FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Poland's Tauron at 'BBB-'; Outlook Stable

Wed 12 Oct, 2022 - 1:08 PM ET

Fitch Ratings - Warsaw - 12 Oct 2022: Fitch Ratings has affirmed TAURON Polska Energia S.A.'s (Tauron) Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDRs) at 'BBB-'. The Outlook on the IDRs is Stable. A full list of rating actions is below.

The rating affirmation reflects a continuing dominant share of regulated and predictable electricity distribution in Tauron's business profile, solid market position and projected leverage within rating guidelines. We view Tauron's planned divestments of coal-fired power plants and coal mines to the Polish state as credit positive.

Tauron's main risk relates to weaker profitability in generation and insufficient compensation from the state's plan for capping retail electricity prices in 2023 at their current level, despite a substantial increase in the cost of electricity production.

KEY RATING DRIVERS

High Share of Regulated Business: The ratings reflect a high share of regulated electricity distribution with good predictability in Tauron's EBITDA (73% in 2021 and about 60% on average over our forecast period of 2022-2026) and the company's position as the largest electricity distributor in Poland covering southern, densely populated regions. The regulatory framework in Poland is stable and has further improved with the introduction of a regulatory account from 2021, which offsets volume risk.

Expected Weaker Profitability for Generation: We expect substantial deterioration in Tauron's 2022 EBITDA in conventional generation mainly due to an increase in fuel prices. This is because most of the electricity sold for 2022 has a price contracted one year before delivery, while the cost of generation, particularly the coal price, has increased considerably in recent months due to a tighter demand-supply balance partly due to a ban on Russian coal. The ban has increased demand for domestic coal while reducing supply for energy groups, with the latter leading to demand for more expensive imported coal. Tauron has set up a PLN943 million provision in its 1H22 financial statements for losses in the generation segment.

Nowe Jaworzno Adds Generation Woes: Tauron's new generation unit in Nowe Jaworzno had operational issues resulting in several unscheduled maintenance shutdowns during the year. As the unit's planned generation volumes were sold on the forward market, the missing volumes had to be replaced with purchases on the spot market at significantly higher prices. Losses in generation are only partly offset by profits in the mining segment, driven by increase in coal prices and demand.

Supply Under Pressure: Tauron's supply business (averaging 10% of 2017-2021 EBITDA) may come under pressure from 2023, if the company is not allowed to pass on higher purchase costs of electricity to retail customers, as envisaged under the government initiative to cap prices for households in 2023 at their current level, without full reimbursement from the state. The government has announced that it is working on a support mechanism, but important details are yet to be determined.

Divestment of Mining Positive: Fitch views the sale of Tauron's three coal mines to the state by end-2022 (for a symbolic amount of PLN1) as positive for Tauron's business mix and financial profile. The sale is also consistent with the company's strategy and in line with the reform of the Polish conventional energy sector. Although the hard-coal mining segment turned profitable in 1H22 due to a sudden increase in coal prices on the global commodity exchanges following an embargo on coal delivered from Russia, it has been structurally loss-making in the last six years and is viewed by Fitch as even a higher-risk segment than coal-fired generation.

Advantageous Spin-Off of Coal-Fired Units: Fitch has not included the planned divestments of the company's coal-fired power plants to a state-controlled National Agency for Energy Security (NABE) in its rating case as the key transaction terms, including the price and payment terms, have not yet been agreed on.

Fitch believes the divestment will improve Tauron's business profile by eliminating high-risk coal-fired electricity generation from the business mix and allowing Tauron to focus on more predictable, regulated electricity distribution and renewable generation. The transaction is likely to lead to higher debt capacity for the current rating and improved ESG Relevance Scores.

Shift to Renewables: Tauron aims to invest in renewables that would increase renewable capacity to 1.6GW in 2025 and 3.7GW in 2030, from 0.6GW at end-2021. It targets mostly investments in onshore and offshore wind, and photovoltaics. We expect the share of renewables in EBITDA to increase to about 10% on average in 2022-2026 from an average of 8% in 2020-2021. Once the spin-off of the coal-fired assets is completed, the renewable segment will become even more important for Tauron's new business model with its EBITDA share growing towards 15% in the medium-to-long term.

Rated on a Standalone Basis: Tauron is 30%-owned and effectively controlled by the Polish state (A-/Stable). Based on Fitch's Government-Related Entities (GRE) Rating Criteria, we assess status, ownership and control links as 'Strong', support record as 'Weak', socio-political impact of a default as 'Moderate', but the financial implications of a default as 'Weak'. Consequently, we do not apply any rating uplift for its links with the Polish state.

DERIVATION SUMMARY

Tauron's close peer group includes the three other electricity-focused integrated utilities in Poland, which are PGE Polska Grupa Energetyczna S.A. (PGE; BBB+/Stable), ENEA S.A. (BBB/Stable) and Energa S.A. (BBB-/RWP).

Tauron and Energa have comparable business profiles benefitting from the large share of regulated distribution in EBITDA, which provides good cash flow visibility. However, Tauron has a greater share of hard-coal fired generation in its business profile, which is currently under pressure. Tauron also controls a mining division, which has been loss-making in the past six years, except for 1H22, and has a negative impact on credit risk.

As a result, we assess that Energa has a more sustainable business profile, which is reflected in its higher debt capacity, with a negative rating sensitivity of 5.0x for its Standalone Credit Profile of 'bbb-' compared with 4.5x for Tauron. Energa's IDR is equalised with that of its parent, PKN ORLEN S.A. (BBB-/RWP).

PGE is Poland's largest utility company and has the lowest leverage among the peer group. It derives most of its EBITDA from electricity generation and has a high share of lignite in the generation fuel mix, which provides cost advantage over hard coal-fired peers. Due to a sudden increase in hard coal prices, Tauron and Enea are not able to fully reflect rising generation costs in prices of electricity contracted a year ahead, while PGE is less exposed to this mismatch as it has a high share of lignite-fired generation in its electricity mix. Lignite is priced domestically and has smaller fluctuations of prices.

ENEA has a lower share of regulated distribution than Tauron and Energa and at the same time higher exposure to hard coal-fired generation, but controls a profitable mining business. The maximum leverage sensitivity for ENEA's 'BBB' rating is 3.0x.

KEY ASSUMPTIONS

Fitch's Key Assumptions Within Our Rating Case for the Issuer:

- Following disposal of mining subsidiary a lack of EBITDA contribution from mining in 2023-2026

- Higher CO2, hard coal and gas prices passed on to wholesale electricity prices in Poland

- Weighted-average cost of capital (WACC) in the distribution segment at 5.78% in 2022, 6.64% in 2023, 6.8% in 2024, 7.93% in 2025, 7.68% in 2026 (in 2022-2023 WACC includes reinvestment premium at 1.1%)

- Capex at PLN23.5 billion over 2022-2026

- No dividend payments in 2022-2026

- The six-month Warsaw interbank offered rate at an average of 6.1% in 2022-2026

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

- FFO net leverage below 3.5x on a sustained basis

- A more diversified fuel generation mix, for example through divestment of coal assets to NABE or investments in renewable generation

- Increased focus on regulated and quasi-regulated business in capex and overall strategy

Factors that could, individually or collectively, lead to negative rating action/downgrade:

- FFO net leverage above 4.5x and FFO interest cover below 5x on a sustained basis, for example due to higher capex or acquisitions, reinstatement of dividends, unfavourable conditions for the coal assets' spin-off to NABE or problems in getting a waiver for a covenant breach

- Weaker EBITDA or working-capital outflows, for example due to economic downturn, under-performance of mining or coal-fired generation, or tariff deficit

- Weakening of business profile, for example due to delays in implementation of strategy or increased exposure to higher-risk businesses

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Non-Financial Corporate issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

LIQUIDITY AND DEBT STRUCTURE

Adequate Liquidity: At end-June 2022 Tauron had PLN702 million of Fitch-calculated readily available cash as well as PLN6,815 million of committed credit facilities. This was against debt maturities of PLN1,779 million in 2H22 and PLN284 million in 2023 as well as Fitch-expected negative free cash flow over 2022-2023, driven by capex. The company has sufficient liquidity until end-2023.

Adequate Covenant: Tauron has adequate headroom under the main covenant included in its debt arrangements of net debt-to-EBITDA of up to 3.5x. Its net debt-to-EBITDA increased to 2.9x at end-June 2022 from 2.4x at end-2021, due to deterioration of EBITDA in 1H22.

ISSUER PROFILE

Tauron is the second-largest electric utility in Poland by EBITDA (after PGE and marginally before ENEA). The company is focused on electricity distribution, which is complemented by electricity generation, supply of electricity and gas and hard-coal mining.

SUMMARY OF FINANCIAL ADJUSTMENTS

Fitch-adjusted debt calculation included guarantees for the ECSW gas-fired power plant joint venture.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Tauron has ESG Relevance Scores of '4' 'GHG Emissions & Air Quality' and 'Energy Management'. This is due to the dominant share of hard coal in its electricity generation mix, which is carbon-intensive and under regulatory pressure in the EU. These issues have a negative impact on the credit profile, and are relevant to the ratings in conjunction with other factors.

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

RATING ACTIONS

ENTITY / DEBT	RATING			PRIOR
TAURON Polska Energia S.A.	LT IDR	BBB- Rating Outlook Stable	Affirmed	BBB- Rating Outlook Stable
	ST IDR	F3	Affirmed	F3
	LC LT IDR	BBB- Rating Outlook Stable	Affirmed	BBB- Rating Outlook Stable
	LC ST IDR	F3	Affirmed	F3

	Natl LT	A(pol) Rating Outlook Stable	Affirmed	A(pol) Rating Outlook Stable
senior unsecured	LT	BBB-	Affirmed	BBB-
subordinated	LT	BB	Affirmed	BB
subordinated	Natl LT	BBB(pol)	Affirmed	BBB(pol)

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Government-Related Entities Rating Criteria (pub. 30 Sep 2020)

Corporate Hybrids Treatment and Notching Criteria (pub. 12 Nov 2020)

National Scale Rating Criteria (pub. 22 Dec 2020)

Corporates Recovery Ratings and Instrument Ratings Criteria (pub. 09 Apr 2021) (including rating assumption sensitivity)

Corporate Rating Criteria (pub. 15 Oct 2021) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Corporate Monitoring & Forecasting Model (COMFORT Model), v8.0.3 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

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Corporate Finance Utilities and Power Europe Poland