Eesti Energia Q3 Results 2013 Conference Call

MODERATORS:
MR. MARGUS KAASIK, CFO

Margus Kaasik: Hello, my name is Margus Kaasik, and I am CFO of Eesti Energia, and I am going through the results of the third quarter.

And now, jumping straight to slide three, where we have the snapshot of our results, it has been a good quarter. We have been able to grow our revenues by nearly 9%. EBITDA also has grown a percent and the significantly better performance we have had with operating cash flow. So all major indicators are on the plus side.

Let's now turn to the next page about the power market. If we look at the Estonian side, Nord Pool, our home area, then we have had reasonably good power price, the last quarter was EUR44 per megawatt hour and more importantly the margin that we get, the so called clean dark spread, has been nearly EUR30 per megawatt hour, 29 to be exact.

So that's all good.

We have seen during this quarter, narrowing of the gap between Helsinki and Tallinn price areas recently. We have enjoyed better prices than there are in Finland. The gap has narrowed and what we do expect going forward is that from next year, when there is a new cable online between Estonia and Finland, then the prices should converge, basically fully, that is our basic assumption.

Now the next slide, slide five, we have presented the price difference between Estonian and Latvian price areas, and this is something that has brought to us some concerns, over the last quarter. What has happened here is that Nord Pool has started operating in all three Baltic states, so Estonia, Latvia, Lithuania, all are covered by the same market platform, and also in connection to that, the cross border capacity between Estonia and Latvia went to full implicit auctioning, so basically Nord Pool Spot is allocating the capacity, cross border capacity, and there is significant congestion in that border that we have seen, during this summer and still to some extent, see. There are basically no instruments to hedge that cross border risk. In connection to that we have had losses, that during that quarter alone amount to some EUR7 million, so that has been a significant issue for ourselves.

We are working on that issue. We have stopped basically selling from Estonia to Latvia and Lithuania because of that cross border risk, and inability to hedge it. So risk is only now with our existing portfolio and reducing over time, and we are also working on finding ways with regulators, with TSOs, to actually have some instruments available to hedge that risk. But it has been a significant issue for us during the last quarter.

Going forward, we actually don't see the things or the, let's say the physical side of things, the congestion, improving that much, as Estonia will be more dragged towards Helsinki the price, towards Nordic price, and there isn't any improvement in the pricing of power in Latvia and Lithuania for the next year or two. But we do see that the congestion in that Estonian Latvian border probably gets worse, and then we will see how well it enables us to do business in Latvia and Lithuania.

If there is some efficient measures for ourselves to cross the border or hedge that risk are available, probably those markets will give us excellent opportunity to sell the power. If not, then probably we are unable to do business there.

Next slide, slide six on the market side, then now the fuel oil or just oil, what we have seen during the last quarter is that oil prices have recovered somewhat, we are showing on our graphs the prices in Euros because that's more relevant for ourselves, and we do see prices bumping back quite significantly over the last quarter in oil. In fuel oil not so much, so the crack spreads have widened significantly over the last quarter, and are, let's say, if we look at the history of the last two years then they are on the levels of two years low.

What we see is that most of this weakening in the price of fuel oil has been brought about because of less demand in Asia for fuel oil as the fuel oil in Europe mainly gets shipped to Asia to fill that demand, and that demand has declined and that has made fuel oil relatively weaker.

On slide seven, about the group revenues and EBITDA. Our power business is doing better than expected, we have been able to grow revenues quite significantly. The EBITDA hasn't followed that much, there is a slight decrease in EBITDA, but comparing to our expectations, then it is exceeding our expectations quite significantly. Distribution has done very well, given the very stable nature of the business, EUR2 million more EBITDA and EUR4 million more revenues, is also expecting our expectations somewhat, and they are doing very well.

On the oil side, the most, this is the bit, the product that is not performing to our expectations, and although the revenues are in line with last year, the margins have gone down somewhat and that has reduced the EBITDA. The other products where we have oil shale sales, where it's more minor oil shale sales to third parties, we have heat sales, we have some basically scrap metals sales from old equipment, this area also has done quite well.

Now moving in more detail to the next slide. Now are on slide eight, about the power revenues. We have seen the average price growing 9% over the whole portfolio. Most of these increases are due to the fact that the market has liberalized and instead of regulated power price to some of the Estonian market, we now have fully liberalized market. If we look at the market side, power market side then, on the market we do see an 11% increase in the power prices.

On the volume side, we have seen some growth, 3%, mainly the growth is driven by wholesale side of our business, but the resale side has somewhat declined, mainly because of the Estonian market opening. More on that on the next slide, and if we turn to the next slide, slide nine, then what we see is that on the Baltic level, the market share of Eesti Energia has been quite stable. We have 31% market share now, and it has declined 0.4% percentage points. But in that Baltic area, there are some changes over the year, and most significantly we have less market share in Estonia because the market has liberalized and we have gained significantly market share in Latvia and Lithuania, that has sort of offset the decline in Estonia.

Going forward, there is a question of, how we will continue course in the Baltic side.

Now, on the electricity EBITDA, as we showed EBITDA has declined about EUR 2million. Most of the decline has come from a margin decline, and on the margin side I would bring out perhaps two most important things. One is CO2, that now from this year we are pricing that fully in, we buy all the CO2 from the market. The second important point is that the border crossing, basically, cost that we have, that have incurred during the last quarter, and that is significantly more than a year ago. So these two are the main reasons for lower margins on the power side.
The volumes are up somewhat, that has brought additional EBITDA, and then perhaps to comment on this revaluation column that is mainly due to the fact that last year during the third quarter we revalued down some part of our CO2 portfolio, and that is not occurring this year, so that sort of in comparison with last year has brought some significant growth in EBITDA.

On distribution side, we are very happy with the result that we have got from distribution business, as the revenues have increased and also the EBITDA has increased. If we will look at the sort of operating results and on this slide also, we are noting the losses for network, the losses are very low, 5.2% during this quarter. They are significantly lower, one percentage point lower than they were a year ago, so on that front, we are doing very well. If you look at the nine month rolling losses, these are even lower, so the performance in that area has been significantly good.

Also what is important to note on the regulations side is that the regulated return was lowered from first of August 2013. Just because regulator does this regulated return calculations every year, and the markets have gone down or the expected returns on other markets also have gone down, and that has also fed into that calculation, that regulator does.

Second important note is that the regulation on the distribution side has changed somewhat, not much, it’s basically still the same regulation of regulated asset base, and regulated return, but what now has changed from this year, or for ourselves if applied from next year, is that now there is no sort of three year regulatory period and those yearly corrections in that regulatory period, and basically the system is now such that distribution in the company, if it’s at any point feels that the tariff is too low and wants to raise the tariff, it will go and apply for a new tariff, higher tariff, and as far as the company is comfortable with the tariff, they will stay with the current tariff.

We do see that as a sort of opportunity, in a sense that it does make us, give us opportunity to optimize ourselves on that current tariff, and we are not sort of required to pass through to a regulator or to the customer all the efficiency gains that we do on a yearly basis. So from our end, we do see that as a sort of positive change actually.

On the distribution EBITDA as we have shown, there is EUR 1.5 million growth, the main drivers here actually are the losses that we, I was showing on the previous slide. We have outperformed significantly the losses that are sort of calculated into the tariffs, and the losses, and this gain on the losses side is actually the main driver that increases the margin on the distribution business side.

One perhaps thing to note, and we even didn’t have time to put it into our report I guess, is that recently we had some storms, like most of Europe did, and although I think they were not as bad here as in some other European countries, but still, they are still here, significantly strong, and probably that we expect about EUR1 million additional cost we will incur on the distribution side, because of that, in the last quarter of this year. But it doesn’t affect much the overall result of distribution network.

Now, let’s turn to shale oil business, page 13. There we have seen that revenues are more or less on par with the last year, and the volumes, sales volumes are up 5%, but we see a 6% decline in the shale oil price. The market price has declined even more. The reason why we have sort of outperformed the market is that just last year we had much more impact from the hedges, and so we incurred more cost on the financial hedges side. This year, our hedges were more or less on par with the market price, the average or difference being only basically EUR2 per tonne. So the impact was neglible this year, but it was much much stronger last year.

Perhaps on the hedging side, going over the last quarter then, for last quarter we have hedged about 40,000 tonnes of oil, with the average price of EUR464 per tonne, so it may very well be that during the last quarter, the hedges will give some additional revenue for ourselves and also protection from that price decline.

On the EBITDA front, as I already noted, the EBITDA did decline. There are few reasons why the margins are lower, but one obvious reason is that the sales prices have declined somewhat. On the cost side, there are also some additional factors that have contracted the margin. One is that we are now incurring the CO2 cost, which is not that significant on the oil side, but something still, and also on the variable cost, there are some influences from the oil shale cost side, or the raw material cost side, and also we have purchased some oil, whereby we are recycling or blending some of the heavier fractions of our production with the lighter purchased oil, and then sell that to the market.All in all that actually should improve the margin in the long run.

The next slide, slide 15 about other products. This other sort of segment has performed very well in the last quarter. There are the other products and services, among them, quite a significant part is scrap metal sales, or sales of dismantled equipment, that are now redundant and we have sold them. Also, we have significant improvement in the heat side, and the heat improvement comes mainly from the fact that now we have new this waste-to-energy power unit in Iru Power plant, that is supplying heat to Tallinn and also consuming the waste in the northern part of Estonia. That investment is improving our bottom line quite importantly.

And also on the oil shale side, where we are selling a slight or a little amount of oil shale to a third party, there we have, also selling less amount, but with a significantly higher price and earning more EBITDA in the process.

Looking at the cash flow, slide 16, here the most important thing to note is the CO2 impact, and that is mainly due to the fact that now we are costing in fully that CO2 cost, that is quite a significant cost. We are doing provisions for the costs all over the year, or all over the course of the year, and basically the cash flow effect of that CO2 provision comes in later, in the end of the year in December, when we actually buy out those forward contracts, so that is why basically this quarter and also two previous quarters we can report excellent performance on the cash flow side. On a yearly basis it should even out of course.

On the next slide we have another take on the cash flow, and this time we are comparing two years, last year third quarter and this year third quarter, and again, the main difference here comes from CO2, and the fact that the CO2 regulations are different this year.

Other things to perhaps note is that on this slide, we have also been able to reduce our inventories significantly, as we are operating our power plants more or less fully, then that has started to decrease our oil shale inventories, and that gives a good result on the cash flow slide as well.

On the Capex slide, slide 18, the Capex is somewhat higher than last year, and what is here interesting to note is that 75% of our Capex this quarter went to two projects, one is Auvere Power Plant, that is ready in less than two years' time, and then the distribution network. If you look at the ongoing projects then, then basically these are the two projects that are still ongoing, the power plant in Auvere and the distribution network, and some commitment in international projects as well, but other than that, the quite long list that we had at one point in time is now shorted significantly, as we have completed the constructions in many projects.

Now, for ourselves, an extremely important point is the new oil plant, where the construction has ended already in the end of last year. The plant itself is not running yet, on slide 19, we are still on the start up mode. We have been able to achieve quite high capacities on the oil plant. We have been able to run the plant at 85% for short term, but for longer term we are still not able to operate the plant stably. Several mechanical issues that we have had over this year, those are solved, and there we have made good progress, but where we still have challenges is the CFB boiler, the circulating fluidized bed boiler, which is not operating to the standard that we need. If you look the new oil plant then, this is the part of the oil plant that is sort of new, from the technological process as well, and also gives significant benefits to the project. But combining that basically oil retorting with the CFB boiler has turned out to be a bit of a bigger challenge that we have anticipated so far, and with that CFB boiler we are currently working on being able to run that one stably.

Now turning to more financial questions, slide 20, we have recently renewed our revolving credit facilities The amounts are lower because now we have now much less capital commitments ahead, so our liquidity needs from that end are much much lower. Now we have basically concluded EUR150 million of revolving credit facilities with three regional banks. We have extended the duration to five years, the previous ones were three year contracts, now they are five year contracts. The competition was pretty good among banks, and the conditions that we have achieved are very good, and were favourable for ourselves, that we wanted to do the deal for the next five years.

On the liquid assets side, as of end of last quarter, we had EUR158 million of liquid assets. We had EUR245 million of unused credit lines, so all in all basically 400 million of liquid assets and unused loans available by the end of last quarter. In addition to that, we also, by now, have signed another contract with the European Investment Bank to support our distribution network investments and that contract is also for EUR100 million.

Next slide, about some financial targets and metrics. We see that leverage has been stable over the last quarter, increased ever so slightly. We do expect that by the end of the year, leverage or net debt EBITDA will grow somewhat. We are seeing 2.5, it may be the realistic expectation at the end of the year. Perhaps one would like to draw attention to the dividend side as well, the dividend payment is reduced basically, almost halved, compared to last expectation that we had from the government, and the reason here is that, because of the oil plant as well, not running, then we are basically shifting that expected dividend from this year to the next one. We expect that during next year the oil plant is working to better standards.

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Now, on the outlook slide. Still, keeping the outlook, we have performed during the last nine months to our expectations, both on the revenues and EBITDA side, our expectations were pretty much the same that actually we have been able to perform, and also if we look at the last quarter, then the last quarter we expect to outperform the last quarter of last year, and that in the end should bring us to better results that we had last year. So all in all, the growth in revenue side and growth in the EBITDA side is what we are expecting in terms of the end of this year.

Now, we are already on slide 23, the summary slide, to sum up. We are happy with the last quarter we had, we were able to increase the revenues by 9%, EBITDA by 1%. The performance on the power side has been definitely beyond our expectations and has effectively been able to mitigate the lost oil from the new oil plant. On the cash flow side we have been also very strong, although the CO_2 cost still has to be paid in December, then at least until September, the cash flow has been very strong. That has enabled us to keep the leverage growth very modest. Also on the financing side we are very happy with the result that we got from this revolving credit facility tender and also the new line from EIB, that is something that we are very happy with. So all in all, good quarter, and we really expect to end the year, the whole year with a positive note as well.

So thank you for listening and if you have any questions we are really happy to answer them during a Q & A session.

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 * and 1 on their touchtone telephone. If you wish to remove yourself from the question queue, you may press * and 2. 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 * followed by 1 on your telephone. One moment for the first question please.

Ladies, and gentlemen, you may now use your opportunity to ask questions. To do so, please press * and 1 on your telephone at this time. I repeat, if you would like to ask a question, please press the * followed by 1 on your telephone. Okay, excuse me Mr Kaasik, there are no further questions at this time, so you can go ahead and continue and bring up any points you wish to raise.

Margus Kaasik Yes, from our end, we again, thank everybody for listening. If there are no questions then maybe those questions come on the next time, and then we are hoping to see and hear everybody on our annual results call, that will be in the end of February. So thank you for listening and bye.