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# RWE AG

**Primary Credit Analyst:**
Hugues De La Presle, Paris (33) 1-4420-6666; hugues_delapresle@standardandpoors.com

**Secondary Credit Analyst:**
Andreas Kindahl, Stockholm (46) 8-440-5907; andreas_kindahl@standardandpoors.com

## Table Of Contents

Major Rating Factors

Rationale

Outlook

Business Description

Business Risk Profile: Leading Domestic Position And Prudent Hedging Partly Offset By High Carbon Intensiveness

Financial Risk Profile: Under Some Pressure Following Essent Acquisition And Sustained Capital Spending

Financial Statistics/Adjustments

# RWE AG

## Major Rating Factors

| Corporate Credit Rating |
| --- |
| A/Negative/A-1 |

**Strengths:**

- Leading positions in Germany in generation and supply.
- Prudent hedging policy.
- Significant regulated operations.

**Weaknesses:**

- High carbon intensiveness of generation operations.
- Weakening of financial profile following the acquisition of Essent.

## Rationale

The ratings on major Germany-based integrated utility RWE AG are underpinned by its leading domestic position in power generation and supply in Germany, focus abroad on Northwestern European countries whose power markets are increasingly linked to the German power market, and significant share of regulated earnings (about 30% of earnings). These strengths are partly offset by the high carbon intensity of RWE's generation fleet and resulting exposure to the tightening of carbon constraints in the EU, especially from 2013; its exposure to wholesale power prices, although this is mitigated by the group's prudent strategy of selling forward the bulk of its output; heightened regulatory pressures in Germany; and the weakening of its financial profile following the €7.3 billion debt-financed acquisition of Dutch utility Essent N.V. (A/Negative/A-1), which was completed in September 2009.

### Key business and profitability developments

RWE has proven resilient in 2009 despite the steep decline in both power demand and wholesale power prices in Germany. While consolidated EBIT was down 4.4% in the first nine months of 2009, the group expects its EBIT to be stable for the full year. This reflects the continued robust performance of RWE's core German generation operations (RWE Power), which continued to benefit in 2009 from forward sales concluded in previous years at favorable prices. In addition, despite regulatory pressures on tariffs, RWE's large regulated and supply operations (RWE Energy) are expected to have maintained stable earnings last year thanks to efficiency improvements. RWE also benefited in 2009 from an exceptionally high contribution from its volatile supply and trading business.

Thanks to its prudent policy of selling 12-36 months forward the bulk of its output and locking in margins, RWE will continue to benefit in 2010 from the higher wholesale forward prices of previous years. As of the end of September 2009, RWE had sold forward 90% of its 2010 German output. The group will continue to benefit from its hedging policy beyond 2010, albeit to a lesser degree as of the end of September 2009: It had sold forward, respectively, 65% and 30% of its 2011 and 2012 German output. Given current lower forward prices, RWE is likely to achieve lower prices than those it has already locked in on its open 2011 and 2012 positions.

Given its high carbon intensiveness, RWE is exposed to the EU's tightening carbon constraints: Under Phase II of the ETS (European Trading System, 2008-2012) its free allocation of $CO_2$ certificates has declined to about 60% of its carbon emissions from about 90% in Phase I. From 2013 under Phase III of the ETS, all $CO_2$ certificates will be auctioned, which should weigh on RWE's generation operations which are its key earnings driver. The group expects, however, to mitigate this negative impact through its underway cost reduction program, higher contribution of its other businesses especially exploration and production (E&P) and renewables, and its effort to reduce its CO2 emissions.

Through the recent acquisition of Essent, RWE has become a leading player in the Netherlands. This transaction has further strengthened RWE's critical mass in Northwestern Europe. Essent's generation operations are also significantly less carbon-intensive than RWE's.

**Key cash flow and capital-structure developments**

RWE's reported net debt (which includes postretirement and decommissioning liabilities) increased steeply with the acquisition of Essent to €25.7 billion at the end of September 2009 from €14.4 billion at the end of 2008 (excluding the debt of now disposed American Water). The increase in debt also reflects RWE's substantial €26 billion capital expenditure program over 2009-2012, of which €6 billion was spent in 2009.

**Short-term credit factors**

RWE's 'A-1' short-term rating is underpinned by its large and diversified cash flows, and a benign maturity profile with limited maturities until 2012. The rating is also supported by substantial liquidity, including more than €9.3 billion of cash and marketable securities at end-September 2009 held to offset on-balance-sheet postretirement benefit and nuclear liabilities and a committed undrawn syndicated €2 billion line maturing in October 2011. The €1.6 billion 364-day tranche of that syndicated line was replaced in October 2009 by a €2 billion line maturing in October 2010 with an extension option at RWE's discretion until October 2011.

## Outlook

The negative outlook reflects our view that RWE's financial profile is below our expectations for the ratings following the Essent acquisition and the uncertainty as to its recovery to levels in line with the ratings. It also reflects our opinion that RWE could opportunistically consider midsize debt-funded acquisitions in Eastern Europe. We could lower the ratings if we consider that RWE is unlikely to sustainably improve its credit measures to a level commensurate with the ratings, especially funds from operations coverage of net debt on an adjusted basis approaching 25%. Conversely, we could revise the outlook back to stable if RWE demonstrates that it can maintain a financial profile in line with the ratings.

## Business Description

RWE's two main operations are:

- RWE Power (50% of EBIT in first nine months of 2009), which comprises large-scale electricity generation and significant lignite mining operations, mainly in Germany.
- RWE Energy (32%), which comprises electricity and gas supply operations in Germany but also in Eastern Europe, as well as regulated electricity and gas transmission and distribution grids.

RWE's other main businesses include RWE Supply & Trading (14%), which covers large trading activities and the group's midstream gas operations; RWE DEA (2.7%), the moderately sized oil and gas exploration activities in Germany, and selected markets in Europe as well as North Africa; RWE npower PLC (2.6%), which covers U.K. electricity generation and electricity and gas supply operations; and recently acquired Essent, which will be responsible for the group's activities in the Netherlands and Belgium.

## Business Risk Profile: Leading Domestic Position And Prudent Hedging Partly Offset By High Carbon Intensiveness

We consider RWE's business risk profile as "excellent" according to our criteria, supported by the following factors:

- Leading position in the only moderately competitive German power market: RWE is the largest generator in Germany with a 31% market share and a strong competitive position due to its large scale, low-variable-cost plants. Generation operations are reasonably diversified, although there's a large share of carbon intensive lignite (40% of output in first nine months of 2009) and hard coal plants (22%). RWE has a long position in generation in Germany: Its output in the first nine months of 2009, including long-term purchase agreements as well as procurement contracts and purchases on the wholesale market, was 219.7 terawatt hours (TWh), well in excess of direct electricity sales, including electricity losses, of 183 TWh. RWE thus sold over the first nine months its net long position of 24.4 TWh on the wholesale market. RWE is also a leading electricity and gas supplier with market shares of 16% and 6%, respectively.
- Prudent hedging policy: RWE systematically sells forward the bulk of its output. As of September 2009, it had sold forward over 90% of its German 2010 output, more than 65% of its 2011 output and more than 30% of its 2012 output, locking in margins. RWE also benefits from the natural hedge provided by its integration downstream in supply but also upstream in E&P (the gas production of the RWE DEA unit represented 15% of the group's 2008 overall gas requirements). The group thus has very good earnings visibility for 2010. Visibility beyond is, however, more limited and RWE is likely to achieve lower prices on its open 2011 and 2012 positions.
- Resilient performance of RWE Energy: In a challenging environment with a 5% decline in both power and gas demand in Germany in 2009, the division's supply operations managed to increase their earnings over the first nine months of 2009. This reflects the success of the division's strategy of maintaining market shares (net gain of 95,000 customers over the first nine months of 2009) while focusing on improving profitability. It also reflects RWE Energy's diversified and balanced customer portfolio with only 32% of more cyclical corporate and industrials, which moreover largely operate under take-or-pay contracts. RWE Energy's large regulated operations (about 30% of group EBIT) have been able to largely offset the impact of regulatory pressures on tariffs cuts through cost savings.
- Primary focus abroad on Northwestern Europe with leading positions in countries neighboring Germany and whose power markets are increasingly linked to the German power market (Netherlands, U.K., Eastern Europe). While mature and currently affected by declines in demand, the Northwestern European markets offer investment and growth opportunities as their reserve margin will significantly tighten in the medium term.

These supporting factors are partially offset by:

- Substantial carbon intensiveness of RWE's generation operations and resulting exposure to increasing carbon constraints: Under Phase II of the ETS from 2008, RWE's free allocation of $CO_2$ certificates has declined to 60% of RWE's German emissions versus 92% in 2007, which was the last year of Phase I. RWE will be further affected in 2013 when all $CO_2$ certificates will be auctioned under Phase III. The impact on RWE's earnings of having to buy more $CO_2$ certificates in Phase II has been fairly muted so far given high achieved power prices and the decline in the cost of $CO_2$ certificates in 2009. RWE expects to soften the negative earnings impact from the full auctioning of $CO_2$ allocations from 2013 through the full benefit of its underway €1.2 billion efficiency program, and higher contribution of its E&P and renewables businesses (it is investing €1 billion per annum in the latter between 2009 and 2012 with a view to tripling its capacity to 4,500 megawatts (MW) by the end of 2012). RWE also expects power prices to be higher at that time. In addition, the group is aiming for a 20% reduction by 2012 in its $CO_2$ emissions to 138 million tons per annum from 172 million tons per annum through more efficient new build which will replace old capacity, renewables, the clean development mechanisms/joint implementation (CDM/JI) mechanisms and the extension of the lifetime of its German nuclear plants.

- Pressures on the profitability of RWE npower, the group's U.K. subsidiary. npower is a leading U.K. utility present in both generation (9% market share) and supply (respectively 15% and 12% market share in electricity and gas). In contrast to most of its U.K. peers, it has no regulated distribution operations. npower's EBIT declined by 61% in the first nine months of 2009. Its generation operations were affected by lower spreads. This reflects that while it pursues the same strategy as the rest of the group of selling forward its output, it retains nevertheless a larger open position, reflecting the high short-term liquidity of the U.K. market. npower's supply operations also remained under pressure, given intense competition and higher social obligation costs.

## Financial Risk Profile: Under Some Pressure Following Essent Acquisition And Sustained Capital Spending

The main strengths of RWE's "intermediate" financial risk profile, according to our criteria, are:

- Its moderate financial policy. The group's objective, which was set in early 2008, is to maintain its debt factor (which is defined by RWE as net debt including postretirement and asset-retirement provisions to EBITDA) between 2.8x and 3.4x. On a pro forma basis, i.e. factoring in Essent's full year EBITDA, RWE expects this ratio to be within that range in 2009, up from 2.2x in 2008.
- Its prudent funding policy as shown by the early refinancing through bonds of the acquisition facility for Essent, and primary recourse to medium- to long-term bonds for funding (74% of reported consolidated gross financial debt at the end of the third quarter of 2009). RWE's debt profile is moreover favorable, with no financial covenants, rating triggers, or major short-term maturities. Debt maturities are spread out except for an increase to about €1.8 billion in 2012 (plus the renewal of its syndicated loan in 2011). In addition, the group undertakes cash pooling for its German subsidiaries as well as some foreign subsidiaries including Essent, and centralizes all funding.

These strengths are moderated by:

- The steep increase in RWE's debt in 2009 as a result of the €7.3 billion acquisition of Essent and sustained capital expenditures under the group's €26 billion investment program between 2009 and 2012. RWE's capital expenditure program is evenly spread between Germany and abroad as well as between maintenance and growth investments. As a result, we expect RWE's credit measures at the end of 2009 to be below our current rating expectations.
- The uncertainty regarding the recovery of RWE's financial profile to levels in line with the ratings: In turn this is a function of RWE's limited discretionary cash flow capacity given its substantial capital expenditure program and dividend payout of 50%-60% of recurrent net income.
- Some acquisition risk, as RWE could be interested by some opportunistic midsize transactions in Eastern Europe as shown by its interest at the end of 2009 in Polish utility Enea. That said, we understand from management that its primary focus in coming years should be on organic growth. Moreover, despite the full price paid for Essent,

RWE has a relatively prudent and disciplined approach to M&A. It has thus walked away from the Enea acquisition. In terms of disposals, RWE has committed to sell its German gas transmission grid but is waiting for full clarity on the regulatory framework before doing so. In 2009, RWE fully disposed of its U.S. water business American Water, which led to proceeds of €527 million.

## Financial Statistics/Adjustments

RWE reports under International Financial Reporting Standards (IFRS). To calculate ratios, we make the following adjustments to the group's reported accounts:

- Asset-retirement obligations: These include obligations for the retirement of nuclear power plants in Germany, opencast mining operations, and oil and gas field infrastructure. Due to the conservative nature of the underlying cost assumptions, we have included the gross numbers in debt at about 70% of their on-balance-sheet value, i.e. €8.6 billion. Adjustments are made to interest expense to reflect the unwinding of the discount on the related provisions, along with an adjustment to funds from operations (FFO) to reflect the increase in future obligations (new provisions plus interest accretion) less cash payments actually made.
- Post-retirement liabilities: We add to debt the balance for funded plans €842 million as well as the liabilities under the unfunded plans (€1,896 million) minus the net deferred tax asset relative to pensions of €237 million. Similar adjustments to those detailed above for asset-retirement obligations have been carried out to interest and FFO with respect to postretirement liabilities.
- Surplus cash: In the calculation of adjusted debt, we give 100% credit for RWE's marketable securities (including both current marketable securities of €7.7 billion and €317 million of noncurrent securities) and cash and cash equivalents (€1.3 billion). This is due to the intrinsic relationship between the value of marketable securities held and the unfunded future postretirement benefit and asset-retirement obligations. 84% of RWE's securities were invested in fixed-income instruments at end-September 2009. We exclude, however, the €1.3 billion of other financial receivables which we do not consider as liquid enough, as well as collaterals for trading activities received (€3.6 billion), both of which RWE includes in its liquidity position. Likewise, we exclude from debt the €541 million corresponding to collateral for trading activities owed by the group, which RWE includes in its financial debt.
- We exclude from debt the €4.2 billion corresponding to the debt of American Water, the U.S. water company which RWE has fully disposed of.

In addition we have made the following ad hoc adjustments to FFO in 2008:

- We subtracted €298 million corresponding to the tax benefit linked to one-off tax items.
- We added back €404 million corresponding to the negative impact of the mark-to-market of commodity and power derivatives.
- We subtracted the €900 million corresponding to the cost for 2008 $CO_2$ allowances which will only be paid for in 2009. We will reverse this adjustment in 2009, which will have a positive impact of the same magnitude on the 2009 FFO.
- We subtracted €473 million corresponding to the cash flow of discontinued operations in line with our stance of excluding from debt the debt of discontinued operations.

**Table 1**

**Reconciliation Of RWE AG Reported Amounts With Standard & Poor's Adjusted Amounts (Mil. €)***

| | --Fiscal year ended Dec. 31, 2008-- | | | | |
|---|---|---|---|---|---|
| **RWE AG reported amounts** | | | | | |
| | **Debt** | **Shareholders' equity** | **Operating income (before D&A)** | **Interest expense** | **Cash flow from operations** |
| Reported | 13,483.0 | 11,587.0 | 8,133.0 | 690.6 | 9,326.0 |
| **Standard & Poor's adjustments** | | | | | |
| Operating leases | 299.3 | -- | 20.4 | 20.4 | 47.1 |
| Postretirement benefit obligations | 2,501.0 | -- | -- | 97.0 | (9.0) |
| Surplus cash and near cash investments | (9,301.0) | -- | -- | -- | -- |
| Share-based compensation expense | -- | -- | 71.0 | -- | -- |
| Asset retirement obligations | 8,631.7 | -- | -- | 582.0 | (576.0) |
| Reclassification of nonoperating income (expenses) | -- | -- | -- | -- | -- |
| Reclassification of working-capital cash flow changes | -- | -- | -- | -- | (1,687.0) |
| Minority interests | -- | 1,553.0 | -- | -- | -- |
| Ad hoc adjustments of FFO¶ | -- | -- | -- | -- | (1,267.0) |
| Collateral for trading activities | (541.0) | -- | -- | -- | -- |
| Capital gains and one-offs | -- | -- | 172.0 | -- | -- |
| Total adjustments | 1,590.0 | 1,553.0 | 263.4 | 699.4 | (3,491.9) |
| **Standard & Poor's adjusted amounts** | | | | | |
| | **Debt** | **Equity** | **EBITDA** | **Interest expense** | **Funds from operations** |
| Adjusted | 15,073.0 | 13,140.0 | 8,396.4 | 1,390.0 | 5,834.1 |

*Please note that two reported amounts (operating income before D&A and cash flow from operations) are used to derive more than one Standard & Poor's-adjusted amount (operating income before D&A and EBITDA, and cash flow from operations and funds from operations, respectively). Consequently, the first section in some tables may feature duplicate descriptions and amounts. ¶See text for full details.

**Table 2**

**E.ON AG -- Peer Comparison***

| | **E.ON AG** | **GDF SUEZ S.A.** | **RWE AG** | **Electricite de France S.A.** |
|---|---|---|---|---|
| Rating on Feb. 4, 2010 | A/Stable/A-1 | A/Positive/A-1 | A/Negative/A-1 | A+/Stable/A-1 |
| | --Fiscal year ended Dec. 31, 2008-- | | | |
| **(Mil. €)** | | | | |
| Revenues | 86,753.0 | 75,066.0 | 47,500.0 | 64,279.0 |
| Net income from cont. oper. | 1,394.0 | 4,462.0 | 3,125.0 | 3,400.0 |
| Funds from operations (FFO) | 8,988.7 | 9,052.4 | 5,834.1 | 9,871.9 |
| Capital expenditures | 9,284.6 | 9,816.7 | 4,454.0 | 10,229.1 |
| Debt | 41,533.4 | 36,785.0 | 15,073.0 | 54,233.9 |
| Equity | 38,417.0 | 63,114.7 | 13,140.0 | 25,108.5 |
| **Adjusted ratios** | | | | |
| Oper. income (bef. D&A)/revenues (%) | 14.6 | 16.3 | 17.6 | 24.8 |

**Table 2**

| E.ON AG -- Peer Comparison* (cont.) | | | | |
|---|---|---|---|---|
| EBITDA interest coverage (x) | 4.2 | 6.9 | 6.0 | 3.8 |
| Return on capital (%) | 12.1 | 9.4 | 29.3 | 13.2 |
| FFO/debt (%) | 21.6 | 24.6 | 38.7 | 18.2 |
| Debt/EBITDA (x) | 3.3 | 3.0 | 1.8 | 3.5 |

*Fully adjusted (including postretirement obligations). Excess cash and investments netted against debt.

**Table 3**

| RWE AG -- Financial Summary* | | | |
|---|---|---|---|
| | --Fiscal year ended Dec. 31-- | | |
| | **2008** | **2007** | **2006** |
| Rating history | A/Stable/A-1 | A+/Negative/A-1 | A+/Negative/A-1 |
| **(Mil. €)** | | | |
| Revenues | 47,500.0 | 41,053.0 | 41,169.0 |
| Net income from continuing operations | 3,125.0 | 2,941.0 | 2,405.0 |
| Funds from operations (FFO) | 5,834.1 | 5,495.3 | 5,566.2 |
| Capital expenditures | 4,454.0 | 4,093.1 | 4,552.9 |
| Debt | 15,073.0 | 11,269.7 | 17,832.9 |
| Equity | 13,140.0 | 14,331.0 | 13,440.0 |
| Debt and equity | 28,213.0 | 25,600.7 | 31,272.9 |
| **Adjusted ratios** | | | |
| FFO int. cov. (x) | 4.9 | 4.1 | 3.5 |
| FFO/debt (%) | 38.7 | 48.8 | 31.2 |
| Discretionary cash flow/debt (%) | 4.4 | (9.0) | (4.1) |
| Net cash flow/capex (%) | 86.0 | 80.5 | 95.7 |
| Debt/debt and equity (%) | 53.4 | 44.0 | 57.0 |
| Return on common equity (%) | 24.5 | 21.6 | 19.5 |

*Fully adjusted (including postretirement obligations). Excess cash and investments netted against debt.

| **Ratings Detail** (As Of February 5, 2010)* | |
|---|---|
| **RWE AG** | |
| Corporate Credit Rating | A/Negative/A-1 |
| Commercial Paper | |
| *Foreign Currency* | A-1 |
| Senior Unsecured (22 Issues) | A |
| **Corporate Credit Ratings History** | |
| 13-Jan-2009 | A/Negative/A-1 |
| 03-Jun-2008 | A/Stable/A-1 |
| 25-Feb-2008 | A+/Watch Neg/A-1 |
| **Business Risk Profile** | Excellent |
| **Financial Risk Profile** | Intermediate |

| **Ratings Detail** (As Of February 5, 2010)***(cont.)** |
|---|
| **Debt Maturities** |
| 2010: €0.6 bil.<br>2011: €1.5 bil.<br>2012: €1.8 bil.<br>2013: €1.7 bil.<br>2014: €0.5 bil. |

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

**Additional Contact:**
Infrastructure Finance Ratings Europe; InfrastructureEurope@standardandpoors.com

**Additional Contact:**
Infrastructure Finance Ratings Europe; InfrastructureEurope@standardandpoors.com