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Research

Estonian Power Utility Eesti Energia Outlook To Stable On Reduced Debt; 'BBB' Ratings Affirmed

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- In our view, Eesti Energia's reduced investment plans support gradual deleveraging and sound credit metrics.
- We anticipate relatively stable earnings from regulated electricity distribution and decent operating cash flows, despite pressure on the power generation segment.
- Moreover, we continue to see a moderately high likelihood of Eesti Energia receiving extraordinary support from the Estonian government if needed.
- We're therefore revising our outlook on Eesti Energia to stable from negative and affirming our 'BBB' ratings.
- The stable outlook reflects our expectation that, over 2018-2019, the company will maintain funds from operations to debt sustainably above 25% and continue receiving government support.

MOSCOW (S&P Global Ratings) March 22, 2018--S&P Global Ratings said today that it has revised its outlook on Estonia-based integrated energy utility company Eesti Energia AS to stable from negative. We affirmed our 'BBB' long-term issuer credit rating on the company and our 'BBB' issue ratings on its outstanding debt.

The rating actions reflect Eesti Energia's sustained credit metrics in line with its 'bb+' stand-alone credit profile (SACP), supported by the company's reduced investment plans and relatively stable earnings from its regulated electricity distribution network. This mitigates pressure on earnings in the

power generation segment owing to decreasing prices and rising costs.

In 2017, Eesti Energia's S&P Global Ratings-adjusted EBITDA was €259 million compared with €319 million in 2016, stronger than we previously expected, due to compensation from General Electric for the delay in constructing the Auvere power plant. At the same time, the adjusted debt figure declined to €759 million from €835 million after revisions of the investment program, including postponement of the Tootsi windfarm project and investments for the new Auvere power plant in 2018. As a result, adjusted funds from operations (FFO) to debt amounted to 34% in 2017 and 37% in 2016, which are higher than we expected. Despite continued pressure on EBITDA, we expect FFO to debt will decrease to only 27%-30% in 2018-2019, owing to continued modest investment spending. This is in line with Eesti Energia's significant financial risk profile and our revised thresholds for the SACP of FFO to debt higher than 25%, compared with 20% previously.

We continue to view Eesti Energia's business risk profile as being at the lower end of our satisfactory category. In our view, Eesti Energia's power generation operations remain exposed to competitive and volatile wholesale power markets following the greater interconnection of Nordic and Baltic power markets. In addition, the company is exposed to higher costs for carbon-emission allowances, given its reliance on oil-shale-based power plants.

In the lower power-price environment, Eesti Energia is seeking to protect its earnings by scaling back production, but targeting peak power production. This strategy could give it a price premium of up to 20% over the market price. In 2017, Eesti Energia's average selling price--including retail margins--was €39 per megawatt hour, with a premium of 17%. We assume the company will stick to this strategy in the medium term. However, in our opinion, in the longer term, the company may face challenges related to its relatively high-cost and environmentally unfriendly asset composition and fuel mix, and risks related to potential tightening of environmental standards. We believe that the longer-term rating evolution will, to a significant degree, depend on the company's strategy to address these challenges.

We observe that Nord Pool for Estonia and Nord Pool system prices are converging, while the company has limited capacity to reduce the cost of electricity production. The oil-shale-based generation portfolio exposes it to increasing carbon-emission costs and competition from more efficient power production from Nordic countries. We therefore consider that these factors put additional pressure on the business risk profile, which is the main reason for our updated ratio thresholds.

Eesti Energia's vertically integrated oil-shale operations reduce fuel price volatility, however. Over the past few years, the company has worked to enhance the value added from its oil-shale resources by increasing its shale oil production. Yet we consider that the group's competitive position in this area is constrained by its small operations. This business has been volatile

in recent years, with the drop in oil prices affecting its profitability. In 2017, Eesti Energia's shale oil production increased by 24% to 394,800 tonnes following better market conditions. The shale oil selling price for the company averaged €233 per tonne in 2017 versus €222 in 2016, and the segment reported EBITDA of €23.9 million. Currently, the market price is fluctuating at about €300 per tonne, which is favorable for the company. In addition, about 70% of expected sales volumes in 2018 is hedged at €256 per tonne, and about one-third at €261 per tonne in 2019. We expect the segment will continue to generate positive EBITDA over the next two years, thereby supporting the company's credit metrics.

We consider that the main strength of Eesti Energia's business profile remains its ownership of most of Estonia's electricity distribution network. This asset contributes 35%-40% of the group's EBITDA and its stability helps mitigate the volatility from the shale oil production and power generation segments. In our view, the regulatory framework continues to provide predictability and support. However, there could be some pressure on the distribution tariffs because of declining weighted average cost of capital, due to currently low interest rates. We understand there are proposals for revisions to the framework, which if approved, could support the company's business risk profile and stronger cash flows from electricity distribution. However, we do not currently include any potential changes in our base case.

The stable outlook on Eesti Energia stems from our expectation that, over 2018-2019, the company will maintain credit metrics in line with its 'bb+' SACP, including FFO to debt sustainably above 25% and debt to EBITDA at about 3x. It also reflects our expectations of ongoing and extraordinary support to the company from its sole owner, the Estonian government. We believe that, over the next 2-3 years, risks from volatile power and commodities prices and relatively high costs of oil-shale power generation will remain partly mitigated by the company's strategy to address electricity demand at peak hours, and by relatively stable earnings from its regulated electricity distribution network.

We could lower our ratings if we saw Eesti Energia's operating and financial performance deteriorating without prospects for near-term recovery, with FFO to debt falling below 25%. This would likely result from a tougher market environment and even-lower power prices, since we view the company's ability to contain generation costs as limited, or from new large investment projects not included in our current base case.

We could also lower the rating if we considered that Eesti Energia's business risk had weakened permanently as a result of a structural change in EBITDA generation, with a higher share of more volatile power generation and commodity trading business than regulated distribution, or weaker profitability.

Moreover, we would likely lower the rating if we saw a weakening of the Estonian government's ability or willingness to provide timely and sufficient

extraordinary support to the company in the event of financial distress, although we see such a scenario as unlikely currently.

We could raise the rating if Eesti Energia's credit metrics improved and we saw a clear path for the company to maintain FFO to debt above 35%, provided its business position does not weaken. This could, for example, result from increasing oil and Estonian area power prices, an improving cost position for power generation, a more favorable generation-asset mix, and positive revisions to the regulatory framework for electricity distribution business.

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