FitchRatings

RATING ACTION COMMENTARY

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

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Fitch Ratings - Warsaw - 18 Oct 2021: 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 on the IDRs is Stable. A full list of rating actions is below.

The rating reflects a dominant share of stable electricity distribution in Tauron's business profile, which is complemented by higher-risk coal-fired generation and mining, and large rating headroom under the leverage guidelines for the current rating.

The key upside is the planned divestments of Tauron's coal-fired power plants and coal mines to the Polish state, which once finalised would likely be positive for the company's credit profile. The main risk relates to potentially insufficient reflection of surging wholesale electricity prices in its retail tariffs from 2022.

KEY RATING DRIVERS

High Share of Regulated Business: The ratings reflect a high share of regulated and fairly stable electricity distribution in Tauron's EBITDA (72% in 2020, 60%-65% in our 2021-2025 rating case) and the company's position as the largest electricity distributor in Poland covering southern, densely populated regions. The regulatory framework in Poland is stable and has further improved by the introduction of a regulatory account from 2021, which allows for automatic reflection of differences between actual and forecast distribution volumes in the next tariff year.

Capacity Payments Provide Stability: From 2021, Tauron receives capacity payments amounting to around PLN0.7 billion per annum or around 15% of EBITDA in our 2021-2025 rating case. We treat capacity payments as quasi-regulated and supportive of Tauron's credit profile as they are a more reliable source of cash flows than selling electricity to the wholesale market.

Shift to Renewables: Tauron has set up a renewables division and is targeting 1.1GW of capacity in onshore wind and 0.3GW in photovoltaics by 2025, on top of its existing hydro and biomass assets. We expect the share of renewables in EBITDA to increase to around 10% in 2025 from 7% in 2020, which will be positive for Tauron's business profile, though the size of the renewables division will likely remain smaller than peers'.

Mining under Pressure: Tauron's mining division has been loss-making since 2016, due to low production and high costs. Our rating case expects a break-even in 2022 and zero EBITDA in 2022-2025. Upside may come from currently booming global hard-coal prices, if sustained and reflected in the domestic hard-coal market. Nevertheless, the planned divestment of the mining business to the state (letter of intent signed in September 2021) would improve Tauron's credit profile.

Coal-fired Generation Under Pressure: Tauron has a large hard coal-fired generation fleet (2020: 5GW), which is profitable (8% of EBITDA in 2020, 3% on top of capacity payments in our 2021-2025 rating case), but an increasing decarbonisation focus by the EU, including very high CO2 prices, will erode its business rationale in the long term. Furthermore, due to on-site fires in 2021, Tauron has ceased operations of its new 0.9GW unit in Jaworzno for repairs. In the interim, higher generation volumes are provided by older units of the Jaworzno power plant.

Booming Price Environment: Surging gas prices have pushed wholesale electricity prices in western Europe to record levels, while booming CO2 prices have stimulated wholesale electricity prices in Poland. Nevertheless, prices in Poland are lower than in western Europe and the country turned into a net exporter of electricity. Should this persist for longer, results of Tauron's coal-fired generation should be better than currently anticipated, due to increased generation volumes.

Supply Potentially Under Pressure: Tauron's supply business (16% of 2020 EBITDA) may come under pressure from 2022, if the company is not allowed to pass on higher purchase costs of electricity to retail customers (or be reimbursed for keeping prices low). The government announced that it is working on a support mechanism, but important details are yet to be determined. Tariffs for households for 2022 will be approved by the Regulatory Office in late 2021.

Spin-Off of Coal-Fired Units: The Polish government proposed to spin off coal-fired power plants owned by Tauron and its Polish peers to a fully state-owned entity, National Agency for Energy Security (NABE). It should have a positive impact on Tauron's credit profile, allowing the company to focus on electricity distribution and renewable generation, and improve its debt capacity. The deal is not yet binding and lacks important details such as the price to be paid by NABE and the amounts of debt to be transferred to NABE, therefore we have not included it in our rating case.

Large Rating Headroom: We expect Tauron's capex to increase in 2021-2025, mainly because of renewables. However, it will be accompanied by EBITDA increase (in particular from capacity payments) and we therefore do not expect material pressure on credit metrics. We anticipate that funds from operations (FFO) net leverage will average 3.8x over 2021-2025, which is comfortably within the rating guidelines of 3.5x-4.5x for the current rating.

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

ESG Influence: ESG issues have a negative impact on the ratings, in combination with other factors, primarily given the dominant share of coal in Tauron's fuel mix, but also because of coal mining, which is hit by long-term weak market economics and the global push for renewables. This is reflected in our ESG credit relevance scores of '4' in categories "GHG Emissions & Air Quality" and "Energy Management".

DERIVATION SUMMARY

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

Tauron and Energa have comparable business profiles, benefitting from a large share of regulated distribution in EBITDA, which provides good cash-flow visibility when conventional generation and mining are under pressure. However, Tauron's leverage is higher than Energa's, while the latter's IDR is also constrained by that of parent, PKN ORLEN S.A. (BBB-/Rating Watch Positive).

PGE is Poland's largest utilities 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, which provides cost advantage over hard coal-fired peers. However, further increase of CO2 prices, lower prices of hard coal or rising inability to pass on generation costs to end-customers would diminish this cost advantage over time.

ENEA has a lower share of regulated distribution than Tauron and Energa and at the same time higher exposure to hard coal-fired generation, but controls a profitable mining business and has lower leverage.

KEY ASSUMPTIONS

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

- Pass on of CO2, hard coal and gas prices to wholesale electricity prices in Poland;

- Annual revenue from capacity payments at around PLN0.7 billion over 2021-2025;

- Mining EBITDA negative in 2021 and neutral from 2022 to 2025;

- Weighted-average cost of capital in the distribution segment at 5.32% in 2021 and 5.5% in 2022-2025;

- Full or close to full reflection of higher wholesale electricity prices in price for end-customers;

- Capex at PLN21 billion over 2021-2025;

- Continuation of a zero-dividend policy over 2021-2025; and

- Lack of capital investment at Rafako S.A., the general contractor of the Jaworzno unit.

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, for example, through a spin-off of coal-fired units to NABE or investments in renewable generation

- Capex and overall strategy to focus on regulated and quasi-regulated businesses

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 higher capex or acquisitions, reinstatement of dividends, unfavourable conditions for the coal assets' spin-off to NABE or problems in getting a waiver in case of a covenant breach

- Weaker EBITDA or working capital outflows, for example, due to economic downturn, under-performance of mining or coal-fired generation, or tariff deficit

- Weakening of Tauron's business profile, for example, due to delays in implementation of the strategy or increased exposure to higher-risk businesses

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Non-Financial Corporate issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

LIQUIDITY AND DEBT STRUCTURE

Adequate Liquidity: At end-June 2021, Tauron had PLN379 million of Fitch-calculated readily available cash as well as PLN5,010 million and EUR45 million of committed credit facilities. This was against debt maturities of PLN279 million in 2H21 and PLN2,138 million in 2022 as well as Fitch-expected negative free cash flow over 2021-2022, driven by capex. The company has sufficient liquidity until 4Q22, when PLN2 billion of a consortium loan will mature.

Covenant Headroom: Tauron has adequate headroom under the main covenant included in its debt arrangements of net-debt-to-EBITDA of up to 3.5x. Its reported net-debt-to-EBITDA decreased to 2.1x at end-June 2021 from 2.5x at end-2020, due to improved EBITDA.

ISSUER PROFILE

Tauron is a large-scale integrated utility operating in Poland. The company is focused on electricity distribution, which is complemented by electricity generation, supply of electricity and gas and hard-coal mining.

SUMMARY OF FINANCIAL ADJUSTMENTS

Fitch-adjusted debt calculation included guarantees for the ECSW gas-fired power plant joint venture and for the Wind T1 renewable project. Fifty percent equity credit was allocated to outstanding hybrid bonds.

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 Credit Relevance Scores of '4' in categories "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, and an unprofitable coal-mining business. These issues have a negative impact on the credit profile, and are relevant to the ratings in conjunction with other factors.

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This 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. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

RATING ACTIONS

ENTITY/DEBT	RATING	PRIOR

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	F3	Affirmed	F3

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. 15 Oct 2021) (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), v7.9.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

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Corporate Finance Utilities and Power Europe Poland
