Research Update:

Latvian Electricity Transmission Operator AST Outlook Revised To Stable On Sovereign Downgrade; 'A-' Rating Affirmed

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Rating Action Overview

- S&P Global Ratings lowered its long-term rating on Latvia to 'A' from 'A+' on May 31, 2024, reflecting geopolitical risks that will weigh on the sovereign's economy over the medium term.
- Although this doesn't affect our 'A-' rating on Augstsprieguma Tikls (AST), we now view an upgrade of AST over the next 12-18 months as less likely. That said, we continue to believe there is a high likelihood that the Latvian government would support AST in case of financial distress, which continues to translate into two notches of uplift from the stand alone-credit profile (SACP) of 'bbb'.
- We have therefore affirmed our 'A-' long-term issuer credit rating on the company and revised our outlook on AST to stable from positive.
- The stable outlook indicates that AST will continue to use its congestion income efficiently, maintaining regulatory funds from operations (FFO) to debt at around 40%-45% while volatility of credit metrics reduces as congestion income is used.

Rating Action Rationale

The sovereign downgrade to 'A' translates into a lower probability of an upgrade for AST. On May 31, 2024, S&P Global Ratings lowered its long-term foreign and local currency sovereign credit ratings on Latvia to 'A' from 'A+'. The outlook on the long-term rating is stable. The downgrade reflected our view that the impact of the war in Ukraine and wider regional geopolitical risks will continue to weigh on Latvia's public finances, economic growth, and competitiveness over the medium term, although the magnitude of the impact remains difficult to measure (see "Latvia Long-Term Ratings Lowered To 'A' On Economic, Fiscal, And Security Risks; Outlook Stable," published May 31, 2024, on RatingsDirect). Although this doesn't directly affect our 'A-' rating on AST, we now view an upgrade of AST over the next 12-18 months as less likely.

We assess support from Latvia (A/Stable) as highly likely. This reflects our view of AST's very important role as the sole electricity transmission operator in Latvia ensuring supply security and desynchronization from Russian electricity. Our assessment of the link with the government as "strong" is based on the 100% ownership by 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. To factor in this support, we rate AST two notches above the SACP of 'bbb'.

We view AST's regulatory framework as somewhat supportive, with updates to the regulatory framework from end-2025. The second regulatory period for AST started in July 2023 with a new tariff in place. The methodology is 70%-80% based on installed capacity in Latvia and 20%-30% on volume. 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 of regulatory advantage to strong/adequate (see "Latvian Gas And Electricity Transmission And Gas Storage Regulatory Frameworks: Mostly Supportive," published Nov. 30, 2022, on RatingsDirect). We also understand that there will be a significant need to balance the Latvian electricity system once Latvia desynchronizes from the Russian electricity network. We expect such changes to be incorporated in the third period starting January 2026.

We will continue to monitor the efficient use of accumulated congestion income amid price stabilization across the Baltics and adjusted metrics trending toward 40%-45%. As of first-half 2024, AST recorded €155 million of congestion income on its balance sheet having allocated €3.5 million to revenues during the period. This is in line with our expectation of about €150 million-€155 million by year-end 2024, of which we consider about €20 million-€25million as unallocated. Because electricity prices in Latvia have declined to €80-€100 per megawatt hour (/MWh) from €350-€450/MWh at the peak of the energy crisis, we expect the magnitude of congestion income to decline to about €1 million-€2million per month, resulting in annual growth of unallocated congestion income of about €15 million-€25 million per year. As we continue to consolidate unallocated congestion income with debt in our calculations, we forecast that adjusted FFO to debt will remain around 40%-45% until the new regulatory period.

Outlook

The stable outlook incorporates our view that AST will continue to use its congestion income efficiently, maintaining regulatory FFO to debt around 40%-45% while volatility of credit metrics reduces as congestion income is used.

Downside scenario

A downgrade of Latvia would trigger a similar action on AST.

A downgrade could also stem from AST reporting regulatory FFO to debt below 23% or a weakening of the regulatory framework that could come from adverse regulatory outcome for the period starting January 2026 or more volatility within the current period. In these scenarios, we would likely revise downward our SACP by one notch to 'bbb-'.

Upside scenario

We could revise the SACP upward by one notch to 'bbb+' if we have more visibility on the regulatory framework starting January 2026, combined with significant reduction and usage of accumulated congestion income. This would have no impact on the issuer credit rating unless we also raised the rating on Latvia to 'A+' from 'A'.

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. It 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.

Liquidity

We assess AST's liquidity as adequate because we expect liquidity sources will cover uses by more than 1.1x over the 12 months started Sept. 30, 2024. The adequate liquidity is further underpinned by AST's good relationship with banks, given it has successfully contracted bank loans and overdraft facilities at reasonable prices.

Principal liquidity sources include as of Sept. 30, 2024:

- Cash and cash equivalents of about €50 million-€60 million;
- About €55 million-€60 million of cash FFO over the next 12 months;
- Annual congestion income of €10 million-€15 million; and
- Our expectation of about €10 million-€15 million dividends from Conexus Baltic Grid.

Principal liquidity uses include over the same period:

- About €80 million of capital expenditures net of EU funds;
- Dividends of at least €10 million set in law; and
- No debt maturity until 2026.

Ratings Score Snapshot

Issuer Credit Rating	A-/Stable/--
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 (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	Negative (-1 notch)
Stand-alone credit profile:	bbb
Related government rating	A
Likelihood of government support	High (+2 notches)

Related Criteria

- Criteria | Corporates | General: Sector-Specific Corporate Methodology, April 4, 2024
- 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
- 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
- General Criteria: Country Risk Assessment Methodology And Assumptions, 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

Related Research

- Latvia Long-Term Ratings Lowered To 'A' On Economic, Fiscal, And Security Risks; Outlook Stable, May 31, 2024
- 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-/Stable/--	A-/Positive/--