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Credit Opinion: Elering AS

Global Credit Research - 14 Apr 2015

Tallinn, Estonia

Ratings

Category	**Moody's Rating**
Outlook	Stable
Issuer Rating -Dom Curr	A3
Senior Unsecured -Dom Curr	A3

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Key Indicators

[1]**Elering AS**

	12/31/2014	**12/31/2013**	**12/31/2012**	**12/31/2011**
FFO Interest Coverage	**6.7x**	**6.8x**	**5.8x**	**4.7x**
Net Debt / Fixed Assets	**44.7%**	**49.1%**	**44.5%**	**41.3%**
FFO / Net Debt	**21.8%**	**21.1%**	**26.1%**	**23.5%**
RCF / Net Debt	**21.8%**	**21.1%**	**26.1%**	**23.5%**

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

Note: For definitions of Moody's most common ratio terms please see the accompanying User's Guide.

Opinion

Rating Drivers

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

- Historically high capex levels are reducing

- Credit metrics expected to deteriorate from current levels

- Government support assumption results in rating uplift

Corporate Profile

Elering AS (A3 stable) is the owner and operator of Estonia's 5,223 km high-voltage electricity transmission network. In addition, Elering is present in the gas segment, following the acquisition of a 51.4% stake in the Estonian gas transmission operator AS Võrguteenus Valdus. The company plans to increase its shareholding to 100% by the end of 2015.

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 megawatts, 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 (ECA).

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

SUMMARY RATING RATIONALE

Elering's rating is underpinned by (1) the low business risk profile of its regulated transmission network operations and (2) the historically supportive regulatory framework, which provides for visibility of cash flows. However, the rating is constrained by (1) the company's small scale and (2) the expected deterioration of credit metrics vs. historical levels, mainly resulting from the reduction of the beneficial impact from congestion revenues on operating cash flows, in conjunction with the accumulated leverage associated with the completion of its sizable investment programme.

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

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 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 appropriate to do so. Such form of regulation gives Elering more discretion in its approach to tariff changes, but 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 5.58% for 2015 (2014: 6.74%). We understand that the decrease in the WACC will not be reflected in Elering's applied tariffs in 2015, 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.

The regulatory approach to current costs is generally supportive. Operating and maintenance costs are no longer subject to efficiency requirements (previously subject to decreases in real terms on a 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 last three-year actual volumes (vs. the last one year only as previously applied), thus helping 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.

HISTORICALLY HIGH CAPEX LEVELS ARE REDUCING

Elering's investments have been very high in the recent past considering the company's relatively small size. Total capital expenditure in 2011-14 amounted to EUR455 million, of which EUR100 million was in 2014, and EUR203 million in 2013.

All large investment projects are now fully complete. These mainly included 1) a second undersea cable between Estonia and Finland - Estlink 2 (EUR160 million); 2) the purchase of the Estlink 1 cable (EUR38 million) and 3) the construction of two emergency reserve power plants with a cumulative capacity of 250 MW (EUR135 million). Regular maintenance investments to replace the ageing transmission equipment and develop the grid amount to some EUR30 million per year for electricity and materially less for the gas transmission assets.

Whilst we expect significantly lower capital expenditure levels in the next two to three years, Elering has identified some larger projects to implement over the longer term, including a new electricity interconnection between Latvia and Estonia and the so-called Baltic Connector, a gas subsea pipeline connecting Estonia and Finland. Both projects are at an early stage of development and associated investment requirements remain modest at present.

CREDIT METRICS EXPECTED TO DETERIORATE FROM CURRENT LEVELS

In light of the implementation of its sizeable investment programme, Elering's debt increased from a low level to reach about EUR350 million as of December 2014 (vs. EUR190 million as of December 2010). However, financial metrics remained relatively stable in 2014. Net debt/EBITDA was 3.9x in 2014 (2013: 4.0x) and funds from operations (FFO)/net debt was 21.8% (2013: 21.1%), mainly supported by the exceptional level of congestion revenues earned by the company in 2014. This more than compensated for the 7.8% decrease in tariffs implemented from April 2014 as a result of the reversal of past congestion revenues, which are taken into account for the purpose of tariff calculations.

Despite the reduction in investments, Elering's financial metrics are anticipated to deteriorate from current levels. This reflects the expected reduction of the contribution from congestion revenues to operating cash flows (balanced by a correspondent reduction in investing cash flows) and the accumulated debt levels of the company arising from investments and, to a lesser extent, the acquisition of the Estonian transmission gas operator AS Võrguteenus Valdus (for a consideration of EUR27.6 million for the 51.4% stake acquired in January 2015, implying a total acquisition cost of just over EUR55 million for 100%). In addition, if sustained, a lower WACC allowance vs. historical levels would negatively impact cash flow generation as a consequence of future tariff revisions.

GOVERNMENT SUPPORT ASSUMPTION RESULTS IN RATING UPLIFT

Elering's A3 rating incorporates two notches of uplift to its standalone credit quality which we express as a baseline credit assessment (BCA) of baa2. 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 that there is a high probability of government 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 (MEAC). 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 has a track record of providing support to the company, for example, it issued two comfort letters to the creditors of long-term loans and increased the company's share capital by EUR5.8 million in 2010 and further EUR9.9 million in September 2011.

Overall, 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. We understand that there are currently no privatisation plans and the government of Estonia will remain the sole shareholder of Elering.

Liquidity Profile

As of 31 December 2014, Elering's liquidity was supported by (1) EUR31.9 million of cash, (2) a EUR20 million undrawn revolving facility with a final maturity in July 2016, and (3) a EUR32 million undrawn term loan granted by the European Investment Bank (EIB).

Elering does not have material near-term debt maturities. The majority of outstanding debt is represented by the company's EUR225 million 4.625% notes due in 2018, as well as drawdowns under EIB and Nordic Investment Bank (NIB) facilities, which have a scheduled amortisation profile.

We expect that the above sources together with net cash generation in the year will be sufficient to cover Elering's financial needs in the short term, although the potential acquisition of the remaining stake in AS Võrguteenus Valdus and the company's announced dividend distribution (EUR20 million in 2015) could result in the need to raise additional funding to support its near term liquidity profile.

We note that the EIB and NIB facilities include the following financial covenants: equity/assets of more than 30% (40% as of December 2014) and net debt/EBITDA of less than 7.0x until 2015 and 6.0x thereafter (3.9x in 2014). We expect headroom under the covenants to remain adequate in the medium term.

Rating Outlook

Despite the anticipated deterioration in credit metrics, the stable rating outlook reflects 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.

What Could Change the Rating - Up

Given the expected deterioration in financial metrics in the near term, we do not see upward rating pressure. 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.

What Could Change the Rating - Down

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.

Other Considerations

The principal methodologies used in rating Elering were Moody's "Regulated Electric and Gas Networks" published in November 2014; and "Government Related Issuers", published in October 2014. Please see the Credit Policy page on www.moodys.com for a copy of these methodologies.

Rating Factors

Elering AS

Regulated Electric and Gas Networks Industry Grid [1][2]	**Current FY 31/12/2014**		[3]**Moody's 12-18 Month Forward ViewAs of 14/04/2015**	
Factor 1 : Regulatory Environment and Asset Ownership Model (40%)	**Measure**	**Score**	**Measure**	**Score**
a) Stability and Predictability of Regulatory Regime		A	A	A
b) Asset Ownership Model		Aa	Aa	Aa
c) Cost and Investment Recovery (Ability and Timeliness)		A	A	A
d) Revenue Risk		A	A	A
Factor 2 : Scale and Complexity of Capital Program (10%)				
a) Scale and Complexity of Capital Program		Baa	Baa	Baa
Factor 3 : Financial Policy (10%)				
a) Financial Policy		Baa	Baa	Baa
Factor 4 : Leverage and Coverage (40%)				
a) FFO Interest Coverage (3 Year Avg)	6.5x	Aa	4.3x - 4.5x	A
b) Net Debt / Fixed Assets (3 Year Avg)	46.2%	A	44% - 46%	A
c) FFO / Net Debt (3 Year Avg)	22.6%	A	13% - 14%	Baa
d) RCF / Net Debt (3 Year Avg)	22.6%	Aa	8% - 14%	Baa
Rating:				
Indicated Rating from Grid Factors 1-4		A2		A3

Rating Lift		0		0
a) Indicated Rating from Grid		A2		A3
b) Actual BCA Assigned		baa2		

Government-Related Issuer	Factor
a) Baseline Credit Assessment	baa2
b) Government Local Currency Rating	A1
c) Default Dependence	Very High
d) Support	High
e) Final Rating	A3

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. [2] As of 31/12/2014; Source: Moody's Financial Metrics [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

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on http://www.moodys.com for the most updated credit rating action information and rating history.

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