Eesti Engeria “Release Q2 2013 financial results” Conference Call

MODERATORS:
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Margus Kaasik: Hello and welcome to Eesti Energia Earnings Call for second quarter of 2013. My name is Margus Kaasik and I am CFO of Eesti Energia. Let me now jump straight to page 3 for summary of our quarter result and the quarter result was good. We are happy with the result that we were able to generate. We saw sales revenues grow 22 percent the second quarter. We also did grow EBITDA by 4 percent and we had a significant growth in operating cash flow that was 76 percent. Investments were a little less than a year ago, but roughly on the same level, EUR95 million. And now to give you a little market update about the power and oil market. On page 4 about the power market, the power market was more beneficial for ourselves this year. We saw price in the Estonian Nord Pool area increase from 35 to 45. That is quite a significant increase of close to 30 percent. What is also perhaps important to note, is that with price increase also we got a significant increase in our clean dark spread so it is a spread after CO2 cost and oil shale cost, our fuel cost, and that margin increased from 18, that was last year it was 18 and it was basically the lowest. In two years time, it increased to 31. That was basically the highest in last two years and it is a great result for ourselves.

A couple of comments on the Baltic market, we had a development in the Baltic market from 1st June or beginning of June this year when Nord Pool started operating also in Latvia and also with that Lithuanian price area was integrated to the Nordic, the whole Nordic power market so now there is a complete power market starting from Lithuania all the way to Norway, where all the cross border is implicitly auctioned 100 percent. What also was characterizing our power market here in Estonia is that basically we had two important border crossings to Finland and to Latvia and the bottle-neck changed from time to time from Finnish side to Latvian side. During this summer, we saw quite low prices in the Nordic side, especially the system prices were low but the Finnish prices were better but low as well. And there were significantly higher prices in the Baltic area – well, just to illustrate prices were roughly on 30s in the Nordics and at the same time 50s or 60s in the Latvia and Lithuania. And also the Estonian power market was quite volatile jumping between those two extremes, depending on whether the bottle-neck was on the south side or on the north side. We do expect that this phenomenon will continue perhaps until the end of this year where we see volatility in Estonia prices between the Nordic side and between the Nordic prices and the Lithuanian ones. From the next year, when the second Estlink cable is commissioned and the capacity between Estonia and Finland is increased three-fold, we expect that Estonian prices will converge pretty much to Finland ones and that the bottle-neck will stay on the south border so Estonian prices will be quite similar to Finnish ones and then the Latvian and the Lithuanian prices are what they are.

On the next page, about fuel oil and oil markets in general, we have seen and probably all others as well have seen the Brent price retreating from the peak of first quarter 2012, where Brent was EUR91 per barrel. It has now retreated to EUR79 per barrel gradually. And on the fuel oil side the crack spread has shown quite a bit of volatility. There was a good performance of that spread, spread decreasing all the way until Q3 2012 and then there was a steep increase in that spread whereby fuel oil prices decreased compared to Brent and now the crack spread has tightened somewhat but it is still wider than it was a year ago, so all in all therefore we see larger decline in the fuel oil price than we see in the Brent price.

On the next page, page 6, just a brief overview between our segments, the sales and EBITDA. The main growth in revenues came from the electricity where we generated a lot more and also the prices were a bit down. This did not convert much to it, where EBITDA on the electricity was pretty much flat compared to last year. In distribution we had very good results whereby we had the EUR5 million increase in revenues and also EUR2 million increase in EBITDA profitability which is a high increase as well. Shale oil did not do very well last quarter where we saw a decline both in the revenues and EBITDA. I believe we come to those readings in a minute.

Now more thoroughly on the electricity side, page 7. As I told, we had significant increase in both volumes and price. On the volumes side, the main reason for higher volumes were significantly better margins than we had last year. As you recall we had lower prices last year and the margins were at times quite low. And when we did not generate much from our plant. This year the prices and margins were much better and we utilised our generation capacity basically fully. We also had a significantly better average price for our generation, mainly due to liberalisation of Estonian Power Market, so the regulated prices are gone and replaced by market prices now. And third perhaps very important thing to note is that we had significantly less support for renewables last year. We had subsidies for renewable energy, EUR11 million; this year close to nothing, and the main reason being that we do not use biomass in Narva power plants anymore because it did not receive support anymore.

On the next slide, slide 8, about the market shares, we have significant market share in Estonia, still 70 percent. The market share has declined in a year which is quite expected results when the market is liberalised. We do have some decline in market share is expected. And what is good is that we have compensated the decline in the Estonian market share by increasing our market share in Latvia and Lithuania and looking the Baltic countries as a whole, our market share even has increased by one percentage point. But nevertheless, the market share that we have currently is rather satisfactory to us but on the financial results it bears quite a little impact as the retail margins are pretty low and then the Baltic markets and the main EBITDA, main profit, is still generated from the generation side, not the retail sales side.

On slide 9, about the electricity EBITDA - you saw a couple of slides back - we did not increase EBITDA although the volumes increased significantly and indeed the volume increase effect on EBITDA was plus EUR19 million, so quite substantial, but most of this volume, most of this effect caused by volume, is offset by both lower margins on power generation and also higher fixed cost that we had in our generation side. So all together the volume increase did almost offset those negative effects but all in all we saw EUR3 million decrease in the EBITDA of our electricity sales.

On the next slide, about the distribution, the sales revenues increased quite significantly as average tariff increased. Main reason for tariff increases were those regular tariff increases that we have by our current regulation and also one-off increase that was caused by start of this market liberalisation whereby the distribution network also has to buy electricity for losses from open markets. But the distribution volume did not change much - that was a slight one percent increase only. Important probably to tell is that from 1st August this year, so from tomorrow actually, the tariff will be changed again. There is a next regular tariff change from 1st August this year and then we see a slight decrease in the tariff and mainly the reason is that the regulator, Estonian Competition Authority, has reduced the regulated return to 6.76 percent. They have their own methodology how to calculate the allowed return for distribution networks, which is based on the historical German Bond yields. And as those historical yields are reaching an all-time low, then it also impacts the returns of our distribution networks are allowed to recieve.

On the EBITDA slide, the next slide, slide 11, the distribution EBITDA, the EBITDA grew about EUR2 million, definitely good and it is a result of a fact that tariff increased. Some of those increased components were sort of a pass-through elements for instance higher network losses or higher transmission costs but part of that tariff increase we were able to use for improving our EBITDA, our profitability. And perhaps again on the distribution side, two things that we are very happy with is that the losses in the distribution network are lowest that they have been so far and it also definitely helps to increase EBITDA in the network. And secondly also some network reliability figures have improved, for instance this SAIDI, the average duration of interruptions, is lower than it was a year ago so the investments that we do into distribution network have resulted also in a better network service quality.

On the next slide, slide 12, about shale oil, nothing really good to report here. We have produced oil for less similar amounts compared to last year. The oil that we have produced has come from the old oil plant. The new one is not yet contributing to our oil production. Sales volumes were significantly lower than last year, mainly because of this shipping interval that we have. The last shipment was due in the beginning of July, so it was just missed from the end of last quarter. So therefore the oil inventories were higher and sales lower. Sales price also declined, for our benefit less than the market price declined because of the hedging effects. But still there was a slight decrease also on the sales side so all together we saw sales revenues decrease by 38 percent. And as we see on the next slide, slide 30, because it feeds into lower EBITDA as well, whereby if we look at the effects of a bit lower margin and lower volumes, that almost wiped out the whole EBITDA. And the slight EBITDA that we earned on the shale oil side was because of a little less fixed expenses that we had last year and also gains from derivative instruments. We have some part of oil sales is hedged with options and those options are accounted not with hedge accounting but they are going through the P&L. And the effect of those options as oil price retreated a bit, the option values were increased and that contributed EUR1.3 million. So that about shale oil. We come to later on, to update on this new oil plant and how it is progressing.

So slide 14, about other products, here I would just mention two, perhaps most importantly, contributing to EBITDA was heat and other revenues, altogether, actually the EBITDA from other products and services increased by EUR6 million, so a significant increase actually, and close to half of it, EUR2.7 million, was due to this new waste-to-energy plant in Iru, that started operating and that increased significantly the profitability of our heat production. And second important contributor to EBITDA was sales of scrap metal, where we sold the old and unused equipment.

Now turning to cash flow, slide 15, as we noted on the first page, we had a very good result on the cash flow side. Firstly just explaining the path from EBITDA to operating cash flow, mainly if we net off the effect in the current assets side then mainly actually the growth came from CO2 accounting. But more thoroughly we had quite a good performance on receivables side. It is also sort of a seasonal nature as that power or electricity bills are lower during summer time than in spring so the receivables were lower also by seasonal nature but other than that, also we had good performance. So EUR24 million we were recovering from receivables. We also had lower payables and a bit larger inventories in the oil inventories, which almost basically as I told, almost offset each other. And then we have the CO2 impact that more or less remains and the CO2 impact comes from the fact that although we now have to account for 100 percent of CO2 cost, on our generation side and that decreases or offsets mainly almost all the increase that we have on the revenues side or the price side. This cost of CO2 is not a cash cost until the end of this year where we actually buy the CO2 allowances. We mainly hedge ourselves with CO2 with those December forward contracts. And therefore all the way through the year we account for or make the CO2 cost provisions, which reduce the cost or reduce EBITDA but do not affect the cash flow until we actually pay or actually purchase those CO2 allowances in the end of this year. So until December, we actually run with a good cash flow in our generation side, especially, and the group as a whole as well. But then this is reversed in December when we actually buy out the CO2 allowances.

On the next slide, slide 16, comparing last year’s cash flow to this year’s cash flow, then the increase was significant – 76 percent. And again, mainly half of that increase comes from the same CO2 impact as last year we had much less CO2 to buy as we were almost covered with the pre-allowances and therefore this effect on our cash flow was much, much higher this year and second important factor was income tax that last year we paid out during second quarter the income tax on dividends. This year the dividends are postponed until later this year and also the income tax will be then paid out later this year.

On the next slide, slide 17, about our Capex, Capex were EUR95 million, about the same that it was last year. The main projects where it went were this new power plant in Auvere, EUR35 million, and then the electricity network, EUR24 million. We see our list of ongoing projects contracting quite substantially. Basically there is only three projects left as still ongoing - the construction of Auvere power plant, we still definitely invest in the distribution network, Iru waste-to-energy unit is also, by now, basically all completed - some amounts still left to pay, but the plant itself is completed. And then the international projects are ongoing. The things that we have had here previously, the wind parks, the oil plant, the infrastructure for the oil plant, everything else is already completed and operational. Besides that, of course, the Enefit280 that is not yet operational.

On the next slide, there is an update on this new oil plant. We have not yet had any material contribution to oil production from this new oil plant. The commission is still ongoing. We had two important issues to tackle. First was vibration in one cyclone, which now has been cured. And second issue was with a semicoke screw conveyor where the design did not meet the expectations and now the new design for this conveyor has been worked out and will be installed late this year. We will do new start-ups also with that old screw conveyor and then the next one is due already in August but we do expect that still we need to change this screw conveyor later this year to make the plant operational.

On the next slide, slide 19, on the liquidity and cash flow side again, it was a good quarter in a sense that we were cash positive, actually a second consecutive quarter where we were cash positive. Still I have to admit that most likely the year as a whole will not be cash positive because part of the reason of why we were cash positive this year and also this quarter and last quarter was that some of the cost is postponed until September, as I explained a few moments back. But nevertheless, the quarter on the cash side was good for ourselves and the liquidity position is very strong. We have a good amount of liquid assets, very close to EUR200 million and also close to EUR400 million unused credit lines so from the liquidity end we are very well located. And now we are already working on extending those liquidity lines for ourselves to have a comfortable or a longer period of time.

On the next slide, slide 20, we were pleased that our credit rating from Standard & Poor’s was affirmed and maintained with a BBB+ with a stable rating. If we look at the important financial metrics, debt metrics, then we see even some improvement over the last year so our financial leverage actually has decreased slightly. And if you look at the net debt EBITDA figure then, it is also actually lower than it was say during the last quarter and on the same level that it was a year ago so we have been able to actually keep our debt metrics under control so far.

On the outlook side, slide 21, we keep our outlook. There is no change in outlook that we expect to see revenues, both revenues and EBITDA growing this year. If we look at the results for the first half of this year, then we were able actually to meet our expectations and also we would therefore expect that the whole year we are keeping our expectations and despite the fact that most likely the new oil plant will not contribute much to EBITDA or sales but there are mainly the generation that will fill the gap.

On the next slide, to summarise, page 22, we are pleased with the results that we were able to generate last quarter. The sales revenues increased significantly, 22 percent, and the main contributor here was electricity with both sales volume and price increases. We were also able to grow EBITDA, 4 percent, to EUR72 million and the most positive effect came from the heat sales and distribution network. Electricity profitability did decrease a bit. But because of the high volumes, the decrease was quite small. We did complete several investment projects last quarter. The Iru Waste-to-Energy plant is completed and now also the pre-compliance tests are completed and the plant starts to receive renewable support. Paldiski and Narva wind parks that started already to generate (in the end of last year) electricity, now also passed the pre-compliance test and will start to receive subsidy. So this will also definitely support the financial result during the next quarters. And finally we are also very pleased with the cash position that we have, that we were able to generate free cash flow and were cash positive and that is definitely good for ourselves and then keeps the financial position under control. So that was it from our part. Thank you for listening and if you have any questions I am glad to answer those.

Operator: Thank you. Ladies and gentlemen, at this time, we will begin the question and answer session for the financial analyst community. Anyone who wishes to ask a question may press star and one on their touchtone telephone. If you wish to remove yourself from the question queue, you may press star and two. Your questions will be answered in the order they are received. If you are using speaker equipment today, please lift the handset before making your selection. I repeat, if you would like to ask a question, please press the star followed by one on your telephone.

We are waiting for questions. Excuse me, Mr Kaasik, there are no further questions at this time.

Margus Kaasik: Very well. Then again, I thank everybody for listening and let us do that again in three months’ time when we report the third quarter results. Thank you.