MOODY'S
INVESTORS SERVICE

Credit Opinion: Fingrid Oyj

Global Credit Research - 15 Dec 2015

Helsinki, Finland

Ratings

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

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Key Indicators

[1]**Fingrid Oyj**

	12/31/2014	12/31/2013	12/31/2012
FFO Interest Coverage	**6.2x**	**5.6x**	**4.8x**
Net Debt / Fixed Assets	**64.4%**	**67.0%**	**70.4%**
FFO / Net Debt	**16.5%**	**14.0%**	**13.5%**
RCF / Net Debt	**8.8%**	**12.8%**	**12.5%**

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. Source: Moody's Financial Metrics

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

Opinion

Rating Drivers

- Established and transparent regulatory framework provides good visibility of cash flows

- Continued improvement in cashflows expected following changes to WACC calculation for forthcoming control and a smaller capex programme going forward

- Upwards rating pressure likely to be constrained by high dividend payout policy

- Access to potential government support provides rating uplift

Corporate Profile

Fingrid Oyj ("Fingrid", rated A1/P-1 with a stable outlook) is the transmission system operator and owner of Finland's high voltage electricity assets and interconnectors. It also owns a 18.8% stake in Nord Pool Spot AS, the

Nordic electricity exchange. The Government of Finland (Aaa negative) owns 53.1% of Fingrid, and has 70.9% of the voting rights, giving it overall control. Fingrid has a number of other shareholders in the pension and insurance industry including Mutual Pension Insurance Company Ilmarinen (with 19.9% of the shares and 17.2% of the voting rights).

SUMMARY RATING RATIONALE

Our rating assessment of Fingrid reflects, as positives: (1) the very low business risk profile of its regulated electricity transmission network operations; (2) its stable and predictable cash flows generated under an established and transparent regulatory framework; (3) the company's solid financial profile, which will be further supported by the higher allowed returns for the forthcoming control and a more moderate capex programme going forward; and (4) the potential support of the majority owner, the Government of Finland. However, the rating is constrained by Fingrid's current financial policy of distributing substantially all its parent company profit as this limits the extent of the continued improvement in financial profile at an operating level.

Fingrid's A1 rating incorporates a one-notch uplift to its standalone baseline credit risk assessment (BCA) of a2 as a result of potential support from the Government of Finland. We continue to view the probability of extraordinary support by the Government of Finland as moderate given the government's non-interventionist approach.

The stable rating outlook reflects our expectation that whilst Fingrid's Funds From Operations (FFO)/Net Debt will be significantly above the guidance for the existing rating (14-16%), particularly during the later years of Regulatory Period(RP) 4, the group's current dividend policy of distributing substantially all parent company profit will mean Retained Cash Flow (RCF)/Net Debt remains at a level commensurate with our ratio guidance for the existing rating (10%).

DETAILED RATING CONSIDERATIONS

ESTABLISHED AND TRANSPARENT REGULATORY FRAMEWORK UNDERPINS STABLE AND PREDICTABLE CASH FLOWS

We view the Finnish regulatory framework as stable, transparent and largely supportive of credit quality. With each control period, the regulatory methodology has become more sophisticated but these changes have been largely evolutionary. Whilst there will be significant changes in the forthcoming `4+4' control, 2016-23, we view favourably the increased consultation and transparency around the changes. For example, the Finnish regulator, Energiavirasto (EV), published two guidelines on regulatory methods, informed by numerous stakeholder meetings and workshops, which were the subject of consultation prior to the publication of the Draft Determination in October 2015, and Final Determination, due before end 2015.

A key change introduced for the coming control is the extension of the applicable period of the control methodologies from four to eight years, although the regulatory period remains four years (RP4, 2016-19; and RP5, 2020-23). While longer controls increase the potential for companies to wait longer for prices to be reset if specific costs increase, this risk is largely mitigated by a number of uncertainty mechanisms (such as the reference years for setting cost allowances continuing to be updated at the end of each period, as well as use of indices to set the risk-free rate and credit spread in the WACC calculation) included within the regulatory package.

Although an ex-ante regulatory framework has existed since 2005, this is a shorter period than some other regulatory frameworks within Europe - e.g. Great Britain, whose regime we view as the `gold standard' within Europe. As well as the short track record, the distinction between Great Britain and Finland also reflects the absence of published financial models. These factors are reflected in Fingrid's `Aa' sub-factor score pertaining to "Stability and Predictability of Regulatory Regime" under our Regulated Electric and Gas Networks methodology, published in November 2014.

CONTINUED IMPROVEMENT IN OPERATING CASH FLOWS EXPECTED FOLLOWING DRAFT DETERMINATION, PRIMARILY DUE TO HIGHER WACC

Fingrid's operating cash flows have improved significantly in the current regulatory period (RP3, 2012-15). This is principally due to Fingrid increasing tariffs by over 60% between 2012-14, resulting from the change in shareholdings in 2011, to bring its return in line with the regulatory allowed profit during RP3 (it had previously been under-recovering due to a previous low-tariff policy).

We expect a further material improvement in operating cash flows during RP4 as well, primarily resulting from the announced changes to the company's weighted average cost of capital (WACC) calculation for RP4. In Finland the WACC is mainly driven by the current 10-year Finnish government bond yield as this is used to set the risk-free parameter used in both the cost of debt and cost of equity calculations. Due to the sustained low interest rate environment this rate has fallen sharply, particularly since 2011.

However, for RP4 and RP5 the risk-free rate will be updated, on an annual basis, according to the higher of the spot (April - September values in previous year) and a 10-year trailing average (October - September values in previous 10 years) of the 10-year Finnish government bond yield. The latter is over two percentage points higher than the former for the reference period for the 2016 WACC. This change also provides Fingrid with protection both against the continuation of the prevailing low interest rate environment and any sharp uptick in market rates during the 2016-23 period. The latter is particularly important given the significant portion of short-term commercial paper debt in Fingrid's capital structure. Fingrid is rare amongst European TSOs in being protected against both types of risks.

We understand Fingrid's regulatory capital is around EUR3 billion in 2015. Consequently, a one percentage point increase in the WACC corresponds to approximately a EUR30 million increase in regulatory allowed profit (EUR90 million in 2015). The change to the risk-free rate calculation, coupled with other credit positive changes to parameters in the WACC calculation, in particular (1) the lower notional gearing assumption, 50% vs 60%; and (2) the higher risk premium on debt (for RP4 at least, a 40bps increase), result in a regulatory allowed profit in RP4 which is expected to be double RP3 levels, averaging around EUR200 million per annum, based on the current forward curve, compared to just over EUR90 million in RP3.

FFO BASED METRICS MAY VARY FROM YEAR-TO-YEAR BUT GENERAL STEP-UP IN RP4 DUE TO HIGHER WACC

Primarily due to fluctuations in congestion volumes on the interconnectors, but also other factors such as electricity demand and reserve costs, Fingrid may over- or under-recover against regulatory allowed profit in a given year, inturn affecting FFO in that year. For example, in October 2015, Fingrid guided to a significant over-recovery in 2015 due to the year's abnormal hydrological conditions in the Nordic region driving a very wide power price differential between Finland and Sweden and higher congestion income. Indeed, congestion income on the interconnectors for the first nine months of 2015 has been almost double total 2014 congestion income, EUR67.7 million versus EUR37.6 million. However, since any under- or over-recovery of regulatory allowed profit during a regulatory period is adjusted for in the following regulatory period, this is expected to be a temporary phenomenon. We note that since congestion income is excluded from the annual regulatory profit calculation for RP4 and RP5, deviations from regulatory allowed profit are likely to be smaller going forward.

Despite the anticipated over-recovery in 2015, to be given back in 2016 tariffs, the extent of the increase in the WACC for RP4 based on the Draft Determination led Fingrid to announce at the end of October 2015 a 14% increase in tariffs from the start of 2016. Assuming a return to more normal hydrological conditions in 2016, we expect another large increase in tariffs in 2017 before tariff moderation during the remainder of RP4. Reflecting this, we anticipate FFO / Net Debt will be in the high teens in percentage terms in 2015 and 2016 before rising to the low twenties in percentage terms in the latter years of RP4.

SMALLER CAPEX PROGRAMME GOING FORWARDS PROVIDES FURTHER BENEFIT TO CASH FLOWS

Fingrid's latest grid development plan, published in October 2015, shows investments of EUR1.2 billion over the 2015-25 period (or EUR110 million per year on average over the period). Whilst we expect the expenditure programme to be slightly front-loaded, with the construction of new transmission grid in Ostrobothnia and the replacement of the line from Imatra to Turku, scheduled for completion in 2017 and 2020 respectively, this represents a material step-down in capex from recent years. Between 2011 and 2013, average annual capex was more than EUR200 million as major investments in reserve plants, new interconnectors (Estlink 2 which came online last year) and grid upgrades were completed. The higher allowed regulatory profit coupled with the reduced capex requirements is expected to result in the group being Free Cash Flow (FCF) positive from 2017 onwards.

HIGH DIVIDEND PAYOUT LIKELY TO CONSTRAIN RATING

Fingrid's current dividend policy, clarified in June 2014, is to distribute substantially all of the parent company profit as dividend, although it retains some flexibility around this, in order to provide a reasonable return to shareholders. The substantially higher dividends paid in 2014 and 2015, EUR82 million and EUR65 million respectively, compared to previous years, EUR7-13 million per annum between 2010 and 2013 inclusive, reflects 1) this higher distribution policy; 2) higher declared profits following tariff increases; and 3) deferral of dividends to absorb higher capex during the 2010-13 period.

Due to the expected increase in Fingrid's operating cash flows and reduced capex requirement over the 2016-23 period, we expect a further step-up in dividends during RP4 to over EUR100.1 million per annum on average. Therefore, whilst Fingrid's financial profile is solid, reflected in net debt to regulatory capital ("RC") of around 40% during RP3 we understand, the stated dividend policy means we expect this measure of leverage to remain in the mid-to-high thirties in percentage terms and RCF / Net Debt to remain at a level commensurate with our guidance for the current rating (10%). We consider RC in Finland as the most relevant input into our leverage metric as regulated network companies earn a reasonable return on this asset base rather than on the Regulated Asset Base (RAB). (A number of balance sheet adjustments are applied to the RAB, the age adjusted regulatory value of the network, to arrive at RC - these include items such as: work-in-progress, net working capital and removal of connection fee liabilities.)

RATING UPLIFT FROM GOVERNMENT SHAREHOLDING

Fingrid's A1 ratings incorporate one notch of uplift from the company's a2 BCA under our methodology for government-related issuers (Government-Related Issuers, October 2014) - a measure of standalone financial strength. This uplift takes into account the government ownership of the company, the credit quality of the majority owner and our expectation of support should it become necessary. The government maintains control of Fingrid through its holding of 70.9% of voting rights, and is involved in the supervision of the company through its representatives in the company's board of directors. We continue to view the expected level of support from the government as moderate. This reflects Fingrid's strategic importance as owner and operator of key infrastructure and our belief that the strongly non-interventionist Finnish government would hesitate to support state-owned companies except in the most extreme of circumstances. In our view, the government would expect Fingrid in the first instance to seek to raise user tariffs to meet emergency requirements. We view Fingrid as having very high dependence on the Government of Finland.

Given the aforementioned high dividends that Fingrid is expected to pay during RP4, we do not believe the government intends to sell all or part of its shares in Fingrid in order to raise the targeted EUR1.6 billion by 2018 from stakes in state-owned companies to finance growth prospects, announced by the government in September 2015.

Liquidity Profile

Fingrid's liquidity profile is good, underpinned by (1) the company's predictable and improving operating cash flow, although there is some year-on-year volatility; (2) its significant cash liquidity balances of EUR102 million as of end September 2015; and (3) its undrawn committed back-up revolving credit facility amounting to EUR300 million containing no financial covenants and not expiring until at least December 2020 (Fingrid has the option of two further one year extensions). The company's has a stated financial policy of maintaining cash and undrawn committed credit facilities to cover a minimum of 110% of debt falling due over the next 12 months, and for refinancing in any given year to be less than 30% of total debt outstanding. Fingrid traditionally funds requirements through its debt issuance programmes.

Rating Outlook

The stable rating outlook reflects our expectation that whilst Fingrid's FFO/Net Debt could rise significantly above the guidance for the existing rating (14-16%), particularly during the latter years of RP4, the group's current dividend policy of distributing substantially all parent company profit is likely to mean that RCF/net debt will remain at a level commensurate with our ratio guidance for the existing rating (10%).

What Could Change the Rating - Up

A sustainably improved financial profile over the next regulatory period, retaining strong financial flexibility within the company. This is likely to be consistent with both FFO/net debt in the high teens and RCF/net debt in the low-to-mid teens in percentage terms.

What Could Change the Rating - Down

Downward rating pressure is unlikely given the higher allowed returns during RP4 and the company's low level of leverage, net debt to regulatory capital around the high 30s in percentage terms, assuming the Final Determination is in line with the Draft Determination and no material change in business or financial risk.

We note that the single notch of uplift to the BCA under our methodology for government-related issuers (Government-Related Issuers, October 2014) is unlikely to be reduced in the event of a limited fall in the ratings of the Finnish government.

Other Considerations

The BCA of a2 is based on the application of Rating Methodology for Regulated Electric and Gas Networks, published in November 2014. Based on the company's three-year (2012-2014) average historical financial metrics, the grid-indicated BCA is a3, although this will shift to a2 in the future if FFO based metrics improve as expected.

The one-notch uplift to the ratings for government support reflects the application of our GRI methodology.

Rating Factors

Fingrid Oyj

Regulated Electric and Gas Networks Industry Grid [1][2]	**Current As at 12/31/2014**		[3]**Moody's 12-18 Month Forward ViewAs of 12/15/2015**	
Factor 1 : Regulatory Environment and Asset Ownership Model (40%)	**Measure**	**Score**	**Measure**	**Score**
a) Stability and Predictability of Regulatory Regime	Aa	Aa	Aa	Aa
b) Asset Ownership Model	Aa	Aa	Aa	Aa
c) Cost and Investment Recovery (Ability and Timeliness)	A	A	A	A
d) Revenue Risk	Aa	Aa	Aa	Aa
Factor 2 : Scale and Complexity of Capital Program (10%)				
a) Scale and Complexity of Capital Program	A	A	A	A
Factor 3 : Financial Policy (10%)				
a) Financial Policy	Baa	Baa	Baa	Baa
Factor 4 : Leverage and Coverage (40%)				
a) FFO Interest Coverage (3 Year Avg)	5.5x	A	6x - 7.5x	Aa
b) Net Debt / Fixed Assets (3 Year Avg)	67.2%	Baa	63% - 70%	Baa
c) FFO / Net Debt (3 Year Avg)	14.6%	Baa	16% - 20%	A
d) RCF / Net Debt (3 Year Avg)	11.4%	Baa	10% - 12%	Baa
Rating:				
Indicated Baseline Credit Assessment from Grid Factors 1-4		a3		a2
Rating Lift	0	0	0	0
a) Indicated Baseline Credit Assessment from Grid		a3		a2
b) Actual Baseline Credit Assessment 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
e) Final Rating Outcome	A1

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. [2] As of 12/31/2014; Source: Moody's Financial Metrics [3] This represents Moody's forward view; not the view of the issuer; and unless noted in the text, does not incorporate significant acquisitions and divestitures

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