

# 2009 Employee Share Plan Risk Factors

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## Risk factors related to the Company's business

### **The Group operates worldwide, in competitive and cyclical markets**

The worldwide markets for the Group's products are competitive in terms of pricing, product and service quality, development and introduction time and customer service. The Group faces strong competitors, some of whom are larger or developing in certain lower cost countries. The Group is exposed to cyclical fluctuations in the rate of economic growth of and level of capital expenditures in the various countries in which it operates, though the impact of downturns in a particular market may be limited by the diversified nature of its end user markets.

As the Group also operates in emerging or developing countries for approximately 30% of its business, it is exposed to the risks associated with those markets.

The Group's wide international presence exposes it to many economic, legal and political risks in its host countries. These include risks arising from social unrest (particularly, strikes and walk-outs), political instability, unforeseen regulatory changes, restrictions on capital transfers and other obstacles to free trade, and local tax laws, all of which may have an adverse effect on the Group's business, results of operations or financial position.

The Group has implemented procedures designed to protect it from the effects of these risks, which are generally beyond its control, and to manage them as effectively as possible. The protection provided by these measures may nevertheless prove to be inadequate.

### **The growth and success of Schneider Electric's products depends on its ability to develop new products and services and adapt to the market and to customer needs**

The markets in which the Group operates experience rapid and significant changes due to the introduction of innovative technologies. Introducing new technology products and innovative services, which Schneider Electric must do on an ongoing basis to meet customers' needs, requires a significant commitment to research and development, which may not result in success. The Group's revenue and margins may suffer if it invests in technologies that do not function as expected or are not accepted in the marketplace or if its products, systems or service offers are not brought to market in a timely manner, become obsolete or are not responsive to our customers' requirements.

To meet these challenges, the Group has an R&D budget which, at more than 4% of revenue, is among the highest in the industry. R&D and forward-looking engineering involves some 7,300 employees around the world, a number of them in development centers located in 25 countries. This ongoing commitment has allowed the Group to accelerate time to market and leverage the technology of strategic partners with whom it has also forged alliances to expand its lineup or

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geographic coverage. The Group has brought together all of its electrotechnical, electronic, electromechanical, software and other technical competencies by creating technology parks in China, the US, France and Japan.

Support centers have also been established in Mexico, India and China to provide the technology parks with additional skills and development capacity at a very competitive cost.

The Group's business growth depends on its ability to develop, deepen and enhance customer relationships. The Group must constantly offer customers innovative solutions built around high quality products and services incorporating leading-edge technologies that are closely tailored to customer needs and expectations. However, the Group does not have any exposure with a particular customer. Its ten largest customers represent less than 25% of total revenue.

Increasingly high customer satisfaction rates represent an important source of competitive advantage for the Group. It closely tracks the results of the quarterly surveys conducted in 55 countries among customers representing some 96% of its annual revenue. Improvement targets are set for each country, backed by specific action plans and progress monitoring procedures.

### **The Group's strategy involves growth through acquisitions, joint ventures and mergers that may be difficult to identify and/or execute**

The Group's strategy involves strengthening its capabilities through acquisitions, strategic alliances, joint ventures and mergers.

External growth projects are examined in detail by the business units, country organizations and corporate functions (Strategy, Finance, Legal Affairs and Human Resources) concerned under a rigorous internal process developed and led at Group level. A launch committee is responsible for initiating the review process to identify the risks and opportunities associated with each external growth project, while a validation committee reviews the results. Projects that successfully come through the review process are submitted for approval to the Group Acquisitions Committee made up of the main members of senior management. The largest projects require the prior approval of the Management Board and, in some cases, the Supervisory Board.

External growth transactions are inherently risky because of the difficulties that may arise in integrating people, operations, technologies and products, and the related acquisition, administrative and other costs.

The Group has therefore developed a process for integrating newly-acquired businesses that extends over a period of 6 to 24 months depending on the type and size of the newly acquired unit. The integration scenario for each acquisition varies depending on whether the business was acquired to strengthen or extend the Group's existing lineup or penetrate a new segment. All told, there are five scenarios ranging from total integration to separate organization. Depending on the strategic objective, a matrix is drawn up showing the required level of integration for each of the newly-acquired business's core functions, i.e., front office (sales force and brand), back office, R&D, corporate functions and

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management reporting. An integration plan is drawn up for each acquisition and submitted to the acquisitions committee for approval. The plan is implemented by an integration manager who reports to a Steering Committee that initially meets at monthly intervals and then on a quarterly basis.

The unit that presents the external growth project is accountable to Group senior management for meeting clearly-defined business plan targets covering the performance of the new business and expected synergies with existing businesses. Actual performance is measured against business plan targets during quarterly business reviews and, for the largest acquisitions, by the Management Board and Supervisory Board.

Value in use is determined by discounting estimated future cash flows that will be generated by the tested assets, generally over a period of not more than five years. Estimated future cash flows are based on management's economic assumptions and operating forecasts. The discount rate corresponds to Schneider Electric's weighted average cost of capital (8.2% at December 31, 2008 and 7.5% at December 31, 2007), plus a risk premium depending on the region in question. The perpetuity growth rate was 2% in 2008, unchanged from the previous year.

Goodwill is allocated to a Cash Generating Unit (CGU) when initially recognized. The allocation is made on the basis used to track the performance of Group operations and to assess the benefits derived from the synergies of the business combination. Impairment tests are conducted by the CGUs, which at Schneider Electric correspond to the Operating Divisions (Europe, North America, International and Asia-Pacific) and Business Units (Critical Power & Cooling Services (CPCS), Building Automation (BA) and Customized Sensors & Technologies (CST)).

If the recoverable amount of an asset or CGU is lower than its carrying amount, an impairment loss is recognized. To the extent possible, impairment losses on CGUs comprising goodwill are recorded as a deduction from goodwill.

### **The Group may be the subject of product liability claims and other adverse effects due to defective products, design faults or harm caused to persons and property**

Despite its testing and quality procedures, the Group's products might not operate properly or might contain design faults or defects. These design faults and defects could result in product liability claims, loss of revenue, warranty claims, litigation, a fall-off in demand or harm to Schneider Electric's reputation for safety and quality. To prevent or limit these risks, the Group recalls products if there are any doubts about a component, even if the defect is random and does not pose a safety risk.

Schneider Electric is covered by a global liability insurance program. Insured values under these programs adequately cover the Group's exposure to liability claims in connection with its businesses.

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## **Information systems risk**

The Group operates, either directly or through service providers, a wide range of highly complex information systems (servers, networks, applications, databases, etc.) that are essential to the efficiency of its sales and manufacturing processes. Failure of any of these hardware or software systems, a fulfillment failure by a service provider, human error or computer viruses could adversely affect the quality of service offered by the Group.

The Group regularly examines alternative solutions to protect against this type of risk and has developed contingency plans to mitigate the effects of any information system failure. Dedicated governance structures have been set up to manage relations with service providers responsible for outsourced IT systems operations.

Problems may also be encountered during the deployment of new applications or software. In particular, a project was launched in 2005 to design, develop and build a Group-wide SAP-based ERP system. The initial vision and detailed design phases were completed in July 2005 and the core system was built and deployed at several pilot sites in 2008. The system will be rolled out to the entire Group from 2009 onwards.

In view of the project's complexity, extensive functionalities and its worldwide deployment, a dedicated governance and cost control structure has been set up to track attainment of project milestones and limit the related risks.

However, despite the Group's policy of establishing governance structures and contingency plans, there can be no assurance that information systems projects will not be subject to technical problems or execution delays. While it is difficult to accurately quantify the impact of any such problems or delays, they could have an adverse effect on inventory levels, service quality and, consequently, the Group's financial results.

## **The Group is dependent upon hiring and retaining highly qualified management and technical personnel**

Competition for highly qualified management and technical personnel is intense in the Group's industry. Future success depends in part on the Group's ability to hire, assimilate and retain engineers and other qualified personnel.

The Group's human resources strategy is designed to create a motivating working environment. Specific policies have been developed covering international mobility, career development, training and compensation. The Group's expatriates help prepare the future of its business, build local teams and assemble the necessary skill-sets in targeted regions. The Group places considerable emphasis on training to deepen its skills base and retain employees.

## **The development and success of the Group's products depends on its ability to protect its intellectual property against competitors**

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The Group's future success depends to a significant extent on the development and maintenance of its intellectual property rights. Third parties may infringe the Group's intellectual property rights, and the Group may expend significant resources monitoring, protecting and enforcing its rights. If the Group fails to protect or enforce its intellectual property rights, its competitive position could suffer, which could have an adverse effect on its business.

To mitigate this risk, the patents developed or purchased by the Group are tracked by the Industrial Property team within the Finance & Control - Legal Affairs Department. All industrial property information for the main Group subsidiaries is transmitted to this team, which is responsible for managing and protecting these intangible assets throughout the world. The same procedure is followed for trademarks.

Since 2005, the Group has decided to combat violations of industrial property rights more vigorously, taking legal action against patent counterfeiters in China, Germany, Italy, France and other jurisdictions.

### **The Group's plants and products are subject to environmental regulations**

The Group's plants and products are subject to extensive and increasingly stringent environmental laws and regulations in all of its host countries.

To limit risks related to the environment in general, the Group is involved in a process to continuously improve the environmental performance of its plants and products. In 1992, the Group published a formal environmental policy, which was recently redefined to take account of changes both inside and outside Schneider Electric.

The policy is designed to improve manufacturing processes, promote eco-design and integrate customer concerns in the area of environmental protection. It also aims to identify, assess and prevent environmental risks, in order to guarantee full compliance with all environmental laws and regulations applicable to the Group's businesses. Environmental provisions are booked when the risks can be reliably measured or it is probable that clean-up work will be performed and the related cost can be reasonably estimated. No estimate is made of the potential cost of unidentified environmental risks. The Group expects its spending on environmental compliance programs to increase as a result of changes to existing environmental regulations and the introduction of new regulations.

There can be no guarantee that the Group will not be required to pay significant fines or compensation as a result of past, current or future breaches of environmental laws and regulations by companies that are currently or were previously members of the Group. This exposure exists even if the Group is not responsible for the breaches, in cases where they were committed in the past by companies or businesses that were not part of the Group at the time.

The Group may be exposed to the risk of claims for breaches of environmental laws and regulations. Such claims could adversely affect the Group's financial position and reputation, despite the efforts and investments made to comply at all times with all applicable environmental laws and regulations.

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If the Group fails to conduct its businesses in full compliance with the applicable environmental laws and regulations, the judicial or regulatory authorities could require the Group to conduct investigations and/or implement costly clean-up measures to deal with the current or past contamination of current or former facilities or off-site waste disposal facilities, and to scale-back or temporarily or permanently close facilities in accordance with the applicable environmental laws and regulations.

### **The Group's international operations expose it to the risk of fluctuations in foreign exchange rates**

Because a significant proportion of transactions are denominated in currencies other than the euro, the Group is exposed to risk arising from changes in exchange rates. If the Group is not able to hedge them, fluctuations in exchange rates between the euro and these currencies can have a significant impact on its results of operations and distort year-on-year performance comparisons.

The Group actively manages its exposure to currency risk to reduce the sensitivity of earnings to changes in exchange rates. Hedging programs mainly concern foreign currency receivables, payables and operating cash flows, which are generally hedged by means of forward purchases and sales.

Depending on market conditions, risks in the main currencies may be hedged based on recurring forecast flows using contracts that expire in 12 months or less.

The Group's currency hedging policy is to protect subsidiaries against risks on all transactions denominated in a currency other than their functional currency. More than twenty currencies are involved, with the US dollar, Hong Kong dollar and British pound representing the most significant sources of risk.

The financial instruments used to hedge the exposure of the Group to fluctuations in exchange rates are described in Note 19 to the consolidated financial statements for fiscal year 2008, pages 148 to 150 below.

In 2008, revenue produced in foreign currencies came to around €13 billion.

The main exposure of the Group in terms of currency exchange risks is related to the US dollar and to currencies influenced by the US dollar. The Group estimates that in the actual structure of its operations, a 10% increase of the euro compared to the US dollar would have a negligible impact on operating margin.

### **Interest rate risk**

The Group is exposed to risks associated with the effect of changing interest rates. Interest rate risk on borrowings is managed at Group level, based on consolidated debt and according to market conditions. The core aim of interest rate management policies is to optimize overall borrowing costs. Most bond debt is fixed rate. At December 31, 2008, 74% of gross debt was fixed rate.

Maturities of financial assets and liabilities are presented in Note 19 to the consolidated financial statements.

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A 1% change in interest rates would have an impact of around €1 million on the Group's financial expense.

The financial instruments used to hedge the exposure of the Group to fluctuations in interest rates are described in Note 19.1 to the consolidated financial statements for fiscal year 2008 on page 148 below.

### **Counterparty risk**

Financial transactions are entered into with carefully selected counterparties. Banking counterparties are chosen according to the customary criteria, including the credit rating issued by an independent rating agency.

Group policy consists of diversifying counterparty risks and periodic controls are performed to check compliance with the related rules.

In addition, the Group takes out substantial credit insurance and uses other types of guarantees to limit the risk of losses on trade accounts receivable.

### **Liquidity risk**

Liquidity is provided by the Group's cash and cash equivalents and commercial paper programs. These programs are backed by undrawn confirmed lines of credit. At December 31, 2008, the Group had access to cash and cash equivalents and commercial paper programs totaling €1.7 billion. In addition, the Group recently renegotiated a one-year extension to a €1.6 billion line of credit expiring in November 2009, bringing total lines of credit expiring after November 2010 to €2.3 billion.

The Group's credit rating enables it to raise significant long-term financing and attract a diverse investor base. The Group currently has an A- credit rating from Standard & Poor's (upgraded in November 2008) and an A3 credit rating from Moody's. The Group's liabilities and their terms and conditions are described in Note 16, pages 145 to 147 below.

In line with the Group's overall policy of conservatively managing liquidity risk and protecting its financial position, when negotiating new liquidity facilities the Group resists the inclusion of clauses that would have the effect of restricting the availability of credit lines, such as covenants requiring compliance with certain financial ratios and material adverse change clauses. At December 31, 2008, no financing or confirmed lines of credit were subject to covenants requiring compliance with financial ratios.

The loan agreements for some of its liquidity facilities nevertheless include cross-default clauses whereby if the Group were to default on any of its liquidity facilities, it would immediately be considered as having defaulted on all such facilities.

Moreover, anticipated reimbursement provisions exist for certain financing and lines of credit in case of change of control.

### **An increase in raw material prices could have negative consequences**

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The Group is exposed to fluctuations in energy and raw material prices (in particular steel, copper, aluminum, silver, lead, nickel, zinc and plastic). If the Group is not able to hedge, compensate or pass on increased costs to customers, this could have an adverse impact on its financial results.

The Group has, however, implemented certain procedures to limit its exposure to rising non-ferrous and precious raw material prices. The purchasing departments of the operating units report their purchasing forecasts to the Corporate Treasury Center. Purchase commitments are hedged using forward contracts, swaps and, to a lesser extent, options.

The financial instruments used to hedge the exposure of the Group to increases in raw material prices are described in Note 19.1 to the consolidated financial statements for fiscal year 2008, page 148 below.

In 2008, purchases of raw materials totaled around €1.3 billion, including around €711 million for non-ferrous metals, of which more than 59% were for copper. The Group enters into swap and options agreements in order to hedge all or part of its raw material purchases. Decisions to hedge such purchases, mostly of non-ferrous metals, depend on Group forecasts of changes of raw material market prices. As of December 31, 2008, Group hedges for non-ferrous metal purchases amounted to €175 million, of which €119 million for copper.

### **Equity risk**

Exposure to equity risk primarily relates to treasury stock and shares in AXA. These positions are not hedged. At December 31, 2008, the AXA shares' market value exceeded their acquisition cost.

### **The Group's products are subject to varying national and international standards and regulations**

The Group's products, which are sold in national markets worldwide, are subject to regulations in each of those markets, as well as to various supranational regulations. Those regulations include trade restrictions, tariffs, tax regimes and product safety standards. Changes to any of these regulations or standards or their applicability to the Group's business could lead to lower sales or increased operating costs, which would result in lower profitability and earnings.

The Group's products are also subject to multiple quality and safety controls and regulations, and are governed by both national and supranational standards, though the majority of the lineup complies with world-recognized International Electrotechnical Commission (IEC) standards. Costs of compliance with new or more stringent standards and regulations could affect its business if the Group is required to make capital expenditures or implement other measures.

Since the Group's products comply with the dominant standards in its host markets, the Group is able to meet most all of its customers' needs.

### **Claims, litigation and other risks**

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In 2001, Schneider Electric made a public offer to purchase Legrand as part of a proposed merger project. When the offer closed in July 2001, the Group held 98.1% of Legrand. In an initial decision dated October 10, 2001, the European Commission vetoed the merger, and in a second decision dated January 30, 2002, it ordered the two companies to separate as quickly as possible. As a result, Schneider Electric sold its interest in Legrand to the KKR-Wendel Investissement consortium even though the Court of First Instance of the European Communities overruled the Commission's decisions on October 22, 2002. Schneider Electric launched proceedings against the European Commission to obtain damages for the prejudice caused, estimated at €1.6 billion. On July 11, 2007, the Court ordered the Commission to compensate two-thirds of Schneider Electric's losses, once their amount has been determined. The Commission appealed this decision. The Luxembourg Court is expected to hand down a decision in 2009 following an appeals hearing held on December 3, 2008.

Following public offers launched in 1993 by SPEP (the Group holding company at the time) for its Belgian subsidiaries Cofibel and Cofimines, Belgium initiated proceedings against former Schneider Electric executives in connection with the former Empain-Schneider Group's management of its Belgian subsidiaries, notably the Tramico sub-group. At the end of March 2006, the Brussels criminal court (*tribunal correctionnel*) ruled that some of the defendants were responsible for certain of the alleged offenses. The court also appointed an expert to assess the loss suffered by those plaintiffs whose claims were ruled admissible. Schneider Electric and its Belgian subsidiaries Cofibel and Cofimines were held civilly liable for the actions of their senior executives who were found liable. Schneider Electric is paying the legal expenses not covered by insurance of the former executives involved. In addition, the new owners of the Tramico sub-group, to which a Cofimines subsidiary had advanced funds during the sub-group's liquidation, refuse to pay back said funds and are claiming compensation for having been involved in the Belgian legal proceedings. Arbitration proceedings are currently under way in Geneva.

In connection with the divestment of Spie Batignolles, Schneider Electric booked provisions to cover the risks associated with certain major contracts and projects. Most of the risks were extinguished during 1997. Provisions were booked for the remaining risks, based on management's best estimate of the expected financial impact.

In China, Schneider Electric was ordered to pay Chint RMB330 million (around €31 million) in compensation for patent infringement by one of its Chinese subsidiaries. Schneider Electric has appealed this decision. The appeal, which has resulted in a stay of judgment, is still outstanding. The dispute concerns production of a circuit breaker that uses technology for which Chint filed a utility model patent in 1997. The patent has since expired. Schneider Electric had already used this technology for more than 15 years on products sold in numerous countries, including China, before the Chint filing. Schneider Electric contests the validity of Chint's utility model and has appealed to the Beijing High

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People's Court following the Beijing Intermediate People's Court's rejection of its request that the utility model be ruled nul and void.

Schneider Electric SA, along with other companies in the industry, was involved in an investigation concerning Gas Insulated Switchgear launched by New Zealand's Commerce Commission. The Group, which was implicated through two former subsidiaries sold in 2001, decided to settle amicably and has signed an agreement with New Zealand's Commerce Commission that calls for the payment of a fine capped at NZD1,100,000. Schneider Electric has also been notified that a class-action type proceeding in Israel concerning the same equipment manufactured by the same former subsidiaries and other competitors has been abandoned

The Group is not aware of any other governmental, legal or arbitration proceedings (including any such proceedings which are pending or threatened of which the Group is aware) during the previous 12 months that may have significant effects on the Group's business, assets, financial position or profitability.

### Insurance

Schneider Electric's strategy for managing insurable risks is designed to defend the interests of employees and customers and to protect the environment, the Company's assets and its shareholders' investment.

This strategy entails:

- Identifying and quantifying the principle areas of risk.
- Preventing risks and protecting manufacturing through site audits, hazard and vulnerability studies and safety management for people and equipment.
- Organizing and deploying crisis management resources, notably for technical and political risks and natural disasters.
- Maintaining the necessary insurance cover for the main risks facing Group companies under global programs. The Group carefully screens insurance and reinsurance companies and evaluates their solvability.

In addition, the Group has taken out specific cover in response to certain local conditions, regulations or the requirements of certain risks, projects and businesses. To extend guarantees and reduce budgets, the Group coordinates purchasing of local cover.

### Liability insurance

The Group is covered by an integrated global liability insurance program set up on January 1, 2007 and extended until December 31, 2010. Insured values under this "all risks except" program total €230 million per claim and per year, representing adequate coverage of the Group's exposure to liability claims in connection with its businesses.

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Certain specific risks, such as aeronautic or environmental risk, are covered by specific programs.

### **Property and casualty/business interruption insurance**

This global property and casualty/business interruption insurance program was renewed for a two-year period on July 1, 2008. An “all risks except” contract, it covers fire, explosion, natural disaster, machine damage and other events that could affect Schneider Electric’s property, as well as operating losses caused by business interruption. Settlements under the global program are capped at €350 million per claim and specific limits apply to certain risks, such as natural disasters and machine damage. These limits were determined on the basis of claims scenarios established by specialists and available capacity in the insurance market.

Assets are insured at replacement value. Specialized engineers from the program’s main insurance companies visit the Group’s largest sites.

### **Shipping and transport insurance**

On January 1, 2009, the Group implemented a new global shipping/transport insurance program that covers all goods shipments, including between Group facilities, by all means of transport, with a maximum insured value of €15.2 million per convoy. The two-year program covers Group’s subsidiaries that had previously been insured under local, non-integrated contracts.

### **Self insurance**

To optimize costs, Schneider Electric self insures certain frequent risks through two captive insurance companies.

- Outside North America, a captive reinsurance company offers property/casualty and liability coverage capped at €11 million per year.
- In North America, a captive reinsurance company is used to align deductibles and self-insured retentions imposed by the insurers of primary layer automobile, liability and workers’ compensation insurance. Self-insured retentions range from USD 0.5 million to USD 5 million per claim, depending on the risk.

The cost of the Group’s main insurance programs has declined since 1996. In 2008, it was equivalent to 2.95‰ of consolidated revenues.