

Research Update:

# Latvian TSO Augstsprieguma Tikls Rated 'BBB+'; Outlook Stable

February 16, 2021

## Rating Action Overview

- State-owned Augstsprieguma Tikls (AST) is a monopoly electricity and gas transmission system operator (TSO) in Latvia, which generated about €40 million of EBITDA in 2020.
- Our assessment of AST's creditworthiness reflects that the Latvian government is highly likely to provide extraordinary support if needed. We also factor in the supportive and predictable regulatory framework, somewhat balanced by the moderately high risk of operating in Latvia.
- Our assessment of AST's stand-alone credit quality is currently constrained by its sizable upcoming maturities due to the recent merger between AST and LET, which weigh on our liquidity assessment.
- We are assigning our 'BBB+' long-term issuer credit rating to AST.
- The stable outlook mirrors that on Latvia, and reflects our assumption that AST will proactively manage its upcoming maturities and continue to enjoy a high likelihood of extraordinary government support.

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## Rating Action Rationale

**Our assessment of a high likelihood of support from the Latvian government underpins our 'BBB+' rating.** AST is the government's strategic asset as the owner and operator of the country's power transmission network and majority owner of the gas transmission network (Conexus Baltic Group), with 68.46% of capital. We factor in three notches of uplift to the 'bb+' stand-alone credit profile (SACP) for AST to derive the rating. This is because we believe the government of Latvia (A+/Stable/A-1) is highly likely to provide timely and sufficient extraordinary support to AST in the event of financial distress. Our assessment is based on AST's:

- Very important role as the backbone of the energy system, which cannot be easily replaced. In addition, AST is the vehicle through which the government implements its energy policy, notably relating to the 2025 target of disconnection from Russia, the synchronization of the Baltic and Scandinavian power markets, and the acquisition of CBG as per the government's plan.

- Strong link with the government, mostly driven by the government's full ownership of AST. Privatization is unlikely because the full historical ownership of Latvenergo (now AST and Latvenergo) is embedded in law. In addition, the majority of AST's supervisory board comprises members of the ministry of finance who define the company's strategy and are involved in major decisions, notably after the regulator's approval of the 10 year investment plan.

We expect the government to be willing and able to support AST in case of financial distress, as highlighted by the 'A+/Stable' sovereign rating.

We will monitor our government support assessment over the next 12 months as AST faces a large upcoming maturity (€116.2 million) that might trigger liquidity issues if not refinanced for any unforeseen reasons (which is not our base case). We expect the government to support AST if the company can't refinance.

**A supportive regulatory framework provides cash flow visibility and protection against volume risk, despite the limited track record, with a new methodology introduced from 2021.** We

believe Latvia's new regulatory framework for power networks, established from January 2021, is credit supportive. Notwithstanding the framework's short track record, the energy market has been overseen by the same regulator--Public Utilities Commission of Latvia (PUC)--since 2001. The regulator operates as a stand-alone entity subject to public law and is financially independent from the Latvian government. We view the PUC as highly independent, with operations and financing being separate from the government.

The new framework introduces regulatory periods, with the first spanning two years; the subsequent periods are five years, in line with other EU regulatory frameworks. We understand the first two years will serve as a trial period to test the efficiency of the framework following the recent reorganization of AST as the historical owner of the transmission network (Latvijas elektriskie tīkli) was merged with AST to implement a full ownership unbundling model.

The new framework follows a revenue cap regulatory asset base (RAB) methodology that provides more transparency and predictability than the previous framework, which followed a cost-plus method (the previous methodology had been in place since 2007). From 2021, allowed revenues are calculated based on the installed capacity in Latvia, allowed and justified costs, and AST's RAB, as well as the regulatory weighted-average cost of capital (WACC):

- AST's RAB used for the allowed revenues calculation in the new methodology is estimated at around €414 million. Despite large ongoing investments in progress, investments financed by EU contributions or by congestion income do not increase the RAB. We therefore expect the RAB to increase slowly because every future investment made with EU funding will be co-financed by AST. However, we expect most investments that materially increased the RAB will be completed soon as most major interconnection projects are to be commissioned this year.
- The WACC has decreased to 2.65% in 2021 from 3.3% in 2020. The WACC is calculated annually and is applied to the tariff upon request from the network; otherwise it is expected to remain stable at 2.65%.

We consider the framework to provide stability and protect AST from volume risk, as 80% of the allowed revenues are fixed and based on Latvian installed capacity, with only 20% based on actual volumes transmitted through the Latvian network.

AST benefits from an efficiency incentive in that it can retain 50% of its over-profit while giving the remaining 50% to end-users through tariff changes (as they report their costs and revenue calculation annually). This is the only incentive under the new framework. We understand that

more incentives and penalties may be discussed over the coming two years and could materialize during the next regulatory period starting in 2023.

**Our assessment of AST's business remains constrained by the moderately high risk of operating in Latvia.**

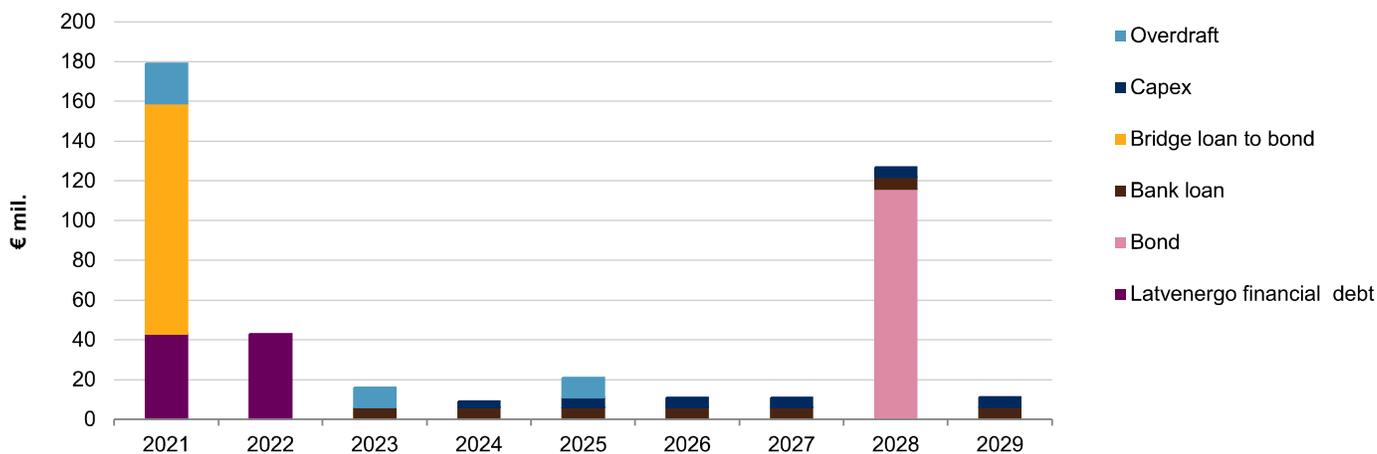
We consider operations in Latvia to be riskier than in other Baltic countries. We believe Latvia has a weaker banking system than neighboring countries, which weighs on Latvian companies' ability to raise debt. The country's biggest bond issuance (Air Baltic's €200 million 6.75% five-year instrument issued in July 2019) emphasizes the infancy and small scale of the domestic capital market and banking system.

**The sizable maturity coming up in 2021 weighs on our assessment of AST's liquidity and constrains its SACP at 'bb+'.**

Following the merger with LET in 2020, AST took on the group's €225 million financial liabilities and plans to fully refinance them by year-end 2022. To refinance the 2020 maturity, AST used some on-balance-sheet cash and raised a bridge loan of €116.2 million maturing in December 2021, which represents a sizable maturity over the next 12 months. Through the bridge loan, AST took advantage of favorable terms to partially refinance LET's financial liabilities until December 2021. We understand that the bridge loan was a short-term solution, related to the post-merger reorganization of the group, to refinance LET's financial liabilities. This maturity is very large compared with AST's expected funds from operations (FFO) of €35 million and cash reserves of about €57 million. AST is planning to issue a bond to refinance the bridge loan in the first half of 2021, but this remains subject to market conditions, which we will closely monitor.

Chart 1

**AST's Debt Maturities**



Source: S&P Global Ratings.

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We believe that, as a regulated utility and a government-related entity, AST is well positioned to address the upcoming refinancing, and we expect the company to maintain a prudent and proactive approach to liquidity management. Still, before the refinancing is completed, we view AST's liquidity over the next 12 months as less than adequate. This constrains our assessment of the group's SACP at 'bb+'.

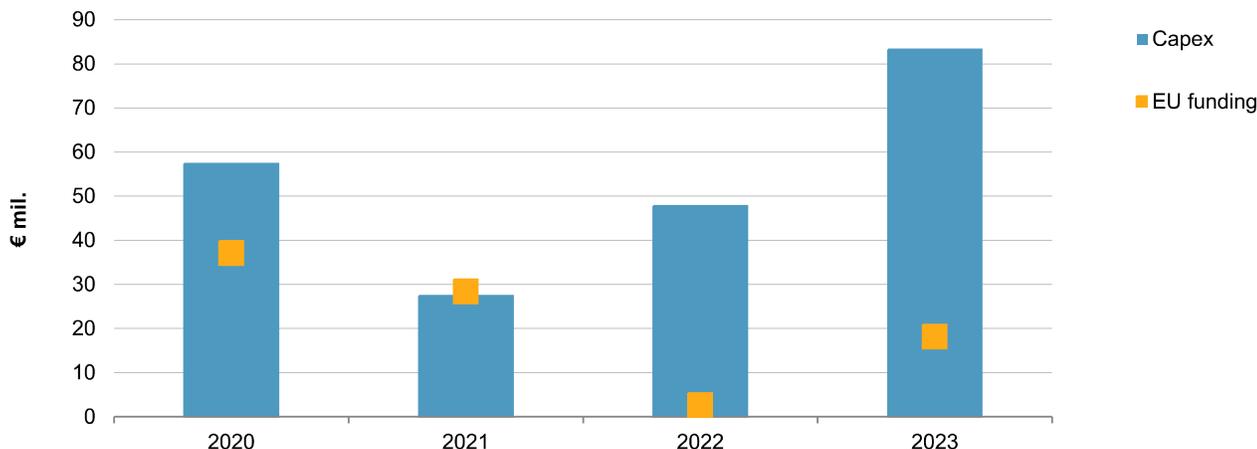
**We expect AST's FFO to debt to be about 20%-22% and debt to EBITDA about 4.0x-4.5x in 2021-2022, with potential weakening after 2023 because of higher capital expenditure (capex).**

Following the integration of LET in 2020, AST took on €225 million of financial liabilities, increasing its 2020 S&P Global Ratings-adjusted leverage substantially to 4.7x from 1.2x in 2019 (this includes adjustment for lower expected lease liabilities, as AST now owns the network). We expect our adjusted EBITDA to be stable at around €40 million annually and FFO around €35 million, excluding dividends from CBG (as these are passed-through to the government). We forecast FFO to debt and debt to EBITDA will stabilize around 20%-22% and 4.0x-4.5x, respectively, over the next two years.

From 2023, we expect AST to ramp up capex to €229 million (through to 2030) mainly to improve and maintain the existing network. With lower EU funding to support such investments, FFO to debt will likely decrease to about 17%-18% and debt to EBITDA will increase to around 5.0x, which we still view as commensurate with the 'bb+' SACP.

Chart 2

### AST's Capex Plan And EU Contributions



Source: S&P Global Ratings.

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## Outlook

The stable outlook mirrors that on Latvia and assumes AST's high likelihood of extraordinary government support and successfully refinancing its upcoming maturities. It also takes into account our forecast of stable and predictable cash flows from AST's low-risk regulated transmission business, with FFO to debt of around 18%-22% in the next two-to-three years.

## Downside scenario

A downgrade of Latvia would result in us taking the same action on AST.

We could also lower the ratings if AST's financial and operating performance materially deviates

from our base case, leading us to revise down its SACP. This may result from:

- Weaker and more volatile cash flows, such that FFO to debt deteriorates below 13% without any prospects for recovery; or
- Higher capex than planned, combined with lower EU funding over the forecast period.

We could also lower the rating if we see a reduced likelihood of AST receiving extraordinary support from the Latvian government, including through the 2021 refinancing exercise. This is not our base case.

## **Upside scenario**

If we took a positive rating action on Latvia, this would result in a similar rating action on AST. We could also upgrade AST if government support strengthens or if we revise AST's SACP up by two notches, which we view as unlikely in the medium term.

If AST's liquidity becomes adequate, with over 1.1x coverage of 12 months maturities with committed liquidity sources, we would likely revise upward our SACP assessment by one notch, which will not be sufficient for an upgrade. On top of liquidity improvement, an SACP-triggered upgrade would require S&P Global Ratings-adjusted FFO to debt to be consistently above 23% or an upward revision of Latvia's country risk.

## **Company Description**

AST is the only power 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 Finance 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 kept the generation and distribution activities, the latter regulated under the same framework as AST.

In 2017, AST purchased 18.31% and 16.05% of Conexus Baltic Grid, 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 CBG by acquiring 34.1% of CBG's shares from Gazprom.

AST owns 5,424km of power lines and 140 substations. In 2019, AST transmitted 6 terawatt hours of electricity throughout Latvia and neighboring 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**

In our base case until 2023 we assume:

- A new regulatory framework starting in 2021 with the first period lasting two years; the subsequent periods will be five years, from January 2023.
- Close to no revenue growth over the forecast period based on a predictable and stable new

regulatory framework, for which allowed revenues are computed for the entire period.

- 80% of allowed revenues fixed and based on Latvian power generation capacity. We expect it to remain stable as Latvia's aim is to synchronize with Central Europe through increased connection between Latvia and Poland, while disconnecting from Russia.
- WACC of 2.65% from 2021 (from 3.31% in 2020) with the possibility of being reassessed upon the network's request to change tariffs during regulatory periods.
- Stable EBITDA at around €42 million-€45 million over the next two regulatory periods (seven years).
- Exclusion of congestion income from revenues (about 4% revenues) and EBITDA (about 10% EBITDA) but included in operating cash flows.
- Exclusion of CBG income from EBITDA as this is pass-through and 100% is expected to go to the government.
- Investments in line with the board and regulator-approved 10-year investment plan comprising:
  - --€0.2 million due in 2021 to finalize the third EE-LV Interconnection;
  - --€45 million over 2020-2024 to reinforce two 49km-long intra-Latvia transmission lines and co-financed by the EU;
  - --€104 million over 2021-2025 to synchronize condensers in Latvia through three substations. Co-financed with the EU, AST is expected to pay 25% of total capex; and
  - --€229 million over 2021-2030 for internal network modernization, including substations and transmission lines to increase the security of supply.
- 80% dividend payout ratio in line with AST's dividend policy. Total dividend payments include CBG's dividends to the government.
- Expected interest rates of 1.5% for the 2021 bond issuance and EURIBOR + 74 basis points (bps) for the 2021 bank loan.
- 2020 and 2021 restricted cash in line with annual repayment of LET's financial liabilities as it is a priority for AST following the merger at year-end 2020. It amounts to €22.4 million in 2020 and €43.3 million in 2021. We don't restrict any cash from 2022.

## Key metrics

(Mil. €)	fiscal year end Dec. 31			
	2020e	2021f	2022f	2023f
EBITDA	38-42	38-42	38-42	38-42
Funds from operations (FFO)	37-40	34-38	34-38	34-38
Capital expenditures	55-60	25-30	45-50	80-85
Dividends	0-5	15-20	10-15	10-15
Debt	165-185	165-185	140-160	175-195
Debt to EBITDA (x)	4.0-5.0	4.0-5.0	3.5-4.5	4.0-5.0
FFO to debt (%)	20-25	20-25	20-25	15-20

\*All figures adjusted by S&P Global Ratings. e--estimate. f--Forecast.

## Liquidity

We assess AST's liquidity as less than adequate because we do not expect liquidity sources to cover uses by more than 1.1x over the 12 months starting Jan. 1, 2021.

We believe, however, that AST has a good relationship with banks as demonstrated by its bank loans and overdraft and capex facilities with a 1.5%/EURIBOR + 74bps interest rate. We believe AST's standing in the credit markets will improve following the bond issuance expected in 2021.

Principal liquidity sources include:

- Cash and cash equivalents of about €57 million.
- Operating cash flows of about €42 million.
- No committed bank lines maturing beyond the next 12 months.

Principal liquidity uses include:

- Bridge loan maturity of €116.2 million.
- About €28 million of capex fully covered by the EU funds over the next 12 months.
- Dividends of about €9 million including dividends from CBG to the government.

## Covenants

AST has three covenants under its SEB loans constituting the bridge loan, the overdraft facilities over 2020-2022, and capex facilities from 2023:

- Debt service coverage ratio > 1.2x
- Equity > 25%
- Debt to EBITDA < 6x

We believe there is no risk that AST will breach its covenants over the next two years.

## Ratings Score Snapshot

Issuer Credit Rating: BBB+/Stable/ --

Business risk: Satisfactory

- Country risk: Moderately High
- Industry risk: Very Low
- Competitive position: Satisfactory

Financial risk: Significant

- Cash flow/Leverage: Significant

Anchor: bbb-

Modifiers:

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- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Less than Adequate (-1 notch)
- Financial policy: Neutral (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: bb+

- Sovereign rating: A+/Stable
- Likelihood of government support: High (+3 notches)

## Related Criteria

- 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
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- Criteria | Corporates | Utilities: Key Credit Factors For The Regulated Utilities Industry, 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

## Ratings List

### New Rating

#### Augstsprieguma Tikls

Issuer Credit Rating
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.standardandpoors.com](http://www.standardandpoors.com) for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at [https://www.standardandpoors.com/en\\_US/web/guest/article/-/view/sourceId/504352](https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352) Complete ratings

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