficial state of government finances as well as the state of the economy, resulting in downgrades.

Financial Policies Will Be Key To Future Rating Developments

We currently don't envisage major threats to the operating environment of the Austrian utility companies, such as sharply increasing competition in the domestic market or significant regulatory changes affecting their network or supply operations. What's more, their higher share of environment-friendly assets compared with their Central European peers seem certain to gain them competitive advantages from ongoing energy policy changes. First, they face fewer costs than peers from EU policies to significantly reduce carbon dioxide emissions by 2020. Furthermore, should electricity and commodity prices increase according to long-term industry forecasts, the impact for hydropower generators will be strongly positive.

We also note that amid the deteriorating economic climate and political environment for European utilities over the past few years, Austrian utility companies have maintained a healthy working relationship with politics. This is in contrast to many other European countries, where in our view political tension has increased and the climate has become less friendly toward utility providers. This has so far materialized as higher taxes and unfavorable policy decisions in a few countries, and is likely to continue. We believe that the high proportion of public ownership in

Austrian utilities, which we see as unlikely to change in medium term, largely prevents clashes between policymakers and utilities, and therefore reduces political risk.

Given that we don't foresee forthcoming major business risk shifts for the Austrian utilities we rate, we believe the ratings will be influenced mostly by companies' financial policy decisions. Whereas some of the companies have more room to maneuver, for others the rating headroom is more limited because of currently relatively high leverage, resulting mainly from debt-fueled expansion before the financial crisis (see table 2). Yet, here too, we currently perceive a shift toward more cautious use of financial leverage to align investment volumes better with cash generation. In a similarly more cautious vein, we note that many of the Austrian utility companies have revised their foreign expansion plans and refocused their investment on core domestic activities, which we perceive as lower risk.

We believe all these factors will continue support the credit quality of Austrian utilities over the coming years. As a result, we think they can look forward to the future with more confidence than some of their European peers.

Table 2

Austrian Utilities Rated By Standard & Poor's -- Peer Comparison					
	Verbund AG	EVN AG	Energie AG Oberoesterreich	KELAG	Energie Steiermark AG
Ratings (as of Nov. 3, 2011)	A-/Stable/	A-/Negative/--	A/Stable/--	A/Stable/--	A/Stable/--
Stand alone credit profile	bbb+	bbb+	a-	a	a-
Business risk profile	Strong	Satisfactory	Strong	Strong	Satisfactory
Financial risk profile	Significant	Intermediate	Intermediate	Modest	Modest
FFO to debt guidance	20%	25%	25%-30%	30%	35%-40%
--Fiscal year ended--					
(Mil. €)	Dec. 31, 2010	Sept. 30, 2010	Sept. 30, 2010	Dec. 31, 2010	Dec. 31, 2010
Revenues	3,307.9	2,807.9	2,052.0	1,528.0	1,297.8
EBITDA	1,085.9	433.7	300.4	171.0	184.4
Net income from cont. oper.	400.8	207.0	64.6	91.0	67.5
Funds from operations (FFO)	788.0	516.2	266.2	178.7	175.5
Cash flow from operations	779.5	546.2	275.0	209.0	193.1
Capital expenditures	661.2	383.3	174.8	155.9	202.3
Free operating cash flow	118.3	162.9	100.3	53.2	(9.1)
Discretionary cash flow	(337.0)	80.1	44.4	28.1	(45.2)
Cash and short-term investments	80.3	0.0	0.0	0.0	0.0
Debt	4,365.8	2,189.8	899.0	284.8	209.2
Equity	4,782.2	3,405.5	1,697.7	636.2	1,510.6
Adjusted ratios					
EBITDA margin (%)	32.8	15.4	14.6	11.2	14.2
EBITDA interest coverage (x)	4.0	4.7	5.4	6.1	12.7
EBIT interest coverage (x)	3.4	3.9	2.7	4.8	8.6
Return on capital (%)	10.4	6.1	5.4	14.8	7.4
FFO/debt (%)	18.0	23.6	29.6	62.7	83.9
Cash flow from operations/debt (%)	17.9	24.9	30.6	73.4	92.3
Free operating cash flow/debt (%)	2.7	7.4	11.2	18.7	(4.4)
Discretionary cash flow/debt (%)	(7.7)	3.7	4.9	9.9	(21.6)

Table 2

Austrian Utilities Rated By Standard & Poor's -- Peer Comparison (cont.)					
Debt/EBITDA (x)	4.0	5.0	3.0	1.7	1.1
Total debt/debt plus equity (%)	47.7	39.1	34.6	30.9	12.2
--Average of past three fiscal years--					
Adjusted ratios					
EBITDA margin (%)	35.2	15.0	16.0	12.7	13.1
EBITDA interest coverage (x)	5.1	3.9	5.2	5.9	10.7
EBIT interest coverage (x)	4.7	3.5	2.8	4.7	9.5
Return on capital (%)	15.8	6.4	6.5	15.1	9.3
FFO/debt (%)	25.6	23.5	26.7	55.2	110.0
Cash flow from operations/debt (%)	23.6	22.7	24.7	69.6	106.3
Free operating cash flow/debt (%)	9.9	2.8	3.0	23.4	16.5
Discretionary cash flow/debt (%)	(0.9)	(1.8)	(2.7)	11.6	(18.4)
Debt/EBITDA (x)	3.1	5.0	2.9	1.8	1.0
Total debt/debt plus equity (%)	50.0	37.4	35.6	33.4	10.6

Additional Contact:

Infrastructure Finance Ratings Europe; InfrastructureEurope@standardandpoors.com

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