Research Update:

Latvian TSO Augstsprieguma Tikls Outlook Revised To Positive On Efficient Congestion Income Usage; 'A-' Rating Affirmed

December 12, 2023

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Rating Action Overview

- Following the decisions announced by Latvian utilities regulator, PUC, on the redirection of Congestion income for synchronization projects as well as for tariff reduction, all €150 million congestion income accumulated until April 2023 was allocated.
- As a result, we no longer consolidate this amount in our adjusted funds from operations (FFO) to debt, our forecast of S&P Global Ratings-adjusted debt is now about €40 million for 2023, compared with our previous forecast of about €170 million.
- We expect Augstsprieguma Tikls (AST) to post adjusted FFO to debt of about 35% over 2024-2025. This reflects lower debt, with the anticipated continuous growth of adjusted EBITDA to more than €50 million over 2024-2025 from €47 million in 2022. That said, credit metrics are likely to remain volatile as congestion income final use may vary from our assumptions.
- We therefore revised our rating outlook on AST to positive from stable and affirmed our 'A-' issuer credit rating.
- The positive outlook reflects upgrade potential if AST reports FFO to debt exceeding 35% on a sustainable basis in a normalized power prices environment.

Rating Action Rationale

We continue to see the Latvian regulatory framework for electricity transmission as supportive. The new two and a half-year regulatory period for AST started in July2023 with a new tariff in place. The methodology remains 70%-80% based on installed capacity in Latvia and 20%-30% on volume. The tariff was increased by 30% on a nominal basis following approval to use congestion income to compensate for general operating expenditures and is expected to apply until December 2025. Considering our expectation of 9.5% consumer price index (CPI) growth in Latvia in 2023, the real tariff increase is about 16.5%. As a result, we expect AST's reported EBITDA to stabilize at approximately €40 million-€45 million until end 2025. This is in line with our framework assessment as it is supportive of AST's financial health and cash flow predictability. However, the lack of track record for the framework constrains our assessment to strong/adequate (see "Latvian Gas And Electricity Transmission And Gas Storage Regulatory Frameworks: Mostly Supportive," published on RatingsDirect on Nov. 30, 2022).

Unallocated congestion income when fully allocated could align IFRS metrics with our adjusted metrics for AST. As of April 2023, AST recorded €150 million of congestion income on its balance sheet. The full amount is allocated as follows:

- €45.9 million was allocated to existing commissioned projects, hence reducing the regulated asset base (RAB) as investments from congestion income should not build RAB.
- €40.2 million for investment in new projects.
- The remaining €62.1 million was allocated to revenues and stabilize EBITDA over 2023-2025.

As a result, all congestion income received since April 2023 is now considered unallocated congestion income, with its usage to be approved by the regulatory body. We estimate monthly congestion income received to amount to €2.0 million-3.0 million resulting in unallocated congestion income of €20 million-25 million as of end-2023, accumulating to reach an annual amount of €25 million-€30 million for the following years until power prices align in the region. This has a positive impact on our adjusted FFO-to-debt ratio, as we no longer consolidate that amount in our adjusted debt, which is now expected at about €40 million for 2023, down from our previous forecast of about €170 million. Lower debt, with the expected continuous growth of adjusted EBITDA to more than €50 million over 2024-2025 from €47 million in 2022, leads us to forecast adjusted FFO to debt of about 35% for 2024-2025.

AST's small size compared to peers continues to constrain the business risk profile. AST's reported annual EBITDA amounts to €40 million-€50 million which is amongst the smallest among our rated peers. Compared to the size of the country however, AST seems to align with its peers in terms of network per inhabitant and EBITDA per inhabitant. However we understand the growth is limited and such small scale could lead to further metrics volatility compared to peers.

We continue to view Conexus Baltic Grid as an equity affiliate, despite AST owning 68.46%, affecting AST's adjusted EBITDA. We understand that, despite having a majority ownership of Conexus, AST's budget is defined on a stand-alone basis and AST has similar control as the minority shareholder over Conexus' supervisory board. As a result, our rating on AST reflects Conexus as an equity affiliate. In our base case scenario we estimate annual dividends from Conexus to AST to amount to €5 million-€10 million hence increasing AST's adjusted EBITDA to about €50 million-€55 million over 2023-2025. Due to AST's small size, a change in dividends from Conexus could significantly affect AST's ratios. If Conexus reduces its dividend payout to AST, we would reassess our base case scenario.

Our assessment of high likelihood of support from Latvia (A+/Negative) improves the standalone rating by two notches. This reflects our view of the very important role as the sole electricity transmission operator in Latvia ensuring supply security and desynchronization from Russian electricity. The strong link is based on the 100% ownership from Latvia and the track record of support as demonstrated by the November 2022 capital increase of €25.7 million to support upcoming investments for electricity links synchronization with continental Europe, further solidifying AST's strong position.

Outlook

The positive outlook indicates that AST could operate with FFO to debt of about 35% on a sustainable basis if it continues to successfully allocate congestion income and reduces volatility of its metrics. Our positive outlook also reflects stable dividend distribution from equity-accounted affiliate Conexus, and continuous EBITDA growth on the back of a supportive regulatory framework until 2025. Moreover, a one-notch rating downgrade of Latvia to 'A', in itself, would not result in an outlook revision to stable.

Downside scenario

We could revise the outlook to stable if AST fails to fully allocate congestion income and reduce volatility with FFO to debt remaining within the 23%-35% range.

Upside scenario

An upgrade would require a outlook revision on the sovereign rating to stable, combined with FFO to debt remaining sustainably above 35% within a normalized prices environment.

Company Description

AST is the sole power transmission system operator (TSO) in Latvia. Established in 1939, it was part of Latvenergo until 2012, when the company was unbundled in line with EU directives. The Ministry of Climate and Energy currently owns the TSO. Since 2012, AST has leased its network from LET, the Latvia-based network owner that maintains the existing transmission network and constructs new ones. Latvenergo has maintained generation and distribution activities, the latter regulated under the same framework as AST.

In 2017, AST purchased 18.31% and 16.05% of Conexus, the Latvian gas TSO, from Uniper and Itera Latvija, respectively. In December 2020, AST merged with LET, effectively owning the transmission network and taking on 68.46% of Conexus by acquiring 34.1% of its shares from Gazprom. Conexus is accounted for as an equity affiliate within AST.

AST owns 5,554 kilometers of power lines and 140 substations. AST transmits approximately six terawatt hours of electricity throughout Latvia and neighbouring countries including Estonia, Lithuania, Russia, and Belarus through seven interconnections (two with Estonia, four with Lithuania, and one with Russia). By 2025, AST aims to have synchronized with Europe and disconnected Latvia from the Russian power system.

Our Base-Case Scenario

Assumptions

- Real GDP growth of 1.0% in 2023, 2.5% in 2024, and 2.8% in 2025; CPI growth of 9.5% in 2023, 3.5% in 2024, and 2.8% in 2025. The new regulatory period started in January 2023, with a tariff period starting in July 2023 until December 2025.
- 70%-80% of allowed revenues fixed and based on Latvian installed capacity.

- Weighted-average cost of capital (WACC) of 2.72% over 2023-2025 from 2.65% in 2021-2022, and 3.31% in 2020.
- Usage of €62.1 million congestion income accrued to cover increased operating expenditures until year-end 2025. Stabilizing reported EBITDA at about €40 million- €45 million over 2023-2025.
- Investments in line with the board and regulator-approved 10-year investment plan.
- Dividend payout ratio of 64% (excluding corporate income tax [CIT]; 85% including CIT) from 2023 onward. The dividend calculation is based on the previous year's net income including the dividend received from Conexus (considered an equity affiliate).
- Stable annual dividends from Conexus of approximately €5 million-€10 million, paid in the first half of each year.
- Interest rate of 0.5% based on the sole €100 million bond maturing in January 2027 in the capital structure, although increasing with the €30 million bank loan to be contracted in 2024.
- About €2.3 million monthly congestion income inflow over the forecast period; considered unallocated and accruing annually.

Augstsprieguma Tikls--Key metrics*

	--Fiscal year ended Dec. 31--				
(Mil. €)	**2021a**	**2022a**	**2023e**	**2024f**	**2025f**
EBITDA	94	47	45-50	50-55	50-55
Funds from operations (FFO)	91	47	45-50	50-55	50-55
Capital expenditure	32	31	70-100	150-200	70-100
Dividends	8	29	0-10	5-15	10-20
Debt	69	26	39.8	143.9	147.8
o/w accumulated unallocated congestion income	N/A	N/A	15-20	40-50	70-80
FFO to debt (%)	131.8	181.0	>100	35-40	30-35
Debt to EBITDA (x)	0.7	0.5	0-1	2.5-3.5	2.5-3.5

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

Liquidity

We assess AST's liquidity as adequate because we expect liquidity sources to cover uses by more than 1.1x over the 12 months starting Nov. 30, 2023. The adequate liquidity is further underpinned by AST's good relationship with banks, given it has successfully contracted bank loans and overdraft facilities at quality prices.

Principal liquidity sources include as of Nov. 30, 2023:

- Cash and cash equivalents of about €50 million-€55 million;
- About €50 million-€55 million of cash FFO over the next 12 months;
- €16 million of working capital inflows, excluding congestion income;'
- Accrued congestion income since May 2023 of €15 million-€20 million; and

- A €30 million bank loan to be contracted in 2024 already confirmed by the banks although it still needs to be approved by respective committees.

Principal liquidity uses include over the same period:

- About €100 million-€150 million of capital expenditures excluding EU funds;
- Dividends of at least €10 million set in law; and
- No debt maturity until 2026.

Environmental, Social, And Governance

ESG factors have no material influence on our credit rating analysis of AST. The group's focus is on Latvia's electrification and synchronization with continental Europe by 2025.

Ratings Score Snapshot

Issuer Credit Rating	**A-/Positive**
Business risk:	Strong
Country risk	Intermediate
Industry risk	Very low
Competitive position	Satisfactory
Financial risk:	Intermediate
Cash flow/leverage:	Minimal (medial volatility table)
Anchor	bbb+
Modifiers:	
Diversification/Portfolio effect	Neutral
Capital structure	Neutral
Financial policy	Neutral
Liquidity	Adequate
Management and governance	Fair
Comparable rating analysis	Negative (-1)
Stand-alone credit profile:	bbb
Related government rating	A+/Negative
Likelihood of government support	High (+2 notches)

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

- 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 | 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: Country Risk Assessment Methodology And Assumptions, 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

- Augstsprieguma Tikls, Aug. 28, 2023
- Latvia, June 19, 2023
- Three Northern European TSOs Ratings Affirmed As Congestion Income Is Broadly Credit Neutral; Outlooks Remain Stable, April 14, 2023
- Eastern Europe | Credit Resilience Despite Increasing Affordability Concerns, Jan. 13, 2023
- Eastern European Utilities Handbook 2023, Jan. 5, 2023
- Latvian Gas And Electricity Transmission And Gas Storage Regulatory Frameworks: Mostly Supportive, Nov. 30, 2022

Ratings List

Ratings Affirmed; Outlook Action

	To	From
Augstsprieguma Tikls		
Issuer Credit Rating	A-/Positive/--	A-/Stable/--