

Fitch Rates Poland's Tauron's Domestic Bonds 'A(pol)' [Ratings](#) [Endorsement Policy](#)

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Fitch Ratings-Warsaw/London-05 November 2014: Fitch Ratings has assigned TAURON Polska Energia S.A.'s (Tauron, BBB/Stable) PLN1.75bn five-year domestic bonds a final National senior unsecured rating of 'A(pol)'. A full list of ratings is available at the end of this commentary.

The bonds are rated at the same level as Tauron's National Long-term rating as they constitute the company's direct senior unsecured obligations. The bonds were issued under Tauron's PLN5bn bond issue programme and have a floating coupon of six-month WIBOR plus 90 basis points.

Tauron's ratings reflect the company's leading position in Poland's electricity distribution and strong position in power generation. At the same time, the ratings are constrained by the worsening financial performance of the generation segment, concentrated generation fuel mix (mostly coal-fired plants) and Fitch's forecasts of a weakening of credit metrics for 2014-2018, mostly due to replacement and expansionary capex in the generation segment.

KEY RATING DRIVERS

Strong Market Position

Tauron maintains its position as the second-largest utility in Poland by revenue and EBITDA after PGE Polska Grupa Energetyczna (PGE, BBB+/Stable). With 47.9TWh of electricity distributed in 2013 it is the largest distributor in Poland and its 5.4GW of installed capacity is second only to PGE's 12.8GW.

High Share of Regulated Business

Tauron's creditworthiness continues to benefit from a high EBITDA contribution from regulated electricity distribution (60% of total EBITDA in 2013, up from 51% in 2012). This contributes to cash flow visibility. Until new power generation units come on stream to boost the performance of the weak generation segment Fitch expects the share of Tauron's regulated EBITDA to remain over 60% in the medium term, elevated by the regulatory asset base (RAB) remuneration process and increased grid revenue due to large capex in distribution.

Weaker Generation Environment

Fitch expects the generation segment to remain under pressure in the medium term, due to the obligation to purchase a growing amount of CO2 allowances at market prices rather than receiving them for free; full exposure to the volatility of wholesale electricity market prices after expiration of the PPA compensation mechanism; and decommissioning of old generation units.

Weak Generation Fleet

The ratings are constrained by the group's lack of generation fuel mix diversification (coal-fired plants account for 92% of generation capacity), which is unlikely to change materially before 2018, as well as by the significant age of the generation fleet, which will result in the decommissioning of its plants by approx. 1.5GW, out of the currently installed 5.4GW, by 2019. However, Tauron's generation activity benefits from having 35% of its fuel needs met by the group's own coal mines.

Large Capex

Tauron's capex will further increase until 2018, mostly in the generation segment. In the latest strategy update in June 2014 Tauron announced plans to spend approx. PLN37bn in 2014-2023. Fitch rating case assumes capex of about PLN28bn until 2020. The single largest investment project is the Jaworzno III 910 MW coal-fired power plant (net investment of PLN4.4bn) whose construction started in 2H14 and should complete in 2018. Another large generation project is in Lagisza (450MW), in cooperation with Polskie Inwestycje Rozwojowe and should also be finalised by end-2018. The net effect of decommissioning and investments in generation should allow Tauron to increase installed capacity to 6.1GW in 2023 from the current 5.4GW and increase the share of modern coal-fired power plants with lower CO2 emissions in the generation mix.

Nuclear Project

Tauron has also agreed to acquire a 10% stake in an SPV established to build and operate the first nuclear power plant in Poland. Decision on the construction is expected in 2017. We assume that any substantial cash outflows related to the nuclear project will not occur over the five-year rating horizon and therefore have not been included in the Fitch rating case. We will assess the rating impact of the nuclear project on Tauron and other companies involved in the project once its size and structure, and the impact on leverage, are known, together with details of a probable support scheme for the project's cash flows such as capacity payments or contracts for difference. Implementation of the nuclear project without a support scheme could put negative pressure on the ratings.

Net Leverage to Increase

Fitch forecasts a gradual deterioration of the credit metrics over 2014-2018, due to the large partially debt-financed capex plans. According to Fitch's projections, funds from operations (FFO) adjusted net leverage will increase to around 3x in 2017 from 1.4x in 2013. The net leverage ratio may temporarily exceed 3x in 2017 or 2018 until new generation units are commissioned in 2019, increasing FFO and lowering leverage.

RATING SENSITIVITIES

Positive: Rating upside potential for Tauron is limited due to the company's business profile and large capex plans. However, future developments that could lead to positive rating actions include:

- A successful implementation of the capex plans in the long term without jeopardising the financial profile, together with operating cost reduction, a more diversified fuel mix in generation and substantially reduced exposure to CO2 costs

Negative: Future developments that could lead to negative rating action include:

- Increase in FFO adjusted net leverage to above 3x on a sustained basis - for example, due to full implementation of capex and weaker-than-expected operating cash flows

LIQUIDITY & DEBT STRUCTURE

Tauron's liquidity was adequate at end-June 2014 with unrestricted cash and equivalents of PLN92m and fully committed funding of PLN3.4bn. This is sufficient to cover short-term debt of PLN355m and negative free cash flow of PLN0.9bn projected by Fitch for 2014. The first significant debt repayments are in 2015 (PLN1.5bn) and 2016 (PLN3.2bn). Yesterday's PLN1.75bn five-year bond issue has improved the company's debt maturity profile.

FULL LIST OF RATINGS:

Long-term foreign and local currency Issuer Default Ratings (IDRs) of 'BBB'; Outlook Stable

Short-term foreign and local currency IDRs of 'F3'

National Long-term rating of 'A(pol)'; Outlook Stable

National senior unsecured rating of 'A(pol)'

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Additional information is available on www.fitchratings.com. For regulatory purposes in various jurisdictions, the supervisory analyst named above is deemed to be the primary analyst for this issuer; the principal analyst is deemed to be the secondary.

Applicable criteria, 'Corporate Rating Methodology: Including Short-Term Ratings and Parent and Subsidiary Linkage', dated 28 May 2014, are available at www.fitchratings.com.

Applicable Criteria and Related Research:



[Corporate Rating Methodology - Including Short-Term Ratings and Parent and Subsidiary Linkage](#)

Additional Disclosure

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