MOODY'S
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Credit Opinion: Elering AS

Global Credit Research - 25 Apr 2014

Tallinn, Estonia

Ratings

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

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Key Indicators

[1]**Elering AS**

	12/31/2013	12/31/2012	12/31/2011
FFO Interest Coverage	**6.8x**	**5.8x**	**4.7x**
Net Debt / Fixed Assets	**49.1%**	**44.5%**	**41.3%**
FFO / Net Debt	**21.1%**	**26.1%**	**23.5%**
RCF / CAPEX	**0.3x**	**0.7x**	**0.6x**

[1] All ratios are calculated using Moody's standard accounting adjustments. Source: Moody's Financial MetricsTM

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

Opinion

Rating Drivers

- Low business risk profile of electricity transmission network operations

- High levels of capex are decreasing

- Financial metrics expected to deteriorate from the current strong levels

- Support from the Government of Estonia provides rating uplift

Corporate Profile

Elering AS is the owner and operator of Estonia's 5,223 km high-voltage electricity transmission system network. Its activities as a transmission system operator are regulated by the Estonian Competition Authority.

The Estonian electricity transmission network was built as part of the north-western common power system of the former Soviet Union and thus the average age of the transmission assets is around 30 years. The transmission

system is connected with Latvia and Russia, as well as with Finland through a submarine cable, Estlink 1 (350 megawatts (MW) and Estlink 2 (650 MW).

The company is 100% owned by the Government of Estonia (A1 stable).

SUMMARY RATING RATIONALE

Elering's rating is underpinned by (1) the low business risk profile of its electricity transmission network operations in Estonia; and (2) the historically supportive regulatory framework, which supports visibility of cash flows. The rating is, however, constrained by the company's small scale and expected increase in financial leverage following completion of the investment programme and in light of a reduction in allowed regulatory return.

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

DETAILED RATING CONSIDERATIONS

LOW BUSINESS RISK PROFILE OF ELECTRICITY TRANSMISSION NETWORK OPERATIONS

Elering's rating is underpinned by the regulated income stream earned from its electricity transmission assets.

We view the regulatory framework in Estonia as transparent and supportive of Elering's credit quality. Transmission network activities are subject to the regulation by the Estonian Competition Authority (ECA). Whilst the regulatory framework in Estonia is fairly well developed and based on generally used principles of a return on a regulated asset base (RAB), we note that the regulator took a lighter approach to regulation last year. There are no longer three-year regulatory periods and tariffs do not need to be adjusted on an annual basis. Such form of regulation gives the company more discretion in its approach to investments and tariffs. We note, however, that this regulatory approach remains untested.

As a general principle, Elering is allowed to cover its costs over time and realise a reasonable return based on the weighted average cost of capital (WACC) applied to the company's RAB. The cost of capital is reset every year due to changes in the underlying calculations of cost of debt and cost of equity. The WACC for 2014 was set at 6.74%, down from 7.81% a year earlier.

Elering's operating costs are no longer subject to efficiency requirements, a change from the previous regulatory period where the regulatory formula provided for a CPI-X (rate of inflation, measured by the consumer price index, minus expected efficiency savings X) allowance in the case of operating and maintenance costs. The current regulatory framework assumes that Elering's costs should generally not exceed inflation, except for uncontrollable costs.

Network losses are a pass-through based on last 12 month volumes and prices. We note that with the commissioning of the Estlink 2 cable this year, the amount of network losses is likely to be higher and this has been recognised by the regulator.

Exposure to volumes remains limited with the tariffs calculated based on the last three-year actual volumes, a change from one year applied until end 2013. If actual transmission volumes are higher, the company will be able to keep a realised profit. In the opposite case, Elering will incur lower income and will not be compensated.

HIGH LEVELS OF CAPEX ARE DECREASING

Elering's historical investments have been very high considering the company's size. Total capex in 2011-13 amounted to EUR355 million, with the last year spending reaching EUR203 million.

The largest projects included investments into the second undersea cable between Estonia and Finland - Estlink 2 (EUR160 million) and purchase of the Estlink 1 cable (EUR38 million). In addition, the company undertook construction of an emergency reserve power plant with a total capacity of 250 MW. The first 110MW stage of the plant was completed last year. This plant will not be used for daily production of electricity but will serve as a back-up facility fuelled by light fuel oil and natural gas. Until this reserve plant is completed, the capacity of interconnectors from Finland to Estonia will be limited to 860 MW instead of 1 GW.

Elering's capex commitments will be lower for the period 2014-18, as major investments are now completed or close to finalisation. Regular investments to replace the ageing transmission equipment and develop the grid in order to meet increased demand consumption amount to some EUR30 million per year. We note, however, that

Elering is also obliged 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. The current investment plans for the period until 2018 amount to EUR295 million.

FINANCIAL METRICS EXPECTED TO DETERIORATE FROM THE CURRENT STRONG LEVELS

In 2013, Elering reported a solid performance, with a 22% rise in regulated revenues to EUR134 million. The increase in revenues was mainly influenced by cross-border auctions which generated a profit of EUR14 million, an increase by EUR10 million on the previous year. Given that this profit is taken into consideration for the purpose of the regulated tariff calculation, Elering's average network tariff effective 1 April 2014 is 7.8% lower than a year before and as such is likely to result in lower cash flow generation this year.

With the implementation of the investment programme, Elering's debt increased to EUR312 million. As a result net debt/EBITDA went up to 4x from 3.3x in 2012. The company's funds from operations (FFO)/net debt stood at 21.1%.

With a further increase in debt used to finance the capex programme and a reduction in allowed return coupled with the above mentioned adjustment for the cross-border auction profit, we expect Elering's financial metrics to deteriorate from the current levels.

SUPPORT FROM THE GOVERNMENT OF ESTONIA PROVIDES RATING UPLIFT

Elering's A3 rating incorporates two notches of uplift for potential government support to its standalone credit quality: we express this as a baseline credit assessment (BCA) of baa2. The uplift to the BCA is a result of the credit quality of the government of Estonia, which owns 100% of Elering's shares, and also our assessment that there is a high probability of government support for the company in the event of financial distress.

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 government has a track record of providing support to the company. The Ministry issued two comfort letters to the creditors of long-term loans and increased the company's share capital by EUR5.8 million in 2010 and further EUR9.9 million in September 2011.

Overall, we consider 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.

Liquidity Profile

As of 31 December 2013, Elering's liquidity was supported by (1) EUR1.2 million of cash, (2) a EUR20 million undrawn debt facility with a final maturity in July 2016, and (3) EUR35 million available to be drawn under term loans.

Elering does not have any near-term debt maturities. The outstanding debt is primarily related to the company's EUR225 million 4.625% notes due in 2018 as well as drawdowns under the European Investment Bank (EIB) and the Nordic Investment Bank (NIB) facilities, which have a scheduled debt amortisation profile.

Given the planned investments and some reduction in operating cash flows, we expect the company to raise additional funding in the near term to support its liquidity.

We note that the EIB and NIB facilities include the following financial covenants: equity/assets of more than 30% and net debt/EBITDA of less than 7.0x until 2015, and 6.0x thereafter. The company exhibits adequate headroom under its financial covenants (net debt/EBITDA was at 4x and equity/assets was at 41% as at 31 December 2013).

Rating Outlook

The stable rating outlook reflects our expectation that Elering will exhibit financial profile that will be commensurate with the current rating.

What Could Change the Rating - Up

Before considering any upward move, we would require evidence that Elering's credit metrics were improving on a sustainable basis, with funds from operations (FFO) interest cover above 4.5x and FFO/net debt in the 20s 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 FFO/net debt were to decline to the low teens (in percentage terms) for a sustained period. Downward pressure could also be exerted on the rating as a result of (1) a deterioration in the credit quality of the government of Estonia; (2) a reduction in the support assumptions currently incorporated into our assessment; or (3) a materially unfavourable change in the regulatory framework leading to a significant increase in the company's business risk.

Other Considerations

METHODOLOGY GRID:

Elering's rating reflects the application of Moody's Rating Methodology for Government-Related Issuers (GRIs). The company's rating incorporates two notches of uplift for potential government support to its standalone credit quality: we express this as a baseline credit assessment (BCA) of baa2. The uplift to the BCA is a result of the credit quality of the government of Estonia, which owns 100% of Elering's shares, and also our assessment that there is a high probability of government support for the company in the event of financial distress, as well as a very high level of default dependence (i.e., the degree of exposure to common drivers of credit quality).

When assessing Elering's BCA, we apply our Rating Methodology for Regulated Electric and Gas Networks, published in August 2009. The company's historical financial performance indicates a BCA of a3. This compares with a BCA of baa2 assigned to Elering.

Rating Factors

Elering AS

Regulated Electric and Gas Networks	**Current**		[1]**Moody's 12-18 months forward viewAs of 4/25/2014**	
Factor 1: Regulatory Environment & Asset Ownership Model (40%)	Measure	Score	Measure	Score
a) Stability and Predictability of Regulatory Regime		A		A
b) Asset Ownership Model		Aa		Aa
c) Cost and Investment Recovery		A		A
d) Revenue Risk		A		A
Factor 2: Efficiency & Execution Risk (10%)				
a) Cost Efficiency		Baa		Baa
b) Scale and Complexity of Capital Programme		Baa		Baa
Factor 3: Stability of Business Model & Financial Structure (10%)				
a) Ability and Willingness to Pursue Opportunistic Corporate Activity		A		A
b) Ability and Willingness to Increase Leverage		Baa		Baa
c) Targeted Proportion of Operating Profit Outside Core Regulated Activities		Aa		Aa
Factor 4: Key Credit Metrics (40%) [2][3]				
a) FFO Interest Cover (3 Year Avg)	5.8x	Aa	4.9x - 5.3x	A
b) Net Debt / Fixed Assets (3 Year Avg)	45.6%	A	47% - 51%	A
c) FFO / Net Debt (3 Year Avg)	23.2%	Aa	14%-15%	A
d) RCF / CAPEX (3 Year Avg)	0.5x	B	0.5x - 1x	Ba
Rating:				
a) Indicated Rating from Grid		a3		a3

b) Actual BCA Assigned		baa2		baa2

Government-Related Issuer	Factor
a) Baseline Credit Assessment	baa2
b) Government Local Currency Rating	A1
c) Default Dependence	Very High
d) Support	High

[1] This represents Moody's forward view; not the view of the issuer; and unless noted in the text, does not incorporate significant acquisitions and divestitures [2] As of 12/31/2013, average 2013-2011 [3] All ratios are calculated using Moody's Standard Adjustments; Source: Moody's Financial Metrics

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