Credit FAQ: Will European Utilities' Investments In Russian Power Pay Off?

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Frequently Asked Questions

The fast-growing Russian power sector presents an increasingly attractive investment opportunity for Western European utilities. The industry predicts that the sector will grow at about 5% over the next few years and that it will need investments of more than $20 billion per year over the next 15 years to modernize power stations and transmission systems and to construct new generation capacity. The ongoing liberalization of Russia's wholesale power sector, which is in part driven by the need to create conditions to attract investment to the market, could lead to investment opportunities for European utility companies. By transferring expertise gained from operating in already deregulated markets, they could potentially create a growth platform and boost their returns through efficiency enhancements. Still, investors in this sector also face the risks associated with a transitional economic environment, and an uncertain political and regulatory regime. Here, Standard & Poor's Ratings Services addresses some of the most frequent questions we receive regarding the likely credit impact on European utilities investing in Russian power.

Frequently Asked Questions

How does Standard & Poor's factor investments in the Russian power sector into its ratings on Western European utility companies?

Investments in the Russian power sector would be generally credit dilutive, as would most investment in Eastern Europe, owing to the greater macroeconomic, sovereign, and country risks than investing in a Western European country. The Russian economy is less diversified and may be less stable over time, the political system may be subject to change, and the regulatory system is less mature creating regulatory and political uncertainty. Weaker macroeconomic characteristics and higher political and regulatory risks translate into a weaker business profile for Russian power utilities compared with western European peers. As a result of sovereign- and sector-specific risk factors, the average credit quality of Russian and Eastern European power companies is lower than that of EU power companies. The ratings on Russian utilities are below investment grade, in the 'BB' or 'B' category, because they are smaller, less diversified, and less profitable than Western European peers (see table 1). They generate less or no free cash flow and face greater political, legal, and regulatory risks than utilities in the EU. By contrast, more than 90% of EU utility ratings are rated in the investment-grade rating categories ('BBB' or higher).

Table 1

European And Russian Utilities Peer Comparison

(Mil. €)	E.ON AG	Enel SpA	Fortum Oyj	Irkutskenergo, AO EiE	Mosenergo (AO)	RAO UES of Russia
	A/Stable/A-1	A/Watch Neg/A-1	A-/Stable/A-2	B+/Positive/--	B/Watch Pos/--	BB/Stable/--
Business risk	Excellent	Excellent	Excellent	Weak	Weak	Weak

profile

Country	Germany (Federal Republic of)	Italy (Republic of)	Finland (Republic of)	Russian Federation (The)	Russian Federation (The)	Russian Federation (The)
Sovereign credit rating (foreign currency)	AAA/Stable/A-1+	A+/Stable/A-1+	AAA/Stable/A-1+	BBB+/Stable/A-2	BBB+/Stable/A-2	BBB+/Stable/A-2
Sovereign credit rating (local currency)	AAA/Stable/A-1+	A+/Stable/A-1+	AAA/Stable/A-1+	A-/Stable/A-2	A-/Stable/A-2	A-/Stable/A-2
Key markets	Germany, U.K., Nordic region, U.S. Midwest market, Centeral & Eastern Europe. (Potential market: Russia).	Italy, America & Europe (renewable energy and distribution activities).	Core markets are Finland and Sweden, with Russia and Poland as target growth markets.	Irkutsk Oblast in east Siberia.	City of Moscow and the Moscow Oblast.	Russia-Commonwealth of Independent States, including Armenia, Georgia, Kazakhstan, Moldova, and Tajikistan.
Financial statistics						
Fiscal year end	'Dec. 31, 2006	Dec. 31, 2006	Dec. 31, 2006	Dec. 31, 2006	Dec. 31, 2006	Dec. 31, 2005
Total revenues	64,197.0	38,513.0	4,491.0	694.9	1,971.1	21,814.0
Net income from continuing operations	4,930.0	3,036.0	1,071.0	61.9	251.6	521.0
Funds from operations (FFO)	12,351.9	6,190.0	1,397.8	138.8	152.8	2,924.5
Capital expenditures (capex)	4,293.9	3,149.7	487.6	163.2	370.6	2,912.3
Cash and investments	N.A.	282.0	157.0	18.9	167.7	1,056.0
Debt	21,758.1	19,002.9	5,127.2	116.6	718.8	5,016.7
Common equity	44,932.8	18,477.4	7,917.4	1,637.0	1,145.0	17,480.1
Total capital	71,607.8	38,045.4	13,297.6	1,758.3	1,863.8	29,247.4
Adjusted ratios						
EBIT interest coverage (x)	2.7	6.2	7.5	9.2	10.7	13.5
FFO interest coverage (x)	5.0	7.3	7.3	13.5	5.0	17.5
FFO/debt (%)	56.8	32.6	27.3	119.0	21.3	58.3
Discretionary cash flow/debt (%)	8.8	(1.6)	(5.0)	(18.5)	(30.2)	(19.1)
Net cash flow/capex (%)	174.6	70.8	84.2	80.7	37.7	94.2
Debt/total capital (%)	30.4	49.9	38.6	6.6	38.6	17.2
Return on common equity (%)	10.6	16.2	14.2	4.4	22.8	2.7
Common dividend payout ratio (unadjusted) (%)	98.5	99.7	104.5	11.4	5.3	50.3

N.A.--Not available. N.M.--Not meaningful.

such as Germany-based E.ON AG (A/Stable/A-1), or Italy's Enel SpA (A/Watch Neg/A-1) are large diversified companies with relatively strong balance sheets, and the share of future consolidated earnings and investment from Russia isn't expected to represent a concentration risk. We expect the same to be true for smaller companies such as Czech Republic-based CEZ a.s. (A-/Stable/--) or Nordic utility Fortum Oyj (A-/Stable/A-2), which also regard Russia as a target market. Other large acquisitions, however, such as Enel's planned debt-financed purchase of Spanish power utility Endesa S.A. (A/Watch Neg/A-1), could lower ratings and debt capacity for Russian investment.

The ultimate impact of any Russian investment on the credit ratings of a company would depend on its size, whether it represents a majority interest that would be consolidated or a minority investment that would be equity accounted, how it's funded, the earnings and cash-flow visibility of the investment, and finally how much headroom is in the current ratings on the company to absorb credit dilutive investments, such as those in Russia.

Why is the Russian market attractive for EU power companies?

Unified Energy System, RAO UES of Russia (BB/Stable/--), the 52.7% Russian government-owned power and heat utility that is the holding company of RAO UES group, forecasts that demand for power in Russia will grow by up to 5% per year over the period 2007-2011. The sector also has huge investment needs, however, as highlighted by blackouts, supply interruptions, and supply rationing at times of exceptional weather conditions over the past few years. These needs are driving the ongoing reform of the power sector in Russia, which envisages a privatization of all thermal generation in 2007-2008 through initial and secondary public offerings and equity sales (for further details of the reform see "The Credit Effects Of Revamping Russia's Electric Power Industry," published on June 18, 2007, RatingsDirect.) UES's investment program for 2006-2010 envisages new additions in generation capacity totaling 34 gigawatts by 2011, equivalent to 16% of the current national generation fleet, at a cost of Russian ruble (RUR) 3.2 trillion ($123 billion). The plan relies heavily on external equity and debt financing from the capital markets. Russia's revision and acceleration of its power market deregulation last year is also likely to improve the financial performance of Russian generating companies in the medium term and may also improve their business risk profiles.

All this has fueled portfolio investors' appetite for Russian power assets, as shown by the 125% growth in UES's stock price compared with the more moderate 40% ruble growth in the RTS index of Russian equities over the 12 months ended June 12, 2007.

Which European companies have made the biggest investments in Russian power so far?

Among the European utilities targeting the Russian energy sector, Germany's E.ON is a forerunner through its a 6.4% stake in the gas company OAO Gazprom (BBB/Stable/--), which is 50.002% owned by the Russian Federation. It's a partner with Gazprom in the Baltic pipeline, which will provide an alternative access route for Russian gas into the EU through Germany, and is a minority investor in some gas fields that Gazprom owns. Last month, E.ON entered into a 50:50 joint venture with Siberian producer STS. E.ON-STS Energia plans to participate in the privatization of power producer TGC-10 (territorial generation company-10) and acquire a majority in the company. TGC-10 intends to build about 1,000 megawatts of new generating capacity over the medium term.

On June 6, 2007, it was announced that Italy's Enel had won the auction for a 25.03% stake in the Russian wholesale power generating company WGC-5 and would pay RUR39.2 billion ($1.52 billion) for the stake. Enel has indicated it could invest between €2 billion and €4 billion in total in Russia in both the generation sector and gas reserves. Enel previously lost out to Russia's own Norilsk Nickel in an auction for a 38% stake in WGC-3, one of the stakes in Russia's wholesale and territorial generating companies that are being privatized in stages after being spun off from UES as part of the power-sector reforms. It has a 49% stake in power supplier Rusenergosbyt and operates North Western CHP (combined heat and power) plant in a consortium.

Another big stakeholder in the Russian power sector is the Nordic electricity utility Fortum Oyj, with 25% in northwest Russian regional power generator Territorial Generation Co. No.1 (TGC-1), through its stakes in Lenenergo and St. Petersburg Generating Company.

How can EU companies best leverage their investments in Russia?

The restructuring and liberalization process that Russia is now undergoing is similar to what has occurred in the EU over the past seven or eight years. European companies such as E.ON, Enel, and Fortum have therefore gained valuable experience domestically and in other Eastern European countries that they can potentially transfer to Russia. This includes experience of managing operating and capital costs, as well as regulatory and network risks in liberalized markets. In addition, new entrants can bring trading and hedging expertise to mitigate the commodity and power-price risk, which is a characteristic of liberalized power markets. Leveraging these skills is one way for them to add value to their investment.

As Russian utilities have so far been state-controlled companies, there could be opportunities to improve efficiency. Up until now, the Russian tariff system has often been cost-recovery based, so that remuneration earned on assets is based on a cost-plus system, in which a return is allowed on reported costs, leaving no great incentive to improve efficiency. However, smaller private generation utilities owned by private companies have been very successful in implementing cost-cutting programs.

Are European investments in Russia also important in helping the EU gain access to Russian gas and oil?

Yes. Access to long-term secure supplies of the gas, oil, and uranium, that are needed to generate electricity, is a big strategic and political issue in EU countries. For the most part, they're becoming increasingly dependent on imported gas because of the long-term decline in reserves within the EU and greater demand for gas to meet an increasing share of power generation needs. Russian imported gas is one of the principal sources tapped to meet this demand, as Russia has among the largest reserves in the world. And because of its proximity to the EU, lower transport costs make it an attractive option.

As Gazprom owns the Russian gas transmission network and controls most of the reserves, it's very difficult for foreign investors to break into the market. E.ON's 6% holding in Gazprom and other partnerships are strategically very attractive for E.ON and Germany. Gas is an increasingly important generation fuel for E.ON, making it critical to have access to Russian gas.

Could the presidential elections in Russia next year pose a risk to power-sector reforms and to the success of EU investments in Russian power?

At present, we assume the market will continue to deregulate and liberalize, but there's a risk that, following the presidential elections in 2008, a new administration might take a different view. Under a liberalized market, pricing will ultimately be less predictable. Politicians could consider it problematic to move from a regulated market and thereby lose political control of the price-setting process. On the other hand, investment needs are so substantial that reforms are necessary to allow the sector to attract the capital it will need to regenerate. Even if a new government were to try to revise or delay the reform plans, it would be difficult for these efforts to succeed if the key structural changes were already fixed and loans and contracts, with the obligations they entail, were already in place.

The current relative valuations of Russian power utilities look aggressive compared with their European peers, suggesting that a substantial improvement in the regulatory environment and stronger power prices, which it is assumed will be implemented after the presidential elections, are already factored into asset prices.

Does the Russian state's unwillingness to surrender majority stakes in strategic assets represent an investment risk?

We consider it very unlikely that non-Russian investors in utilities will be allowed to control strategically important Russian power companies, the transmission grid, and hydro and nuclear generation companies. Gazprom's even stronger grip of late on Russian gas reserves that are strategically important to the Russian state demonstrates this. For example, Fortum was recently given an indication, albeit unofficial, that it won't be allowed to acquire a controlling stake in TGC-1 in the St. Petersburg area.

This would limit European companies' chances of adding value to their investments through technology transfer and management know-how, as outlined above. As a minority investor, for example, the synergistic benefits of investing in Russian companies would be lower than if they had a controlling interest. From a ratings perspective, the impact of a majority or a minority ownership stake can be quite different. In the first instance, the financial outlay to acquire a minority stake will, by definition, be smaller than that required to take a majority stake (typically, to buy control, an investor needs to pay a control premium). Furthermore, minority stakes would generally not be consolidated in the financial accounts of the acquiring company, but would rather be accounted for using the equity method, and therefore the debt of the target company would not be consolidated.

Standard & Poor's believes that a number of European utilities may view the ongoing liberalization and expansion of the Russian power sector as providing attractive investment opportunities, partly because of the possibility to leverage their expertise in deregulated markets. Despite the risks associated with a transitional macroeconomic environment, such investments are unlikely to be of a magnitude that would endanger the credit quality of large European utilities leading to a negative rating change if companies restrict their investments to a level that the headroom and debt capacity in their existing ratings can accommodate.

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