

Electric-Corporate
Central Europe
Special Report

Central European Utilities — 2010 Outlook

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Related Research

- *Central European Electricity Sector* (November 2009)
- *CEZ, a.s. (October 2009)*
- *PGE Polska Grupa Energetyczna S.A. (October 2009)*
- *Fitch: IPO Improves PGE's Financial Profile* (November 2009)
- *Slovenske Elektrarne, a.s. (June 2009)*
- *Stabilising Corporate Ratings in Europe and Asia-Pacific (October 2009)*

Summary: Stable Outlook Despite Challenges

Fitch Ratings views the outlook for central European (CE) electric utilities as stable for 2010. The agency believes that the large utilities with a solid market position remain fundamentally strong despite the negative effect of the economic downturn – which has mainly meant reduced demand for electricity and lower wholesale prices. Large players enjoy good access to debt markets, which is important in light of their substantial mid- to long-term capex plans which are likely to be co-funded by debt.

Forecasts

Fitch derives its own independent forecasts as part of the rating process. This process, and the aggregate results of the agency's forecasts, are discussed in "Forecasting EMEA Corporates' Recovery: The Slow Haul Back", soon to be released at www.fitchratings.com.

For the CE utilities sector, 2009 should prove a turning point for the three large CE utilities rated by the agency – Czech Republic-based CEZ, a.s. (CEZ, 'A-' /Stable), Poland's PGE Polska Grupa Energetyczna S.A. (PGE, 'BBB+' /Stable), and Slovakia-based Slovenske Elektrarne, a.s. (SE, 'BBB' /Stable). Free cash flow (FCF) will turn negative due to higher capex and dividends (except for SE, which implemented no dividend policy by 2013), following a long period of positive FCF in 2004-2008. Fitch's projections show that negative FCF will widen in 2010-2011 (see the *CE Utilities Sector - Summary of Forecasts* table).

The agency projects an erosion of credit ratios of the three companies by 2012, but their current (December 2009) low leverage provides sufficient room to leverage up to net debt to EBITDA of 2x-2.5x while maintaining their current ratings.

CE Utilities Sector - Summary of Forecasts^a

	2009	2009 vs 2008	2010	2010 vs 2009	2011	2011 vs 2010
Revenue (EURm/%)	14,205	3.0	14,078	-0.9	14,904	5.9
EBITDA (EURm/%)	5,532	3.6	5,488	-0.8	6,154	12.1
EBITDA Margin %	38.9	0.2	39.0	0.1	41.3	2.3
Funds From Operations (FFO) (EURm/%)	4,308	-4.0	4,262	-1.1	4,617	8.3
Free Cash Flow (FCF) (EURm/%)	-951	-241.3	-1,954	105.4	-3,096	58.4
Average FFO Adjusted Leverage ^b (x)	1.4	0.3	1.8	0.4	2.6	0.8
Average Adjusted Net debt/EBITDAR (x)	0.8	0.0	1.4	0.6	2.0	0.6
Average FFO Interest Cover ^c (x)	15.8	-12.0	12.1	-3.7	8.2	-3.8

^a Aggregate values for absolute numbers; average values for ratios; companies included are CEZ, PGE and SE; Calculations based on constant exchange rates of local currencies to the euro as of YE08

^b Gross adjusted debt/FFO+ Interest + Rents

^c FFO + Interest/ Interest

Source: Fitch

The key assumptions underlying the sector's forecasts are:

- Power generation: weaker funds from operations (FFO) for 2010 due to lower electricity prices on a forward basis. For CEZ, the average achieved baseload price for 2010 is around 10% lower than in 2009; 2010 prices in Poland will depend on fuel prices in the 2010 contracts and bilateral contracts for power sales signed mainly in Q409.

Capex Plans for 2009-2012 of Selected CE Utilities (EURbn)^a

Company	Country	Capex plan	Increase in capex ^b (%)
CEZ	Czech Republic	10.5	74
PGE	Poland	9.5	103
Tauron	Poland	3.3	108
SE	Slovakia	3.3	357

^a Capex plan for SE for 2009-2013

^b Increase in average annual capex between 2009-2012 and 2007-2008
Source: Company reports and announcements

- Transmission or distribution: lower impact of weaker industry conditions, thanks to the regulatory income streams. FFO in this segment is likely to be relatively flat in 2010, as the negative impact of lower sales has already been reflected in the 2009 results.

FFO under Moderate Pressure in 2010

The agency expects FFO to remain relatively healthy for integrated utilities in 2010, reflecting these companies' higher resilience to the economic downturn than would be the case with more cyclical businesses. However, FFO in power generation is likely to be weaker than in 2009, which was a strong year for cash flow given that utilities sold power for 2009 on a forward basis in 2008 at record high average prices. This helped utilities to report solid FFO in generation despite a deep fall in power consumption (down by 7% in the Czech Republic and by 5.5% in Poland in the first nine months of 2009 (9M09) yoy). The negative impact of the fall in wholesale prices in 2009 will be seen in the 2010 results, due to the companies' forward hedging of power for one-to-two years ahead.

Fitch's projections for CE utilities assume that power demand will remain roughly flat in 2010, and may start to modestly grow in 2011 due to the slow economic recovery in the CE region.

Deterioration in Credit Ratios Due to Large Capex Plans

Fitch expects that the large CE utilities will substantially increase capex in 2010, as they enter a capex-intensive period. Large capex plans for 2010-2012 are related to the renewal of their old generation portfolio, and the need to optimise generation fleet by investment in renewable energy or generation sources with low carbon dioxide (CO₂) emissions. Large investments for modernisation of the distribution networks are also on the agenda. In many cases, annual capex will at least double in the 2009-2012 period compared with 2007-2008 – see the table *Capex Plans for 2009-2012 of Selected CE Utilities*. The steep rise in capex will lead to negative FCF after dividends, and a need to increase debt.

Fitch's projections for the three large CE utilities show that their financial leverage, which is currently low (net to EBITDA in the 0.2x-1.2x range), will rise due to higher capex to 2x-2.5x by 2012, and will reach levels slightly below the average for western European utilities.

Fitch's projected ratios are within the limits for their current ratings – and, as a result, should not lead to changes in ratings or outlooks. Deterioration in credit ratios is likely to be gradual in 2010-2012, which gives management some room to manoeuvre to adjust capex plans in the case of weaker-than-expected FFO.

CE Electric Utilities Rated by Fitch (Financial Data for 2008 in EURm)^a

Issuer Name	Sector	Long-Term IDR	Outlook	Senior Unsecured	Ratings Headroom	Country	Revenue	Operating EBITDAR	FFO	Free Cash Flow	Adjusted Debt Net of Cash/Operating EBITDAR (x)	FFO/total adjstd debt (%)	FFO Interest Coverage (x)
CEZ, a.s.	Integrated utility	A-	Stable	A	Currently medium, expected to lower by 2012	Czech Republic	6,746	3,237	2,584	118	1.0	65.4	16.9
PGE Polska Grupa Energetyczna S.A.	Integrated utility	BBB+	Stable	A-	Currently high, expected to lower by 2012	Poland	4,997	1,287	1,374	161	1.0	75.3	10.7
Slovenske Elektrarne, a.s.	Power generation	BBB	Stable	BBB	Currently high, expected to lower by 2012	Slovakia	1,989	782	502	399	0.3	174.6	24.3

^a Foreign exchange rates to euros at FYE08
Source: Fitch, based on company reports

The financial strategy of CEZ and PGE incorporates the publicly-stated maximum medium-term leverage targets, which are important ratings considerations for Fitch. CEZ's medium-term ceiling is for net debt/EBITDA not to exceed 2.0x-2.5x, and PGE has committed not to exceed 2.5x in the medium term. According to Fitch's projections, both companies will come close to their maximum leverage by 2012 owing to their large capex plans for 2009-2012 (EUR10.5bn for CEZ and EUR9.5bn, including EUR1.2bn allocated for acquisitions for PGE). As a result, the agency believes that both companies are not likely to pursue large acquisitions (beyond the current business plan) if they were to stay within the stated leverage ceilings.

Capex Funding

According to Fitch's projections, about 60% of the 2009-2012 capex of the three rated CE utilities will be funded from cash flow from operations (CFO) after dividends, and the remaining 40% from a mix of bank loans and corporate bonds. In the case of PGE, the funding mix includes cash proceeds from the recent equity increase (15% of the capex plan), which reduced the need for debt-funding to about 25% of the 2009-2012 capex plan.

The agency believes that large CE utilities, often with implicit state support (generally not enhancing their ratings), have relatively good access to the bank loan and bond markets, which is not the case with smaller projects or lower-rated companies.

Bonds are likely to become a more important source of funding for CE utilities, given that banks continue to have decreased lending capacity, which is reflected in the cost and availability of bank debt. In addition, raising large loans in the bank market (EUR500m or more for large capex projects) remains challenging as it is difficult to arrange syndicated bank loans, while the domestic bank loan markets have much lower depth than before the financial crisis.

Fitch expects CEZ – which issued two large long-term Eurobonds totalling EUR1.2bn in 2009 – to continue to tap the Eurobond market to co-fund its capex in 2010. Polish utilities are also likely to issue bonds either in the Eurobond market (PGE, which plans a debut Eurobond in H210 and the second-largest power group Tauron Polska Energia S.A.(Tauron)) or domestic bond market.

The agency does not expect any major changes in the dividend policies of the rated players. In the case of SE, shareholders agreed to provide financial support to the company through a zero-dividend policy until at least 2013, due to high capex spending. In the case of majority state-owned companies, such as CEZ and PGE, Fitch does not expect a significant decrease in dividends due to the funding needs of governments (in light of budget deficits).

Fitch takes a positive view of the equity increase via IPOs of Polish state-controlled utilities, such as PGE (it raised about EUR1.4bn in November 2009) or ENEA S.A. – as an important funding avenue for medium-term capex. Tauron's planned IPO also includes raising equity in Q210. For more details on Polish power and its planned privatisation in 2010, see Fitch's *"Polish Energy Utilities - Outlook 2010"* report soon to be released at www.fitchratings.com.

For more details on the CE Electricity Sector – including changes in power demand, significant capex plans, expected funding of the capex, and current and future generation mix by fuel – please see the agency's *"Central European Electricity Sector"* report published on 19 November 2009. The report also includes comparative analysis of CEZ, PGE and SE.

CE Oil & Gas Companies Rated by Fitch (Financial Data for 2008 in EURm)

Issuer	Sector	Long - Term IDR	Outlook /Watch	Ratings Headroom	Country	Revenue	Operating EBITDAR	FFO	Free Cash Flow	Adjusted Debt Net of Cash/ Operating EBITDAR (x) ^b	FFO/ Total Adjusted Debt (%)	FFO Interest Coverage (x)
OMV AG	Integrated oil & gas	A-	Stable	Medium	Austria	25,543	3,698	2,727	-563	1.1	55.5	11.0
Petrol AD	Fuel marketing	CC	Negative	Low	Bulgaria	707	11	4	39	9.8	4.0	1.4
Petrol Ofisi A.S.	Fuel marketing	BB-	Stable	Medium	Turkey	8,103	429	146	577	-0.6	31.6	2.2
Polski Koncern Naftowy ORLEN S.A. (PKN)	Refining and marketing	BB+	RW Negative	Low	Poland	19,296	876	456	-387	2.7	12.0	4.5
Rompetrol Group N.V. (The) ^a	Refining and marketing	B+	Stable	Medium	Romania	5,014	39	-114	-152	10.3	-9.2	0.1
Slovensky plynarensky priemysel, a.s. (SPP)	Gas transit, distribution and supply	A	Stable	High	Slovakia	3,170	1,023	951	-272	-0.2	3,847.3	251.6
Turkiye Petrol Rafinerileri A.S. (TUPRAS)	Refining and marketing	BBB-	Stable	Medium	Turkey	14,346	674	228	-179	0.3	27.0	5.8

^a Rating for The Rompetrol Group includes a three-notch uplift for parental support from its sole owner KazMunaiGaz National Company ('BBB-'/Negative)

^b For refining companies, adjusted debt net of cash/operating EBITDAR excludes inventory holding gains/losses

Source: Fitch

Fitch's Central European Energy and Utilities Universe

Fitch currently rates three CE companies operating in the utilities sector and seven CE companies operating in various sub-sectors of the oil and gas sector (see the tables CE Electric Utilities Rated by Fitch and CE Oil and Gas Companies Rated by Fitch). The rating outlooks for the three rated CE utilities are stable underpinning the stable outlook for the CE electric utility sector.

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