

Credit Opinion: Energa S.A.

Global Credit Research - 23 Dec 2011

Gdansk, Poland

Ratings

Category	Moody's Rating
Outlook	Negative
Issuer Rating -Dom Curr	Baa1

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Key Indicators

Energa S.A.[1]	Dec-2010	Dec-2009
FFO Interest Cover	26.2x	29.5x
FFO / Debt	106.5%	206.0%
FFO / Net Debt	-256.8%	-220.9%
RCF / Debt	96.9%	202.9%
FCF / Debt	-3.5%	8.5%

[1] Standard adjustments in accordance with "Rating Methodology: Moody's Approach to Global Standard Adjustments in the Analysis of Financial Statements for Non-Financial Corporations, Part 1, Part 2 and Part 3." In addition, Moody's adjusts for one-time items.

Note: For definitions of Moody's most common ratio terms please see the accompanying [User's Guide](#).

Opinion

Corporate Profile

Energa S.A. is a holding company for the state-owned vertically integrated electric utility in Poland; it was created in 2007 as a part of the major reorganisation of the energy market.

Energa's primary activities are distribution, generation and supply of electricity in Poland. The group covers the north-central Poland, where it employs over 12,000 people. With 185,000 kilometres of network, Energa's share in the Polish electricity distribution market is about 16%. In addition, the group supplies electricity to approximately 2.9 million customers (as at October 2011) and has an installed generation capacity of around 1.2 gigawatts (GW), which accounts for 3.4% of the Polish market. Amongst its

competitors in Poland, Energa has the highest share of renewable energy in its generation portfolio (about 33% of total production).

Energa is currently majority owned (84.2%) by the State Treasury, although the State started a privatisation process in 2010, following a decision to sell it to Polska Grupa Energetyczna S.A.. This transaction was, however, challenged by the Office of Competition and Consumer Protection and is now pending court resolution.

Energa's revenues amounted to PLN9.1 billion (equivalent of EUR 2 billion) as of end-2010.

Rating Rationale

Energa's Baa1 is underpinned by: (i) its well-established position as one of four large vertically integrated energy groups in Poland; (ii) the low business risk profile of Energa's activities in the distribution segment - which accounted for 46% of the group's EBITDA for year-end 2010 - given that these are regulated under a relatively well-established and transparent, albeit evolving, regulatory framework; and (iii) the historically strong financial position of the group, which mitigates risks associated with its sizeable investment plans.

However, the rating is constrained by: (i) Energa's short position in generation and high generation asset concentration; (ii) the small scale of the company's generation activities; (iii) its short track record of operations as a group, and relatively low level of integration; and (iv) its significant investment programme, with spending of around PLN16 billion over the period to 2015, which will result in increased leverage from the current low levels.

Energa's rating incorporates one notch of uplift for potential support from its owner, the Government of Poland (A2, stable outlook).

DETAILED RATING CONSIDERATIONS

When assessing Energa's BCA, Moody's applies its Rating Methodology for Global Unregulated Utilities and Power Companies, published in August 2009, which identifies key areas of focus for assessing the relative fundamental credit quality of unregulated electric and gas companies. The methodology examines the core factors which Moody's considers most relevant to unregulated utilities, sets out the range of possible outcomes by factor and maps these to a rating range. Each factor is appropriately weighted and, in combination, contributes to the rating output by the grid.

Based on historical financial performance it indicates a BCA of 6 (equivalent to A2). This compares with the BCA of 9 (equivalent to Baa2) assigned to Energa. Moody's expects that the difference between the methodology grid outcome and the actual BCA will narrow in the future, reflecting the expected deterioration in Energa's strong debt protection metrics as the group undertakes its investment programme.

We consider the following factors under the rating methodology:

FACTOR 1: MARKET ASSESSMENT, SCALE AND COMPETITIVE POSITION

(a) Size and Scale

Energa's assets amounted to PLN12.6 billion (US\$4.5 billion) as of year-end 2010. Whilst the group has market share of approximately 16% in the distribution segment in Poland, it has a relatively small generation capacity compared with other Polish generators and is even a smaller player in the wider Central and Eastern Europe (CEE) region. Therefore, Energa's small asset base constrains the score within this factor.

(b) Competitive Position and Market Structure

Energa is one of four large energy groups that control around 80% of the market in Poland. The group's installed capacity - totalling 1.2 GW - is mainly based on coal and hydro sources. The latter represents

around 33% of Energa's total production. Given the very low marginal costs of production associated with its hydro sources, Energa has an attractive generation portfolio, albeit very small in the context of the Polish market, where the group has a 3.4% market share.

Energa is the smallest of Poland's four vertically-integrated power utilities. Its only conventional plant - Elektrownia Ostroleka - is the only baseload power plant in north-eastern Poland. Ostroleka B has a total installed capacity of 647 MW (electrical) and was commissioned in 1972, and Ostroleka A, commissioned in 1956, has installed capacity of 93 MW (electrical) and 456 MW (thermal). In 2010 the annual electricity production of Ostroleka plants was 2.9 TWh.

Given that Energa earns its profits purely in Poland, the group is exposed to any potential negative developments in the domestic market. The electricity supply market is only liberalised for corporate customers, with tariffs for households approved by the Energy Regulatory Office (ERO). We note that historical tariffs for households have been kept at a low level, thereby constraining the energy companies' ability to earn a return.

We note that whilst the switching rate (between competitors) remains low in Poland, competition among the energy companies and thus pressure to defend market share will intensify. The Ba score under this sub-factor is constrained by Energa's low market share in generation (less than 5%) but further recognises the strong position of the group in the distribution and sales segments.

FACTOR 2: CASH FLOW PREDICTABILITY OF BUSINESS MODEL

(a) Fuel Strategy and Mix

Energa benefits from a relatively clean generation base as a sizeable (33%) portion of its installed capacity is in hydro. However, its old and coal-based Elektrownia Ostroleka is a heavy emitter of CO₂.

Around 70% of Energa's electricity generation is derived from coal-based generation and the remainder is derived from renewable energy sources (47 hydropower facilities). The most important hydro power plant is located in Wloclawek on the Vistula river. It was constructed in 1970 and has an installed generation capacity of 160 MW. Its average production amounts to around 747 GWh, although in common with all hydro power plants, there is some volatility in the production levels. Energa therefore has a relatively diversified and favourable power generation fleet (there is limited scope for expanding hydro capacity in Poland by virtue of geography, and thus future renewable investments are likely to be in wind generation), although the group's installed capacity is minimal in the context of the overall energy market (total net installed generation capacity in Poland is approximately 33.3 GW).

With regard to CO₂ emissions, Energa currently receives around 3 million tonnes of allowances per annum (and will do so until year-end 2012). In 2010, Energa received CO₂ emission allowances of 3.2 million tonnes, and the actual emissions exceeded this allowance by approximately 10%. Moody's notes that, starting from 2013, Energa will need to buy a higher portion of the carbon credits necessary to offset the greenhouse emissions. Until new generation plants are built, the impact on Energa is expected to be relatively modest as Poland, together with some other CEE countries, negotiated a derogation of the requirements to purchase all CO₂ emissions from 2013. During 2013-20, the quota granted for free will be gradually reduced down to 0% in 2020.

The Baa score under this sub-factor recognises a considerable share of hydro in Energa's portfolio but also the company's small size.

(b) Degree of Integration and Hedging Strategy

Energa's electricity generation amounted to 4.6 TWh compared with sales of 17.8 TWh in 2010. The group has to procure electricity on the open market and is thus exposed to changes in market power prices.

The score of Ba under this sub-factor reflects a substantial short generation position versus its customer

base.

(c) Capital Requirements and Operational Performance

Moody's uses the ratio of capex to property, plant & equipment (PP&E) to measure the risk associated with an investment programme. Energa scores single-B under this sub-factor given the scale; this score is in line with the sector.

Energa's capital investment plans are substantial. The total amount of investments planned over the period to 2015 is over PLN16 billion, with a significant increase in capex in 2013 and 2014, when it is expected to exceed PLN3.5 billion and PLN4 billion, respectively. In the distribution segment, Energa plans to spend about PLN6.9 billion over the same period. We understand that a substantial portion of those investments is to be directed to connections of new customers and producers, and the construction of a new network for the connections. Therefore, there is, in our view, a risk that some of these investments may experience delays or fail to materialise given the complex planning and permits process in Poland.

Energa's existing assets are old by international standards, albeit similar to those of other Polish generators. In Poland, over 55% of the power plants is over 30 years old. Therefore many old, inefficient coal-fired plants are set to be decommissioned over the next decade, largely as a result of their age and constraints on emissions. As a result of the age of these plants, efficiency ratios are relatively poor despite an ongoing programme of upgrades. Energa's coal plants have efficiency of around 37%, which is in line with similar type of power plants in Poland.

With regard to the performance of the electricity distribution segment, Energa's network losses (measured with regard to volumes delivered to final customers) amounted to around 8.8% in 2010, which was slightly higher than in previous years. Planned investments should, however, result in a reduction of network losses by 2015.

(d) Contribution from Low/ High Risk Businesses

Energa's rating is supported by cash flows generated from its regulated activities, which have a higher degree of visibility and predictability. In 2010, the group generated about 46% of its EBITDA from regulated activities in the distribution segment.

We note that apart from distribution, group G electricity sales as well as heating sales and distribution services are regulated activities. Heating sales and distribution services are, however, minimal in the context of group's EBITDA.

Energa-Operator, operating under a license valid until 2020, is one of the largest electricity distribution companies in Poland. Its market share in the distribution segment is approximately 16%. Energa distributes electricity to around 2.9 million customers, and its sales of electricity amounted to 17.8 TWh in 2010. We note that whilst Energa may have lost some of its customers as the switching rate in Poland increases, the group has been successful in gaining new customers, and thus overall numbers and volumes have recently risen.

Poland is considered to have developed a relatively transparent regulatory regime for its electricity networks, although it still needs to gain a proven track record compared to more established regulatory regimes. Regulation in the electricity network segment appears to be generally spared from political interference. Overall, we believe that the regulatory framework and its transparency are improving.

Retail electricity sales in Poland are also subject to ERO approval. However, retail sales companies are only required to obtain approval for tariffs for end-users in tariff group G (predominantly households). With respect to other customers (groups A-C), the retail sales market is competitive and prices are determined by the market. Moody's understands that prices for households are also to be liberalised, although before taking any decision, the ERO would seek to ensure that all the necessary legislation is in place, and ensure protection of the most vulnerable customers.

We score Energa at Aaa under this sub-factor, reflecting that regulated businesses account for almost 50% of the consolidated EBITDA. In the short to medium term, in light of regulatory asset base (RAB) revaluation in the distribution segment, the share of regulated businesses is projected to increase above 50%. We foresee a gradual reduction in the relative contribution from regulated activities as Energa's large investments in power generation assets come onstream. This outlook is, however, based on a more long-term horizon.

FACTOR 3: FINANCIAL POLICY

In scoring financial policy at Baa, we factor in Energa's stated focus on managing its capital structure by reference to a leverage ratio (defined as net debt/EBITDA) of up to 3.0x.

Energa does not have any history of corporate activity given its short track record as a holding company for the group. At present, Energa exhibits a strong financial profile, which will, however, deteriorate with execution of a sizeable investment programme and given the associated financing needs. Clearly, this will affect the group's financial profile over the medium term. At this stage, we are unable to predict the dividend policy of the potential future owner but we would expect a prudent approach to the dividend policy in light of the needs of an extensive capital programme.

The existing debt documentation includes certain covenants, which will limit the group's indebtedness. Whilst we believe that Energa will not compromise the minimum financial ratio required under the terms of the financing, the company's leverage is expected to increase over the medium term.

FACTOR 4: KEY CREDIT METRICS

In 2010, Energa presented a very strong set of results owing to increased hydro generation, stronger heating demand and the introduction of a new industry methodology of RAB calculation. An improvement in profitability was also achieved on the back of the reduction in costs and more efficient management. The restructuring process has been ongoing for the past three years and has involved consolidation of companies and centralisation of management. As of year-end 2010, the group's debt amounted to PLN1 billion, whilst cash held on balance sheet was PLN1.7 billion. The significant cash surplus and low leverage result from a relatively slow and modest capex programme in previous years. In addition, dividend payments were relatively low compared with the net profit realised.

We expect Energa's financial metrics to fall from the historically strong levels as the group executes its sizeable investment programme. The current rating anticipates that Energa will demonstrate funds from operations (FFO) interest cover in excess of 5.0x and FFO to net debt in excess of 30%, and a deterioration below these levels would exert negative pressure on the rating.

OTHER GRI CONSIDERATIONS

Moody's considers there to be a moderate probability of support for Energa in the event of extraordinary need, reflecting the company's vital importance to the economy of Poland and 84.2% state ownership but at the same time recognising the ongoing privatisation process. The assumed support is lower than in case of PGE, which is one of the largest employers in the country and meaningful contributor to the state budget.

The very high level of dependence reflects Energa's significant exposure to the Polish economy as virtually all its revenues and cash flows are generated from domestic activities and have a high level of correlation to common drivers of credit quality.

Structural Considerations

We have not made any adjustment for structural subordination to the issuer rating of Energa. This is based on our understanding that there are no material debt amounts at the operating companies' level that would not be guaranteed by the holding company, and all future debt will be at the holding company level. At the

same time, cash can be upstreamed to the holding company without restrictions.

Liquidity Profile

Energa's solid short-term liquidity position is supported by: (i) strong expected gross cash flow generation; (ii) a comfortable maturity profile; and (iii) sufficient headroom under committed credit lines of over PLN1.3 billion. However, the sizeable capex that consumes a large part of the available funds constrains an otherwise solid liquidity profile. We expect Energa's liquidity profile to weaken as the capital investment programme increases over the short- to medium-term horizon, resulting in negative free cash flow.

Energa is subject to a number of financial covenants under its bank facilities agreements, and was in compliance with those as of end-June 2011. We understand that some of its facilities include a "change of control" event, which refers to (i) the State Treasury ceasing to hold at least 51% of share capital of Energa or (ii) any majority shareholder (succeeding the State Treasury) ceasing to hold at least 51% of share capital. In such event, a consultation with a bank may be required.

Rating Outlook

The negative outlook assigned to the rating reflects the uncertainty surrounding the future ownership and its implications for the group's financial strategy and profile going forward.

What Could Change the Rating - Up

To consider any upward move, Moody's would require evidence that Energa's credit metrics were improving on a sustainable basis, with funds from operations (FFO)/net debt ratio in the forties in percentage terms. However, upward rating pressure is unlikely in the short term given uncertainty surrounding the ownership of Energa, the challenges that the group faces in terms of carrying out its capital investment programme and the anticipated decline in its credit metrics.

What Could Change the Rating - Down

The rating could come under downward pressure if Energa's FFO interest coverage ratio were to fall below 5.0x and its FFO/net debt ratio were to decline below 30% on a sustainable basis. In addition, negative pressure on Energa's rating could develop as a result of (i) material adverse changes in the regulatory framework in Poland; (ii) a change in the group's ownership structure, which would result in it adopting a materially different strategy; (iii) a deterioration in the credit quality of the Government of Poland and/or a reduction in the support assumptions currently incorporated into Moody's assessment; or (iv) a deterioration in the credit quality of PGE, were the acquisition transaction executed.

Rating Factors

Energa S.A.

Unregulated Utilities	Aaa	Aa	A	Baa	Ba	B	Caa
Factor 1: Market Assessment, Scale & Competitive Position (25%)							
a) Size and Scale					x		
b) Competitive Position and Market Structure					x		
Factor 2: Cash Flow Predictability of Business Model (25%)							
a) Fuel Strategy and Mix				x			
b) Degree of Integration and Hedging Strategy					x		
c) Capital Requirements and Operational Performance						x	

d) Contribution from Low/High Risk Businesses	x						
Factor 3: Financial Policy (10%)							
a) Financial Policy				x			
Factor 4: Financial Strength Metrics (40%) [1]							
a) (CFO Pre-W/C + Interest) / Interest Expense (3 year Avg)	x						
b) (CFO Pre-W/C) / Debt (3 year Avg)	x						
c) RCF / Debt (3 year Avg)	x						
d) FCF / Debt (3 year Avg)	x						
Rating:							
a) Indicated Rating from Grid			A2				
b) Actual BCA Assigned				Baa2			

Government-Related Issuer	Factor
a) Baseline Credit Assessment	9 (Baa2)
b) Government Local Currency Rating	A2
c) Default Dependence	Very High
d) Support	Moderate

[1] Standard adjustments in accordance with "Rating Methodology: Moody's Approach to Global Standard Adjustments in the Analysis of Financial Statements for Non-Financial Corporations, Part 1, Part 2 and Part 3." In addition, Moody's adjusts for one-time items.



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