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Q1 2019 Vattenfall AB Earnings Call

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PRESENTATION

Karin Lepasoon Vattenfall AB - Head of Communications

Good morning and welcome to this presentation of Vattenfall's Q1 Report 2019. As usual, this is a live meeting here in Solna combined with a webcast and a telephone conference.

In a moment, we will hear from Magnus Hall, our CEO and Anna Borg our CFO, and after that we will open up for questions. So with that, Magnus, it's over to you.

Magnus Hall Vattenfall AB - CEO

Thank you very much Karin and also from my side a very warm welcome to this morning's quarterly report for Vattenfall 2019. And I also welcome everybody on the web and in this room.

We saw a quarter which was clearly a good contribution from our fossil free power production sources, being hydro, and nuclear, and wind. But we also weighed our earnings, were weighed down by the storm Alfrida, and I will get back to that.

That was a significant effect that we had during the first quarter, SEK850 million it has cost us. We also saw some deteriorating returns and earnings in the Customers & Solutions business, mainly because of price increases on the sourcing side that we will be able to recover later.

The result, profit for the period increased with SEK2.3 billion to SEK6.4 billion and that's mainly owing to change market values of the Swedish Nuclear Waste Fund. But let’s go through a little bit more in detail on the results.

This page I would like to draw your attention to the first one where we can see that we have an increase in net sales. A big part of that is increased prices that we see in the market. I will return to that a little bit later.
You can see that the EBIT result we are reporting is an increase of 17% from SEK7 billion to SEK8.2 billion. And that gives a return on capital employed for the last 12 months actually at 7.1%.

The customer sales in electricity is almost on the same level as last year, but we can see we had some warmer weather in the first quarter, we can see that affecting both gas sales and heat sales.

And when it came to electricity production, as I just mentioned earlier, we can see that we have a slightly lower production in nuclear power and hydro power but the prices were good. On the total we saw some declines, but of course also increased now in wind power and I will also return to that.

Customers & Solutions, looking at the underlying operating profit, close to SEK400 million compared to SEK1 billion last year is of course a much lower result. And here as prices are going up, it takes time before we can actually take and transfer those prices to our customers and that will be the next step during the year.

But we can also see of course in the turnover, the price effects that we have of increased prices generally in the market, but we need also to continue to work to increase our own prices.

Increased customer base in Germany, we are continuing to increase our customer base, which is a good thing. And then because of the situation we have generally with competition in the sales business, we are looking at intensifying work on cost reductions in all markets.

In the meantime, we have acquired a Dutch retailer called DELTA, and they are fairly locally represented -- very strong representation in parts of the Netherlands, which makes a good contribution to our sales business in the Netherlands. So we're happy for that.

And we continue to expanding our e-mobility networks all over in Europe and now we have just entered also Norway as a market, which is probably the most advanced market of e-mobility in Europe where car sales for electrical cars now is coming over 50% of the new sales, which is a significant change of course of their market.

We have talked earlier about the situation in the UK where we had an acquisition two years ago and where the pressure has increased significantly. We can see that easing slowly, but still we are of course not happy with the situation as we have it there.

Power generation is consisting of our production of nuclear and hydro, and then also our trading and market access operations. Here we have a significant improvement of operating result from SEK3.8 billion to SEK5.4 billion. And, you can see the net sales increased because of electricity prices going up.

And we had some lower production mainly we had it in hydro, but we also had it in nuclear, based on a problem we have with one generator in our reactor number two in Ringhals, which we are just now repairing. So hopefully that will be back during the quarter two.
We have also acquired an interesting company called Senfal which is a young company who works with software that can actually help us aggregate customers and help them use their electricity as a flexible tool to earn money on there. And we as a market access company can offer this service to our customers. So we really look forward to that.

Yes, you can see on the picture here to the right some graphs. In the middle one if I can draw your attention to that, that is the price in Sweden. And it's a system price in Sweden, it's also the hydro balance, which is actually how much water we have in the system and that determines pretty much the balance of the system in Sweden.

And you can see that we have had some improvements in terms of the hydro balance. You could also see that last year we had a significant downturn in the hydrobalance which meant the prices were coming up.

And now in the last period prices have been slowly coming up. But if you look to the longer term, to the right, at least over two years you can see that we have a significant change in prices versus the same situation last year.

Wind is where we put a lot of our investment money and of course we can see also here now an increase in the profitability from roughly 1 billion first quarter last year to 1.5 almost this year.

We have offered two new bids, big bids that we have under consideration right now. One is the Hollandse Kust Zuid 3 & 4 which is then connecting to the 1 & 2 which we have already won in the Netherlands.

Big wind farms, roughly 750 megawatts each and a considerable part of the development and of course there are synergies that we hope will be able to help us win this tender. And, then we are also participating in France in a wind farm outside Dunkirk.

So let’s see how that works. We inaugurated a few wind farms and I’d like also, we don’t talk that much about solar but we inaugurated our biggest solar farm which we have built around our Magnum plant, our big gas-fired power plant in the Netherlands, close to 6 megawatts of solar power.

You can see to the right also we have now just crossed 3 gigawatts of wind power installed and we continue to grow and invest going forward.

Heat, there we had almost the same situation as last year with rather warm weather during the period, but we delivered an operating result of 1.5 billion on the same level as last year. We continue to increase with customers roughly 0.5% in terms of customers which we see, it continues to grow.

This is also consisting not only of district heating units which is of course the main business, but also our
condensing units in gas and coal and our Hemweg 8 which is our only coal-fired power plant in the Netherlands.

There the Dutch government had taken the decision to actually not allow us to use coal as of the first of January 2020. It means that we will close it because we have no other options to run it on other fuels. It's earlier than planned but it's also being compensated in a discussion with the government so it will be financially neutral to Vattenfall.

We are continuing our investments in district heating. We have just now taken an investment in Amsterdam where we are cooperating with the waste processing company, waste incineration company in Amsterdam and where we will connect our grid and make use of more waste incineration, reducing the gas usage in the district heating which is of course exactly the right development going forward.

And we have also a decision which is not clear what it will mean in the end but of course we have a proposal now for a way forward in terms of how coal should be phased out in Germany with the Coal Commission.

And the latest date for that should be in 2038. Now that has to be a discussion with the government on how they will actually go forward based on that proposal, so we will see where that will land.

Yes, I think I'll stop there. Distribution which is of course the biggest individual factor during this quarter, the storm Alfrida, where 65,000 customers of Vattenfall got cut off from electricity. We immediately deployed a lot of people.

We were over 500 people working at the same time solving the problem but even though we did this, it took more than three weeks for us to actually connect the last customer, and of course that for customers is a very big issue. But I think we have dealt with it in a very good way.

But 850 million that it costs us, half of it is costs for repairs and the other half is actually costs that we have to pay as penalty to the customers because they have been cut off for such a long time. And just to mention, there would be no real way for us to invest in a grid like that to make it safe for a storm like Alfrida.

So this is the penalty we will have to pay. Yes, we pay it but it will be very difficult to really make it work under those circumstances. The result thereby decreased to 1.3 billion mainly because of this but also because of the warm weather we had some lower volumes.

We keep our investments on the same high level as before and we continue to do that and of course we have the discussion around the regulation in Sweden where the new regulatory period comes up in 2020, and where the government has decided to decrease the earnings and the price that we can take. And of course that will in the end, will have an effect on investments. We will see how that plans out.
But in the meantime we actually won a court case where we could take the old framework for costs into 2020 and actually use it for further investments. But that now seems also to be challenged by a law that the government is proposing. So we will see how this view goes forward.

For us it still remains that the grid is a really important part of the development when it comes to giving cities the possibility to grow, to connect renewable energy sources, to connect new users of electrification, and therefore the need to invest in the grids is still there so we really hope that we can get to a good discussion going forward and continue to invest. But as it looks now the next regulatory period will actually work against this development.

We have also had a decision by the Senate in Berlin to award the concession for the grid which we today operate in Berlin to Berlin Energie which is a Berlin city-owned company. We have worked on that and investigated.

We have now filed a complaint, because we don’t believe that this process has been fair. And we will now, first send that complaint to the Senate of Berlin. And in the second stage we reserve of course the rights to take that further to appeal in court if that is necessary.

This is of course a very important part of the Vattenfall operation in Germany. I think we have been exceptionally good at running this for the Berliners best.

We have been awarded something called super efficient, which means that we are running on top level when it comes to grid operations. And we have difficulty in seeing that the concession should not be with us. But we of course have to take this process in [due wait] and see where it lands.

Just to mention the last point here, Vattenfall Networks. We are also increasing our business in other places. And we have individual networks, independent networks that we have now. Three small networks contracted in the UK, which we are proud of because they are sort of a starting point.

They are not big but they're an interesting starting point for a new business, also for Distribution. So with that I would like to stop this part of the presentation and I would like to turn the word to Anna Borg, CFO of Vattenfall, thank you.

Anna Borg Vattenfall AB - CFO
Thank you Magnus and good morning. Let’s have a look at the financials for the first quarter. We can see an increased net sales compared to the first quarter 2018 of SEK5.7 billion. So the net sales for the first quarter this year is SEK49.6 billion.

That is mainly due to increased spot prices in the markets and also due to increased sales, both in the Nordics, in the Netherlands and in Germany. Our underlying EBIT is also increasing from SEK9.4 billion to SEK9.7 and our EBIT is increasing from SEK7 billion to SEK8.2.
Here we see the positive effects from the price increases coming through in our generation business. And we also see the impact of the growing wind portfolio and the new wind assets that we now have up and running.

On the other hand we see a lower production, especially in our Nuclear operations where the availability is lower than the same period last year. The reason for that is the exchange of the generator in Ringhals 2. And on top of that we have the cost for the exceptional storm of Alfrida in Sweden in the beginning of the year, which is amounting too almost SEK850 million.

The profit for the period is increasing by SEK2.3 billion and is now SEK6.4 billion for the first quarter. This means that on a rolling 12 months basis our ratios is a 7.1% return on capital employed, and a 18.1% FFO over adjusted net debt.

As I mentioned this is rolling 12 numbers which means that we're carrying with us nine months of results from last year which was a bit of a heavy year for us, and also a very heavy investment year.

If we take a look at the underlying EBIT of the first quarter you can see that the result for our Customers & Solutions business is lower than the same period last year. This is mainly due to two temporary effects.

The first one is the increased cost for sourcing, since the prices in the market have increased. This will be transferred to increased tariffs for our customers but there is a time lag in order to make this happen.

At the same time we're taking in a lot of new customers, especially in the German market, almost 180,000 new customers during the first quarter this year. This means that we have an increased cost in the first quarter, a cost to acquire these customers.

But that's coming back as an increased profitability for the remaining part of the year and also for the coming years. There is a little bit of a warm weather effect as well but the two temporary ones are the main ones.

I would also like to mention in relation to our retail business in UK that we see a little bit of light in the tunnel. March was a month where we saw a net increase of customers again and an improvement, slight improvement of margins.

So the difficulties are for sure not over there yet but we do see a little bit of light at the end of that tunnel. In our generation business we have an impact of the increased prices in the result, and also a contribution of an increased trading result for the first quarter this year compared to last.

Our wind business has an increased result due to new capacity, being up and running, but there's also an effect here of the increased prices in the market. The price effect in total is, however, of course capped a bit by the hedges that we make, but it's still floating through, to some degree in our numbers.
In our heat business, we have struggled a bit in the district heating business due to warm weather in basically all of our countries the first quarter. But, we have an increased result in our condensing business in the Netherlands compared to the same period last year.

That is due to both increased prices but also increased availability. The condensing part of our heat business in Germany is still struggling, and that is due to the low clean dark spreads. The total result for Heat is, however, in line with the same level as last year the first quarter.

In our distribution business, we clearly see the impact of the Alfrida storm with this increased cost of 850 million SEK. We’re counting on approximately a cost of one billion SEK before this is over, that is not including any additional investments that we might have to do in order to repair the networks.

But, we are counting on prioritizing that among the existing investment budget. The cost, however, is approximately half related to compensation to customers due to outages, and approximately half of it is simply cost for work in order to repair the networks.

Looking at our cash flow development, we have a negative cash flow for the first quarter this year. You can clearly see the impact of the volatility of the market prices in these numbers, and I would like to start by commenting the cash flow from the operating activities. This is negative mainly due to three reasons. The first and absolutely most impactful one is margin calls.

As you recall we had a huge inflow of margin calls last year, as a matter of fact it was so big that we postponed the planned refinancing that we had set up for 2018. And now we see some of that margin call is going out of the portfolio again, and that is the main effect here.

The second effect is the seasonality effect in Customers & Solutions and Heat, which you see every first quarter and that is the net receivables and liabilities. And the third one is related to changes in CO2 emission allowance prices.

You also see that we have an outflow due to growth investments, and those investments are mainly going into our wind business, which is a good bridge to this slide where you can see that we have spent five billion SEK in investments during the first quarter. That is more than the 3.1 billion that we spent the first quarter last year.

We are spending less this year compared to last in our fossil investments. The fossil investments that we are making are related to conversions from coal as a fuel to other fuels.

You can also see that the absolute majority of the total investments, but, also the highest increase in investments compared to last year is coming into wind, solar, biomass and waste and the absolutely majority of the part here is going into wind.

The number you see under other is, to some extent, related to some other equipments, but it's also
related to the acquisition of DELTA Energie in the Netherlands.

So, looking at the overall numbers, the summary is basically that we have the effect of the Alfrida storm with more than 0.8 billion SEK in increased cost this quarter.

We have a lower result in our Customers & Solutions business, mainly due to these two temporary effects that I mentioned. We have a solid contribution from our generation business and an increased contribution from our wind business.

We continue to see challenges in the heat business, but the result is in line with the same level as the first quarter last year. So, we do have an increased net sales, an increased underlying EBIT, and also an increased EBIT.

We also have an increased profit for the period compared to last year. So, all in all, I think you can say it's been a decent start of the year, but we are working full speed ahead in order to improve even further.

Thank you.

QUESTIONS AND ANSWERS

Karin Lepasoon Vattenfall AB - Head of Communications
Thank you very much Anna, and Magnus, and welcome Markus as well. It's time for a Q & A. And we start by asking if there are any questions from the audience here in Solna.

That does not appear to be the case and we actually don't have any questions on the telephone currently either. Let's see Markus, if we have any questions on the web.

Markus Friberg Vattenfall AB - Communications
We can start with question from Andrew Moulder in CreditSights.

Andrew Moulder CreditSights - Analyst
Can you give a comment on the amount of compensation that you are receiving for A, the loss of Berlin electricity network, and B, how you intend to use these proceeds, both of that compensation and from the sale of the heat business in Hamburg. And, also if you can give an update on our strategy in Germany?

Magnus Hall Vattenfall AB - CEO
Yes. The two processes we're talking about is the sale of the heat network in Hamburg which we currently just received the okay from the European Commission that it's not state aid that they buy it from us at a higher price than the valuation that was made.

But that will not be concluded until after summer. So that money, we have no real plan for it, it will go
straight to our discussions around investments and growth.

The second part when it comes to the Berlin network, there we don't see in front of us that we will immediately come to a situation where we will have this operation being disconnected from Vattenfall.

So our intention now is to follow the process and appeal and see where we come with that. So when it comes to a valuation of these assets, I think this is much too premature to have any view on.

Karin Lepasoon Vattenfall AB - Head of Communications
And then it was the question about a strategy for Germany.

Magnus Hall Vattenfall AB - CEO
Yes, for us, Germany is equally important as it was before. But I can also see the question because we have now left the grid networks in Hamburg, we have left the heat networks in Hamburg and we might come to a situation further out in time where we will have to leave also the networks in Berlin.

I think when it comes to Berlin, it is also important to say that we have also made other offers which means a corporation offer with the city of Berlin where we take a 50-50 position together with the city. So there are different options going forward. We will see how that pans out.

But if you look to our situation in heat Berlin, we are very strong there. We see good growth. We also feel that we have a good support from the citizens in Berlin for what we do and we have a clear path towards coal face out there, which we are discussing together with the city.

So I see a good development, good growth in terms of customers and a growing city, of course, which is the basis for any growing business in district heating. So we are very positive about that.

We also have on the retail side in Germany, closing in on four million customers, which is now close to our biggest markets in terms of retail and we continue to grow. So we see that, from our perspective, a good opportunity also in Germany.

And there will also be possibilities to go into offshore wind investment, onshore wind investments and then also we have corporations in Sweden with various companies on electrification, both for industry but also for transportation.

So we will take those business opportunities also further in Germany. So from our perspective, Germany remains a main market when it comes to the development of the Vattenfall Group.

Karin Lepasoon Vattenfall AB - Head of Communications
Okay, good. Thank you, Magnus. We have a question from the telephone conference. Let’s take that now.
Operator
Jakob Magnussen, Danske Bank.

Jakob Magnussen Danske Bank - Analyst
Relating to your costs relating to Alfrida in Q1, according to the regulatory model, will you be able to recoup some of those costs by increasing your tariffs temporary in the coming quarters or years so that your long-term return on investments will be protected from such one-off events?

And then, your FFO to adjusted net debt is at 18% which is some way from the minimum of 22% that you have as your target, so will this metric be repaired by just the normalization of working capital going forward in the absence of these one-off events? Or are you going to do other measures to repair this metric? Thank you.

Karin Lepasoon Vattenfall AB - Head of Communications
Good, let's start with the first one, yes.

Magnus Hall Vattenfall AB - CEO
Yes, I'd like to answer that question when it comes to Alfrida, the question was whether out of the SEK 850 million that we are now paying for this storm event in the first quarter, roughly half of it goes to repairs and those repairs are costs that we can put into our framework for distributing it to customers.

It's over a period of time, I don't know exactly. We can't recover that only in the next few quarters, but we can recover it in the model.

The remaining 50%, which is a penalty, we can't recover. So that, we just have to take out of the cash flow of the operations. And the FFO to adjusted net debt, I think, Anna, you?

Anna Borg Vattenfall AB - CFO
Yes, when it comes to FFO over adjusted net debt, it's true it's 18.1% if you look at the rolling 12 months, which means that it's mainly a reflection of the result in 2018, which we knew would be burdened by a lot of investments that year. So we knew our ratios would be a bit lower during 2018.

We're not providing a forecast for 2019 but we are, of course, aiming at reaching our targets, both when it comes to return on capital employed of 8% and the FFO over adjusted net debt of 22% as soon as possible.

Karin Lepasoon Vattenfall AB - Head of Communications
Very good, thanks. And Markus, we have one question or a couple of questions from the web.

Markus Friberg Vattenfall AB - Communications
Yes, we have a number of questions here from Christian Schuetz at PIMCO. I think they are -- some of them quite detailed and we probably will have to come back to some of them afterwards.
Christian Schuetz PIMCO - Analyst
Could you please explain the reduced sensitivity to market prices in your continental portfolio as of Q1 in '19 for 2020 - 21 when compared to what you reported at the end of 2018 across electricity, coal and CO2. The 2021 sensitivity went up from Q3 in '18 to Q4 '18 and looks to have improved again per Q1 '19. Is this entirely hedging related?

Anna Borg Vattenfall AB - CFO
Well, we are making hedging on an overall Vattenfall perspective, not per portfolio or per country level. So that can, of course, impact the different countries a bit different depending on the total hedge ratios.

In general, we are hedging a bit less than we used to do historically and the main change made in the German portfolio was, of course, when we sold off the lignite, which dramatically reduced the exposure in Germany. But apart from that, we haven't made any other changes in our assets in Germany.

Karin Lepasoon Vattenfall AB - Head of Communications
All right, should we take the second question here?

Markus Friberg Vattenfall AB - Communications
Yes. So, FFO we already talked about, so, customer segment.

Christian Schuetz PIMCO - Analyst
Could you describe customer acquisition cost trends in your German and UK activities? And how do these compare to targets?

Magnus Hall Vattenfall AB - CEO
We don't generally discuss that. The cost trends are fairly stable for acquiring customers, but what we now had is more of a one-off event in the first quarter this year was a possibility to actually acquire and get customers in a bigger chunk and that cost was actually lower than normal I should say. But apart from that we don't see any real change in customer acquisition costs.

Markus Friberg Vattenfall AB - Communications
Okay, let's go on with one more here from Christian.

Christian Schuetz PIMCO - Analyst
When it comes to renewables and wind, could you illustrate the expected effect on wind underlying EBITDA for 2019 and 2020 with the capacity under construction/completion for 2019 and '20? And is Vattenfall on track for its 2.3 gigawatt capacity addition plan for between 2016 to '20?

Magnus Hall Vattenfall AB - CEO
We are on our plan, but we are slightly delayed because we will have the final implementation of coming to 2.3 megawatts in 2021 and not 2020.
Karin Lepasoon **Vattenfall AB - Head of Communications**
All right, I think we have another question from the telephone conference. Please go ahead.

**Operator**
Orlando Finzi M&G.

**Orlando Finzi M&G Investments - Analyst**
A quick question on the distribution, from the, I guess, the lessons from the storm effect. I'm presuming most of the damage was trees falling on lines, but maybe you can give some color, physically how the network was affected?

And whether this could lead to any future changes in [press] remuneration for more cable undergrounding or other measures to better insulate the network from storm damage?

**Magnus Hall Vattenfall AB - CEO**
Well, that's an ongoing discussion. Are we expecting more storms than before? And we don't -- I mean, that could be potentially so.

What we are doing and I think everybody are doing since the storm 2005 is actually weather-proofing a lot of the lines which are previously quite sensitive. But you can never totally take them away. They will still be there.

And you can just make a comparison, if we were to fully protect ourselves against the storm Alfrida we would probably increase the fees to our customers two to three times in order to cover those types of investments. So, that will never be the case that we can survive a storm like Alfrida.

But, we will continue to weatherproof the network and, of course, when we have a change like this, we look at it, what is reasonable. We do the changes that we feel are reasonable to actually protect them from the next storm, but we will never be able to totally do it.

And that's why we are also arguing sometimes that this fee that we're paying is a difficult fee, because we cannot really have the alternative to actually invest and totally reduce the risk. That's just not possible. So, it is a balanced discussion going in the right direction, but we will see effects like this also in the future, unfortunately.

**Anna Borg Vattenfall AB - CFO**
Maybe to give just a little bit of flavor to what's happened out in the woods is that this storm was very unusual in the sense that it came from the north. That's not usually the case.

So, it also means that the trees actually don't have the same kind of resistance to wind from that direction. So, there was an unusual amount of trees falling in the woods. And the last time we had a
storm like this in Sweden was in 1964 I think. So, also from that perspective it was unusually big damages from an unusual direction of the storm.

Karin Lepasoon Vattenfall AB - Head of Communications
Coming from the north sounds like "Game of Thrones," which it's not, of course. Anyway, we are going to end now I believe because there are no further questions on the telephone, there's no further questions on the web.

Are there any further questions here from the audience? That does not appear to be the case. Then, we thank you very much for your attention. Thank you so much.

Magnus Hall Vattenfall AB - CEO
Thank you.

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