MOODY'S INVESTORS SERVICE

CREDIT OPINION

10 August 2016

Update

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RATINGS

Elering AS

Domicile	Estonia
Long Term Rating	A2
Type	LT Issuer Rating - Dom Curr
Outlook	Stable

Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

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Elering AS

Ratings reflect supportive regulatory regime and conservative financial profile

Summary Rating Rationale

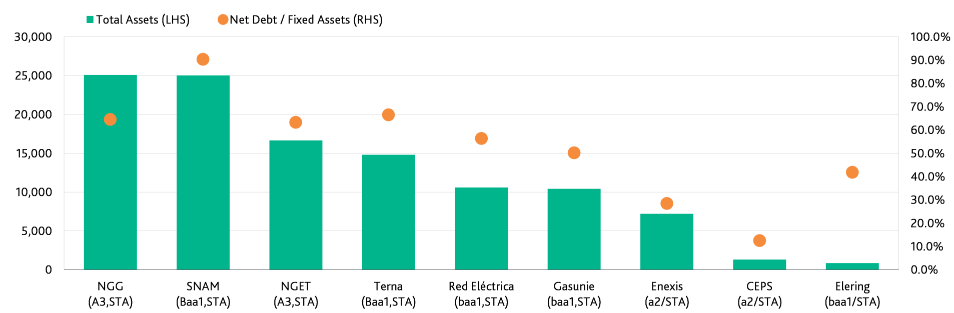
Elering's rating is underpinned by (1) the low business risk profile of its regulated transmission network operations; (2) the supportive regulatory framework, which provides for visibility of cash flows, albeit under a less prescriptive system of tariff calculation and application than seen elsewhere in Europe (leaving year-on-year tariff application decision at Elering's sole discretion), and (3) a conservative financial risk profile. However, the rating is negatively impacted by the company's small scale and the continued challenges of integrating Estonia into the wider European energy transmission system.

Elering's rating incorporates two notches of uplift for potential support from its owner, the Government of Estonia (A1 stable).

Exhibit 1

Elering's rating is constrained by the company's small size compared to European peers, but benefits from a conservative financial risk profile

Total Assets in € million versus Net Debt / Fixed Assets as of FY2015 (FY2016 for NGG and NGET)



Note: [1] Financial metrics are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations; [2] Ratings represent stand-alone credit quality expressed as assigned final rating or baseline credit assessment where applicable; [3] NGET – National Grid Electricity Transmission plc and NGG – National Grid Gas plc.
Source: Moody's Financial Metrics™

Credit Strengths

» Monopoly electricity transmission network operations, regulated under a fairly well developed and transparent regime underpins low business risk profile

» High support by Elering's owner, the Government of Estonia (A1, stable) results in two-notch uplift from standalone credit quality

Credit Challenges

» Falling regulatory returns in the low interest-rate environment reduce financial flexibility

» Capex programme to include a new Balticconnector gas pipeline linking Estonia and Finland, following the acquisition of gas TSO in 2015

Rating Outlook

The outlook on Elering's ratings is stable, reflecting our expectation that Elering will exhibit a financial profile commensurate with the current rating and that the company will continue to prudently manage its liquidity position.

Factors that Could Lead to an Upgrade

Before we consider any positive movement in the rating, we would expect to see Elering consistently maintain funds from operations (FFO) interest cover above 4.5x and FFO/net debt at least in the 20s in percentage terms.

Factors that Could Lead to a Downgrade

The rating could come under downward pressure if Elering's FFO interest cover were to fall below 3.5x, or FFO/net debt were to decline to the low teens (in percentage terms) for a sustained period. Downward pressure could also be exerted on the rating as a result of (1) a deterioration in the credit quality of the government of Estonia; (2) a reduction in the government support assumptions currently incorporated into our assessment; or (3) a materially unfavourable change in the regulatory framework leading to a significant increase in the company's business risk.

Key Indicators

Exhibit 2

Cash-flow based metrics in 2015 were negatively impacted by dividend payments and a different accounting treatment of congestion revenues

	12/31/2015	12/31/2014	12/31/2013	12/31/2012
FFO Interest Coverage	5.9x	6.7x	6.9x	5.9x
Net Debt / Fixed Assets	41.8%	44.6%	49.1%	44.5%
FFO / Net Debt	18.4%	21.8%	21.1%	26.2%
RCF / Net Debt	12.1%	21.8%	21.1%	26.2%

Note: All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations.
Source: Moody's Financial Metrics™

Detailed Rating Considerations

Low business risk profile underpinned by good visibility of cash flows and supportive regulatory framework

We consider electricity and gas network operations to be generally characterised by low business risk due to their regulated nature and cash flow visibility. Elering's rating is underpinned by the regulated income earned from its electricity and gas transmission assets. Gas transmission operations are expected to remain small and account for less than 10% of consolidated cash flows.

We view the regulatory framework in Estonia as supportive of Elering's credit quality. Gas and electricity transmission network activities are subject to the same regulatory principles and oversight by the Estonian Competition Authority (ECA). Whilst the regulatory framework is fairly well developed and based on generally used principles of a return on a regulated asset base (RAB), we note that ECA introduced a lighter-touch approach to regulation in 2013. As a result, the mandatory three-year regulatory periods are no longer applied and tariffs are not subject to automatic annual reviews. Instead, Elering approaches the regulator for a review of tariffs on an ad hoc basis when it thinks it is appropriate to do so. Such form of regulation gives Elering more discretion in its approach to tariff changes, but it also somewhat reduces the overall transparency of the rate setting process.

With respect to both electricity and gas transmission activities, Elering is allowed to cover its costs over time and realise a reasonable return based on the weighted average cost of capital (WACC) applied to the company's RAB. The WACC allowance is reset by ECA every year and is 4.92% for 2016 (2015: 5.58%). The corresponding rate for the gas segment has historically been slightly higher and stood at 4.93% in 2016 (2015: 5.63%). The decrease in the electricity WACC is not reflected in Elering's applied tariffs in 2016, as the company has not applied for a tariff revision. However, a financial balance is expected to be maintained. Some of the investments executed in 2014 (and thereafter) will not earn a return until the tariff is revised. We expect Elering to apply for new tariffs to be effective in 2017.

The regulatory approach to current costs is generally supportive. Operating costs are no longer subject to efficiency requirements (previously subject to decreases in real terms on an inflation adjusted, CPI-X, basis). Also, the full annual cost of network losses is passed through to customers in tariffs.

Exposure to electricity volumes remains limited. Since 2013, tariffs are calculated on the assumption that transmitted electricity reflects the average of the last three-year actual volumes (vs. only one year, as previously applied). This helps to limit the financial impact of large year-on-year fluctuations. However, if actual transmission volumes are different from the assumptions embedded in the tariff calculations, Elering bears the relative loss or collects the relative gain in income. Also, updates related to volume assumptions included in tariff calculations are finalised in conjunction with tariff revisions, which are no longer automatically implemented on an annual basis.

Exhibit 3

In spite of decreasing WACC, Elering can keep the higher profitability by not applying for new tariffs each year

Tariff year	2012	2013	2014	2015	2016
Risk-free rate	3.58	3.354	2.810	2.330	1.920
Country risk premium	1.90	2.042	1.510	0.990	0.700
Debt premium	0.90	1.030	1.030	0.920	1.080
Cost of debt	**6.38**	**6.43**	**5.35**	**4.24**	**3.70**
Risk-free rate	3.58	3.35	2.81	2.33	1.92
Country risk premium	1.90	2.04	1.51	0.99	0.70
Market risk premium	5.00	5.00	5.00	5.00	5.00
Beta	0.74	0.76	0.76	0.72	0.70
Cost of equity	**9.18**	**9.20**	**8.12**	**6.92**	**6.13**
Gearing	0.50	0.50	0.50	0.50	0.50
WACC, nominal pre-tax	**7.78%**	**7.81%**	**6.74%**	**5.58%**	**4.92%**
WACC, current tariffs	**7.78%**	**7.81%**	**6.74%**	**6.74%**	**6.74%**

Source: Estonian Competition Authority, Company

Capex levels will remain elevated in the longer term

Elering's investments have been high in the recent past, considering the company's relatively small size. Total capital expenditure in 2012-15 amounted to €469 million, with the majority of spending occurring in 2014 and 2013 in the amount of €203 million and €100 million, respectively. In 2015, the company acquired 100% stake in the Estonian gas transmission system operator (TSO), for a cash consideration of €53.7 million.

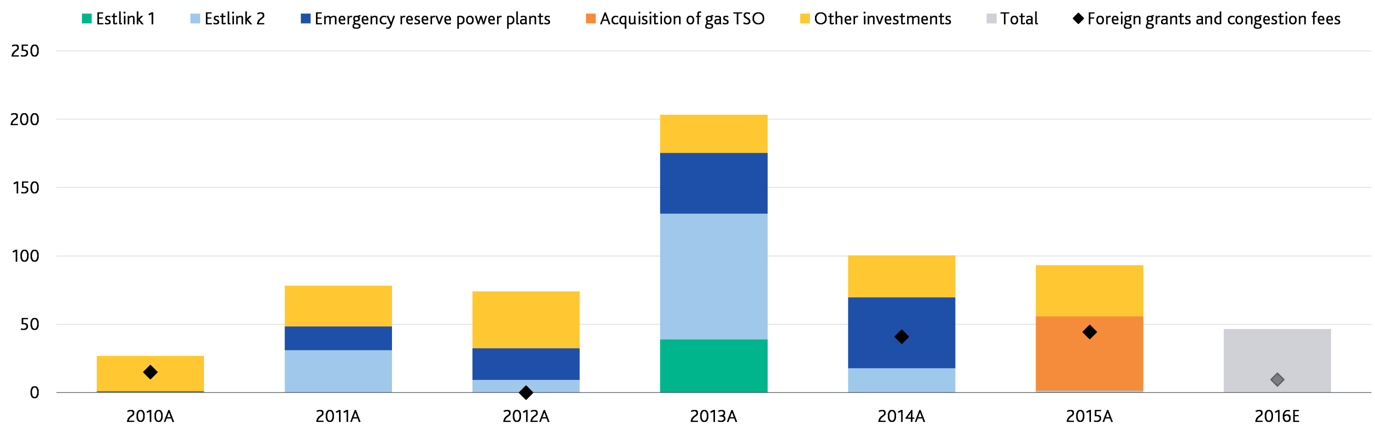
The previous main investment projects in the electricity segment were completed by the December 2014 year end. They included 1) a second undersea cable between Estonia and Finland - Estlink 2 (€160 million); 2) the purchase of the Estlink 1 cable (€38 million); and 3) the construction of two emergency reserve power plants, with a cumulative capacity of 250 MW (€135 million). Regular maintenance investments to replace the ageing transmission equipment and develop the grid amount to some €28 million per year for electricity, and significantly less for gas transmission assets (some €4 million per annum).

Whilst we expect lower capital expenditure levels in 2016 and 2017, Elering has identified a couple of larger projects to be implemented over the longer term. These include a new electricity interconnection between Latvia and Estonia, as well as the so-called Balticconnector – a gas subsea pipeline connecting Estonia and Finland. Both projects are currently at an early stage of development, but we expect the associated investment requirements to grow gradually from 2018 onwards.

Exhibit 4

Capital expenditures will remain modest before expected implementation of interconnection projects (Balticconnector and third Latvia-Estonia cable)

€ million



Note: The estimate represents Moody's forward view; not the view of the issuer.
Source: Company, Moody's Investors Service

Financial metrics expected to deteriorate from current levels

In light of the implementation of its sizeable investment programme, Elering's debt has increased from a low level to reach some €378 million as of June 2016 (compared to €190 million as of December 2010). Nonetheless, financial metrics remained relatively stable. In 2015, Net debt/EBITDA was 4.1x (2014: 3.9x), with funds from operations (FFO)/net debt down to 18.4% (2013: 21.8%). The drop in the latter metric was mainly due to a change in accounting treatment of congestion revenues, which are now excluded from group revenues, and thus do not contribute to cash flow from operating activities. At the same time, however, investing cash flows are decreased by the congestion cash amounts, which are utilised to fund the construction of new interconnectors.

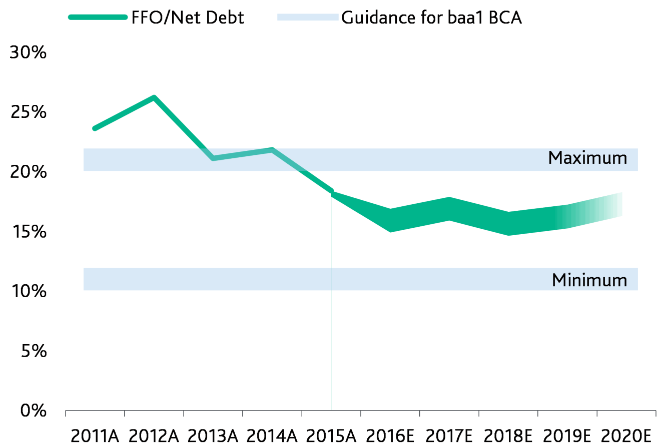
Following the acquisition of the gas TSO in 2015, Elering's investment projects now include the construction of a new gas interconnector linking Estonia and Finland. Combined with the gas network regular maintenance activities, we expect this spending to add some €62 million (net of EU grants) to the group capital expenditure programme for years 2016 through 2020.

Overall, we expect Elering's financial metrics to deteriorate from the current levels. This reflects the expected reduction in operating cash flow due to the aforementioned accounting treatment of congestion revenues, the accumulated debt levels arising from the acquisition of the Estonian transmission gas operator concluded in 2015, and the elevated capital expenditure going forward. Furthermore, we expect a lower WACC allowance to become effective in 2017 (following the anticipated application for new tariffs), which will weigh on company cash flow generation.

Exhibit 5

FFO / Net Debt to remain within the rating guidance over the medium term...

FFO / Net Debt against guidance

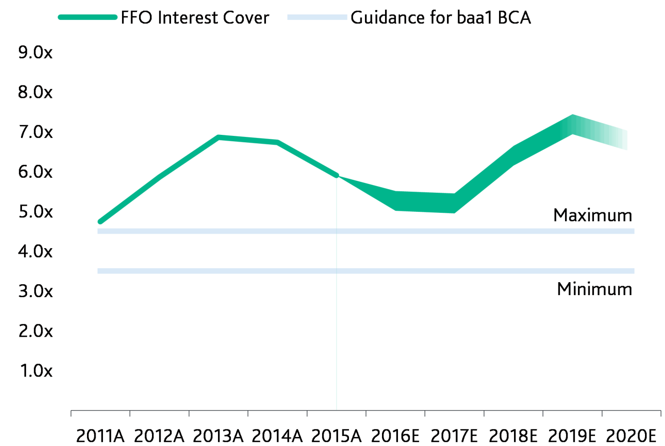


Note: [1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations; [2] As of 8/4/2016; [3] This represents Moody's forward view; not the view of the issuer; and unless noted in the text, does not incorporate significant acquisitions and divestitures.
Source: Moody's Financial Metrics™, Moody's forecast

Exhibit 6

...while FFO Interest Cover will continue to exceed the guidance for baa1 BCA

FFO Interest Cover against guidance



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Source: Moody's Financial Metrics™, Moody's forecast

Government support assumption results in rating uplift

Elering's A2 rating incorporates two notches of uplift to its standalone credit quality, which we express as a baseline credit assessment (BCA) of baa1. The uplift to the BCA is a result of the credit quality of the government of Estonia (the sole shareholder of Elering) and our assessment of high probability of governmental support for the company in the event of financial distress.

As a 100% state-owned company, Elering is subject to special governance rules stipulated in the State Assets Act, based on which shareholder rights are conferred to the Ministry of Economic Affairs and Communications. Although the government of Estonia does not provide any explicit guarantees, Elering's operations are considered of vital importance to the Estonian economy. The government also has a strong track record of support to the company. It issued two comfort letters to the creditors of long-term loans and increased the company's share capital by €5.8 million and €9.9 million in 2010 and 2011 respectively. Also, in order to support the acquisition of gas transmission assets in 2015, the government contributed a total of €40.0 million in equity, with the final tranche of €32.0 million paid in June 2016.

We consider there to be a high probability of support for Elering if such were needed, which reflects the company's strategic importance for the economy and its status as a provider of vital services. Furthermore, we understand that there are currently no privatisation plans and the government of Estonia will remain the sole shareholder of Elering.

Liquidity Analysis

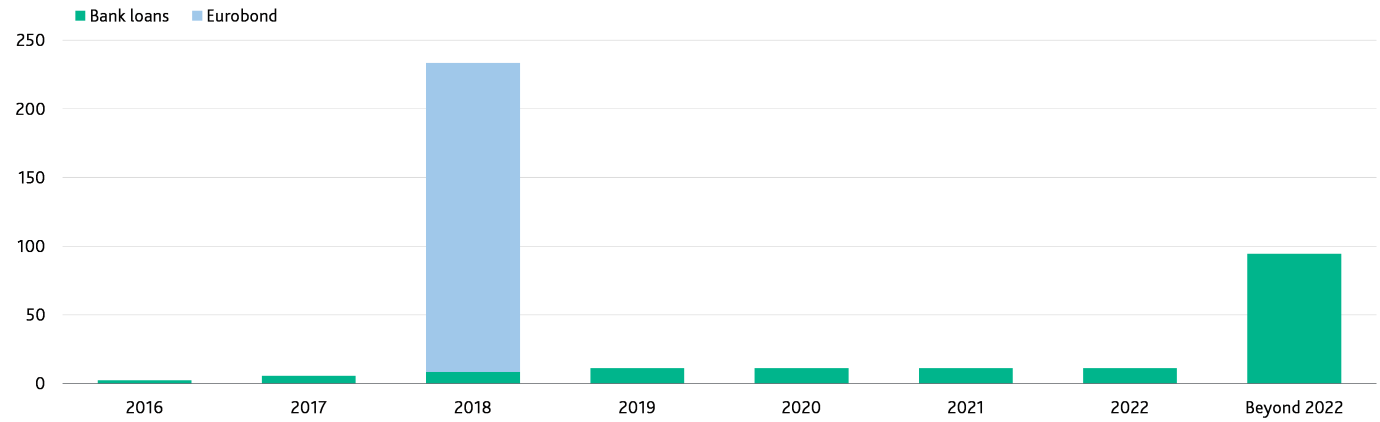
As of 30 June 2016, Elering's cash balance amounted to €91.7 million, up from €60.5 million at December 2015. There are currently no unutilised bank back-up facilities in place. Nonetheless, we expect the company to maintain a solid liquidity position in excess of 18 months, which will be additionally supported by internal cash flow generation.

Elering does not have any material near-term debt maturities. The majority of outstanding debt is represented by the company's €225 million 4.625% notes due in July 2018, as well as drawdowns under European Investment Bank (EIB) and Nordic Investment Bank (NIB) facilities, which have a scheduled amortisation profile (maturity dates between 2025-33).

We anticipate the above sources, coupled with net cash generation in the year, to cover Elering's financial need in the short term. Also, we do not expect to see any significant near-term cash outflows, other than related to the implementation of the company's investment programme. A dividend of €31 million for 2015 has already been paid during second quarter of 2016.

We note that the EIB and NIB facilities include the following financial covenants: Equity/Assets of more than 30% (39% at Q1'16), and Net Debt/EBITDA of less than 6.0x (3.6x at Q1'16). We expect headroom under the covenants to remain adequate in the near-to-medium term.

Exhibit 7
Next sizeable maturity is related to €225 million Eurobond maturing in 2018
€ million



Source: Company

Corporate Profile

Elering AS (A2 stable) is the owner and operator of Estonia's 5,400 km high-voltage electricity transmission network. In addition, Elering is present in the gas segment, following the acquisition of a 100% stake in the Estonian gas transmission operator from Fortum and Gazprom.

The Estonian electricity transmission network was built as part of the north-western common power system of the former Soviet Union and the average age of the transmission assets is around 30 years. The transmission system is connected to Latvia and Russia, as well as to Finland through two submarine cables, Estlink 1 (350 MW) and Estlink 2 (650 MW). The gas transmission network comprises 885 km of pipelines and is connected to Latvia and Russia. Both electricity and gas transmission activities are regulated by the Estonian Competition Authority.

Elering is 100% owned by the Government of Estonia (A1 stable).

Rating Methodology and Scorecard Factors

Elering is rated in accordance with the rating methodology for Regulated Electric and Gas Networks, published in November 2014, and Government-Related Issuers, published in October 2014.

Based on the company's historical financial results, the rating methodology grid indicates a factor outcome of A2, which is above the assigned Baseline Credit Assessment (BCA) of baa1. Elering's BCA reflects its relatively small size compared to Western European peers, its operations being concentrated in a relatively small economy, as well as the expected deterioration in credit metrics in the near-to-medium term.

Exhibit 8
Elering AS - Rating Grid

Regulated Electric and Gas Networks Industry Grid [1][2]	Current FY 12/31/2015		Moody's 12-18 Month Forward View As of 8/4/2016 [3]	
Factor 1 : Regulatory Environment and Asset Ownership Model (40%)	Measure	Score	Measure	Score
a) Stability and Predictability of Regulatory Regime	A	A	A	A
b) Asset Ownership Model	Aa	Aa	Aa	Aa
c) Cost and Investment Recovery (Ability and Timeliness)	A	A	A	A
d) Revenue Risk	A	A	A	A
Factor 2 : Scale and Complexity of Capital Program (10%)				
a) Scale and Complexity of Capital Program	Baa	Baa	Baa	Baa
Factor 3 : Financial Policy (10%)				
a) Financial Policy	Baa	Baa	Baa	Baa
Factor 4 : Leverage and Coverage (40%)				
a) FFO Interest Coverage (3 Year Avg)	6.5x	Aa	5x - 5.5x	A
b) Net Debt / Fixed Assets (3 Year Avg)	45.0%	Aa	39% - 41%	Aa
c) FFO / Net Debt (3 Year Avg)	20.4%	A	15% - 17%	Baa
d) RCF / Net Debt (3 Year Avg)	18.3%	A	8% - 11%	Baa
Rating:				
Indicated Rating from Grid Factors 1-4		A2		A3
Rating Lift	0	0	0	0
a) Indicated Rating from Grid		A2		A3
b) Actual Rating/BCA Assigned				A2/baa1

Government-Related Issuer	Factor	Factor
a) Baseline Credit Assessment	baa1	baa1
b) Government Local Currency Rating	A1	A1
c) Default Dependence	Very High	Very High
d) Support	High	High
e) Final Rating Outcome	A2	A2

Note: [1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations; [2] As of 12/31/2015; [3] This represents Moody's forward view; not the view of the issuer; and unless noted in the text, does not incorporate significant acquisitions and divestitures.
Source: Moody's Investors Service

Ratings

Exhibit 9

Category	Moody's Rating
ELERING AS	
Outlook	Stable
Issuer Rating -Dom Curr	A2
Senior Unsecured -Dom Curr	A2

Source: Moody's Investors Service

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