MOODY'S
INVESTORS SERVICE

CREDIT ANALYSIS

Elering AS

Estonia

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This Credit Analysis provides an in-depth discussion of credit rating(s) for Elering AS and should be read in conjunction with Moody's most recent Credit Opinion and rating information available on Moody's website.

Corporate Profile

Elering is the owner and operator of Estonia's electricity transmission network

Elering AS ("Elering", rated A3 with a stable outlook) is the owner and operator of Estonia's 5,252 km high-voltage electricity transmission system network. Its activities as a transmission system operator are regulated by the Estonian Competition Authority. As at December 2010, Elering reported revenues of EEK1.4 billion (equivalent to €89 million). The company employs 139 people.

The company was established in 2004 as a private limited company and a wholly owned subsidiary of the state-owned vertically integrated utility Eesti Energia AS (Eesti Energia). The Ministry of Economic Affairs and Communications was authorised to purchase Elering in 2009. This followed the decision of the Government of Estonia to separate the assets and operations of the transmission system from Eesti Energia to ensure complete independence of the transmission network operator from electricity production and sales activities. The transaction was completed in the following year and since January 2010, Elering's sole shareholder has been the Government of Estonia.

Figure 1, below, shows the company's key financial information for 2009 and 2010.

FIGURE 1
Financial Highlights

EEK million (1EUR=15.6466EEK)	2010	2009
Turnover of which:	1,390	1,181
Sales of network services	1,107	1,062
Sales of other goods	36	17
EBIT	325	319
EBIT margin	23%	27%
Net income	212	82

Management Strategy

Focus on transmission activities with significant investments in interconnectors and reserve capacity

Elering's management is very clearly focused on its role as a transmission owner and operator. It also has responsibility for system and balancing operations. The strategic goals of Elering's management include high quality supply of electricity and facilitation of the functioning of the energy markets. In this context, the company plans to deliver an extensive capital programme to expand and reinforce its existing network and provide the required interconnectors in the Baltic area.

Elering's strategy is aligned with the government's energy policy. The company's capital expenditure (capex) over the next five years is projected to total €475 million. It will include investments in the renewal of networks in order to minimise supply interruptions and their duration, but also will involve the construction of new interconnectors with Finland and the building of an emergency reserve power plant (ERPP). The strategic project includes the construction of the Estlink 2 subsea connection together with Fingrid Oyj (Finnish transmission grid).

Rating Rationale

Given its 100% ownership by the government of Estonia, Elering falls within the scope of Moody's rating methodology for government-related issuers (GRIs). In accordance with this methodology, Elering's rating incorporates a two-notch uplift to its standalone credit assessment, which results from the credit quality and potential support from its owner. Its A3 rating reflects a combination of the following components:

» A baseline credit assessment (BCA) of 9 (on a scale of 1 to 21, where 1 represents the lowest risk and 9 is equivalent to a Baa2 rating). The BCA is a representation of the company's credit quality before taking into account any support.

» The A1 rating, with a stable outlook, of the Government of Estonia, Elering's sole shareholder.

» A high probability of support, which reflects the strategic importance of Elering's transmission assets to the state and Moody's view that the government will maintain its full ownership of the company in the foreseeable future.

» Moody's assessment of very high dependence, which reflects the fact that Elering's revenues are generated from domestic activities and hence there is a link with the domestic macroeconomic environment.

Elering's BCA is underpinned by the low business risk profile of its electricity transmission network operations in Estonia, given that they are carried out under a transparent, albeit relatively new, regulatory framework. The rating is, however, constrained by the company's expected large capital investment programme, which will gradually increase its financial leverage from initially moderate levels. Moody's rating for Elering also reflects the small size of the company, which leaves it more exposed to cost shocks, cost overruns on individual projects or other negative events that may affect a larger portion of assets, revenues or costs.

Shareholders and GRI Factors

As a 100% state-owned company, Elering is subject to special governance rules stipulated in the State Assets Act based on which shareholder rights are conferred to the Ministry of Economic Affairs and Communications (MEAC). The rights and responsibilities of the Supervisory Board (five members) are set forth in the Articles of Association, the Commercial Code and the State Assets Act. The Management Board (three members) is the directing body. The Chairman has the right of sole representation of Elering and the other two members have the right to represent the company jointly.

Under its governing legislation, Elering is required to obtain the consent of the shareholder to engage in a variety of transactions. All investments need to be approved by the Supervisory Board, whose members are appointed by the MEAC and the Minister of Finance. In particular, the development of Elering's strategic plan involves significant involvement of the Government of Estonia as the sole shareholder.

Although the Government of Estonia does not provide any explicit guarantees, Elering's operations are considered of vital importance to the economy of Estonia. The shareholder has provided support to Elering in the form of two comfort letters issued to the creditors of long-term loans and increased the company's share capital by €5.8 million in 2010. A further increase in the share capital of €9.9 million was decided in May 2011.

Moody's considers there to be a high probability of support for Elering in the event of extraordinary need, reflecting the company's strategic importance for the Estonian economy and status of vital services provider. We understand that there are currently no privatisation plans and the Government of Estonia will remain the sole shareholder of Elering. The dividend policy was approved by the Supervisory Board on 15 December 2010, with a view to strengthening the company's financial profile in light of its significant investment programme. The current dividend policy assumes that no dividends will be paid in the years 2011-14. Thereafter, dividend amounts will be determined by the level of financial covenants and predetermined safety margins as decided by the Supervisory Board.

The high level of dependence reflects that Elering derives almost all its revenue from domestic activities.

Key Rating Factors

When assessing Elering's BCA, Moody's applies its Rating Methodology for Regulated Electric and Gas Networks, published in August 2009, which identifies key areas of focus for assessing the relative fundamental credit quality of regulated electric and gas network companies. The methodology focuses on the assessment of the regulatory environment and ownership model, efficiency and execution risk, stability of business model and financial structure and key credit metrics. Based on historical financial performance, it indicates a BCA of 7 (equivalent to A3). This compares with a BCA of 9 (equivalent to Baa2) assigned to the company. 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 Elering's strong debt protection metrics as the company completes its investment programme.

FIGURE 2
Rating Factors
Elering AS

Regulated Electric and Gas Networks [1][2]	Aaa	Aa	A	Baa	Ba	B
Factor 1: Regulatory Environment & Asset Ownership Model (40%)						
a) Stability and Predictability of Regulatory Regime			X			
b) Asset Ownership Model		X				
c) Cost and Investment Recovery			X			
d) Revenue Risk			X			
Factor 2: Efficiency & Execution Risk (10%)						
a) Cost Efficiency				X		
b) Scale and Complexity of Capital Programme						X
Factor 3: Stability of Business Model & Financial Structure (10%)						
a) Ability and Willingness to Pursue Opportunistic Corporate Activity			X			
b) Ability and Willingness to Increase Leverage				X		
c) Targeted Proportion of Operating Profit Outside Core Regulated Activities		X				
Factor 4: Key Credit Metrics (40%)						
a) (FFO + Interest) / Interest Expense			X			
b) Net Debt / Fixed Assets			X			
c) FFO / Net Debt			X			
d) RCF / CAPEX					X	
Rating:						
a) Indicated Rating from Grid factors 1-4			7 (A3)			
b) Impact from Rating Uplift						
c) Indicated Rating from Grid			7 (A3)			
d) Actual Rating Assigned (BCA)				9 (Baa2)		

[1] All ratios are calculated using Moody's Standard Adjustments.

[2] As of 12/31/2010

Source: Moody's Financial Metrics ™

We consider the following factors under the rating methodology:

Factor 1 : Regulatory Environment and Asset Ownership Model

Regulatory framework relatively new but supportive of the transmission operations

The assessment of the regulatory and political framework in which Elering operates plays a key part in determining the company's overall credit quality. The electricity transmission operations in Estonia are regulated by the Estonian Competition Authority (ECA). The ECA is also responsible for competition supervision, fuel and energy, and electronic and postal communications.

The transmission system operations have been regulated in their current form since 2004. The 3-yearly regulatory settlements define the company's revenue entitlement based on a formula aimed to cover operating costs and an assumption of a reasonable return on its capital employed, which incorporates the investments made. The current regulatory period runs from 1 January 2011 until 31 December

2013 and allows for a nominal, post-tax return of 7.56% based on a 50/50 debt/ equity ratio. The ECA's assumption regarding cost of debt is based on the 10-year German government bond yield to which a country risk margin and the company risk margin are added. Moody's notes that there have been no changes in the weighted average cost of capital (WACC) calculation principles since the set up of the regulatory framework for the electricity transmission in Estonia.

The regulatory determination is based on the two publications regarding the calculation of justified network charges: "Standard Methodology for Calculating Electricity Network Charges", published in 2003 and "Guidelines for determination of Weighted Average Cost of Capital", most recently published in 2010.

We consider the regulatory framework to be transparent, with all the major methodologies publicly available and well defined by a regulatory office that appears to operate independently from political interference. Whilst we consider the regulatory framework to be relatively well established, we note that it is relatively new and untested compared with regulatory regimes such as the UK system, which is regarded as the most transparent and predictable in Europe.

Overall, we consider the current regulatory framework as supportive for the stability of Elering's credit profile, although still relatively untested and thus we assign a score of A to Elering under this methodology sub-factor.

Owner of the assets under a license granted by ECA

With regards to the asset ownership model, we score Elering in the Aa category under this sub-factor, recognising the fact that the company owns the transmission grid assets but operates under a license granted by the ECA. Whilst the license issued on 9 February 2006 is for an indefinite period, changes in the Estonian legislation or European regulation could lead to its termination or suspension.

Timely cost and investment recovery subject to certain efficiency targets

Under the Estonian regulatory framework, Elering is allowed to cover its costs and realise a reasonable return based on the WACC applied on the company's regulated asset base (RAB), with annual tariff increases implemented by the company.

The regulatory formula provides for a CPI-X allowance in the case of operating and maintenance costs. The efficiency X factor is set for a 3-year regulatory period and currently amounts to 1.5%. In the case of capex, new investments as agreed at the regulatory review are fully reflected in the company's RAB. Moody's understands that the risk of overspending on capex is low given the number and size of the individual projects, which means that the overall expenditure can be adjusted during the regulatory period. In the case of delays, which result in underspending, the regulator has the right to adjust the tariffs at the next review.

Elering's positioning in the A category under this sub-factor recognises the current transparent tariff setting mechanism, enabling timely cost and investment recovery, subject to certain efficiency targets in terms of its operating and maintenance costs.

Limited exposure to volume risk

Under the current regulatory framework, each year the next year's tariff applicable from 1 January is calculated based on the last known 12-month actual volumes at the time the tariff application is submitted, i.e. typically this would be a September – August period. This means that if the following

year actual transmission volumes are higher, the company will be able to keep the realised profit. In the opposite case, Elering will incur lower income and will not be compensated. Whilst typically there are no significant changes in volumes from one year to another given the size and the structure of the Estonian economy, in 2009, which could be considered an exceptional year, domestic consumption dropped by 6.4% due to the economic recession. This resulted in over 12.5% lower revenues than transmission levels used by the regulator for the calculation of tariffs. Given the significant difference between the projected and actual volumes, in December 2009, Elering submitted an application to the regulator, which recognised the scale of the decline and calculated new tariffs based on the lower actual levels. Consequently, tariffs were increased by 18.9% as of 1 June 2010.

We score Elering in the A category under a revenue risk sub-factor in light of the company's limited exposure to volume risk associated with the current regulatory regime. Under the current system, should the actual volumes in the previous year be lower or higher than expected, tariffs are amended in the subsequent year.

Factor 2: Efficiency and Execution Risk

Elering's operational performance in line with regulatory assumptions

The Estonian transmission electricity system has been built as part of the northwestern common power system of the former Soviet Union and thus the average age of the transmission assets is 25-30 years. It is connected with Latvia (500-650 MW) and Russia (500-900 MW), as well as with Finland through a submarine cable, Estlink 1 (350 MW).

Over the two regulatory periods, Elering delivered around 4% savings in its operating expenses (opex) compared with the regulatory determination. Significant savings were achieved in 2008-10 through a combination of higher productivity and lower costs of procurement in the midst of the recession in Estonia.

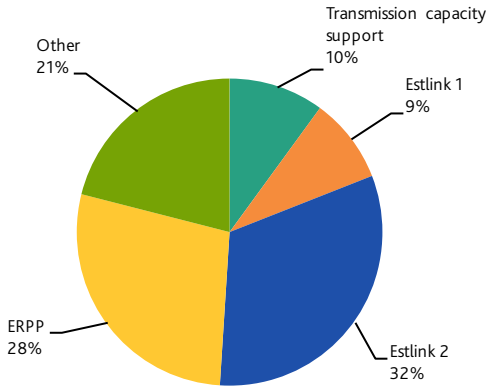
The regulatory settlement for 2011-13 necessitates further reduction in opex, 1.5% below the inflation rate per annum.

We score Baa under this sub-factor, recognising that Elering's performance was generally in line with regulatory assumptions, although the company may need some time to establish a performance track record given the short history of the company's operations under the existing regulatory regime.

Large capex programme until 2015

For the current regulatory period, the ECA has approved capital investments totalling €350 million. Main projects include grid reinforcements, international interconnections (investment into the second undersea cable between Estonia and Finland – Estlink 2, and purchase of the cable of Estlink 1) and construction of ERPP required to maintain the emergency reserve capacity.

FIGURE 3
Capital Programme Split (2011-13)



We note here that apart from the regular investments to replace the aging transmission equipment and develop the grid so that it meets the needs of the growing domestic consumption that have been set by the ECA at €29.8 million per annum, the company needs to make some extraordinary investments as set out under the Electrical Energy Sector Development Plan of Estonia until 2018, as approved by the Government of Estonia on 26 February 2009.

Major extraordinary investments include international interconnections (investment into the second undersea cable between Estonia and Finland – Estlink 2, and purchase of the cable of Estlink 1) and construction of ERPP required to maintain the emergency reserve capacity.

Estlink 1 is an existing interconnector between Estonia and Finland, with a total transmission capacity of 350 MW. The cable, which is a commercial connection, has been operational since 2006. Estlink 1 is currently owned by AS Nordic Energy Link, co-owned by the Estonian Eesti Energia (40%), the Latvian Latvenergo (25%), the Lithuanian Lietuvos Energija (25%) and the Finnish Finestlink (10%). The Estlink 1 cable has been granted exceptional legislative status of a "commercial project" until 2013, whereby free access to it is not granted to third parties unless its full capacity is unexploited by the owners. However, in 2010 the owners waived their right of use of this cable and since then the power exchange NordPool Spot allocates the transmission capacities. The current owners committed to sell Estlink 1 to Elering and Fingrid at a predetermined price of approximately €80 million on 31 December 2013 at the latest. Elering's share in the acquisition price will be around €40 million.

Estlink 2 will be a new interconnector from Estonia to Finland, with a maximum capacity of 650 MW and total length of 170 km, including 145 km of submarine cables. The total cost of the project, including reinforcements of existing networks in Estonia in Finland, is approximately €320 million. The investment will be funded in equal parts by Elering and Fingrid, with the European Commission providing a €100 million grant to support the project. The cable is expected to be operational in 2013.

The ERPP will have a total capacity of 250 MW. The purpose of the combined fuel (light fuel oil and gas) power plant will be provision of an emergency backup power in the event that an existing power generating unit stops production. Under such scenario, the emergency reserve power plant would be operated in order to restore the country's power balance.

We use the ratio of capex to property, plant & equipment (PP&E) to measure the risk associated with an investment programme. Elering's capital spend in relation to RAB or fixed assets was at 7.7% or 7.4% in 2010. We note, however, that historical ratios are not representative of Elering's future performance given a substantial investment programme in the period 2011-15, totalling around €475 million, with a peak in year 2013 of around €140 million. The planned investment amounts are high in absolute terms but also in relation to the asset base (around 25.7% of RAB in 2012).

Overall, we score Elering at B under this sub-factor given a significant ratio of investments compared with the actual asset base.

Factor 3: Stability of Business Model and Financial Structure

Elering does not have any history of corporate activity given its short track record as a standalone company, which supports the company's positioning in the A category. In accordance with the Electricity Market Act 2003 (EMA), the company is prohibited from carrying on any business other than provision of network services and sale of balancing energy, as well as administration of the fund for support of producers using renewable energy sources. According to the draft amendments to the EMA, a transmission system operator may continue to generate electricity in reserve power plants. We understand, however, that the draft amendments are subject to change.

At the outset Elering is expected to exhibit a relatively strong financial profile, which however, will deteriorate with the significant investment programme and the associated financing needs. Clearly, this will affect the company's financial profile over the medium term. However, Moody's understands that Elering's owner intends to employ a prudent approach to its dividend policy and align cash flow streams to shareholder with the needs of an extensive capital programme.

The existing debt documentation includes certain covenants, which will limit company's indebtedness. Moody's notes, however, that in light of a significant investment programme the current capital structure of the company is going to change. Whilst we believe that the company will not compromise its minimum financial ratios required under the terms of the financing, the leverage is expected to increase over the medium term. Therefore, we assign a Baa score under this sub-factor.

Elering is subject to statutory and regulatory restrictions prohibiting investments outside the core electricity transmission business. Currently, the company retains very limited unregulated operations, which are a pass through. This business is somewhat complementary to the core regulated electricity transmission activity, which generates virtually all Elering's operating profit, thus supporting the positioning in the Aa rating category for this sub-factor.

Factor 4: Key Credit Metrics

To assess the financial risk profile of a regulated electricity network company, Moody's uses four key credit metrics. The key focus remains on two ratios, namely net debt to RAB (or fixed assets) and the funds from operations (FFO) interest cover, which is sometimes adjusted for regulatory depreciation where appropriate. We also consider FFO/net debt and retained cash flow (RCF)/capex ratios, but these are assigned a lower weighting under the rating methodology.

In the case of Elering, we will monitor the development of both net debt/fixed assets and net debt/RAB ratios. We note here that, at present, the RAB is lower than reported fixed assets of the company but the difference is expected to narrow in the future.

Historical financial performance was stable with an exception of 2009

The historical financial performance has been relatively stable. In this context, Moody's notes that 2009 could be considered unusual due to a combination of a few factors, among which was a severe decline in transmission volumes of 6.4%. This was an unprecedented drop and followed a macroeconomic recession, when gross domestic product (GDP) fell by 14.1%. The financial profile of the company further deteriorated due to the dividend payment made as a part of the Elering's buyout plan, when the Government of Estonia and the former owner of the company – Eesti Energia – agreed that Eesti Energia would receive dividends of the amount of EEK480 million. According to the Estonian income tax law, the income tax is only payable on dividend paid and not on an accounting profit and therefore the company made an income tax payment of EEK127 million.

FIGURE 4
Financial Ratios

in EEK million (1EUR=15.6466EEK)	2010	2009
Adjusted cash flow statement		
Funds from operations (FFO)	566	384
Dividends paid	0	-480
Retained cash flow (RCF)	566	-96
Capex (net of subsidies)	-157	-487
Interest expense	132	121
Adjusted debt		
Gross debt as reported	2,905	2,936
Operating leases (6x rental expense)	17	48
Cash and equivalents	-627	0
Net debt, as adjusted	2,296	2,983
Key credit metrics		
(FFO + Interest Expense) / Interest Expense	5.3x	4.2x
FFO / Net Debt	24.7%	12.9%
RCF / Net Debt	24.7%	-3.2%
RCF / Capex	3.6x	-0.2x

Moderate financial leverage to gradually increase with the execution of the capex plan

Elering's 2010 financial profile was strong. However, as noted above, Elering is expected to significantly increase its capex. Main investments will be aimed at reinforcing of the grid network, increasing reserve power capacity and participating in funding of the Estlink 2 cable between Estonia and Finland. Whilst the agreed tariff increases will somewhat mitigate significant spending, the debt requirements associated with Elering's investment plan will weigh on the company's debt protection metrics. For this reason, the scoring for key credit metrics reflects Moody's view of Elering's likely performance over the next three years rather than the historical results.

In order to maintain the current rating, Moody's expects Elering to exhibit minimum financial parameters – namely, FFO interest cover of 3.5x and FFO/net debt in the mid teens – on a sustainable basis.

The rating could come under downward pressure if Elering's FFO interest cover were to fall below 3.5x or the FFO/net debt ratio were to decline to low teens for a sustained period of time due to, for example, operational underperformance or a higher cost of debt. In addition, negative pressure on Elering's rating could develop as a result of a deterioration in the credit quality of the Government of Estonia or a reduction of the support assumptions currently incorporated into Moody's assessment.

Given the significant investment programme and the associated funding requirements in the future, Moody's sees limited potential for a rating upgrade over the medium term. Before considering any upward move, Moody's would require evidence that Elering's credit metrics were improving on a sustainable basis, with FFO interest cover above 4.5x and FFO/net debt ratio in the twenties in percentage terms.

Liquidity

Good liquidity position underpinned by regulatory cash flows but significant medium term refinancing requirement

Elering exhibits a solid liquidity profile underpinned by the relatively stable cash flows generated from its regulated transmission network activities and further supported by the available amounts of cash and committed facilities. We understand that as of 31 March 2011, the company had €50 million of cash and €20 million of undrawn overdraft maturing in December 2012. Elering further benefits from committed lines from European Investment Bank (EIB) and Nordic Investment Bank (NIB) in the total amount of €100 million which will be used to finance the construction of Estlink 2 cable.

The company's bank syndicated debt in the amount of €187 million is maturing in December 2012 and there are no other loans outstanding. Moody's notes that Elering's bank facilities include financial covenants: equity/assets > 35% until repayment of the syndicated loan and 30% thereafter and net debt/EBITDA < 6.0x until repayment of the syndicated loan, 7.0x until 2015 and 6.0x thereafter. We note that the company currently shows adequate headroom under its net debt/EBITDA financial covenant (3.3x as at 31 December 2010). The estimated headroom under equity/assets covenant is, however, tight (38% as at 31 December 2010) but is expected to improve with the equity injection provided by Elering's shareholder and the repayment of the syndicated loan.

Rating Positioning and Peer Comparison

The below table compares the methodology scores for Elering with those of its peer group.

FIGURE 5
Peer Comparison

	Estonia	Portugal	Norway	Italy	Finland
Regulated Electric and Gas Networks	Elering	REN	Statnett	Terna	Fingrid
Factor 1: Regulatory Environment & Asset Ownership Model (40%)					
a) Stability and Predictability of Regulatory Regime	A	A	Aa	Aa	Aa
b) Asset Ownership Model	Aa	Aa	Aaa	A	Aa
c) Cost and Investment Recovery	A	A	A	A	Aa
d) Revenue Risk	A	Aa	Aa	Aa	Aa
Factor 2: Efficiency & Execution Risk (10%)					
a) Cost Efficiency	Baa	Baa	A	Baa	Aa
b) Scale and Complexity of Capital Programme	B	Ba	B	Ba	Ba
Factor 3: Stability of Business Model & Financial Structure (10%)					
a) Ability and Willingness to Pursue Opportunistic Corporate Activity	A	A	A	Baa	A
b) Ability and Willingness to Increase Leverage	Baa	Baa	Baa	Baa	Baa
c) Targeted Proportion of Operating Profit Outside Core Regulated Activities	Aa	Aa	Aa	A	Aa
Factor 4: Key Credit Metrics (40%)					
a) FFO interest cover	A	Baa	A	Aa	A
b) Net Debt / Fixed Assets	A	Baa	Baa	Baa	Baa
c) FFO / Net Debt	A	Baa	A	A	A
d) RCF / CAPEX	Ba	B	B	B	Ba
Rating:					
a) Indicated BCA from Grid	A3	Baa1	Baa1	A3	A2
b) Actual BCA Assigned	Baa2	Baa2	Baa2	A3	A2

Elering scores slightly lower in relation to the regulatory framework and asset ownership model given a relatively new regulatory framework and certain exposure to volume risk, albeit mainly in terms of time lag. The company faces a substantial investment period, which is expected to weigh on the financial metrics. Elering is also the smallest transmission grid and therefore in Moody's view is more exposed to shocks than its larger peers.

Moody's Related Research

Special Comments:

» Moody's Rating Approach for European Infrastructure & Utility Companies in an Environment of Declining Credit Quality, November 2010, (128915)

Rating Methodologies:

» Regulated Electric and Gas Networks, August 2009 (118786)

» Government Related Issuers: Methodology Update, July 2010 (126031)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

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