FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Poland's Tauron at 'BBB-'; Outlook Stable

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Fitch Ratings - Warsaw - 05 Oct 2023: Fitch Ratings has affirmed TAURON Polska Energia S.A.'s (Tauron) Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDRs) at 'BBB-'. The Outlook is Stable. A full list of rating actions is below.

The affirmation reflects the continuing dominant share of regulated and predictable electricity distribution in Tauron's business profile, solid market position and projected leverage within rating guidelines.

We view Tauron's planned divestments of coal-fired power plants to state-controlled National Agency for Energy Security (NABE) as credit positive as we regard coal assets as a burden for the company's generation segment's profitability, ESG Relevance Scores and its debt-funding capability.

KEY RATING DRIVERS

High Share of Regulated Business: The ratings reflect a high share of regulated electricity distribution with good predictability in Tauron's EBITDA (73% in 2021-2022 and slightly above 60% on average over our forecast period of 2023-2027) and the company's position as the largest electricity distributor in Poland covering southern, densely populated regions.

Good results in the distribution segment in 2023 are supported by a higher weighted-average cost of capital (WACC), which has risen to 8.48% (including the reinvestment premium) from 5.78% in 2022, despite a decrease in the volume of distributed energy due to declining market demand. Fitch expects

WACC to remain similarly high in the coming years, which will enable Tauron to proceed with its large planned investments in the distribution grid.

Strong Profitability in 2023: Fitch expects Tauron to post solid results in 2023 with Fitch-adjusted EBITDA rising to PLN5.5 billion from PLN3.7 billion, supported by strong performance in distribution and conventional generation. However, results in renewables and the supply segment will be weaker following recent changes in regulations.

Good Generation Results in 2023: We expect Tauron's EBITDA in the generation segment to reach PLN1 billion in 2023 (after negative EBITDA posted in 2022 following operational issues in new generation unit in Nowe Jaworzno), supported by high energy prices contracted last year, only partially offset by declining trend in generation volumes. The price cap for generators does not put much pressure on Tauron's conventional generation units as the formula considers the high costs of fuel, CO2 cost, high fixed costs and substantial inflation.

Generation Under Pressure in Long Term: In the longer term, we expect deterioration in the profitability of coal-fired assets due to declining electricity prices and increasing CO2 costs, which will put clean dark spread under pressure. Under the rating case, Fitch assumes revenue from the capacity market will partly compensate worsened margins.

Regulatory Changes Pressure Supply: Fitch expects Tauron to post about PLN600 million of EBITDA in supply, in line with last year's results. EBITDA is supported by higher margins on energy supplied to the business segment (despite extra contributions to the Price Difference Payment Fund, estimated at PLN600 million in 2023). It also benefits from higher tariffs approved by the regulator for households as well as the state mechanism to compensate supply companies for capped energy prices for households, SME, local governments and utilities from December 2022 until end-2023.

We expect the full year results for supply will be only slightly better than those posted in 1H23, following further regulatory changes in September 2023. These further reduced bills for households (by PLN125 per household) and will cost Tauron PLN536 million if not compensated.

Coal-Fired Spin-Off on Hold: Fitch has not included the planned divestments of the company's coal-fired power plants to NABE in its rating case as the key legal act enabling the creation of NABE has not yet been enacted. In Fitch's view, this is unlikely to happen ahead of the parliamentary elections scheduled on 15 October 2023. The elections put the whole process at risk in case the ruling party changes. If the ruling party wins the elections and continues the project, we expect the legal process through parliament will take at least three months with the creation of NABE no earlier than Spring 2024.

Fitch believes the divestment will improve Tauron's business profile by eliminating high-risk coal-fired electricity generation from the business mix and allowing it to focus on more predictable, regulated electricity distribution and renewable generation. The transaction is likely to lead to higher debt capacity for the current rating and improved ESG Relevance Scores.

Negative Free Cash Flow: We expect free cash flow to remain negative in 2023-2027, driven by significant capex, especially in the distribution and renewables segments. We do not expect Tauron to distribute dividends during its heavy investment cycle. We forecast funds from operations (FFO) net leverage at 2.9x in 2023 and an average 3.9x in 2024-2027, which is within our current rating sensitivities (FFO net leverage below 4.5x).

Rated on a Standalone Basis: Tauron is 30%-owned and effectively controlled by the Polish state (A-/Stable). Based on our Government-Related Entities (GRE) Rating Criteria, we assess status, ownership and control links as 'Strong', support record as 'Weak', socio-political impact of a default as 'Moderate', but the financial implications of a default as 'Weak'. Consequently, we do not apply any rating uplift for its links with the Polish state.

DERIVATION SUMMARY

Tauron's close peer group includes the three other electricity-focused integrated utilities in Poland: PGE Polska Grupa Energetyczna S.A. (PGE; BBB+/Stable), ENEA S.A. (BBB/Stable) and Energa S.A. (BBB+/Stable).

Tauron and Energa have comparable business profiles, benefiting from the large share of regulated distribution in EBITDA, which provides good cash-flow visibility. 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. However, Tauron has a greater share of hard-coal fired generation in its business profile, which is currently under pressure.

As a result, we assess that Energa has a more sustainable business profile, which is reflected in its higher debt capacity, with a negative rating sensitivity of 5.0x for its 'bbb-' Standalone Credit Profile compared with 4.5x for Tauron. Energa's IDR is equalised with that of its parent, ORLEN S.A. (BBB+/Stable).

PGE is Poland's largest utility company 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.

ENEA has a lower share of regulated distribution than Tauron and Energa and at the same time higher exposure to hard coal-fired generation. The maximum leverage sensitivity for ENEA's 'BBB' rating is 3.0x.

KEY ASSUMPTIONS

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

- Average electricity prices of 644 PLN/MWh in 2023-2027

- Annual revenue from capacity payments at average PLN819 million in 2023-2025 and PLN461 million in 2026-2027

- WACC in the distribution segment of 8.48% in 2023-2027

- Capex of PLN28 billion over 2023-2027

- No dividend payments in 2023-2027

RATING SENSITIVITIES

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

- FFO net leverage below 3.5x on a sustained basis

- A more diversified fuel generation mix and lower carbon footprint for example through divestment of coal-fired power plants to NABE or investments in renewable generation

- Increased focus on regulated and quasi-regulated business in capex and overall strategy

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

- FFO net leverage above 4.5x and FFO interest cover below 5x on a sustained basis, for example, due to weaker than expected EBITDA, higher capex or acquisitions, or reinstatement of dividends

- Weakening of business profile, for example due to delays in implementation of strategy, including with regards to the transfer of coal-fired plants outside the group, or increased exposure to higher-risk businesses

LIQUIDITY AND DEBT STRUCTURE

Adequate Liquidity: At end-June 2023, Tauron had PLN1 billion of Fitch-calculated readily available cash and cash equivalents as well as PLN3.9 billion of available committed credit facilities. This was against debt maturities of PLN978 million in 2H23 (including some short-term debt drawn within 2023) and PLN1,115 million in 2024 as well as Fitch-expected negative free cash flow over 2023-2024, driven by capex. The company has sufficient liquidity until end-2024.

Adequate Covenant: Tauron has adequate headroom under the main covenant included in its debt arrangements of net debt-to-EBITDA of up to 3.5x. Its net debt-to-EBITDA increased to 2.9x at end-2022 from 2.4x at end-2021, due to worsened profitability, especially in generation segment. At end-June 2023 the ratio improved to 2.0x.

ISSUER PROFILE

Tauron is the second-largest electric utility in Poland by EBITDA. The company is focused on electricity distribution, which is complemented by electricity generation, supply of electricity and gas.

SUMMARY OF FINANCIAL ADJUSTMENTS

Fitch-adjusted debt calculation included guarantees for the ECSW gas-fired power plant joint venture.

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.

ESG CONSIDERATIONS

Tauron has ESG Relevance Scores of '4' for GHG Emissions & Air Quality and Energy Management. This is due to the dominant share of hard coal in its electricity generation mix, which is carbon-intensive and under regulatory pressure in the EU. These issues have a negative impact on the credit profile, and are relevant to the ratings in conjunction with other factors.

The highest level of ESG credit relevance is a score of '3', unless otherwise disclosed in this section. A score of '3' 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. Fitch's ESG Relevance Scores are not inputs in the rating process; they are an observation on the relevance and materiality of ESG factors in the rating decision. For more information on Fitch's ESG Relevance Scores, visit https://www.fitchratings.com/topics/esg/products#esg-relevance-scores.

RATING ACTIONS

ENTITY / DEBT	RATING			PRIOR
TAURON Polska Energia S.A.	LT IDR	BBB- Rating Outlook Stable	Affirmed	BBB- Rating Outlook Stable

	ST IDR F3 Affirmed	F3
	LC LT IDR BBB- Rating Outlook Stable Affirmed	BBB- Rating Outlook Stable
	LC ST IDR F3 Affirmed	F3
	Natl LT A(pol) Rating Outlook Stable Affirmed	A(pol) Rating Outlook Stable
senior unsecured	LT BBB- Affirmed	BBB-
subordinated	LT BB Affirmed	BB
subordinated	Natl LT BBB(pol) Affirmed	BBB(pol)

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Government-Related Entities Rating Criteria (pub. 30 Sep 2020)

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)

Corporate Rating Criteria (pub. 28 Oct 2022) (including rating assumption sensitivity)

Climate Vulnerability in Corporate Ratings Criteria (pub. 21 Jul 2023) (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), v8.0.3 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

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TAURON Polska Energia S.A.	EU Issued, UK Endorsed

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