MOODY'S
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Credit Opinion: Fingrid Oyj

Global Credit Research - 10 Dec 2014

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

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Key Indicators

Fingrid Oyj[1]

	31/12/2013	31/12/2012	31/12/2011	31/12/2010
(FFO + Interest Expense) / Interest Expense	5.3x	4.5x	4.3x	6.0x
Net Debt / Fixed Assets	67.3%	70.8%	73.4%	70.2%
FFO / Net Debt	13.6%	12.8%	9.7%	13.4%
RCF / Net Debt	12.4%	11.8%	9.1%	12.7%

[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

Rating Drivers

- Stable and predictable regulatory regime supports good visibility of cash flows

- Solid financial profile

- Improving cashflows as a result of higher tariffs and lower capex; largely absorbed by higher dividends

- Access to potential government support provides rating uplift

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 18.8% stake in Nord Pool Spot AS, the Nordic electricity exchange. The Government of Finland (Aaa stable) 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

Fingrid's A1/P-1 ratings with a stable outlook are underpinned by (1) the low business risk profile of its regulated electricity transmission network operations; (2) the well-established, stable and transparent regulatory framework, which supports good visibility of cash flows; and (3) the support of the majority owner, the Finnish government.

The ratings further factor that Fingrid has increased its operating cash flows over 2012-14 as a result of increasing tariffs to the maximum allowable (achieved in January 2014), in line with the regulatory allowed profit. The improving financial profile at an operating level is, however, somewhat constrained by Fingrid's decision to distribute substantially all its parent company profit as dividend. Nonetheless, we expect Fingrid to maintain a conservative and flexible financial policy to support its operating strength and the implementation of its long term strategy.

In line with this expectation, the company should generally maintain funds from operations (FFO)/net debt in the range of 14% to 16% and retained cash flow (RCF)/net debt of at least 10% from 2014 onwards to support the current A1 rating. We take into account, however, that RCF/net debt may dip below 10% in 2014 and 2015 as a result of (1) the extraordinary dividend of EUR 82 million paid following the clarification of the dividend policy in 2014 and the deferral of most dividends in 2013 to absorb high capex; and (2) a 2% cut in tariffs in 2015 to compensate for slight profit over-recovery due to high congestion charges and lower than expected reserve costs in 2014.The rating also balances these slightly weaker ratios against the fact that the company will enter a more moderate capital expenditure programme focused on grid reinforcement of an average of some EUR 150 million per annum over the 2014-17 period, in contrast with the high investment of EUR 231 million spent in 2013 to complete Estlink 2 and additional reserve capacity.

We provide one notch of uplift to Fingrid's Baseline Credit Assessment of a2, based on the application of our rating methodology for government-related issuers ("GRIs"). We continue to view the probability of extraordinary support by the Government of Finland as moderate, notwithstanding the increase in ownership to 53% direct ownership in April 2011, from 33% direct and indirect ownership, given the government's non-interventionist approach.

DETAILED RATING CONSIDERATIONS

STRATEGY UPDATE RESULTING IN HIGHER CASH FLOW AT OPERATIONAL LEVEL

As of January 2014, Fingrid has increased its tariff levels up to the full regulatory limit as allowed by the Finnish regulator, Energiavirasto (EV). As a result, tariffs have increased by 30%, 15% and 8%, respectively during the years 2012-14 and have significantly boosted the company's operating cash flows.

This operating cash flow improvement will be mitigated by higher dividend payments. In June 2014 the company clarified its dividend policy and plans to distribute substantially all of the parent company profit as dividend in order to provide a reasonable return to shareholders. When making the decision, however, the company mentioned that the economic conditions, the company's near term investment and development needs as well as any prevailing financial targets of the company will be taken into account.

The change in tariff strategy followed the sale by Fortum Oyj (A2 negative) and Pohjolan Voima Oy of their shareholdings in Fingrid in April 2011, in order to comply with the EU's directive requiring electricity transmission system companies to unbundle from companies that generate and sell electricity. As a result, the government's direct ownership in the company is 53.1%, with the remaining ownership distributed among other shareholders, mainly Finnish pension funds. As Fingrid was previously owned by its principal users, it charged low tariffs. This resulted in commensurately low profits and small dividends.

ONE-NOTCH RATING UPLIFT FROM GOVERNMENT SHAREHOLDING

Fingrid's A1 ratings incorporate one notch of uplift from the company's a2 baseline credit assessment (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 ongoing support. 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. Although the increase in ownership confirmed the strong link between the state and the company, we have not revised our view of the expected levels of support from the government, which remains moderate. It reflects Fingrid's strategic importance as owner and operator of key infrastructure. We believe 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.

STABLE REGULATORY FRAMEWORK IS SUPPORTIVE

We view the regulatory framework in Finland as stable, transparent and supportive of credit quality. 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"). The formula includes an allowance for operating costs, outage costs and balancing costs.

Fingrid has increased tariffs to bring its return in line with the regulatory allowed profit during the current regulatory period (2012-15). Tariffs can be altered on yearly basis in order to meet the regulator's allowed return in the case of under- or over-recovery. Any further adjustment needed at the end of the regulatory period, currently 2012-15, can be carried over into the next 2016-19 regulatory period. However, Fingrid will not pursue historical under-recoveries relating to the previous low-tariff policy. Despite recent tariff increases, Fingrid's tariffs remain low when compared with other European electricity grid companies.

Under the current tariff formula, only around 15/20% 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% margin of error to take into account of modest cost fluctuations. The allowed profit also includes an incentive to improve quality and a small premium for research and development.

We note, however, that given current low interest rates, operating cash flows are vulnerable to a further lowering of the 10-year Finnish government bond yield, as the company's weighted average cost of capital (WACC) is based off this benchmark.

CASH FLOW MEASURES EXPECTED TO IMPROVE AS CAPEX MODERATES

The combination of substantial tariff increases and the recent growth in Fingrid's regulatory asset base (RAB) due to the company's large investment programme has resulted in increased operating cash flow.

Fingrid's higher revenues and lower cash outflow for capex will be offset by our expectation of significantly higher dividend payments. Over time the company aims on average to be free cash flow neutral although this may fluctuate quite substantially year on year due to variation in congestion charges, loss power and reserve costs as well as capex and dividend levels and the ability of the company to readjust tariffs in order to remain in line with its regulatory allowed profit (which in turn is in line with its allowed WACC).

We expect FFO/net debt to improve from 13.6% in 2013 to around 16% in 2014 as a result of higher tariffs, high congestion charges and low reserve costs. RCF/net debt could reduce from 12.4% in 2013 to under 10% in 2014 as a result of a high dividend payment of EUR82 million reflecting both the clarification in dividend policy in June 2014 and a readjustment following the modest dividend payout in 2013 to accommodate high capex levels. FFO is expected to dip modestly in 2015 as Fingrid will cut tariffs by 2% to compensate for the regulatory over-recovery in 2014, partly due to high congestion volumes and low reserve costs. We expect that FFO/interest to remain generally strong (above the FFO/interest at 5.3x in 2013), reflecting current low interest rates in the euro area.

We expect Fingrid's capex commitments to be moderate for the period 2014-17 with investments varying between EUR130 - EUR170 million (averaging around EUR150 million) mainly relating to grid reinforcements. This compares with the period of substantial investments for the company between 2011 and 2013, with average annual capex of more than EUR200 million as major investments in reserve plants, new interconnectors (Estlink 2) and grid upgrades were completed. Given the growth in Fingrid's asset base and expected drop in annual investments, projected annual capex over the next three years is likely to be below 8% of the company's net tangible fixed assets of EUR1.9 billion. Towards the latter end of the decade or the beginning of next, Fingrid may invest in improving interconnection with Sweden and improving the connections around Helsinki among other projects.

We also take into account that the Regulatory Asset Base (RAB), which is not published, is likely to be significantly higher than the book value of assets, as the RAB is based on the replacement value of the assets, adjusted for depreciation, which also have longer technical lives than accounting lives. Costs are reviewed and agreed with the regulator.

Generally, we expect that the company should maintain FFO/net debt in the range of 14% to 16% and RCF/net debt of at least 10% to support the current A1 rating. The rating also balances the possible weakness in RCF/net debt in 2014 and 2015 for the reasons described earlier, against the fact that the company will enter a more moderate capital expenditure programme in the 2014-17 period.

Liquidity Profile

Fingrid's liquidity profile is sound, underpinned by; (1) the company's predictable operating cash flow, although there is some year-on-year volatility; (2) its significant cash liquidity balances of EUR180 million as of Q3 2014; and (2) its undrawn committed back-up revolving credit facility amounting EUR250 million (expires in April 2018). The company's financial policy is to maintain cash and undrawn availability under its RCF to cover a minimum of 100% of debt falling due over the next 12 months. At the same time, Fingrid's refinancing needs each year may not account for more than 45% of the total amount of the company's debt financing. Fingrid traditionally funds requirements through its debt issuance programmes. Interest rates are currently hedged into fixed from variable at levels between 30-70% over a 5 year horizon.

Rating Outlook

The stable rating outlook reflects our expectation that Fingrid's financial profile will improve to generally being comfortably in line with the following guidance: FFO/net debt of 14-16% and RCF/net debt of 10% or over. It also assumes there is no negative change in the supportiveness of the regulatory environment in the next regulatory period commencing in 2016.

What Could Change the Rating - Up

Positive pressure on Fingrid's rating could develop if the company's FFO/net debt ratios and RCF/ net debt were to rise to around high teens and low to mid-teens respectively although we think this is unlikely given the company's policy to pay out most of its retained earnings in dividends.

What Could Change the Rating - Down

We could downgrade the rating in the event that Fingrid's metrics were to fall below FFO/net debt of 14-16% and RCF/net debt of 10% on a sustained basis.

An increase in either business or financial risk, potentially through an increase in the size or complexity of the capital programme, or a move downwards in yield on the Finnish government bond, which is the benchmark for deriving the company's weighted average cost of capital, could increase the challenges to the company's business and/or financial profile. We caution that negative pressure could develop on the rating in the event that the company failed to demonstrate sufficient financial flexibility, for example, in its dividend policy, to compensate for such increased pressures should they arise.

We note that the single notch of uplift to the BCA under our methodology for government-related issuers (Government-Related Issuers, October 2014) would be 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 (2011-2013) average historical financial metrics, the grid-indicated BCA is a3, although this will shift to a2 in the future if FFO/interest improves as expected.

Rating Factors

Fingrid Oyj

Regulated Electric and Gas Networks [1][2]	**Current as at 31/12/2013**		[3]**Moody's 12-18 months forward view as at December 2014**	
Factor 1: Regulatory Environment & Asset Ownership Model (40%)	Measure	Score	Measure	Score
a) Stability and Predictability of Regulatory Regime		Aa		Aa
b) Asset Ownership Model		Aa		Aa

c) Cost and Investment Recovery (Ability and Timeliness)		A		A
d) Revenue Risk		Aa		Aa
Factor 2: Scale and Complexity of Capital Programme (10%)				
a) Scale and Complexity of Capital Programme		A		A
Factor 3: Financial Policy (10%)				
a) Financial Policy		Baa		Baa
Factor 4: Leverage and Coverage (40%)				
a) (FFO + Interest Expense) / Interest Expense (3 Year Average)	4.7x	A	6.5-8.5x	Aa
b) Net Debt / Fixed Assets (3 Year Avg)	70.4%	Baa	65-70%	Baa
c) FFO / Net Debt (3 Year Avg)	12.0%	Baa	14-16%	Baa
d) RCF / Net Debt (3 Year Avg)	11.1%	Baa	9-11%	Baa
Rating:				
a) Indicated BCA from Grid		a3		a2
d) Actual BCA Assigned		a2		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 accounting adjustments. [2] As of 31/12/2013 [3] This represents Moody's forward view, not the view of the issuer, and unless otherwise noted in the text does not incorporate significant acquisitions or divestitures.

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