MOODY'S
INVESTORS SERVICE

Credit Opinion: Elering AS

Global Credit Research - 08 Sep 2011

Tallinn, Estonia

Ratings

Category	Moody's Rating
Outlook	Stable
Issuer Rating -Dom Curr	A3
Senior Unsecured	A3

Contacts

Analyst	Phone
Joanna Fic/London	44.20.7772.5454
Richard Miratsky/Prague	420.224.222.929
Andrew Blease/London	

Key Indicators

[1]**Elering AS**

	12/31/2010	12/31/2009
FFO Interest Cover	**5.3x**	**4.2x**
Net Debt / Fixed Assets	**41.4%**	**53.7%**
FFO / Net Debt	**24.7%**	**12.9%**
RCF / CAPEX	**3.6x**	**-0.2x**

[1] All ratios are calculated using Moody's Standard Adjustments. Source: Moody's Financial Metrics TM

Note: For definitions of Moody's most common ratio terms please see the accompanying User's Guide.

Opinion

Corporate Profile

Elering AS 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. In 2010, Elering reported revenues of EEK1.4 billion (equivalent to EUR 89 million).

The company was established in 2004 as a wholly owned subsidiary of the state-owned vertically integrated utility Eesti Energia AS. Following the decision 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 Government of Estonia became Elering's sole shareholder in January 2010.

Rating Rationale

Elering's A3 rating 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 of 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.

Elering's rating incorporates two notches of uplift for potential support from its owner, the Government of Estonia (A1, stable outlook).

DETAILED RATING CONSIDERATIONS

When assessing Elering, 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 baseline credit assessment (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.

We consider the following factors under the rating methodology:

FACTOR 1: REGULATORY ENVIRONMENT AND ASSET OWNERSHIP MODEL

(a) Stability and Predictability of Regulatory Regime

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 regulated assets, which incorporate the investments made. The current regulatory period runs from 1 January 2011 until 31 December 2013 and allows for a nominal, pre-tax return of 7.56%.

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.

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.

(b) Asset Ownership Model

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.

(c) Cost and Investment Recovery

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.

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.

(d) Revenue 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.

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

(a) Cost Efficiency

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 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.

We assign a score of 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.

(b) Scale and Complexity of Capital Programme

For the current regulatory period, the ECA has approved capital investments totalling EUR 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 emergency reserve power plant (ERPP) required to maintain the emergency reserve capacity.

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 EUR 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.

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 EUR 475 million, with a peak in year 2013 of around EUR 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

(a) Ability and willingness to Pursue Opportunistic Corporate Activity

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.

(b) Ability and Willingness to Increase Leverage

Elering exhibits a relatively strong financial profile, which will, however, deteriorate with a 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.

(c) Targeted Proportion of Operating Profit Outside of the Core Regulated Business

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.

The historical financial performance of Elering 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 in 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.

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.

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.

OTHER GRI CONSIDERATIONS

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).

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 EUR 5.8 million in 2010. A further increase in the share capital of EUR 9.9 million was completed in September 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 very high level of dependence reflects the high correlation between economic development in Estonia and Elering's performance as the

company derives almost all its revenue from domestic activities.

Liquidity

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 30 June 2011, the company had EUR 30 million of cash and EUR 20 million of undrawn overdraft maturing in July 2012. Elering further benefits from committed lines from European Investment Bank (EIB) and Nordic Investment Bank (NIB) in the total amount of EUR 100 million which will be used to finance the construction of Estlink 2 cable.

In July 2011, the company's liquidity was enhanced by the issuance of the EUR 225 million, 4.625% notes due in 2018. The proceeds of the notes were used to re-finance the EUR 187 million bank facility maturing in December 2012 and finance the capital investment programme.

Moody's notes that Elering's bank facilities include financial covenants: equity/assets > 30% and net debt/EBITDA < 7.0x until 2015 and 6.0x thereafter. The company currently shows adequate headroom under its financial covenants (net debt/EBITDA was 3.3x and equity/assets was 38% as at 31 December 2010).

Rating Outlook

The rating has a stable outlook, reflecting Moody's expectation that Elering will maintain debt protection metrics above the minimum ratio guidance set for the current rating - namely, FFO interest cover of at least 3.5x and FFO/net debt in the mid teens in percentage terms.

What Could Change the Rating - Up

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.

What Could Change the Rating - Down

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. Downward pressure could also arise as a result of: (i) a deterioration in the credit quality of the Government of Estonia; (ii) a reduction of the support assumptions currently incorporated into Moody's assessment; or (iii) a materially unfavourable change in the regulatory framework leading to a significant increase in the company's business risk.

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 Cover (3 Year Avg)			X			
b) Net Debt / Fixed Assets (3 Year Avg)			X			
c) FFO / Net Debt (3 Year Avg)			X			
d) RCF / CAPEX (3 Year Avg)					X	
Rating:						
a) Indicated Rating from Grid			7 (A3)			
b) Actual BCA Assigned				(9) Baa2		

Government-Related Issuer	**Factor**
a) Baseline Credit Assessment	9 (Baa2)
b) Government Local Currency Rating	A1
c) Default Dependence	Very High
d) Support	High

[1] All ratios are calculated using Moody's Standard Adjustments. [2] As of 12/31/2010

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