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Fingrid Oyj

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Fingrid Oyj

Major Rating Factors

Strengths:

- Monopoly transmission operator in the stable macroeconomic environment of Finland, which has steady growth in electricity demand
- Favorable cost-plus regulation allowing significant freedom in tariff setting, capital expenditure, and quality settings

Corporate Credit Rating

A+/Stable/A-1

Nordic National Scale Rating

--/--/K-1

Weaknesses:

- Weak financial profile, with high leverage and low debt-service coverage ratios
- Large capital-expenditure program expected to result in negative free operating cash flow over the near to medium term

Rationale

The ratings on Fingrid Oyj are based on the utility's strong business position as the monopoly electrical transmission grid company and system operator in the politically and economically stable Republic of Finland (AAA/Stable/A-1+). The ratings also reflect Fingrid's strong track record of network efficiency, a favorable cost-plus regulatory regime, and a clear strategic focus on national electricity transmission networks and enhancement of the Nordic electricity market. The ratings are constrained by a weak financial profile attributable to high leverage and weak debt-service ratios, and our expectation that earnings will decline due to tariff cuts in 2005 and 2006, and that the company's financial ratios will remain weak for an extended period during which capital expenditures are projected to rise.

Fingrid's investment plans, which include enhancement of the transmission grid and strengthening of cross-border connections, will lead to annual capital expenditures of €100–€200 million over the next few years, compared with €53 million spent on the grid in 2006. This will result in negative free operating cash flow over the near to medium term. Fingrid has accumulated a cash pool for this purpose, and has additional financial flexibility within the regulatory framework. Nevertheless, funds from operations (FFO) interest cover and FFO to debt are expected to fall towards 3.3x and 9.2%, respectively, during the next three years.

Compared with its peers, Fingrid's track record on network efficiency is excellent: It has highly efficient operations, with virtually no bottlenecks or disturbances. The transmission system has accommodated the strong demand growth and substantial import/export volumes of recent years. Fingrid benefits from Finland's cost-of-service electricity grid regulation, which allows cost cover, a reasonable ROE, and a high degree of flexibility in tariff setting and capital expenditures. The grid agreement allowed for a tariff increase of 3% in 2006 and 2007, respectively. However, instead Fingrid lowered the tariff by 5% in both years.

Fingrid's debt leverage remains high, amounting to about 72%, including capital loans of €167.9 million as debt, at the end of 2006. Fingrid repaid the €137.9 million capital loan issued in 1997 in May this year and is expected to repay the remaining €30 million in 2009. Debt leverage is expected to fall to about 70% over the next three years,

thanks to a limited increase in debt.

Liquidity

Fingrid's liquidity position is sound. At Sept. 30, 2007, Fingrid had €221 million in cash and marketable short-term securities, compared with €217 million in short-term debt, and an undrawn €250 million revolving credit facility. There are no material financial covenants or material adverse change clauses in the existing credit agreements. Long-term debt, including derivative liabilities, totaled €768 million as at Sept. 30, 2007.

Outlook

The stable outlook reflects Fingrid's stable monopoly position and its flexible regulatory regime, both of which are expected to remain unchanged over the near term. The ratings could be raised if Fingrid's financial risk profile strengthens, the company's credit ratios show a sustainable recovery trend, and free operating cash flow turns positive over the next few years. Although unlikely, the ratings could be lowered if Fingrid increases capital expenditures further and invests in operations or assets in such a way that its business risk profile is negatively affected.

Business Description

Fingrid, established in 1997, is owned by the Finnish state--which has 12.3% of shares and 16.4% of votes--and private sector electric consortia Pohjolan Voima Oy and Fortum Oyj (A-/Stable/A-2; 50.5% owned by the Finnish state), each holding 25.0%, and each representing 33.4% of votes. Finnish institutional investors own the remainder.

Fingrid is the national electricity transmission operator, and its operations are divided into three main business areas: grid service (customer service); grid asset management (grid planning and development); and power system operations (power system operations, balance management, and grid operation). Fingrid is also 20% owner of the Nordic physical electricity exchange, Nord Pool Spot AS.

Business Risk Profile: Low-Risk Monopoly Operations Are A Key Strength

Fingrid's business risk profile is based on the utility's strong business position as the monopoly electrical transmission grid company and system operator in Finland. Its risk profile has marginally weakened, however, as the regulatory framework in Finland has resulted in less stable and predictable revenues than was previously assumed.

Strategy

Fingrid's business strategy is highly focused, and Standard & Poor's Ratings Services does not expect the utility to venture outside its core business in Finland or related cross-border connections.

There is currently an emerging trend towards the development of regional markets in Europe. While day-ahead prices between Finland and Sweden are practically the same, this is true only 33% of the time when including the whole Nordic region, and only 17% of the time when adding Germany. Increased cross-border investments in transmission are the key to better congestion management and greater price uniformity. Accordingly, Fingrid expects to invest €250 million in cross-border connections over the next few years, which will strengthen the integration of

the Finnish electricity grid with neighboring countries. These investments form part of the regional plan, formulated by the Nordic transmission system operators in 2004, involving five major line projects.

Fingrid and Svenska Kraftnät, the Swedish transmission system operator, will for instance invest in a 800MW power transmission cable connection to be constructed alongside the existing Fenno-Skan cable, which is due to be operational by 2011. (The project has been delayed by a year due to difficulties in submarine cable delivery time.) The capital-expenditure project, estimated at about €300 million, is shared equally between Fingrid and Svenska Kraftnät.

Regulation

Finland's regulatory regime is flexible and underpins the ratings on Fingrid. Electricity transmission is regulated and monitored by the Energy Market Authority (EMA), an independent government agency. Although a new methodology for tariff evaluation has been established, the material rules of the Electricity Act regarding reasonable pricing will remain unchanged, and the impact on Fingrid is limited.

EMA has already tested the reasonableness of Fingrid's tariffs under the previous methodology and came to the conclusion that historical tariffs had complied with the EMA's requirements. According to the new methodology, network companies can cover costs and make reasonable ROE, and tariff increases do not need to be sanctioned. Within the current regulatory framework, transmission tariffs are decided by the board of directors following discussions with the customers. Fingrid is also allowed to cover the costs of operating its emergency reserve gas turbines through revenues from power system operations, because the maintenance of emergency reserve capacity is considered part of the utility's system responsibility. The new regulatory period is for a four-year period (2008-2011). Annual realized returns can exceed allowed returns during the period, but would be adjusted for during the next regulatory period.

Within the European Transmission System Operators area, there exists an inter-transmission system operator compensation scheme, which replaces the transaction cross-border tariffs. The net cost of the current scheme is expected to be €5 million-€20 million annually. Cross-border tariffs on electricity trade between Finland and Estonia were abolished when the Estonian TSO Pohivork joined the compensation scheme on June 1, 2007. Cross-border tariffs to Russia are expected to remain in the medium term.

Markets

Fingrid has a monopoly position as electricity transmission service operator in Finland. Customers, of which there were 100 at the end of 2006, comprise electricity producers, major industrial enterprises, and regional and distribution network companies.

Demand grew by 6.5% in 2006. The exceptionally high growth rate was due to the long labor dispute in the Finnish forestry industry in 2005, as a result of which electricity consumption decreased in that year. Electricity consumption growth in Finland has historically been steady, however, at about 2% per year, with 1%-2% growth expected in the medium term. The 1,300MW of interconnection transmission lines with Russia, owned by Fingrid, are fully reserved and used by electricity importers, and they provide additional supply to the transmission market.

Operations

Fingrid's operations are stable and operating profits are expected to be steady over the next couple of years, albeit lower than in the past due to the tariff cuts. Fingrid has an excellent operational track record compared with its peers. The company has come out in the top tier in several international benchmark studies of maintenance and grid

operation in recent years.

Fingrid's grid networks are well scaled for domestic transmission needs, and represent a significant strategic and economic asset. The level of import compared with export generally depends on the supply of hydropower in the Nordic market. In a normal year in the Nordic power system, Finland is a net importer of electricity, with import primarily from Russia and export to Sweden. When hydro levels are low in the Nordic system, the transit between Russia and Sweden and the rest of the Nordic countries becomes even higher. Fingrid has normally managed such situations well without disturbances in the domestic grid, although cross-border capacity has at times experienced some minor disruptions due to technical failures.

However, some incidents occurred last year that highlighted the need to secure the availability of domestic power production capacity in Finland, and to strengthen cross-border connections between Finland and its neighboring countries. An exceptionally cold period at the beginning of the year saw Russia restricting imports to Finland at a very short notice. Nordic cooperation worked well, however, and Finland was able to import electricity from Sweden.

Table 1

Fingrid Oyj Operating Statistics					
	--Year ended Dec. 31--				
	2006	2005	2004	2003	2002
No. of employees	233	231	220	218	210
No. of customers	100	99	98	100	100
Transmission operations					
Units transmitted (TWh)	67.3	62.4	67.3	66.6	62
System peak demand (GW)	14.8	13.5	13.6	14	13.5
Total transmission lines (kilometers)	13,980	13,980	13,980	13,879	13,841
Transmission energy losses (%)	1.5	1.6	1.7	1.9	1.5

Competitive position/Profitability

Fingrid's profitability is weak, reflecting the voluntary tariff policy adopted by the utility. The cost of power transmission losses remains subject to variations in the volatile and highly competitive Nordic electricity market. Continued high Nordic power prices are expected to have a negative impact on earnings and cash flows.

As a result of the tariff cuts in 2006 and 2007, and notwithstanding potential tariff increases going forward, operating profit is expected to trend down to well below €100 million over the medium term from €110 million in 2005, and as seen in the €80 million operating profit generated in 2006. This assumes increasing depreciation charges, and an annual 1%-2% increase in transmission volumes.

Financial Risk Profile: Weak Financial Profile Due To Weak Financial Ratios And Heavy Investment Program

Standard & Poor's lowered its ratings on Fingrid to 'A+' on Oct. 24, 2007, on expectations that the company's financial ratios will be weak for an extended period during which capital expenditures are projected to rise. Also, revenues have not been as stable and predictable as previously assumed, due to the tariff cuts.

Accounting

Fingrid introduced IFRS in financial 2005. Standard & Poor's makes only minor adjustments to calculate debt ratios, adding €9.1 million for operating leases and €0.1 million in pension liabilities (see table 1 below). The company began to apply hedge accounting for its electricity derivatives as of July 1, 2007.

Fingrid's capital loans, totaling €30 million following repayment of €138 million in May 2007, are accounted for as debt and interest payments as interest in the IFRS accounts. This is consistent with our treatment of the loan when calculating credit ratios, since the loan's equity content is regarded as minimal. The loan remains deeply subordinated to Fingrid's senior debt. In addition, annual interest payments and principal on the 1999 capital loan (€30 million) can be deferred even after the maturity of the notes if there are not enough distributable reserves. The rating on the capital loan is two notches below the long-term issuer credit rating on Fingrid--one notch translating the subordination of the debt, and another notch the optional deferral. Fingrid used the option to redeem the 1997 loan this year and we expect Fingrid to use the option to redeem the 1999 loan in 2009. The capital loans are likely to be replaced by ordinary debt.

Table 2

Reconciliation Of Fingrid Oyj Reported Amounts With Standard & Poor's Adjusted Amounts*									
(Mil. €) --Fiscal year ended Dec. 31, 2006--									
Fingrid Oyj reported amounts									
	Debt	Shareholders' equity	Operating income (before D&A)	Operating income (before D&A)	Operating income (after D&A)	Interest expense	Cash flow from operations	Cash flow from operations	Capital expenditures
	970.4	385.5	131.8	131.8	79.5	37.7	104.7	104.7	68.0
Standard & Poor's adjustments									
Operating leases	9.1	--	1.6	0.3	0.3	0.3	1.3	1.3	3.2
Postretirement benefit obligations	0.1	(0.1)	0.0	0.0	0.0	0.0	(0.1)	(0.1)	--
Reclassification of nonoperating income (expenses)	--	--	--	--	7.1	--	--	--	--
Reclassification of working-capital cash flow changes	--	--	--	--	--	--	--	6.8	--
Other	--	--	18.4	18.4	18.4	--	--	--	--
Total adjustments	9.2	(0.1)	20.1	18.8	25.8	0.3	1.2	8.0	3.2
Standard & Poor's adjusted amounts									
	Debt	Equity	Operating income (before D&A)	EBITDA	EBIT	Interest expense	Cash flow from operations	Funds from operations	Capital expenditures
	979.6	385.5	151.9	150.6	105.4	38.0	105.9	112.7	71.2

*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.

Corporate governance/Risk tolerance/Financial policies

Although the company's capital structure is aggressive, its financial policy is characterized by prudent risk management. In addition, the company has diversified funding sources, a well-spread maturity profile, and adequate back-up lines for liquidity purposes. Derivatives are used for hedging purposes only.

Fingrid's shares are not listed, and institutional investors have made their investment in Fingrid with the aim of a safe and stable dividend. The dividend yield includes a 2% margin over the 30-year German government bond. The minimum yield is 6%. Over the next five years, the payout ratio is projected to decrease to about 20% (following repayment of the capital notes).

Cash flow adequacy

In the medium term, FFO to debt is expected to average about 9.2%, falling from its 2006 level of 11.5%, and FFO coverage of interest expenses is expected to fall towards 3.3x from 4.0x in 2006, due to lower earnings and increased interest expenses. The redemption of €137 million in capital loan debentures in 2007 could improve the ratio in the longer term. Due to the increase in capital expenditure over the coming years, cash flow is no longer expected to cover capital expenditure over the medium term, and reported free operating cash flow is expected to be negative. Total investments over the next five years are expected to amount to more than €500 million, compared to €300 million spent on the grid over the past 10 years. Fingrid has accumulated a cash pool for this purpose, and has additional financial flexibility within the regulatory framework. Some risk to cash flows exists from Fingrid's need to procure power for system losses, which amounts to about 1.2 TWh per year. Fingrid has a hedging program to manage this risk but since there is a significant open position, a sustained rise in power prices could harm cash flows.

Capital structure/Asset protection

Fingrid's leverage, including capital notes as debt, is high at about 71.8% at the end of 2006, although it has improved from 76.6% as of Dec. 31, 2004. The total debt to capitalization is expected to improve to about 70.0% over the coming three years.

Although Fingrid's financial flexibility is restricted by its high leverage and dividend payout policy, this is offset by a flexible regulatory regime--even under the new model. Fingrid's policy is to cover short-term debt with a cash balance and backup facilities, and uses its €250 million revolving credit facility for this purpose. The utility is tapping the domestic and international money and capital markets, and has Euro CP and MTN programs. Fingrid uses a €1,000 million MTN program as a long-term funding source.

Fingrid's liquidity position is sound. At Sept. 30, 2007, Fingrid had €221 million in cash and marketable short-term securities, compared with €217 million in short-term debt, and an undrawn €250 million revolving credit facility. There are no material financial covenants or material adverse change clauses in the existing credit agreements. Fingrid repaid €138 million in capital loans in May 2007, and plans to repay the remaining €30 million in 2009. Long-term debt, including derivative liabilities, totaled €768 million as at Sept. 30, 2007.

Table 3

Fingrid Oyj Peer Comparison*				
--Fiscal year ended Dec. 31, 2006--				
Fingrid Oyj	Energinet.dk SOVFI	Statnett SF5	Terna SpA5	Red Electrica de Espana S.A.
A+/Stable/A-1	AA+/Stable/A-1+	AA/Stable/A-1+	AA-/Stable/A-1+	AA-/Stable/A-1+

Table 3

Fingrid Oyj Peer Comparison*(cont.)					
(Mil. €)					
Revenues	353.5	454.8	442.7	1,295.7	954.1
Net income from cont. oper.	38.3	(22.8)	36.9	366.3	231.2
Funds from operations (FFO)	112.7	76.6	120.3	466.9	448.6
Capital expenditures	71.2	55.1	96.6	368.7	308.5
Cash and investments	204.1	8.3	73.7	0.0	13.4
Debt	979.6	819.8	941.3	2,505.3	2,672.7
Preferred stock	0.0	0.0	0.0	0.0	0.0
Equity	385.5	486.5	543.7	2,158.9	997.3
Debt and equity	1,365.0	1,306.3	1,485.0	4,664.2	3,670.1
Adjusted ratios					
EBIT interest coverage (x)	2.8	(0.2)	(1.1)	5.7	4.1
FFO int. cov. (X)	4.0	3.2	4.1	5.3	5.4
FFO/debt (%)	11.5	9.3	12.8	18.6	16.8
Discretionary cash flow/debt (%)	2.9	(5.6)	1.5	5.7	7.3
Net Cash Flow / Capex (%)	149.0	138.9	113.6	54.5	113.5
Debt/total capital (%)	71.8	62.8	63.4	53.7	72.8
Return on common equity (%)	10.4	(5.1)	4.7	18.7	23.3
Common dividend payout ratio (un-adj.) (%)	18.1	0.0	28.7	76.4	42.7

*Fully adjusted (including postretirement obligations). †Fully adjusted. ‡Excess cash and investments netted against debt. Note: Ratings as of Nov. 29, 2007.

Table 4

Fingrid Oyj -- Financial Summary*			
--Fiscal year ended Dec. 31--			
	2006	2005	2004
Rating history	AA-/Stable/A-1+	AA-/Stable/A-1+	AA-/Stable/A-1+
(Mil. €)			
Revenues	353.5	319.1	303.8
Net income from continuing operations	38.3	55.7	49.5
Funds from operations (FFO)	112.7	106.4	105.5
Capital expenditures	71.2	54.3	42.2
Cash and investments	204.1	187.9	143.4
Debt	979.6	993.2	999.4
Preferred stock	0.0	0.0	0.0
Equity	385.5	353.8	304.6
Debt and equity	1,365.0	1,347.0	1,304.0
Adjusted ratios			
EBIT interest coverage (x)	2.8	2.7	2.5
FFO int. cov. (x)	4.0	4.0	3.4
FFO/debt (%)	11.5	10.7	10.6
Discretionary cash flow/debt (%)	2.9	4.7	5.4

Table 4

Fingrid Oyj -- Financial Summary*(cont.)			
Net Cash Flow / Capex (%)	149.0	183.7	234.2
Debt/debt and equity (%)	71.8	73.7	76.6
Return on common equity (%)	10.4	16.9	16.2
Common dividend payout ratio (un-adj.) (%)	18.1	11.9	13.4

*Fully adjusted (including postretirement obligations).

Ratings Detail (As Of November 29, 2007)*

Fingrid Oyj

Corporate Credit Rating	A+/Stable/A-1
<i>Nordic National Scale Rating</i>	--/--/K-1
Commercial Paper	
<i>Foreign Currency</i>	A-1
Preferred Stock	
<i>Local Currency</i>	A-
Senior Unsecured	A+

Corporate Credit Ratings History

24-Oct-2007		A+/Stable/A-1
19-Nov-1998		AA-/Stable/A-1+
17-Feb-1998		AA/Stable/A-1+
14-Jan-2003	<i>Nordic National Scale Rating</i>	--/--/K-1

Business Risk Profile

1 2 3 4 5 6 7 8 9 10

Financial Risk Profile

Aggressive

Debt Maturities

At Dec. 31, 2006 (including capital loan)*

2007: €80.6 million

2008: €43.1 million

2009: €74.1 million

2010: €87.8 million

2011: €96.3 million

2012 and thereafter: €422.8 million

*€138 million capital loan repaid May 2007

Collateralization: Not meaningful.

Total rated debt: At Dec. 31, 2006: €924.0 million.

*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.

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