

## **Fitch Affirms Poland's Energa at 'BBB'; Outlook Stable** [Ratings](#) [Endorsement Policy](#)

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Fitch Ratings-Warsaw/London-07 October 2014: Fitch Ratings has affirmed Poland-based Energa S.A.'s Long-term foreign and local currency Issuer Default Ratings (IDRs) at 'BBB' with a Stable Outlook. A full list of rating actions is provided at the end of this rating action commentary.

The affirmation reflects the dominant share of the regulated distribution business in Energa's EBITDA, which results in low business risk and cash flow predictability. The company's financial leverage is moderate with funds from operations (FFO) adjusted net leverage of 1.8x in 2013. We project this ratio to increase to about 3x by 2016-2017, assuming implementation of a full capex plan, and which we see as the maximum leverage commensurate with the current ratings.

### KEY RATING DRIVERS

#### Distribution Supports Credit Profile

Energa's creditworthiness benefits from a high EBITDA contribution from regulated electricity distribution (74% of total Fitch-adjusted EBITDA in 2013, up from 69% in 2012). We expect the share of regulated earnings to remain around 70% in the medium term, contributing to cash flow visibility.

Energa has the highest share of regulated EBITDA among four Fitch-rated Polish utilities (PGE Polska Grupa Energetyczna S.A. (BBB+/Stable), TAURON Polska Energia S.A. (BBB/Stable) and ENEA S.A. (BBB/Stable)). Unlike its Polish peers the company does not have plans for ongoing coal-fired power plant projects. This reduces business risk given weak market conditions for conventional power generation.

#### Solid Business Profile

The ratings reflect Energa's focus on distribution activity, its main business segment, characterised by lower business risk and greater cash flow predictability than conventional power generation. The company's distribution and supply has a market share of 16.5% and 15% respectively, compared with 3% in generation. Energa also lacks a mining business and has weaker conventional generation assets.

#### Some Weaknesses in Regulatory Framework

Fitch views the regulatory framework for Polish distribution networks as supportive and stable. However, it still has several weaknesses compared with regulatory frameworks in some western European countries despite an improvement since 2010. This includes the lack of a multi-year tariff-setting mechanism. There is also volume risk within the framework; for example, lower-than-expected distribution volumes reduce this segment's EBITDA.

An additional negative factor, which eroded Energa's cash flows in 2013 and 1H14, is the legal obligation of Energa's electricity trading subsidiary, acting as a supplier of last resort, to purchase electricity from renewable energy sources (RES) located in Energa's area of operation. The purchase price is set by the regulator based on the average wholesale electricity price in the market in the previous year. This price mechanism means that if electricity prices are lower than in the previous year, such as in 2013 and 2014, Energa would incur a loss in its supply business given that it has to purchase electricity from RES at last year's prices and then sell it on the market at current lower prices.

Energa's exposure to this unfavourable regulation is higher than its Polish peers' given that a substantial part of the country's RES is located in Energa's area of operations in northern Poland. We expect the negative impact of this regulation to diminish in 2015 as wholesale electricity prices in Poland seem to have bottomed out in 2014.

#### Potential Senior Unsecured Rating Upgrade

The abovementioned regulatory constraints have meant that Energa's senior unsecured rating does not benefit from a single-notch uplift over the Long-term IDR that is typically applied to network utilities in developed markets. This is despite Energa's proportion of regulated cash flow being well above 50% of EBITDA.

Some of the regulatory constraints have been addressed by the energy regulatory office in the past few years, including the gradually increasing return on the regulatory asset base (RAB) since 2010, achievement of a full return on RAB in 2014, and gradual elimination of the gap between operating costs and costs approved by the regulator, leading to stronger cost recovery in tariffs.

We expect that the regulatory framework will continue to improve, including implementation of a multi-year tariff system and elimination or reduction of the cash flow impact of the obligation to purchase electricity from RES. Further improvements in the regulatory framework, contributing to stronger recovery expectations in case of default, may lead us to incorporate a one-notch senior unsecured uplift over the Long-term IDR for Energa and as a result to upgrade the senior unsecured rating of Energa and notes issued by its finance subsidiary Energa Finance AB (publ).

#### Credit Metrics to Deteriorate

We expect the company's capex to increase financial leverage from its current moderate level (FFO adjusted net leverage of around 1.8x in 2013). Increase of leverage will depend on the implementation of the capex programme, which contains some optional projects. These projects are subject to market conditions and the future support mechanism for renewables, as the existing system of green certificates is planned to be replaced by a less favourable auction system from 2016. According to our projections a full capex plan would result in an increase of Energa's net leverage to close to 3x by 2016-17. This leverage is commensurate with the current rating and is broadly in line with projected leverage for other central European utilities rated by us.

A lower capex plan (in case some optional projects are not realised) would result in the company's net leverage increasing to less than 3x by 2016-17. We believe that Energa can easily cut back voluntary capex, such as wind farms, if market conditions deteriorate or if a new support system for renewables does not allow for sufficient profitability.

#### Rated on Standalone Basis

Energa is 51.52%-owned by the Polish state (A-/Stable), but Fitch rates it on a standalone basis because we assess legal, operational and strategic links with the state as moderate based on our Parent and Subsidiary Rating Linkage criteria. Following the changes to the company's articles of association (introduction of a 10% voting cap and voting privilege for some of the state's shares) implemented before its IPO in 4Q13 Energa will remain controlled by the government as long as its share in Energa is above 20%.

#### RATING SENSITIVITIES

Positive: Future developments that could lead to positive rating actions include:

- Continued focus on the distribution business in capex and overall strategy, together with FFO adjusted net leverage below 2.5x on a sustained basis
- Further improvements in the regulatory framework, together with distribution networks remaining a dominant earning stream for Energa, which may lead to an upgrade of Energa's and Energa Finance AB (publ)'s senior unsecured rating in a one-notch uplift over the Long-term IDR

Negative: Future developments that could lead to negative rating action include:

- Increase in FFO adjusted net leverage to above 3x on a sustained basis - for example, due to full implementation of capex and weaker-than-expected operating cash flows. A stronger business risk profile supported by a continued focus on the distribution business could result in higher leverage guideline for the current ratings.

#### LIQUIDITY AND DEBT STRUCTURE

At end-June 2014, the company had Fitch-calculated readily available cash of PLN2.5bn against short-term debt of PLN0.4bn. Debt maturities due within the five-year rating horizon are not significant. The first large debt repayment is not due until 2019 when PLN1.2bn of debt matures.

Energa's committed financing at end-June 2014 amounted to PLN1.9bn and was provided mostly in form of credit facilities and loans from EIB, EBRD and commercial banks.

In Fitch's view Energa's readily available cash and committed financing (PLN4.4bn in total as of end-June 2014) are sufficient to cover negative free cash flow in the next few years in a full capex scenario.

Full list of rating actions:

Energa S.A.

Long-term foreign currency IDR affirmed at 'BBB'; Stable Outlook

Long-term local currency IDR affirmed at 'BBB'; Stable Outlook

National Long-term rating affirmed at 'A(pol)'; Stable Outlook  
Foreign currency senior unsecured rating affirmed at 'BBB'  
Local currency senior unsecured rating affirmed at 'BBB'  
National senior unsecured rating affirmed at 'A(pol)'

Energa Finance AB (publ), guaranteed by Energa S.A.  
Foreign currency senior unsecured rating affirmed at 'BBB'

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Additional information is available on [www.fitchratings.com](http://www.fitchratings.com). For regulatory purposes in various jurisdictions, the supervisory analyst named above is deemed to be the primary analyst for this issuer; the principal analyst is deemed to be the secondary.

Applicable criteria, 'Corporate Rating Methodology: Including Short-Term Ratings and Parent and Subsidiary Linkage', dated 28 May 2014, are available at [www.fitchratings.com](http://www.fitchratings.com).

**Applicable Criteria and Related Research:**

[Corporate Rating Methodology - Including Short-Term Ratings and Parent and Subsidiary Linkage](#)

Additional Disclosure

[Solicitation Status](#)

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