# Fitch Affirms TAURON at 'BBB'; Outlook Stable

Ratings Endorsement Policy

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Fitch Ratings-Warsaw/London-18 July 2014: Fitch Ratings has affirmed TAURON Polska Energia S.A.'s (Tauron) Long-term foreign and local currency Issuer Default Ratings (IDR) at 'BBB' with Stable Outlooks.

The ratings reflect Tauron'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) 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
In 2013 Tauron's generation segment was under pressure due to the termination of compensations for long-term power purchase agreements (PPA), asset impairment charges as well as lower wholesale market electricity prices. Fitch expects the generation segment to remain under pressure in the medium term, due to the obligation to purchase a growing amount of $CO_2$ allowances at market prices rather than receiving them for free; full exposure to the volatility of the 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 approx. 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 is expected to start in 2H14 and 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.

In addition Tauron will acquire a 10% stake in an SPV established to build and operate the first nuclear plant in Poland. However, the final decision with respect to the construction of the nuclear plant and to any substantial cash outflows related to this project is not expected within the five-year rating horizon and have not been included in Fitch rating case.

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.

LIQUIDITY & DEBT STRUCTURE

Tauron's liquidity was adequate at end-March 2014 with unrestricted cash and cash equivalents of PLN237m and fully committed available funding of PLN3.3bn. This is sufficient to cover short-term debt of PLN631m and negative free cash flow of around PLN0.9bn projected by Fitch for 2014.

Available committed funding includes domestic bond issue programmes fully underwritten by commercial banks (PLN2.7bn) and by Bank Gospodarstwa Krajowego (PLN0.5bn). First significant debt repayments are scheduled for 2015 (PLN1.5bn) and 2016 (PLN3.2bn).

RATING SENSITIVITIES

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

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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**

Solicitation Status