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

Fitch Ratings-Warsaw/London-16 July 2015: 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. A full list of ratings is available at the end of this commentary.

The affirmation reflects a high share of the regulated distribution business in Tauron's EBITDA (around 60%), which contributes to cash flow predictability and stabilises cash flows at a time when conventional power generation, another key segment, is under pressure.

The ratings incorporate a balance of risks between a fairly stable regulated distribution segment and a generation business, which faces a challenging operating environment, low margins and limited generation fuel mix diversification with a high reliance on coal.

We project that Tauron's large capex plans will increase funds from operations (FFO) adjusted net leverage to about 3.5x in 2017 from 2.3x in 2014. We view net leverage of 3.5x as the maximum level for the ratings.

KEY RATING DRIVERS

High Share of Regulated Business
Tauron's creditworthiness benefits from a high EBITDA contribution from regulated electricity distribution (around 60% of total EBITDA in 2014 and 2013, up from 51% in 2012). This contributes to cash flow visibility. We expect the share of distribution to increase to 65% in 2015-2017 at the expense of the generation segment. The share of distribution may slightly decrease in 2018-2019 when new power generation units come on stream to boost the performance of the weak generation segment.

Challenging Generation Environment
Fitch expects the generation segment to remain under pressure in 2015-2016 due to low wholesale electricity prices, declining free CO2 allowances, and a rising share of renewables supported by subsidies. Tauron's generation is fully exposed to the volatility of wholesale electricity market prices following the expiry of the long-term power purchase agreements (PPA) compensation mechanism in 2013. Since 2014 Tauron has benefited from additional remuneration for some of its coal-fired units under the operational capacity reserve mechanism with transmission system operator, PSE S.A.

The impact of a challenging conventional generation environment is mitigated by Tauron's ongoing savings programme focused on the generation segment. We do not view the structural change in the Polish generation market as rapid and far-reaching as in Germany and highlight that interconnections are also improving only gradually, giving domestic players time to adjust.

Some Weaknesses in Regulatory Framework
Fitch views the regulatory framework for Polish distribution networks as supportive and stable. However, compared with some western European countries, Poland's regulatory framework is weaker. This includes the lack of a multi-year tariff-setting mechanism, and exposure to unexpected regulatory decisions, such as 5% reduction in return on capital in 2015. There is also volume risk within the framework; for example, lower-than-expected distribution volumes reduce the distribution segment's EBITDA.

Some of the regulatory constraints have been addressed by the energy regulatory office. These include gradually increasing the return on the regulatory asset base (RAB) since 2010, and achieving a full return on the RAB in 2014. In addition the gap between operating costs and costs approved by the regulator has been reduced, helped by Tauron's cost reduction programme in distribution, leading to stronger cost recovery in tariffs.

Weak Generating Diversification
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 age of the generation fleet, which will result in the decommissioning of 1.5GW of capacity by 2019, out of 5.4GW currently.

The company's heavy coal-fired bias exposes its cash flow to rising CO2 costs, which is partially mitigated by the gradual phasing-out of free CO2 allowances in Poland in 2013-2020. Tauron's generation activity benefits from having around 40% of its fuel needs being met by the group's own coal mines.

Strong Market Position
Tauron is the second-largest utility in Poland by revenue and EBITDA after PGE Polska Grupa Energetyczna S.A. (PGE, BBB+/Stable). With 45TWh of electricity distributed in 2014 it is the largest distributor in Poland and its 5.4GW of installed capacity is second only to PGE.

Large Capex
Tauron plans to invest PLN37bn in 2014-2023. Tauron's 2015-2019 capex plan is allocated mostly to the distribution segment (49% of total capex) for network upgrades and expansion, and to the generation segment (44%) for replacement and expansionary capex.

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 2019. Another large generation project is a gas-fired plant in Lagisza (450MW), in cooperation with Polskie Inwestycje Rozwojowe and should also be finalised by 2019. 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 acquired a 10% stake in an SPV established to build and operate the first nuclear power plant in Poland. A decision on the construction is expected in 2017-2018. 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.

Implementation of the nuclear project without a support scheme could put negative pressure on the ratings. However, 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 price difference.

Reassessment of Leverage Guidelines

We view the increased proportion of cash flow contribution from regulated distribution as improving Tauron's business risk. As a result of the increased importance of the distribution segment we have widened the negative rating guidance for the 'BBB' rating to 3.5x from 3x.

We view regulated distribution as a lower risk business than generation, allowing for higher debt capacity. We assume that, for the 'BBB' rating category, Tauron's regulated distribution (59% of 2014 EBITDA) can support FFO adjusted net leverage of about 5x, while Tauron's generation segment (23% of 2014 EBITDA), comprising heat production, conventional power generation, renewables and mining supports FFO net leverage of about 2x. We expect the share of distribution to increase to 65% in 2015-2017 at the expense of the generation segment (18% of 2015-2017 EBITDA).

Net Leverage to Increase

Fitch forecasts a gradual deterioration of the credit metrics over 2015-2018, due to the large partially debt-financed capex plans. According to Fitch's projections, FFO adjusted net leverage will increase to around 3.5x in 2017 from 2.3x in 2014. The net leverage ratio may temporarily exceed 3.5x in 2017 or 2018 until new generation units are commissioned in 2019, increasing FFO and lowering leverage.

Financial Covenants under Pressure

Fitch expects the company's net debt-to-EBITDA to be close to or above 3x in 2016-2018, which is the covenant embedded in some financing arrangements. We assume that Tauron will renegotiate and increase the level of financial covenants in a timely manner or adjust its capex plan so as not to breach the covenant. Failure to renegotiate the covenant well ahead of a possible covenant breach may be negative for Tauron's liquidity and for the ratings.

Rated on Standalone Basis

Tauron is 30.06%-owned and effectively controlled by the Polish state (A-/Stable), but Fitch rates it on a standalone basis with no rating uplift from state ownership factored in. The company operates on a wholly commercial basis and we assess legal, operational and strategic links with the state as moderate, in line with our Parent and Subsidiary Rating Linkage criteria.

KEY ASSUMPTIONS

Fitch's key assumptions within our rating case for the issuer include:

- No major shifts in wholesale electricity prices within the forecast period
- Recovery in coal prices for Tauron to 2013's levels and around 50% increase in CO2 market price within a five-year rating horizon
- Electricity production volumes to rise from 2019 due to commissioning of the 413MW Lagisza gas-fired power plant and the 910MW Jaworzno III coal-fired power plant
- Stable distribution and sales volumes
- Capex in the range of PLN21bn in 2015-2019

RATING SENSITIVITIES

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

- A more diversified fuel generation mix and lower CO2 emissions per MWh which, together with continued efficiency improvements, would result in a stronger business profile

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

- Increase in FFO adjusted net leverage to above 3.5x on a sustained basis - for example, due to full implementation of capex and weaker-than-expected operating cash flows
- Acquisitions of stakes in coal mines or other form of support for state-owned mining companies under financial pressure, such as Kompania Weglowa - leading to net leverage above 3.5x or substantially worsening Tauron's business profile

LIQUIDITY AND DEBT STRUCTURE

Tauron's liquidity is sufficient. At end-March 2015, the company had PLN944m of unrestricted cash and equivalents and PLN3.4bn of committed funding against short-term debt of PLN650m. Fitch projects negative free cash flow close to PLN2bn for 2015.

The company faces a large debt maturity of PLN3bn in December 2016, which comprises bonds issued within the bond programme underwritten by banks. We expect Tauron to cover this maturity with its available liquidity at least 12 months ahead of the due date. The company plans to refinance the bond programme in the next few months, which will enable it to cover the PLN3bn maturity.

In July 2015 Tauron increased committed funding by PLN300m (in the form of a bond programme underwritten by Bank Gospodarstwa Krajowego).

Bonds account for the majority of debt (84% of total debt) at end-March 2015. This includes bonds issued within the programmes underwritten by banks (PLN4.2bn), domestic bonds of PLN1.75bn issued in 4Q14 and bonds issued on the German market (EUR168m, i.e. PLN0.7bn) in 4Q14.

FULL LIST OF RATING ACTIONS:

Long-term foreign and local currency IDRs affirmed at 'BBB'; Outlook Stable
Short-term foreign and local currency IDRs affirmed at 'F3'
National Long-term rating affirmed at 'A(pol)'; Outlook Stable
National senior unsecured rating affirmed at '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 (pub. 28 May 2014) (https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=749393)

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