

**Rating Action: Moody's affirms Eesti Energia's Baa3 ratings; outlook stable**

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28 Jan 2020

Frankfurt am Main, January 28, 2020 -- Moody's Investors Service ("Moody's") has today affirmed the Baa3 issuer and senior unsecured ratings of Estonian national electricity and oil shale company Eesti Energia AS (Eesti Energia). The rating outlook remains stable. At the same time Moody's affirmed the Prime-3 short-term issuer rating.

A full list of affected ratings is provided towards the end of this press release.

**RATINGS RATIONALE**

The rating action reflects Moody's expectation that Eesti Energia's large capital investment program, which is designed to allow it to transition away from the carbon-intensive generation of electricity from oil shale, and towards renewable power generation and shale oil production, can be accommodated within the Baa3 rating, given (1) the support from the company's owner, the Government of Estonia (A1 stable), through capital measures, and (2) the company's flexibility in executing the investment program.

Eesti Energia's oil shale-fueled electricity production, has been under pressure since EU carbon prices began to rise steeply in the second half of 2018. Given the competition from cheaper power coming from Nordic countries and Russia, the company's oil shale-fueled production decreased by around 50% year over year in the first nine months of 2019, which accelerated Eesti Energia's decision to reduce the carbon exposure of its businesses by planning to invest heavily in low-carbon activities, such as renewable power generation, distribution grid operations and electricity retail supply. In addition, Eesti Energia will increase its shale oil production which provides for a less carbon-intensive use of its oil shale reserves compared to power generation. Societal considerations, and notably a large workforce involved in the domestic oil shale industry, are one of the drivers for the Government of Estonia's support for Eesti Energia's transition strategy.

Eesti Energia's high exposure to environmental risks, predominantly carbon regulation, is a key driver of the company's rating. Near-to medium-term risks include the introduction of stricter European or national carbon policies which could (1) force the company accelerate the phasing-out of its oil shale-based power generation which is already under severe pressure from elevated carbon prices; or (2) tighten the conditions of carbon leakage exemptions under the EU's carbon trading system which may raise the cost base of the company's shale oil operations.

Because the company's transition to a less carbon-intensive business profile (1) requires a large investment program with some execution risks; and (2) includes the continuation of highly volatile oil shale power operations for reasons of security of supply, Moody's views the risk of Eesti Energia's business profile as elevated over the next years and expects its credit metrics to weaken. Reflecting the company's weaker business risk profile and expected lower credit metrics, Moody's has downgraded Eesti Energia's Baseline Credit Assessment (BCA), which measures the company's standalone credit quality, to ba3 from ba2. Accordingly, Moody's has revised its ratio guidance for the current BCA and rating, expecting funds from operations (FFO) to net debt to remain at least in the mid teens in percentage terms.

The rating affirmation nevertheless reflects that the lower BCA is offset by Moody's expectation of strong support from Eesti Energia's government owner, including a planned equity contribution for a new shale oil plant. Eesti Energia falls under Moody's rating methodology for Government-Related Issuers (GRI) due to its 100% ownership by the Government of Estonia. Given the combination of (1) high default dependence; and (2) the likelihood of strong support from its owner, the Government of Estonia, in case of financial distress, Eesti Energia's Baa3 rating incorporates three notches of uplift from the BCA of ba3.

The rating affirmation also reflects that the Baa3 rating continues to be supported by (1) a strong contribution from regulated distribution activities, accounting for 34% of reported EBITDA in the first nine months 2019, which support the stability of its cash flow; (2) sizeable cash flows from renewables electricity generation which benefits to a large degree from support schemes; and (3) the flexibility to adjust the investment program to the earnings development and market conditions.

At the same time, the rating is constrained by (1) the group's exposure to volatile commodity prices, namely wholesale power and oil; (2) its substantial and comprehensive investment program which may stretch the company's managerial resources, given the company's relatively small size; (3) the time lag of earnings from new investments with longer ramp-up periods which may put pressure on credit metrics; and (4) the evolving nature of the electricity markets in which Eesti Energia operates.

Amongst the funding sources of the company's capital expenditure program is the planned listing of a minority share of its renewables business, Enefit Green, in the near future. Since Enefit Green is financing its activities with own debt, bondholders of the holding company Eesti Energia will be exposed to increased structural subordination risk following the IPO. Given that the company's earnings continue to be mostly generated by fully controlled subsidiaries that are debt free, Moody's at this time does not apply notching to the holding company's ratings.

#### RATIONALE FOR THE STABLE OUTLOOK

The outlook on Eesti Energia's rating is stable. This reflects Moody's expectation that the company will (1) successfully execute its planned capital spending program; (2) retain a solid capital structure by securing non-debt funding sources or adjusting its expenditure plans as needed; and (3) maintain FFO/net debt sustainably at least in the mid teens in percentage terms.

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

An upgrade of the BCA may not necessarily lead to a higher rating. Upward pressure on Eesti Energia's rating is unlikely to materialise in the near and medium term but could develop in the long term through a combination of the following: (1) successful execution of the investment program; and (2) the maintenance of good liquidity and a financial profile comfortably and sustainably in excess of the current guidance.

Eesti Energia's rating could come under downward pressure if (1) the company were not able to maintain a financial profile commensurate with the current guidance, that is, if FFO/net debt were to decline below the mid teens in percentage terms on a sustained basis; (2) the company's liquidity profile were to deteriorate; (3) there were material adverse changes to the market and/or regulatory environment where the company operates that are not addressed through adequate adjustments of the business transition plans and financial profile; (4) structural subordination were to increase materially; or (5) the credit quality of the Estonian government or the support assumptions currently incorporated into Moody's assessment were materially to weaken.

#### PRINCIPAL METHODOLOGIES

The methodologies used in these ratings were Unregulated Utilities and Unregulated Power Companies published in May 2017, and Government-Related Issuers published in June 2018. Please see the Rating Methodologies page on [www.moody.com](http://www.moody.com) for a copy of these methodologies.

Headquartered in Tallinn, Eesti Energia AS is the dominant vertically integrated utility and leading oil shale mining company in Estonia. The group owns approximately 80% of the country's generation capacity, owns and operates the largest electricity distribution network and is the second largest producer of liquid fuels from oil shale. Eesti Energia is 100% owned by the Government of Estonia. For the nine months ended 30 September 2019, Eesti Energia reported revenues of EUR698.9 million and EBITDA of EUR188.9 million.

#### LIST OF AFFECTED RATINGS

..Issuer: Eesti Energia AS

Affirmations:

.... ST Issuer Rating, Affirmed P-3

....LT Issuer Rating, Affirmed Baa3

....Senior Unsecured Regular Bond/Debenture, Affirmed Baa3

....Outlook Actions:

....Outlook, Remains Stable

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