MOODY'S
INVESTORS SERVICE

# Credit Opinion: Fingrid Oyj

Global Credit Research - 14 Dec 2012

*Helsinki, Finland*

## Ratings

| Category | Moody's Rating |
|---|---|
| Outlook | Stable |
| Issuer Rating -Dom Curr | A1 |
| Senior Unsecured | A1 |
| Commercial Paper | P-1 |
| Other Short Term -Dom Curr | (P)P-1 |

## Contacts



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## Key Indicators

[1]**Fingrid Oyj**

| | 12/31/2011 | 12/31/2010 | 12/31/2009 | 12/31/2008 |
|---|---|---|---|---|
| (FFO + Interest) / Interest Expense | 4.3x | 6.0x | 4.5x | 4.0x |
| Net Debt / Fixed Assets | 73.4% | 70.2% | 67.5% | 66.3% |
| FFO / Net Debt | 9.7% | 13.4% | 11.1% | 15.6% |
| RCF / CAPEX | 0.4x | 0.8x | 0.6x | 1.2x |

[1] All ratios are calculated using Moody's Standard Adjustments. Source: Moody's Financial Metrics TM

*Note: For definitions of Moody's most common ratio terms please see the accompanying User's Guide.*

## Opinion

### Corporate Profile

Fingrid Oyj ("Fingrid", rated A1/P-1, stable outlook) is the transmission system operator and owner of Finland's high voltage electricity assets and interconnectors. It also owns a 19.18% stake in Nord Pool Spot AS, the Nordic electricity exchange.

Fingrid was established in 1997 out of the transmission assets of the electric utilities IVO, (now 50.76% state-owned Fortum Power and Heat Oy (Fortum; rated A2/stable outlook), Finland's largest utility), and Pohjolan Voima Oy (PVO). The Finnish state owns 53.1% of Fingrid, and has 70.9% of the voting rights.

### Recent Developments

In order to comply with EU's directive requiring transmission system companies to unbundle from electricity generating and selling companies by March 2012, the Finnish based unregulated utilities, Fortum Power and Heat Oy and Pohjolan Voima Oy sold their shareholdings in Fingrid to the State of Finland and Mutual Pension Insurance

Company Ilmarinen. The holding of the State of Finland in Fingrid increased to a direct ownership of 53.1%, with the Finnish investment company, Ilmarinen, owning 19.9%. The other shareholders, which are mainly Finnish pension funds and insurance companies, hold 27% between them.

The change in ownership gives the Finnish government a direct majority ownership - Moody's notes that the increase in ownership confirms the strong link between the state and Fingrid. However, we have not revised our view of the expected levels of support from the government, but note the change in strategy resulting from the change in ownership, which we expect will result in higher levels of cash flow at the operational level. We expect dividends to rise significantly over time, however.

In order to fully cover increased costs and extensive capital investments Fingrid is increasing grid tariffs by a further 15% for the year starting January 2013, representing a total tariff increase of nearly 50% for 2012 and 2013 combined. Moody's expects that Fingrid will further increase its tariff levels over the coming years until it meets the regulatory allowed returns, which is a positive credit factor given the high levels of investment that Fingrid is currently undertaking. Fingrid has historically not charged the full regulatory allowed tariffs.

**Rating Rationale**

Fingrid's A1 issuer rating is underpinned by the low business risk profile of its regulated electricity transmission network operations, supported by a well-established, stable and transparent regulatory framework.

Further, it considers company's sizeable investment programme which is expected to achieve over EUR1.3 billion over the period of next 8 years (2013-2020). We expect that the company's annual capital investments will range in between EUR100-150 million in 2014. Based on these investments, Fingrid's long-term financial profile is expected to converge towards FFO Interest Coverage of over 4x, FFO/Net Debt of about 14% and RCF/Net Debt of at least 9%-10%, which would support the current rating.

Fingrid's A1 rating incorporates a one-notch uplift as a result of (i) the credit quality of the company's majority shareholder; and (ii) our assessment that there is a moderate probability of government support in the event of financial distress, as well as a very high level of default dependence.

**Rating Drivers**

Given Fingrid's direct ownership by the Finnish state, the company falls within the scope of Moody's rating methodology for Government-Related Issuers ("GRIs"), which was updated in July 2010. The company's A1 rating reflects the combination of the following components:

- Credit risk profile of Fingrid on a stand-alone basis, known as the Baseline Credit Assessment ("BCA"), of a2. Fingrid's BCA mainly reflects the company's status as Finland's sole TSO operating in a well established regulatory framework and the sizeable investment programme foreseen for the period 2013-20, which is expected to impact the company's financial profile;

- Aaa local currency rating of the Finnish government;

- Very high dependence, reflecting the domestic nature of Fingrid's activities and its revenue sources;

- Moderate support, reflecting Fingrid's strategic importance as owner and operator of key infrastructure. The state holds 70.9% of voting rights through its ownership and is involved in the supervision of Fingrid. However, Moody's believes that the strongly non-interventionist Finnish government would hesitate to support state-owned companies except in the most extreme of circumstances. In Moody's view, the government would expect Fingrid in the first instance to seek to raise user tariffs to meet emergency requirements.

As a result of these parameters, Fingrid's A1 rating incorporates a one-notch uplift from its stand-alone credit quality for potential government support under Moody's GRI methodology.

When assessing Fingrid's BCA, Moody's applies its Rating Methodology for Regulated Electric and Gas Networks, published in August 2009. The methodology examines the core factors that Moody's considers most relevant to electric and gas network operators, sets out the range of possible outcomes by factor and maps these to a rating range. Each factor is appropriately weighted and in combination contributes to the rating output by the methodology grid. Measurements are quantitative where an appropriate metric is defined. However, for some sub-factors, qualitative judgment is necessary to determine the appropriate category. For illustrative purposes, the methodology relies upon historical financial results, while ratings incorporate Moody's expectations for future performance. The suggested output under the methodology grid for Fingrid is a2, as summarised in the table below and based on the

2008-11 average key credit metrics. The methodology grid output is in line with the company's BCA.

FACTOR 1: REGULATORY ENVIRONMENT AND ASSET OWNERSHIP MODEL

(a) Stability and Predictability of Regulatory Regime

Score: Aa

The regulatory framework in Finland is considered stable, transparent and supportive of credit quality. The TSO regulation mechanism is administered by the Finnish Energy regulator, EnergiaMarkkinaVirasto ("EMV" or "Energy Market Authority"), which falls under the Ministry of Employment and the Economy and which administers TSOs regulation mechanism over four-year regulatory periods. The third regulatory period runs from 1 January 2012 and ends on 31 December 2015. Prior to each regulatory period, the EMV sets, ex ante, the methodology to be used in determining transmission rates of return. The methodology is based on the principle that the TSO should earn a reasonable return on capital that over the long-term is equal to its WACC.

After each regulatory period, the EMV officially confirms the amount of any accrued earnings that exceed or fall short of reasonable earnings for the regulatory period. In calculating the reasonable return, the EMV makes several adjustments to earnings and to the capital invested in network operations by the TSO. To the extent that a TSO has either accumulated a surplus or deficit during the previous regulatory period, tariffs for the subsequent regulatory period may be adjusted to compensate either the TSO or its customers. The right to adjust for a deficit accrued during a regulatory period is only valid during the subsequent regulatory period.

In October of each year, the EMV calculates TSO's reasonable return, adjusted actual profit, and amount of distributable profit and communicates these to the TSO. One of the benefits of the ex ante regulation is the TSOs have accurate estimates of all the parameters needed to determine the reasonable return prior to the period in question and can track their actual return on a quarterly basis. The largest variations in annual costs relates to repair costs which are driven largely by weather during the year, particularly relating to snow conditions and storms, both of which can damage power lines. In these cases, Fingrid is likely to have a delay of over a year before costs can be recovered.

(b) Asset Ownership Model

Score: Aa

In its role as Finnish Transmission System Operator ("TSO"), Fingrid owns the transmission grid assets, with operations subject to a licence granted by the regulator, EMV. Moody's understands that the licence, and the associated right to operate the network, could potentially be terminated under specific circumstances, namely: (i) if Fingrid ceases its grid operations, (ii) if Fingrid does no longer fulfil the obligations related to the licence and (iii) if Fingrid repeatedly and substantially breaks the Electricity Market Act or rules and regulations which it governs. In this context, Moody's notes Fingrid's excellent operational track record on this front, as further discussed below.

(c) Cost and Investment Recovery

Score: A

Under the flexible Finnish regulatory framework, Fingrid is allowed to cover its costs over time and realise a reasonable post-tax return on its Regulatory Capital ("RC"), with annual tariff increases implemented by the company, without the requirement for formal approval by the regulator. Fingrid increased tariffs to bring its return in line with the regulatory allowed profit during the current regulatory period (2012 to 2015).

Moody's notes that, under the current tariff formula, only approximately 20% of Fingrid's costs are subject to efficiency requirements. Operating and investment costs are estimated in advance, based on the preceding period, but including an annual efficiency target, which incorporates a +/-5% error margin to reduce the uncertainty that the operating cost levels have been set correctly. Cumulative over- or under-recovery of allowed profits during the 2012-15 period will be adjusted in the 2016-19 period. The allowed profit also includes an incentive to improve quality and a small premium for research and development.

Realised returns from tariff increases implemented by the company can be higher or lower than allowed regulatory returns on an annual as well as a cumulative basis during the relevant period. However, any cumulative difference, either positive or negative, between the realised and allowed returns should be adjusted during the next regulatory period. For the current regulatory period 2012-15, Fingrid is allowed a nominal post-tax return of, on average, approximately 4.4% on its RC reflecting the relatively low debt costs. Fingrid's allowed return is modelled on leveraging of 60% debt to total capital.

Fingrid is also party to the Main Grid Agreement (known as "MGA"), under which tariff policy for the relevant period is agreed with the grid users. Fingrid's tariffs are very low when compared to other European electricity grid companies. However, Moody's notes that Fingrid's increased the average level of tariff by 30% for 2012, to help accommodate the company's significant investment programme and to increase its overall return on assets, which is supportive to Fingrid's credit quality.

(d) Revenue Risk

Score: Aa

Revenue variations are linked to the volumes of electricity passing through the system each year, and subsequently revenue risk is very low, as a result of relatively small swings in volume year on year, and the ability to recover deficits in the following year. Expected electricity transmission losses are hedged forward. Annual variations in electricity are relatively limited, and tariffs can be adjusted over time to maintain the allowed levels of profit.

FACTOR 2: EFFICIENCY AND EXECUTION RISK

(a) Cost Efficiency

Score: A

Fingrid's tariffs remain relatively low on the European scale and the lowest compared to other Nordic countries. According to the European benchmarking of the cost efficiency of electricity transmission system operators for the Council of European Energy Regulators (CEER), Fingrid demonstrated excellent efficiency of operations and quality of services.

However, over time the capital intensive nature of the transmission business, characterized by opex and capex growth is expected to challenge the ability of Fingrid to maintain its low cost base. The growing share of system operation costs increasingly reflects the economic consequences of the deregulated market. Whilst congestion, ancillary and balancing markets represent important revenue items for Fingrid, and power reserves constitute a high cost and investment driver, the cost pass through nature of these services supports Fingrid being scored at single-A in line with its peers.

(b) Scale and Complexity of Capital Programme

Score: Ba

Fingrid's identified capex programme for the period 2013-20 totals nearly EUR1.1 billion (between EUR100 - 200 million per annum), mainly relating to grid reinforcements, international interconnections and increase in reserve capacity. The sizeable plan represents a considerable strengthening of the grid and its balancing requirements, and demonstrates the need for the substantial tariff increase. In assessing the complexity of such investment plans, Moody's compares the size of Fingrid's annual capex with its asset base. In Fingrid's case, whilst the Regulatory Asset Base is considered by the regulator, this is not publicly available and disclosed. Therefore, Moody's refers to net tangible fixed assets as a proxy for this measure (EUR1.4 billion as of YE 2011), with projected annual capex over the next year representing close to 13% of the company's asset base. The general complexity and execution risk associated with such a large investment plan combined with the relatively weak ratio result in the Ba positioning under this rating category.

FACTOR 3: STABILITY OF BUSINESS MODEL AND FINANCIAL STRUCTURE

(a) Ability and willingness to Pursue Opportunistic Corporate Activity

Score: A

Fingrid has a strong track record of no material corporate activity (ie M&A, disposals and investments) which supports the company's positioning in the A category under this factor. Nevertheless, Moody's notes that there are no specific restrictions limiting management's discretion to potentially pursue significant corporate activity included either in the licence, the company's by-laws, financing and debt documentation, or any other binding agreement.

(b) Ability and Willingness to Increase Leverage

Score: Baa

Fingrid's financing and debt documentation does not include restrictive financial covenants which would limit a potential material increase in leverage and specifically protect creditors. Fingrid's requirement to increase debt is based on its forecast capital expenditure, which has seen an increase in overall levels of debt. However, the overall levels of leverage are expected to fall despite the high levels of capex, as increased cash flow will offset the amount of debt increase required to fund the capex.

(c) Targeted Proportion of Operating Profit Outside of the Core Regulated Business

Score: Aa

Fingrid is not specifically subject to contractual, statutory or regulatory restrictions prohibiting investments outside the electricity transmission business. Currently, Fingrid retains very limited unregulated operations, mainly consisting of the company's 18.8% stake in Nord Pool Spot AS, the Nordic Power Exchange for trade in physical power contracts. Moody's notes that this business is somewhat complementary to the core regulated electricity transmission activity, which generates virtually all Fingrid's operating profit.

FACTOR 4: KEY CREDIT METRICS

Moody's expects Fingrid's key credit metrics to improve considerably during the current regulatory period, as revenues are expected to grow somewhat faster than in the past, supported by the significant growth in RAB due to the large investment programme.

Going forward, Fingrid's significant EUR1.1 billion investment plan until 2020 will be a major driver of Fingrid's financial profile. Moody's expects that Fingrid will continue to raise additional debt to fund the investment programme and the expected increase in dividend payments.

Moody's expects that there will be an improvement in Fingrid's headline financial ratios, resulting from higher revenues. Overall, however, we expect the increase in operating cash flow to be offset by increasing dividend payments over time. We expect FFO Interest Coverage to rise to over 4x, FFO/Net Debt in the low teens, and rising to about 14% and RCF/Net Debt of at least 9%-10% to support the current ratings. In comparison with a number of peer transmission grids in Europe, ratios guidance for Fingrid is relatively low in the context of the company's rating positioning. In its assessment, Moody's factors in the company's long and conservative track record.

The change in shareholders means that the owners are no longer Fingrid's primary customers, and Fingrid financial policy has therefore changed. Fingrid no longer has a strong incentive to keep tariffs very low, and tariffs are expected to rise to the level allowed by regulation by 2014. The higher levels of cash flow generation, even after the large capex amounts, are expected to result in a much higher level of dividend payment going forward, which have historically been about EUR7 million per annum.

**Liquidity**

Fingrid has adequate liquidity, given the expectation that Fingrid will have negative FCF for 2012, due to its large capital expenditure programme. The liquidity position of the company is supported by (i) Fingrid's predictable operating cash flow; (ii) significant cash liquidity balances of EUR200 million; and (iii) undrawn committed back up RCF amounting EUR250 million (expires 2016 with two extensions possible).

Fingrid has a clear financial policy requiring the company to fully cover the upcoming 12 months funding needs by means of liquid assets and available long-term committed credit lines. At the same time, the refinancing need each year may not account for more than 45% of the total amount of the company's debt financing.

For 3Q 2012, Fingrid reported operating cash flow of EUR123 million and gross debt of EUR1.3 billion of which EUR1.1 million was long-term and EUR194 million was short term borrowings. Principal cash calls anticipated during the period Q4 2012-Q3 2013 include approximately EUR160 million in debt repayments and extensive capex, estimated to be in the region of around EUR200 million.

Despite the expected improvement in company's cash flow generation resulting from the 30% increase in tariffs in 2012, we anticipate that Fingrid will experience negative FCF position in the near to medium term resulting from its extensive investment needs and newly introduced dividend policy. Fingrid traditionally funds requirements through its debt issuance programmes. Over the past 12 month Fingrid issued SEK1 billion 5-year bond and EUR300 million 12-year bond. The company operates in the international capital markets and can issue bonds under the

Medium Term Note Programme of EUR1.5 billion, and two Commercial Paper Programmes of totalling EUR750 million.

### Rating Outlook

The stable outlook reflects Moody's expectation that Fingrid's financial profile will improve from its current level, helped by increased levels of cash flow resulting from higher tariffs and returns that the company will claim.

### What Could Change the Rating - Up

In view of the significant ongoing investment programme and progressive increase in return, Moody's does not expect any positive pressure on Fingrid's rating in the near term.

### What Could Change the Rating - Down

Moody's could downgrade the rating in the event that Fingrid's FFO/interest coverage and FFO/debt ratios were to fail to meet the rating agency's expectations, falling below 4x and not reaching the mid-teens in percentage terms, respectively, during the upcoming regulatory period. Moody's notes that the single notch of uplift to the BCA under its GRI methodology would be unlikely to be reduced in the event of a limited fall in the ratings of the government of Finland.

## Rating Factors

### Fingrid Oyj

| **Regulated Electric and Gas Networks** [1][2] | **Aaa** | **Aa** | **A** | **Baa** | **Ba** | **B** |
|---|---|---|---|---|---|---|
| **Factor 1: Regulatory Environment & Asset Ownership Model (40%)** | | | | | | |
| a) Stability and Predictability of Regulatory Regime | | X | | | | |
| b) Asset Ownership Model | | X | | | | |
| c) Cost and Investment Recovery | | | X | | | |
| d) Revenue Risk | | X | | | | |
| **Factor 2: Efficiency & Execution Risk (10%)** | | | | | | |
| a) Cost Efficiency | | | X | | | |
| b) Scale and Complexity of Capital Programme | | | | | X | |
| **Factor 3: Stability of Business Model & Financial Structure (10%)** | | | | | | |
| a) Ability and Willingness to Pursue Opportunistic Corporate Activity | | | X | | | |
| b) Ability and Willingness to Increase Leverage | | | | X | | |
| c) Targeted Proportion of Operating Profit Outside Core Regulated Activities | | X | | | | |
| **Factor 4: Key Credit Metrics (40%)** | | | | | | |
| a) (FFO + Interest) / Interest Expense (3-Year Average) | | | 4.9x | | | |
| b) Net Debt / Fixed Assets (3 Year Avg) | | | | 70.6% | | |
| c) FFO / Net Debt (3 Year Avg) | | | | 11.3% | | |
| d) RCF / CAPEX (3 Year Avg) | | | | | 0.6x | |
| **Rating:** | | | | | | |
| a) Indicated BCA from Grid | | | a3 | | | |
| b) Actual BCA Assigned | | | a2 | | | |

| **Government-Related Issuer** | **Factor** |
|---|---|
| a) Baseline Credit Assessment | a2 |
| b) Government Local Currency Rating | Aaa |
| c) Default Dependence | very high |
| d) Support | moderate |

[1] All ratios are calculated using Moody's Standard Adjustments. [2] As of 12/31/2011; Source: Moody's Financial Metrics