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Research Update:

Finnish Power Distributor Elenia Downgraded To 'BBB' On Regulatory Changes; Off CreditWatch Negative; Outlook Stable

January 28, 2022

Rating Action Overview

A revision to the framework for Finnish electricity distribution system operators (DSOs) in October resulted in a weighted-average 17% cut in existing regulatory asset value (RAV) from 2022, adding to an almost 100-basis-point cut in the weighted-average cost of capital (WACC) formula this year and resulting in €295 million lower allowed income for Finnish DSOs from 2022.

- Consequently we now view the regulatory framework as strong/adequate from strong and have revised our ratio requirements for the ratings on Elenia Verkko Oyj (Elenia).
- We now expect Elenia's funds from operations (FFO) to debt will likely remain at about 9%, below the new 10% or more threshold for the 'BBB+' issue rating.
- We therefore lowered our issue ratings on Elenia's senior secured debt to 'BBB' from 'BBB+', and removed them from CreditWatch negative, where they were placed on Oct. 29, 2021.
- The stable outlook indicates that we believe Elenia remains committed to FFO to debt above 8%, and will maintain flexible shareholder remuneration to balance its ratios.

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Rating Action Rationale

In our view, Elenia is unlikely to meet the new thresholds for a 'BBB+' issue rating, so we downgraded it to 'BBB'. As a consequence of our reassessment of the Finnish regulatory framework in October 2021 (see "Finnish Power Distributors Elenia And Caruna Ratings Put On CreditWatch Negative On Regulatory Remuneration Cuts," published Oct. 29, 2021, on RatingsDirect) to strong/adequate from strong, we increased the FFO to debt thresholds for Elenia to 10% from 8% at the previous 'BBB+' rating level. In our view, this revision is warranted to compensate for what we perceive as higher business risks, and we therefore placed Elenia at the lower end of the excellent category. The regulatory framework is an important component of our assessment of any DSO's competitive advantage, and it is untypical that we see changes in the framework during a regulatory period. In our view, this creates uncertainty about the stability of the system, also going forward. We are not expecting any further changes in the current regulatory period but, based upon the regulator's announcement in October 2021, we believe the risk of such interventions has increased. Following our reassessment, we now benchmark the credit metrics for Finnish DSOs against the more demanding medial financial risk table instead of the low volatility table previously, under our methodology. After our review, which included discussions with management, we have concluded that Elenia is unlikely to meet the new requirements for a 'BBB+' issue rating. This acknowledges that it would require a relatively sizable €150 million-€180 million strengthening of its balance sheet to increase its credit ratios, which the owners are unlikely to arrange. However, we note that Elenia has adjusted down its capital expenditure (capex) plan for 2022 to about €30 million-€130 million compared with €160 million in 2021. Going forward, we expect the company to balance its shareholder distributions and show flexibility to maintain credit metrics commensurate with the rating. Therefore, we now expect Elenia to pay significantly lower shareholder remuneration of €50 million-€55 million annually. In our view, the company remains committed to keeping FFO to debt above 8%, as previously, which we now consider in line with a 'BBB' issue rating.

Despite the reduced predictability of the Finnish regulator, we believe Elenia remains one of the most efficient operators in Finland We believe the regulatory environment for DSOs in Finland has weakened as a result of significant changes to the framework in the middle of the regulatory period. It is our understanding that Elenia's allowed income has been cut by €30 million-€40 million. It is highly unusual for frameworks to be amended in the middle of a regulatory period, and this goes against our view of a stable and supportive framework. Moreover, introducing a new unit price list that results in a substantial lowering of the RAV by 2022, and also including investments already made and completed, does not align with our view of a strong regulatory framework. On average, the regulatory asset base, which is the starting point for the reasonable return calculation, has reduced 17% on a weighted-average basis for all DSOs in Finland. We view this as a significant reduction that is untypical among other European regulatory frameworks that we assess as strong. We note that DSOs in Finland have made a legal appeal against the changes, but we don't expect any outcome in the near term. That said, Elenia is one of the largest network operators in Finland and we expect it will remain one of the most efficient operators. This is, among other factors, due to its economies-of-scale advantages and highly competent project management skills, which result in stable and predictable cash flows. We therefore maintained an excellent business risk assessment for Elenia. We expect profitability ratios, such as EBITDA margin, to remain at 60%-65% over 2022-2023.

Pressure from the cut in Elenia's remuneration is limited by its cumulative, regulatory allowed income deficit, implying the group can activate income from previous periods of about €90 million. Historically, Elenia has not charged the full allowed tariff to customers to balance its regulatory allowed income. This has resulted in a cumulative regulatory allowed income deficit that has been transferred from previous periods, totaling almost €90 million by year-end 2020. As Elenia starts to activate this deficit, it will to some extent increase its allowed revenue until the next regulatory period, which starts in 2024, and cushion the effect from the regulatory cut. This will also provide some revenue and cash flow stability, despite the regulatory changes. Currently, it is unclear if the next regulatory reset, in 2024, will result in further remuneration cuts for Finnish DSOs.

The senior secured debt has supporting features that continue to provide rating uplift. The rating remains one notch above the senior secured debt's stand-alone credit profile, thanks to the structural features designed to increase cash flow certainty for debtholders. These include restricted payment conditions and a covenanted liquidity structure that should, in our opinion, enable Elenia to manage temporary cash flow shocks. Debtholders benefit from features that include:

- Two levels of financial covenants (trigger events and events of default) and an automatic 12-month standstill period after an event of default; and
- A €60 million liquidity facility available to draw on if the group enters a standstill, which is sufficient to cover finance charges.

Outlook

The stable outlook reflects our expectation that Elenia's EBITDA and FFO will not decline significantly despite the regulatory changes. This is because it can activate cumulative income from previous years of about €90 million, which should somewhat limit the negative effects. In addition, we expect that Elenia will adjust its shareholder distributions to protect credit metrics. Therefore, we expect FFO to debt will remain comfortably at 8%-10%, and debt to EBITDA below 9x, which we consider commensurate with a 'bbb-' stand-alone credit profile.

Downside scenario

We could lower the rating if Elenia's FFO to debt falls below 8% or debt to EBITDA rises above 9x without clear signs of recovery.

This could occur if:

- The company increases investments or shareholder remuneration beyond our expectations.
- The regulator imposes additional changes to the framework for the next 2024-2027 regulatory period that would have a significant negative impact.

Upside scenario

We see a positive rating action as unlikely at this stage, especially given our belief that Elenia will use its additional flexibility to either expand its investment pipeline or increase shareholder remuneration.

However, we could consider an upgrade if Elenia commits to a deleveraging plan, resulting in FFO to debt sustainably above 10% and debt to EBITDA below 8x. We view this as unlikely over the outlook horizon, given the group's business plan and the recently implemented changes to the regulatory framework leading to lower remuneration.

In addition, we note that Elenia and most DSOs in Finland have appealed the changes imposed by the regulator. We could raise the rating if the appeal is successful. However, it is our understanding that this could be a very lengthy process, and a positive outcome of the magnitude required for a return to 'BBB+' appears unlikely at this stage.

Company Description

Elenia's main business operation is electricity distribution. It is the second-largest electricity distribution operator in Finland behind Caruna, with a 12% market share and network of about

75,500 kilometers serving about 435,000 end users. In 2020, the company reported EBITDA of €195 million.

Elenia's main owners are Valtion Eläkerahasto and Allianz Capital Partners (ACP) on behalf of the Allianz Group, together with Allianz subsidiaries and investment vehicles managed or advised by ACP and Macquarie Super Core Infrastructure Fund.

Elenia's financing structure is ring-fenced, and the financing group is delinked from its ultimate parent. The financing group's issued debt includes structural enhancements designed to reduce the likelihood of default and risk to creditors.

Our Base-Case Scenario

Assumptions

- Finland's GDP will increase 1.7% in 2022 and 1.5% in 2023.
- Pretax WACC at 4.0%, 4.0%, and 4.2% for 2022, 2023, and 2024.
- The company activates its €90 million cumulative allowed income deficit to smoothen the effect from the cut in RAV and lower WACC.
- Shareholder distributions of €50 million-€55 million annually during 2022 and 2023.
- No mergers or acquisitions.

Key metrics

Table 1

Elenia--Key Metrics*

	--Fiscal year ended Dec. 31--			
(Mil. €)	**2020a**	**2021e**	**2022f**	**2023f**
EBITDA	195.1	200-220	200-220	215-225
Funds from operations (FFO)	147.8	160-170	160-170	170-180
Capital expenditure	164.4	150-160	130-140	130-140
Dividends	113	95-105	50-60	55-65
Debt	1,731	1,700-1,800	1,800-1,900	1,800-1,900
Debt to EBITDA (x)	8.9	8.3-8.8	8.5-9.0	8.3-8.8
FFO to debt (%)	8.5	9.0-9.5	9.0-9.5	9.0-9.5

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

Liquidity

We view Elenia's liquidity as strong. We believe that available liquidity sources exceed forecast near-term cash outflows by more than 2x in the next 12 months and more than 1x in the following 12 months.

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In our liquidity assessment, we also factor qualitative factors, such as Elenia's sound relationships with banks, very good standing in credit markets, and likely ability to absorb high-impact, low-probability events with no debt maturities until 2026.

We forecast Elenia will have significant headroom under both its covenants over the next two years. We also believe the company has significant flexibility to reduce shareholder distributions even before reaching lock-up covenants.

Elenia's liquidity sources as of Dec. 31, 2021, comprise:

- Forecast FFO of about €160 million.
- Available cash and marketable securities of about €40 million.
- Access to committed credit lines of about €510 million.

Elenia's liquidity uses over the same period, comprise:

- Capex of about €130 million over the next 12 months.
- About €50 million-€55 million of shareholder distributions.
- Working capital outflows of about €20 million.
- No debt maturities over the next 12 months.

Ratings Score Snapshot

Issuer Credit Rating: NONE

Business risk: Excellent

- Country risk: Very low
- Industry risk: Very low
- Competitive position: Strong

Financial risk: Aggressive

- Cash flow/leverage: Aggressive

Anchor: bbb

Modifiers

- Diversification/portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Strong (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Negative (-1 notch)

Stand-alone credit profile: bbb-

ESG credit indicators: E-2, S-2, G-2

Related Criteria

- 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 | Utilities: Rating Structurally Enhanced Debt Issued By Regulated Utilities And Transportation Infrastructure Businesses, Feb. 24, 2016
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | Project Finance: Project Finance Framework Methodology, Sept. 16, 2014
- Criteria | Corporates | Project Finance: Project Finance Transaction Structure Methodology, Sept. 16, 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
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010

Related Research

- Finnish Power Distributors Elenia And Caruna Ratings Put On CreditWatch Negative On Regulatory Remuneration Cuts, Oct. 29, 2021

Ratings List

Downgraded; CreditWatch/Outlook Action

	To	From
Elenia Verkko Oyj		
Senior Secured	BBB/Stable	BBB+/Watch Neg

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors,