

**Rating Action: Moody's downgrades Eesti Energia to Baa3/P-3; stable outlook**

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Global Credit Research - 15 Apr 2016

London, 15 April 2016 -- Moody's Investors Service, ("Moody's") has today downgraded to Baa3 from Baa2 the issuer rating and the senior unsecured ratings of Eesti Energia AS (Eesti Energia). Concurrently, Moody's has downgraded to P-3 from P-2 the short term issuer rating. The outlook on the ratings is stable.

**RATINGS RATIONALE**

Today's rating action concludes the review initiated on 12 February 2016. The rating downgrade reflects Eesti Energia's exposure to a prolonged weak power and oil price environment and Moody's expectation that the company's credit metrics will deteriorate from recent historic levels over the next two to three years to levels consistent with a Baa3 rating.

Eesti Energia's generation fleet is dominated by carbon intensive oil shale based assets, and is out of line with the low-cost and low CO2 emission hydro power plants prevalent in the Nordic region. With the decreased power prices in Nord Pool Spot Estonia, and the increasing linkage between the Baltic and the Nordic electricity markets, Moody's expects a subdued pricing environment in the Baltic countries to persist into the medium term.

Eesti Energia's Baa3 rating reflects Moody's expectation that lower power and shale oil prices will negatively impact the group's profitability and cash flows. In the short-term, the company's hedging strategy provides a degree of protection to earnings from the weakening power and commodity price environment. Nonetheless, due to the ongoing integration with the Nordic electricity markets, which are characterised by a more diversified generation base, we expect competitive pressures to increase and to weigh on the group's financial profile. Moody's base case assumes average power prices in Estonia of around EUR26 per megawatt hour over the medium term, average carbon prices of EUR7 per tonne, and oil prices in line with Moody's previously published guidance. Moody's also expects Eesti Energia to manage its dividend policy in a way that should mitigate the impact of lower commodity prices.

The rating also reflects the group's strong position in its domestic market as an incumbent vertically integrated utility, its moderate leverage, and the cash flow predictability in connection with the electricity distribution activities. The rating is, however, constrained by the group's (1) shale oil activities, which we perceive to have higher risk than utility services; and (2) its small size and CO2-emission-intensive generation portfolio.

Eesti Energia falls under Moody's rating methodology for Government-Related Issuers (GRIs) given its 100% ownership by the Government of Estonia (A1 stable). The Baa3 rating incorporates a two-notch uplift to the group's standalone credit quality, expressed by Moody's as baseline credit assessment (BCA) of ba2 (a downgrade from ba1).

The two-notch uplift applied to the standalone credit assessment is explained by the strategic importance of the company to the country of Estonia. Given the 100% ownership by the state and the credit quality of Estonia, we consider there to be strong likelihood of extraordinary support from the government, in case of financial distress at the company.

**RATIONALE FOR THE STABLE OUTLOOK**

The outlook on Eesti Energia's ratings is stable, reflecting Moody's expectation that the company's financial profile and credit metrics will remain commensurate with the ba2 BCA and Baa3 rating. While the company is exposed to further downward shifts in commodity prices, which could impact the BCA, an important driver of future rating change would be the attitude and policy of the Government owner towards the company in such circumstances.

**WHAT COULD CHANGE THE RATING UP/DOWN**

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

positive rating pressures in the near term.

Conversely, the BCA and 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 low to high teens in percentage terms); (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.

#### PRINCIPAL METHODOLOGIES

The methodologies used in these ratings were Unregulated Utilities and Unregulated Power Companies published in October 2014, and Government-Related Issuers published in October 2014. Please see the Ratings Methodologies page on [www.moody.com](http://www.moody.com) for a copy of these methodologies.

Headquartered in Tallinn, Estonia, Eesti Energia AS is the dominant vertically integrated utility in the country. The group generates 90% of Estonia's electricity and around 17% of its heating needs, owning and operating most of its distribution networks. Eesti Energia also owns 100% of Estonia's principal 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.

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