

Credit Opinion: Eesti Energia AS

Global Credit Research - 27 Aug 2015

Tallinn, Estonia

Ratings

Category	Moody's Rating
Outlook	Stable
Issuer Rating	Baa2
Senior Unsecured -Dom Curr	Baa2
ST Issuer Rating	P-2

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Key Indicators

[1]Eesti Energia AS	12/31/2014	12/31/2013	12/31/2012	12/31/2011
(CFO Pre-W/C + Interest) / Interest	6.8x	8.9x	7.9x	11.2x
(CFO Pre-W/C) / Net Debt	25.5%	35.5%	34.7%	46.5%
RCF / Net Debt	14.6%	28.4%	24.3%	33.8%
(CFO Pre-W/C) / Debt	22.8%	32.0%	28.0%	42.6%
RCF / Debt	13.1%	25.6%	19.6%	31.0%

[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

- Dominant market positioning in Estonia, overall small in size, added risks in connection with increasing market integration
- Heavy reliance on the CO2-intensive oil shale based electricity generation, coupled with a weaker power price environment
- Regulated electricity distribution activities add a degree of visibility of cash flows
- Development of higher-risk shale oil activities
- Negative free cash flow due to sizeable, albeit reduced investment programme

- Government support provides rating uplift

## **Corporate Profile**

Eesti Energia AS (rated Baa2, stable) is the dominant vertically integrated utility in Estonia. The group generates 90% of the country's electricity and around 17% of its heating needs. It also owns and operates most of the country's electricity distribution network. Primary electricity generation facilities are based in north-eastern Estonia, consisting of oil shale fired Eesti and Balti power plants, owned and operated by Eesti Energia Narva Elektriijaamad AS (EE Narva Power Plants). Eesti Energia also owns 100% of Estonia's main supplier of oil shale, the country's long-term primary fuel source for electricity generation. Eesti Energia is 100% owned by the Government of Estonia.

## **Rating Rationale**

Eesti Energia's Baa2 rating is underpinned by the group's dominant position in Estonia as an incumbent vertically-integrated utility and the cash flow predictability associated with its electricity distribution activities.

However, the company's small scale and concentration on a CO<sub>2</sub>-intensive oil shale based generation portfolio constrains its rating. In the short term, Eesti Energia's hedging strategy provides a degree of protection to earnings from the effect of weakening power prices. We expect that the competitive position of Eesti Energia's oil shale based generation assets will weaken over time due to the increasing integration with the Nordic power market, which has a more diversified generation base.

The Baa2 rating also takes into account Eesti Energia's shale oil activities, which we consider to carry a higher risk than the group's core utility services. In addition, we note a degree of execution risk related to the shale oil facilities, as evidenced by historical production delays at the Enefit280 facility. Moody's understands that Eesti Energia has scaled-down its plans to undertake further investments into these facilities in the foreseeable future, and believes that the company will continue to prudently manage spending in this area.

Eesti Energia's rating incorporates a two-notch of uplift for potential support from its owner, the Government of Estonia (rated A1, stable).

## **DETAILED RATING CONSIDERATIONS**

### **DOMINANT MARKET POSITIONING IN ESTONIA, OVERALL SMALL IN SIZE, ADDED RISKS IN CONNECTION WITH INCREASING MARKET INTEGRATION**

Eesti Energia is the incumbent vertically integrated utility group in Estonia. The company has total installed generation capacity of 2.1 GW, predominantly based on oil shale. At H1 2015, Eesti Energia's electricity sales amounted to 3.9 TWh, which represents a decline of around 13% from the same period in 2014. The group's retail electricity market share in H1 2015 was 61% in Estonia (59% in 2014), 14% in Latvia (15%), and 4% in Lithuania (7%). The combined market share in the Baltics remained unchanged at 26%, compared to 2014 levels.

Eesti Energia is the dominant player in Estonia and enjoys significant presence in the Baltic generation market (approximately a fifth of the region's installed capacity). Nevertheless, both the size and scale of operations are relatively small in the wider pan-European context. These factors expose the group to changes in the increasingly integrated electricity markets.

The Baltic countries are relatively well interconnected with each other (one exception being the insufficient cross-border transmission capacity between Estonia and Latvia) and Eesti Energia benefits from its presence in the neighbouring markets (Latvia and Lithuania), as both of them are characterised by structural electricity deficits.

Interconnection capacity between the Baltic and the Nordic regions has increased recently, following the commissioning of the Estlink 2 sub-sea DC cable (in early 2014), linking Estonia and Finland. This resulted in cross-border throughput between the two countries rising to 1 GW, from the previous 350 MW. The increase in interconnection capacity offers opportunities for Eesti Energia, due to the fact that Finland is characterised by a structural energy deficit. Conversely, it also exposes the company to price pressures and added volatility, stemming from the low cost, hydro-driven generation base in the Nordic region.

Overall, the establishment of the second Estlink interconnector, has resulted in NPS Estonia electricity prices dropping from 43 EUR /MWh in 2013, to 30 EUR /MWh in the first half of 2015. In the short-term, risks related to the level of power prices are mitigated by the hedging policy adopted by Eesti Energia (with 1-year ahead sales volumes hedged usually between 70-90%, and 2-year hedges averaging around 50%). Over the medium-term,

however, the group is exposed to the ongoing integration between the Baltic and Nordic markets. This is likely to result in a reduction to Eesti Energia's achieved prices, and thus, negatively impact on the group's financial profile.

#### HEAVY RELIANCE ON THE CO<sub>2</sub>-INTENSIVE OIL SHALE BASED ELECTRICITY GENERATION, COUPLED WITH A WEAKER POWER PRICE ENVIRONMENT

The company's generation base is dominated by oil shale (c.85% of installed capacity) . The CO<sub>2</sub> intensity of this technology is between 1.0-1.2t/MWh (depending on the specific production unit), which compares unfavourably to the CO<sub>2</sub> intensity of gas or coal of circa 0.45t/MWh and 0.9t/MWh, respectively. This exposes the group to the tightening of carbon emission targets. We note that, depending on electricity generation volumes, annual CO<sub>2</sub> emissions for Eesti Energia range between 8-13 million tonnes. This exceeds the allocated free CO<sub>2</sub> emission allowances, which at December 2014 was a cumulative of 8.5 million tonnes for years 2015-2017. Consequently, the company has to purchase significant volumes of CO<sub>2</sub> allowances, to compensate for the excess emission levels. With CO<sub>2</sub> emission allowances prices on the rise (in Q2'2015 the average price stood at 7.4 EUR /t, and was 33% higher than in Q2'14), this poses risk to Eesti Energia's profitability. Hedging provides some support and visibility to cash flows. Furthermore, the company is investing in the new Auvere plant, which will have lower emissions, as well as in renewable generation sources. The scale of these activities, however, is modest in the context of the group's total generation base, and the company's exposure to CO<sub>2</sub> remains high.

Eesti Energia's cash flows are exposed to wholesale electricity price movements. Price hedging provides a degree of visibility to cash flows in the short-term, but given the increasing integration with the Nordic markets, we expect downward pressures on the prices in the region to continue. In Q2'2015, Estonian power prices averaged 30.0 EUR /MWh, and were decreased 13.6% from Q2'2014 levels. In light of the market dynamics in the region, the lack of a diversified generation base, weighs on the company's overall business risk profile.

#### REGULATED ELECTRICITY DISTRIBUTION ACTIVITIES ADD A DEGREE OF VISIBILITY OF CASH FLOWS

Following full opening of the Estonian electricity market in 2013, heat sales and electricity distribution are the only regulated activities of Eesti Energia. The distribution segment accounts for around one third of Eesti Energia's EBITDA, depending on the actual performance of other business segments. Heat sales are negligible in the context of group's overall financial profile.

Overall, regulated activities support the business profile of the company by adding to cash flow stability and visibility. Distribution network operations are subject to regulation by the Estonian Competition Authority (ECA). Whilst the regulatory framework in Estonia is fairly well developed and based on generally used principles of return on a regulatory asset base (RAB), we note that the regulator took a lighter approach in 2013. Since then, there are no longer three-year regulatory periods and tariffs do not need to be adjusted on an annual basis. This form of regulation is seen as credit positive, as it gives Eesti Energia more discretion in its approach to investments and tariffs. We note, however, that this regulatory approach lacks a longer track record.

#### DEVELOPMENT OF HIGHER-RISK SHALE OIL ACTIVITIES

In addition to core utility services, Eesti Energia is involved in shale oil production, which we consider to carry higher risk due to volatile oil prices and exposure to potential changes in environmental laws. The group remains a small player and as such remains vulnerable to market changes. The company mitigates some of the near-term risks through price hedging.

The share of shale oil activities is expected to increase with the commissioning of the Enefit280 shale oil plant. Eesti Energia originally envisaged starting full operations in September 2012, but due to technological issues, the commissioning has been gradual and the plant is now expected to achieve close to full operations in 2016. In our view, this highlights the execution risk associated with the development of shale oil activities.

Eesti Energia has also been involved in the development of international shale oil projects, with one in Jordan at a more advanced contractual stage. Such projects may result in increased investment requirements for the group in the long-term, but we believe that the company will continue to prudently manage spending in this area. Nevertheless, a material expansion of these activities would weigh on Eesti Energia's business and financial risk profile.

#### NEGATIVE FREE CASH FLOW DUE TO SIZEABLE, ALBEIT REDUCED INVESTMENT PROGRAMME

Eesti Energia's financial profile deteriorated over the past few years as a result of a sizeable investment programme. Capex peaked at around EUR500 million in 2012, but has gradually decreased since. For 2015, we expect investments in the area of EUR300 million. Free cash flow continues to be negative, but with the two

largest projects (the 300 MW power plant in Auvere, as well as the Enefit280 shale oil facility) reaching their final stages in 2015, we expect decreased investment levels for 2016 and beyond. The absence of any new major capital expenditure should enable the company to return to positive free cash levels in the medium-term.

#### **GOVERNMENT SUPPORT PROVIDES RATING UPLIFT**

Eesti Energia's rating incorporates an uplift for potential government support to its standalone credit quality. We express this as a Baseline Credit Assessment (BCA) of ba1. The uplift to the BCA, of two notches, is a result of the credit quality of the government of Estonia (A1, stable), which owns 100% of Eesti Energia's shares, as well as our assessment of there being a strong probability of government support for the group in the event of financial distress, and a moderate level of default dependence (i.e. degree of exposure to common drivers of credit quality).

We regard Eesti Energia to be of high importance to the state, given the group's role in the electricity and shale oil markets in Estonia. This is also confirmed by the EUR150 million equity injection completed in 2012, and the governmental support of the group's strategy.

#### **Liquidity**

We consider Eesti Energia's liquidity profile to be sufficient to support the group's operating expenditure and capex over the next 15 months. As at 30 June 2015, Eesti Energia reported EUR199.1 million worth of liquid assets (cash and bank deposits), EUR150 million of revolving credit lines (RCFs) maturing in 2018 (fully undrawn), and EUR100 million of undrawn term loans. In July 2015, all the RCFs have been refinanced, at an unchanged overall commitment level of EUR 150m, which extended the maturities out to 2020.

The above is further strengthened by a favourable debt maturity profile. The majority of debt is represented by three bonds: two 4.25% bonds totalling EUR400 million due in 2018, and a EUR300 million 4.5% bond due in 2020. Therefore, the company does not face any major refinancing requirements in the medium-term.

#### **Rating Outlook**

The outlook on Eesti Energia's ratings is stable, reflecting our expectation that the company will be able to maintain a financial profile in line with the current rating due to a reduced investment programme, as well as there being some flexibility from the shareholder regarding distributions, which could support free cash flow generation in an environment of lower power and oil prices.

#### **What Could Change the Rating - Up**

Upward rating pressure would develop if Eesti Energia's credit metrics were materially stronger than currently anticipated. However, in light of the group's strategy, and the weak power price environment, we do not envisage any positive rating pressures in the near-term.

#### **What Could Change the Rating - Down**

The rating could come under downward pressure if: (1) Eesti Energia were not able to maintain a financial profile commensurate with the current ratings (i.e. FFO / net debt in the high teens to early twenties in percentage terms, and FFO interest cover above 4.0x); (2) there was a significant shift in the group's business risk profile; (3) there was a material adverse change in the regulatory framework in Estonia; or (4) there was a deterioration in the credit quality of the Government of Estonia and/or a reduction in the support assumptions currently incorporated into Moody's assessment.

#### **Other Considerations**

##### **METHODOLOGY GRID**

The principal methodologies used in rating Eesti Energia are Moody's "Unregulated Utilities and Power Companies", published in October 2014; and "Government Related Issuers", published in October 2014. Please see the Credit Policy page on [www.moody.com](http://www.moody.com) for a copy of these methodologies.

#### **Rating Factors**

##### **Eesti Energia AS**

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Unregulated Utilities and Unregulated Power Companies Industry Grid [1][2]	As of 31 December 2014		[3]Moody's 12-18 Month Forward ViewAs of August 2015	
	Measure	Score	Measure	Score
<b>Factor 1 : Scale (10%)</b> a) Scale (USD Billion)		Ba		Ba
<b>Factor 2 : Business Profile (40%)</b> a) Market Diversification		Ba		Ba
b) Hedging and Integration Impact on Cash Flow Predictability		Baa		Baa
c) Market Framework & Positioning		B		B
d) Capital Requirements and Operational Performance		Baa		Baa
e) Business Mix Impact on Cash Flow Predictability		Baa		Baa
<b>Factor 3 : Financial Policy (10%)</b> a) Financial Policy		Baa		Baa
<b>Factor 4 : Leverage and Coverage (40%)</b> a) (CFO Pre-W/C + Interest) / Interest (3 Year Avg)	7.8x	Baa	5x - 6.5x	Baa
b) (CFO Pre-W/C) / Net Debt (3 Year Avg)	31.5%	Baa	17% - 21.5%	Ba/Baa
c) RCF / Net Debt (3 Year Avg)	22.0%	Baa	11% - 14%	Ba
b) (CFO Pre-W/C) / Debt (3 Year Avg)		NA		
c) RCF / Debt (3 Year Avg)		NA		
<b>Rating:</b> a) Indicated Rating from Grid		Baa3		Ba1
b) Actual BCA Assigned		ba1		ba1

Government-Related Issuer	Factor
a) Baseline Credit Assessment	ba1
b) Government Local Currency Rating	A1
c) Default Dependence	Moderate
d) Support	Strong
e) Final Rating Outcome	Baa2

[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

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