Research Update:

Estonian Utility Eesti Energia Outlook Revised To Negative On Weaker Credit Metrics; 'BBB-' Rating Affirmed

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PRIMARY CREDIT ANALYST

Pauline Pasquier
Paris
+ 33 14 420 6771
pauline.pasquier
@spglobal.com

SECONDARY CONTACT

Per Karlsson
Stockholm
+ 46 84 40 5927
per.karlsson
@spglobal.com

Rating Action Overview

- We believe the operating performance of Eesti Energia's merchant power generation and supply activities will weaken from the very high levels seen in first-half 2023. This is due to more normalized power prices, the rollover of one-year hedges as well as the steep decline in electricity production from unprofitable oil shale plants.
- We forecast the company's profitability could gradually recover from 2025, thanks to the ramp-up of its greener and more contracted generation fleet. However, the pace of renewable development, future volatility of cash flows, and remuneration mechanism for base load thermal units are uncertain.
- We anticipate cumulative negative discretionary cash flow of €1 billion over 2023-2025, due to sustained high annual capital expenditure of €550 million-€750 million to support the transition toward renewables and the €300 million-€350 million mark-to-market derivatives cash drain in 2023 that push S&P Global Ratings-adjusted funds from operations (FFO) to debt below 25%.
- As a result, we revised the rating outlook on Eesti Energia to negative from stable and affirmed the 'BBB-' issuer credit rating.
- The negative outlook indicates we could lower the rating if FFO to debt remains sustainably below 25% with no prospect of recovery over the next two years and without a material improvement in the contracted share of EBITDA and profitability of Eesti Energia's generation activities.

Rating Action Rationale

We expect Eesti Energia's margins to deteriorate in 2024 due to lower power prices weakening Eesti Energia's generation business and the rollover of hedges. Our revised base-case scenario includes Nordpool power prices at around €100 per megawatt hour (/MWh) in 2024-2025. This remains a robust level and in line with that in 2023, but the rollover of hedges signed when power prices were higher, at around €200/MWh during 2022, leads us to assume the group will generate €330 million-€370 million S&P Global Ratings-adjusted EBITDA in 2024, down from €500 million-€540 million in 2023. Furthermore, as oil shale units become unprofitable at below €120-€140/MWh, we expect Eesti Energia's power production to fall from 2023. Therefore, the company's overall margins will deteriorate as electricity purchases at market price increase as production volumes will be significantly lower than the supply volumes sold, weakening its integrated position. In 2023, oil shale constituted about 60% of Eesti Energia's total 4 gigawatt-hour of production and was also the most polluting part of its production.

2025 EBITDA should benefit from increased contracted renewable capacity; however, we expect profits to remain exposed to market price volatility. We expect a ramp up in renewable production to about 50% of the group output in 2025, from 22% in 2022, with most additional production being contracted under long-term power purchase agreements (PPAs). The CO2 intensity of the group's electricity production should decrease by 65% to 0.3 tons/MWh in 2025 from 0.9 tons/MWh in 2022. As a result, we expect 2025 EBITDA to gradually near the €500 million seen in 2023. However, we remain uncertain on the pace of new renewable plants commissioning and the company's integrated margin remains highly exposed to market price volatility, as low power production means more sourcing at market prices for its supply activities. We also see a risk that Eesti Energia would need to produce with less-profitable oil shale plants to ensure power supply in the country.

We forecast network distribution EBITDA to remain stable at €150 million-€160 million post-2024, from €120 million in 2023, as increased tariffs cover past cost inflation and network losses. We expect contributions from regulated operations to form a relatively stable 25% of EBITDA post-2025 only, as the contribution of unregulated activities are volatile depending notably on power prices.

We forecast a deterioration in credit metrics in 2024-2025 due to high investment needs, although these are flexible to some extent. We expect FFO to debt to stay below 25%, the level we view commensurate with the 'bb' stand-alone credit profile, with a low 18% in 2024, before returning to 24%-25% from 2025. We forecast 2023 year-end adjusted debt to reach €1.5 billion from €796 million as of year-end 2022, as we estimate EBITDA noncash items will be at about €300 million. This is mostly related to mark-to-market derivatives, and added to increasing capital expenditure (capex) needs, this deteriorates free cash flow generation. At year-end 2025, we estimate our adjusted debt to amount to €1.8 billion, compared with €796 million as of year-end 2022.

The company's strategy entails investments of €2.5 billion-€3.0 billion over 2022-2026. This includes a major rise in capex, started in 2022 with spend of €454 million. We expect capex will peak at €700 million-€750 million in 2023, compared with €217 million in 2021. This will expose the company to cost overruns and delays. We forecast slightly lower capex from 2024 at €500 million-€550 million annually, as large projects like the new Enefit 280-2 oil production plant complete, resulting in negative discretionary cash flow (DCF) of €300 million-€350 million in 2023-2025. We include the company's full investment plan in our forecast. Nevertheless, Eesti Energia has historically overestimated its expected spend, and a fairly large share of the planned capex is uncommitted. However, any postponing of capex would keep the group from achieving its decarbonization targets and renewable EBITDA growth.

We expect investments will rise to develop new solar and wind power generation capacity and upgrade the Estonian distribution network. The company seeks to reduce its carbon exposure by investing heavily in low-carbon activities, such as renewable power generation, distribution grid operations, and related network services--such as high-speed internet. Eesti Energia focuses on expanding renewable generation capacity through subsidiary Enefit Green. Its strategy includes a 4x increase from the current installed capacity to 1,900 MW by 2026. We view this strategy as very ambitious, and we will monitor progress as Eesti Energia adds new renewable capacity. High inflation in Estonia, which we estimate at 8.9% in 2023, will likely slow through 2024, which could slightly reduce the related pressure on spending.

The transition toward a greener generation fleet could improve generation profitability with more contracted revenues, however we expect the group to remain materially exposed to market price volatility. Investing further in renewables should help Eesti Energia to retain its long-term competitiveness and reduce its exposure to the volatile Nord Pool prices via renewable PPAs or a favorable subsidy scheme, particularly if state support for green energy remains strong. The ambitious investment plan will increase Eesti Energia's unregulated electricity generation and supply to about 65% of expected EBITDA. We understand Eesti Energia will direct most of its investments into renewable generation under its recently listed subsidiary, Enefit Green AS, which it 77.2% owns. Depending on power prices, we foresee the company's regulated activities--namely networks and flexible generation, which we perceive as more stable and predictable--could represent less than 30% of consolidated EBITDA compared with about 40% historically. This is notably due to the higher share of investments in generation assets, representing a strategic shift.

We expect regulated earnings will still constitute a meaningful 20%-30% on average and remain a cornerstone of the utility's strategy. We also expect EBITDA from networks to be relatively stable at €70 million-€85 million annually as energy costs for network losses stabilize in 2023-2024, and that the company will continue to invest at least €60 million-€70 million annually in regulated assets. This somewhat mitigates the increasing market risk exposure from its expansion into renewable generation.

Eesti Energia has also considered investing in the oil shale business, which we view as risky and volatile. That said, we expect this investment's contribution to EBITDA will be limited before 2025, when we expect Enefit 280-2 to be fully operational and result in a slight increase in EBITDA from oil shale sales.

We expect the likelihood of support from the Estonian government to remain moderately high as the company is at the forefront of national energy objectives. We see Eesti Energia as highly important to Estonia, given its crucial role in the electricity and oil shale markets. This is also confirmed by government support for the group's strategy, and its decision not to extract any dividends from the company in 2020. To implement the ambitious targets of the national Climate and Energy plan, we believe the Estonian state will continue to provide some support like dividend cuts. There is uncertainty on potential additional supportive remuneration mechanisms to incentivize renewable development, or contracted remuneration of some oil shale units to ensure security of supply.

We continue to assess the likelihood of extraordinary government support to Eesti Energia as moderately high, based on our assessment of the company's:

- Strong link with the Estonian government, which owns 100% of Eesti Energia, with no expected change.

- Important role for the government, given that Eesti Energia's operations are strongly aligned with the government's interests, in particular ensuring that Estonia is self-sufficient in electricity.

Outlook

The negative outlook reflects our expectation that in 2024-2025 Eesti Energia's FFO to debt will weaken below 25%. This is because we expect the rollover of profitable hedges to achieve lower power prices in 2024 and rising investments to support renewables development growth. Given the sizable investment program, we expect DCF to stay negative at €300 million-€350 million on average in 2023-2025.

Downside scenario

We could lower the rating if we saw Eesti Energia's operating and financial performance deteriorating without prospects for near-term recovery, with FFO to debt falling sustainably below 25%. This could arise from:

- Power prices decreasing below €100/MWh in 2024-2025;
- Squeezed retail margins; and
- Increased investments or cost over runs--absent of any remedy measures i.e., extraordinary state support, subsidies, proceeds from disposals, or dividend cuts.

We could also downgrade Eesti Energia should we perceive that the volatility of its cash flow generation is not decreasing, notably alongside:

- Delays in phasing out highly polluting oil shale plants;
- Significant delays in renewable development with a lower share of contracted generation under PPAs; and
- A material decrease in regulated networks' EBITDA contribution, for example from adverse regulatory decisions.

Although we do not currently expect this, weakening liquidity and any issues with covenant waivers could also pressure the rating.

Upside scenario

We could revise the outlook to stable if we observe that Eesti Energia's FFO to debt has stabilized and we expect that it would stay sustainably above 25%, provided the business position does not weaken.

This would most likely result from:

- Stronger operating results, thanks to increasing Estonian area power prices, operating efficiencies for power generation, or positive revisions to the regulatory framework for electricity distribution business;
- Lower investments than expected; or
- Government support.

We could also revise the outlook to stable if we observed that Eesti Energia's cash flow volatility had materially decreased based on:

- Lower market price exposure with highly contracted remuneration of renewable generation representing the bulk of generation cash flows;
- Capacity market mechanism on strategic reserve thermal plants; and
- Higher share of regulated earnings from network activities.

Company Description

Eesti Energia is a vertically integrated energy company based in Estonia, with operations mainly in the Baltics, but also in Finland, Poland, and the U.S. It is 100% owned by the Estonian government. The group's main operation areas are electricity generation with about 6.2 terawatt-hours (TWh) of generation, oil shale production of about 405,000 metric tons, electricity distribution with 93% coverage in Estonia, and customer solutions. Reported EBITDA amounted to €420.4 million in 2022. On average, about 60% of EBITDA comes from electricity and heat generation and the supply of electricity in Baltic countries; about 30% from regulated electricity distribution in Estonia; and 10% from natural gas sale, oil shale production and other services.

Our Base-Case Scenario

Assumptions

- Estonian real GDP to contract by 1.0% in 2023 and expand by 2.8% in 2024 and 3.2% in 2025.
- Inflation: Consumer price index easing to 8.9% in 2023 and 3.5% in 2024 after a high 19.5% in 2022.
- Subsidiary Enefit Green to be 100% consolidated, despite the divested 22.8% minority interest.
- Nord Pool electricity price in Estonia remaining at about €90-€100/MWh in 2024 and 2025 after €100-€110/MWh on average in 2023.
- Electricity generation:
- --Renewable generation at about 1.5 TWh and 2023, increasing to about 2.1 TWh in 2024 and 3.3 TWh in 2025.
- --Thermal generation decreasing toward 2.5 TWh in 2023-2025 from 5.1 TWh because of mothballing of old thermal plants.
- DSO activities:
- --Average distribution tariff to remain stable during 2024-2025.
- --Stable volume levels over 2023-2025.
- EBITDA margin falling to about 13% in 2024 due to low market prices and a steep decrease in power production, increasing to 17%-18% during 2024-2025.
- Cost of debt increasing to about based on the €600 million new loan signed in 2023.
- Capex of about €730 million in 2023, then about €580 million-€620 million annually in 2024 and 2025.

- Dividends amounting to €82 million in 2023, €8 million in 2024--as we forecast state support with a dividend cut--and about €40 million in 2025, including dividends paid from Enefit Green to minority shareholders.
- We exclude any potential minority stake sale from our base case.

Key metrics

Table 1

Eesti Energia AS--Key metrics*

	--Fiscal year ended Dec. 31--				
(Mil. €)	2021a	2022a	2023e	2024f	2025f
EBITDA	292.9	342.7	500-550	330-380	520-560
Funds from operations (FFO)	272.6	312.1	430-480	260-290	420-480
Capital expenditure	217.5	453.6	700-750	550-650	500-550
Dividends	--	55.8	75-85	0-20	0-100
Debt to EBITDA (x)	2.7	2.3	2.7-2.9	4.0-4.5	3.0-3.5
FFO to debt (%)	34.8	39.2	28-33	15-20	23-27

*All figures adjusted by S&P Global Ratings. a--Actual. E--Estimate. f--Forecast.

Liquidity

We consider Eesti Energia's liquidity to be adequate, based on our estimate that cash resources will cover outflows by 1.2x over the 12 months starting Sept. 30, 2023. We note that Eesti Energia and Enefit Green have separate financing following Enefit Green's IPO, implying Eesti Energia cannot freely access cash at Enefit Green. However, we include in our liquidity analysis cash sources at Enefit Green and related cash uses as those are materially higher. The debt maturity profile is however relatively concentrated, as Eesti Energia has a €600 million loan, of which €300 million matures in February 2028 and €300 million is amortizing. We expect the €150 million Swedbank loan maturing June 2024 to be prolonged. We will closely monitor this prolongation and any covenant waiver negotiation.

Principal liquidity sources over next 12 months starting Sept. 30, 2023, include:

- Cash and cash equivalents of about €146 million.
- Undrawn committed revolving credit facility and long-term loan agreements of €555 million maturing in more than one year.
- Our forecast of cash FFO of about €293 million.
- Working capital inflow of about €180 million.

Principal liquidity uses for same period include:

- Debt maturities of about €366 million.
- Committed capex of about €530 million.
- €8 million dividends, to minorities only.

Covenants

The company's €600 million loan is governed by a maximum adjusted net leverage ratio to not to exceed 3.5x along with a minimum debt service coverage ratio of 1.2x, both tested semi-annually. We see a risk that headroom under the 3.5x net leverage ratio covenant in 2024 could be tight. We will closely monitor the situation as well as any negotiation process.

Environmental, Social, And Governance

Environmental factors are a very negative consideration in our credit rating analysis of Eesti Energia. Eesti Energia's emissions are higher than many rated peers in Europe, at about 280 grams of CO_2 per KWh (gCO_2/KWh) for its total energy production and 440 gCO_2/KWh for electricity production. This ranks Eesti Energia at about the same level as Electricity Supply Board (378 gCO_2/KWh) but with higher pollution than CEZ a.s. (330 gCO_2/KWh) and Fortum including Uniper (320 gCO_2/KWh). That said, the company aims to increase its share of electricity from renewable sources to at least 80% by 2030, and targets carbon neutrality by 2045, which is in line with the Paris Agreement. However, the company plans to continue using oil shale in thermal power plants, but to phase it out during 2026-2030. This, in our view, places Eesti Energia among the bottom tier of performers when it comes to the energy transition.

Ratings Score Snapshot

Issuer Credit Rating	**BBB-/Negative/--**
Business risk:	Fair
Country risk	Intermediate
Industry risk	Intermediate
Competitive position	Fair
Financial risk:	Significant
Cash flow/leverage	Significant
Anchor	bb
Modifiers:	
Diversification/Portfolio effect	Neutral (no impact)
Capital structure	Neutral (no impact)
Financial policy	Neutral (no impact)
Liquidity	Adequate (no impact)
Management and governance	Neutral (no impact)
Comparable rating analysis	Neutral (no impact)
Stand-alone credit profile:	bb
Related government rating	AA-/Negative/A-1+
Likelihood of government support	Moderately high (+2 notches)

Related Criteria

- Criteria | Corporates | General: Corporate Methodology, Jan. 7, 2024
- Criteria | Corporates | General: Methodology: Management And Governance Credit Factors For Corporate Entities, Jan. 7, 2024
- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | Industrials: Key Credit Factors For The Unregulated Power And Gas Industry, March 28, 2014
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010

Ratings List

Outlook Action; Ratings Affirmed

	To	From
Eesti Energia AS		
Issuer Credit Rating	BBB-/Negative/--	BBB-/Stable/--

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.spglobal.com/ratings for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://disclosure.spglobal.com/ratings/en/regulatory/article/-/view/sourceId/504352. Complete ratings information is available to RatingsDirect subscribers at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.spglobal.com/ratings. Alternatively, call S&P Global Ratings' Global Client Support line (44) 20-7176-7176.