

Rating Action: Moody's assigns A3 rating to Elering; stable outlook

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First-time rating

London, 24 May 2011 -- Moody's Investors Service has today assigned an A3 issuer rating to Elering AS ("Elering"), an electricity transmission system owner and operator in Estonia. The rating has a stable outlook. This is the first time that Moody's has assigned a rating to Elering.

RATINGS RATIONALE

The A3 rating assigned to Elering reflects (i) the low business risk profile of its regulated electricity transmission network operations in Estonia carried out under a transparent, albeit relatively new, regulatory framework; (ii) the expected large capital investment programme of the company which will gradually increase its financial leverage from initially moderate levels; and (iii) a two-notch uplift reflecting the potential support from Elering's 100% owner, the Government of Estonia (A1, stable).

The assets and operations of the electricity transmission system were established as a subsidiary of Eesti Energia -- the country's largest vertically integrated utility -- in April 2004. In order to ensure complete independence of the transmission network operator from electricity production and sales activities, the Government of Estonia decided to take full ownership of Elering in November 2009. Consequently, the Government of Estonia has been the company's sole shareholder since January 2010.

The assessment of a low business risk profile is based on the stable and predictable nature of Elering's cash flows from its regulated monopolistic transmission system operations under a transparent regulatory framework established in 2004. The three-year regulatory settlements define the company's revenue based on formulae designed to cover operating costs and a fair return on its investments. However, Moody's rating 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.

Moody's notes that Elering plans a significant investment programme over the period to 2015. The company's spending is projected to total EUR475 million and will primarily relate to the expansion and reinforcement of the grid, international interconnectors and an increase in reserve capacity. Elering will acquire about 50% of the assets of the Estlink 1 submarine cable between Estonia and Finland, which has been operational since 2006. Furthermore, the company will build, together with Fingrid (Finnish transmission grid operator, rated A1 with negative outlook), the second interconnector -- Estlink 2, which is expected to be completed by 2014.

Elering's investment peak is expected in 2013, when the company's total spending will amount to more than EUR140 million, which compares with historical levels of approximately EUR30 million per annum. Moody's notes that the majority of the investment will be in the current regulatory period 2011-13 and therefore is recognised in the development of tariffs, which should mitigate its negative impact on Elering's financial profile, in the rating agency's view. However, Moody's expects the debt requirements associated with this large-scale investment plan and associated funding costs to weigh on the company's debt metrics. Therefore, the rating agency expects Elering's execution of its capital investment programme to cause its financial metrics to fall from their current strong levels.

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 the methodology, Elering's rating incorporates an uplift to reflect potential government support to its standalone credit quality, which is expressed by Moody's as 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 uplift to the BCA, currently at two notches, results from the credit quality of its government shareholder and Moody's assessment of a high probability of government support in the event of financial distress as well as very high default dependence (i.e. the degree of exposure to common drivers of credit quality).

The stable outlook on the A3 rating is based on Moody's view that Elering's medium-term financial profile will reflect a gradual increase in leverage as investments are completed, but nevertheless within the minimum financial parameters -- namely, funds from operations (FFO) interest cover above 3.5x and an FFO/net debt ratio in the mid-teens -- which the rating agency considers to be commensurate with the assigned rating.

The rating could come under downward pressure if Elering's FFO interest cover were to fall below 3.5x and/ or the FFO/net debt ratio were to decline to low teens on a sustainable basis 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 and/ or a reduction of the support assumptions currently incorporated into Moody's assessment. Although unlikely in the short 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 an FFO/net debt ratio in the twenties in percentage terms.

The principal methodologies used in rating Elering were "Regulated Electric and Gas Networks", published in August 2009, and "Government Related Issuers: Methodology Update", published in July 2010.

Headquartered in Tallinn, Estonia, Elering AS is the owner and operator of the Estonia's high-voltage electricity transmission network. Elering generated EUR89 million in revenues in the year ended December 2010.

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London
Joanna Fic
Analyst
Infrastructure Finance
Moody's Investors Service Ltd.
JOURNALISTS: 44 20 7772 5456
SUBSCRIBERS: 44 20 7772 5454

London
Andrew Blease
Senior Vice President
Infrastructure Finance
Moody's Investors Service Ltd.
JOURNALISTS: 44 20 7772 5456
SUBSCRIBERS: 44 20 7772 5454

Moody's Investors Service Ltd.
One Canada Square
Canary Wharf
London E14 5FA
United Kingdom
JOURNALISTS: 44 20 7772 5456
SUBSCRIBERS: 44 20 7772 5454



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