FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Energa at 'BBB+'; Outlook Stable

Wed 21 Dec, 2022 - 7:06 AM ET

Fitch Ratings - Warsaw - 21 Dec 2022: Fitch Ratings has affirmed Energa S.A.'s Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDRs) at 'BBB+'. The Outlook is Stable. The affirmation reflects our unchanged view on the company under our "Parent and Subsidiary Linkage Rating Criteria", under which we equalise Energa's rating with that of Polski Koncern Naftowy ORLEN S.A. (PKN ORLEN). A full list of rating actions is below.

Energa's Standalone Credit Profile (SCP) remains at 'bbb-' and is supported by a solid business profile, with a focus on its predictable regulated electricity distribution business, and strong operational record. We project that a large capex plan will increase Energa's net leverage in 2023-2025, which however should remain solid for the current SCP.

KEY RATING DRIVERS

Distribution Supports Credit Profile: The ratings of Energa reflect its focus on regulated distribution activity, its main business segment, which is characterised by lower business risk and greater cash flow predictability than conventional power generation. We expect the share of regulated EBITDA to average 69% in 2022-2026, contributing to cash flow visibility. The regulatory framework for distribution networks in Poland is stable and has further improved with the introduction of a regulatory account from 2021, which allows for the automatic reflection of differences between actual and forecast distribution volumes with a two-year lag.

Price Cap for Generators: We expect the profitability impact on Energa of price cap on generation will partly be mitigated by its substantial share of quasi-regulated income for renewable assets. The Polish government introduced a maximum price for energy generators that will vary by energy source and among individual units, as the formula considers the fuel, CO_2 cost, and effectiveness of each plant. If the selling price is above the limit, the generator will pass on the additional revenue to the special fund created to finance capped tariffs for end-customers. The price cap will apply from December 2022 throughout 2023.

Conventional Generation Under Pressure: We expect deterioration in the profitability of coal-fired assets due to an increase in fuel and emission allowance costs and the price cap introduced in 2022. Under Fitch's rating case, we assume revenues from the capacity market to partly compensate worsened margins on electricity sales. We view conventional assets as a burden on Energa's generation profitability until its two new combined heat and power units (CCGT) units are commissioned in 2026.

New Generation Units: Our rating case forecasts Energa's capex to average PLN3.4 billion annually in 2022-2026, broadly equally split between distribution and strategic projects, including new CCGTs in Ostroleka and Grudziadz. We expect the new CCGT units to increase Energa's capacity by nearly 1.3 GWe in 2026. Both projects have signed 17-year capacity payments agreements, which will significantly improve the segment's result from

2026 and mitigate the plants' cash flow exposure to gas and CO2 prices. In the event of failure to meet the capacity obligation, a penalty of 5% of the annual capacity market revenue applies. Our rating case does not assume any delays to the projects' commissioning dates.

Introduction of Supply Cap: The government introduced a cap on supply prices at 2022 levels for households with annual consumption of up to 2MWh during 2023, and at PLN693/MWh above this limit, and at PLN785/MWh for SMEs, public utility entities, and farmers. We expect the total negative impact throughout the cap period of PLN930 million, as preliminarily estimated by the company, to reduce EBITDA in the supply segment. We assume no delays in payments of granted compensation due to a monthly settlement mechanism.

Spin-Off to Benefit: Fitch has not included the planned divestment of Energa's coal-fired power plant 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 have a positive impact on Energa's credit profile, allowing the company to focus on electricity distribution and renewable generation, and improve its debt capacity.

Equalisation Rating Approach: We view the parent PKN ORLEN's SCP as stronger than Energa's due to its larger-scale operations, stronger business diversification and lower leverage. Applying the stronger parent/weaker subsidiary approach under our PSL Criteria, we equalise the rating of Energa with that of PKN ORLEN. This is based on our reassessment of 'Medium' legal incentives, combined with 'High' strategic and operating incentives.

DERIVATION SUMMARY

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

All peers are rated on a standalone basis. Energa's and Tauron's business profiles benefit from a large share of regulated distribution in EBITDA, which provides good cash flow visibility when conventional generation and mining are under pressure. Both companies' credit profiles are also supported by inflows from capacity payments that improve revenue visibility, although Tauron benefits from more significant amounts due to its larger coal-fired fleet. Nevertheless, Tauron has a greater share of hard-coal fired generation in its business profile, which is currently under pressure.

We believe that Energa has a more sustainable business profile, which is reflected in its higher debt capacity, with a negative rating sensitivity of 5.0x compared with 4.5x for Tauron.

PGE is the largest energy company in Poland 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 the company with cost advantage over hard coal-fired peers such as ENEA and Tauron. Rising CO2 prices could diminish this cost advantage if not accompanied by high hard coal prices, given the higher carbon footprint of lignite than hard coal.

ENEA has a lower share of regulated distribution than Energa and Tauron and at the same time higher exposure to hard coal-fired generation, but controls a low-cost mining business.

KEY ASSUMPTIONS

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

- Weighted-average cost of capital in the distribution segment at 5.8% in 2022 and on average 8% in 2023-2026

- Electricity prices capped at average PLN573/MWh in 2023-2026

- Ostroleka C to switch to gas-fired from 2026, with 50% plus one share ownership by Energa

- Capex and acquisitions at PLN17 billion in 2022-2026

- Continuation of a no-dividend policy

RATING SENSITIVITIES

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

- Positive rating action on PKN ORLEN

- Funds from operations (FFO) net leverage below 4x on a sustained basis would be positive for the SCP

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

- Negative rating action on PKN ORLEN

- FFO net leverage above 5x on a sustained basis, for example, due to a protracted economic downturn, higher-than-planned capex or reinstatement of dividends would be negative for the SCP

PKN ORLEN's rating sensitivities from the most recent Rating Action Commentary on 9 November 2022 are:

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

- Rating upside is currently limited unless the business profile strengthens significantly with larger scale of operations and geographical diversification combined with lower execution risk in shifting the business towards lower-emission technologies

- Net debt/EBITDA below 1.5x or FFO net leverage below 1.7x on a sustained basis

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

- Net debt/EBITDA above 2.5x or FFO net leverage above 2.7x on a sustained basis

- Higher-than-currently expected variability of cash flows

- Aggressive financial policy with higher-than-expected dividend payments or debt-funded acquisitions

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

Manageable Liquidity: At end-September 2022, Energa had PLN314 million of unrestricted cash and equivalents and PLN2.5 billion of committed unused credit lines against short-term maturities of PLN2.7 billion, and PLN2 billion Fitch-calculated negative free cash flow after acquisitions in the next 12 months from October 2022.

We expect that PKN ORLEN will address Energa's short-term financing needs through intra-group loans, cash pooling, and revolving credit lines, providing funding based on current demand.

ISSUER PROFILE

Energa is an integrated utility operating in Poland. The main areas of operations are electricity distribution, generation and supply.

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.

PUBLIC RATINGS WITH CREDIT LINKAGE TO OTHER RATINGS

Energa is credit-linked to PKN ORLEN.

ESG CONSIDERATIONS

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
Energa S.A.	LT IDR	BBB+ Rating Outlook Stable	Affirmed	BBB+ Rating Outlook Stable
	LC LT IDR	BBB+ Rating Outlook Stable	Affirmed	BBB+ Rating Outlook Stable
	Natl LT	AA+(pol) Rating Outlook Stable	Affirmed	AA+(pol) Rating Outlook Stable
senior unsecured	LT	BBB+	Affirmed	BBB+
subordinated	LT	BBB-	Affirmed	BBB-
senior unsecured	Natl LT	AA+(pol)	Affirmed	AA+(pol)
Energa Finance AB (publ)				
senior unsecured	LT	BBB+	Affirmed	BBB+

VIEW ADDITIONAL RATING DETAILS

FITCH RATINGS ANALYSTS

Renata Dobrzynska, PhD
Director
Primary Rating Analyst
+48 22 103 3035
renata.dobrzynska@fitchratings.com
Fitch Ratings Ireland Limited spolka z ograniczona odpowiedzialnoscia oddzial w Polsce
Krolewska 16, 00-103 Warsaw

Katarzyna Sulek
Senior Analyst
Secondary Rating Analyst
+48 22 103 3032
katarzyna.sulek@fitchratings.com

Arkadiusz Wicik, CFA
Senior Director
Committee Chairperson
+48 22 103 3016
arkadiusz.wicik@fitchratings.com

MEDIA CONTACTS

Tahmina Pinnington-Mannan
London
+44 20 3530 1128
tahmina.pinnington-mannan@thefitchgroup.com

Additional information is available on www.fitchratings.com

PARTICIPATION STATUS

The rated entity (and/or its agents) or, in the case of structured finance, one or more of the transaction parties participated in the rating process except that the following issuer(s), if any, did not participate in the rating process, or provide additional information, beyond the issuer's available public disclosure.

APPLICABLE CRITERIA

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)

Parent and Subsidiary Linkage Rating Criteria (pub. 01 Dec 2021)

Corporate Rating Criteria (pub. 28 Oct 2022) (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), v8.1.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Energa Finance AB (publ)	EU Issued, UK Endorsed
Energa S.A.	EU Issued, UK Endorsed

DISCLAIMER & DISCLOSURES

READ LESS

SOLICITATION STATUS

The ratings above were solicited and assigned or maintained by Fitch at the request of the rated entity/issuer or a related third party. Any exceptions follow below.

ENDORSEMENT POLICY

Fitch's international credit ratings produced outside the EU or the UK, as the case may be, are endorsed for use by regulated entities within the EU or the UK, respectively, for regulatory purposes, pursuant to the terms of the EU CRA Regulation or the UK Credit Rating Agencies (Amendment etc.) (EU Exit) Regulations 2019, as the case may be. Fitch's approach to endorsement in the EU and the UK can be found on Fitch's Regulatory Affairs page on

Fitch's website. The endorsement status of international credit ratings is provided within the entity summary page for each rated entity and in the transaction detail pages for structured finance transactions on the Fitch website. These disclosures are updated on a daily basis.

Corporate Finance Utilities and Power Europe Poland Sweden