Return to Regular Format

Research:

Fingrid Oyj

Publication date: 07-Jul-2004
Primary Credit Analyst(s): Magnus Pettersson, Stockholm (46) 8-440-5929; magnus_pettersson@standardandpoors.com
Secondary Credit Analyst(s): Andreas Zsiga, Stockholm (46) 8-440-5936; andreas_zsiga@standardandpoors.com

Corporate Credit Rating

	AA-/Stable/A-1+

Outstanding Rating(s)

Fingrid Oyj	
Sr unsecd debt	AA-
CP	
Foreign currency	A-1+
Pfd stk	
Local currency	A-

Corporate Credit Rating History

Feb. 17, 1998	AA/A-1+
Nov. 19, 1998	AA-/A-1+

Editor's Note

This article has been amended as figures for Underground lines/total lines in Table 1 were misstated. A corrected version of the article follows.

Major Rating Factors

Strengths:

- Monopoly transmission operator in the stable macroeconomic environment of Finland, characterized by steady growth in electricity demand;
- Favorable cost-plus regulation allowing significant freedom in tariff-setting, capital expenditure, and quality settings; and
- The ability to increase tariffs at very short notice.

Weaknesses:

- Weak financial profile, with high leverage and low debt-service coverage ratios.

Rationale

The ratings on Fingrid Oyj are based on the utility's strong business position as the monopoly electrical transmission grid company and system operator in the politically and economically stable Republic of Finland. The ratings also reflect Fingrid's stable revenue base, a favorable cost-plus regulatory regime, and a focused and prudent strategy. These factors balance a weak financial profile attributable to high leverage and weak debt-service ratios.

Fingrid is responsible for national power-balance management and settlement. Counterparty risk in this business is limited through the continual monitoring of positions and the requirement of guarantees or deposits from the participants. Fingrid benefits from Finland's cost-of-service electricity grid regulation, which allows cost cover, reasonable ROE, and a high degree of flexibility in tariff setting and capital expenditures. Tariffs are mainly charged to consumption, which enhances revenue stability.

Compared with peers, Fingrid's track record on network efficiency is excellent, with virtually no bottlenecks or disturbances, and highly efficient operations. The transmission system has accommodated the strong demand growth and substantial import/export volumes in recent years. Demand grew by 1.1% in the first quarter of 2004 compared with the same period in 2003. Standard & Poor's Ratings Services expects annual growth rates to be 1%-2% in the medium term.

Capital expenditure needs in infrastructure are expected to be moderate in the medium term, and will mainly be focused on grid refurbishment. Investments for 2004 are, however, expected to be slightly higher than in the past, at about €50 million compared with about €40 million per year in recent years.

Fingrid's debt leverage is high, at 78.6% at the end of the first quarter of 2004, including capital notes (65% excluding capital notes). This is, however, expected to fall to about 70% over the next five years due to moderate investment needs and the early redemption of €137 million of capital notes. Funds from operations (FFO) interest coverage is expected to improve further from today's level of slightly more than 3.0x to more than 3.5x over the medium term due to stable operating cash flow and the reduction of debt.

Liquidity.

At the end of the first quarter of 2004, Fingrid had €125 million in cash and marketable short-term securities. The €400 million multicurrency revolving credit facility expiring December 2007, together with cash and liquid assets, serves as backup for short-term use. There are no material financial covenants or material adverse change clauses in the existing credit agreements.

Outlook

The stable outlook reflects Fingrid's stable monopoly position and revenue base, and its flexible regulatory regime, which are expected to remain unchanged for the foreseeable future. This should enable the utility to avoid financial difficulties, despite its highly leveraged balance sheet. No further tariff reductions or leverage increases are expected. Due to moderate investment needs in the medium term, a reduction in debt is likely, as is a gradual improvement in FFO interest coverage ratios.

Business Description

Fingrid began operations on Sept. 1, 1997, following the transfer of the main grid businesses of state-owned electric utility Imatran Voima Oy, now Fortum Oyj (BBB+/Stable/A-2), and Pohjolan Voima Oy (PVO), a private sector electric consortium, to the company. The Finnish State owns 12.3% of Fingrid's equity (representing 16.4% of votes), with Fortum and PVO each holding 25.0% (each representing 33.4% of votes). Finnish institutional investors own the remainder.

Fingrid's operations are divided into three main business areas: grid service (customer service); grid asset management (grid planning and development); and power system operations (power system operations, balance management, and grid operation). The group also includes the wholly owned subsidiary Fingrid Varavoima Oy, which manages the 672-MW gas turbine reserve capacity. The company is likely to be merged with Fingrid Oyj at the end of 2004.

In July 2002, Fingrid became owner of 20% of the Nordic physical electricity exchange, Nord Pool Spot AS, along with the other Nordic system operators, which also own 20% each (Denmark is split, with the two existing system operators each owning 10%) and along with NordPool ASA, which also owns 20%. At the same time, Fingrid's 50%-owned Finnish electricity exchange, El-Ex Electricity Exchange Ltd., was merged into Nord Pool Spot. Fingrid's business strategy is highly focused, and Standard & Poor's does not expect the utility to venture outside its core business in Finland.

Business Profile

Excellent operational track record.

The strong business profile primarily reflects Fingrid's monopoly position as electricity transmission service operator in Finland, and the existing flexible cost-plus regulation. In addition, Fingrid has an excellent operational track record compared with its peers. In 2003, it was in the top tier in an international benchmark study of maintenance and grid operation involving 25 transmission system operators.

Owing to very low hydro levels in the Nordic system in 2003, electricity transit volumes in Finland were extraordinarily high and there were high imports from Russia and high exports to Sweden and the rest of the Nordic system. Fingrid managed the situation without disturbances in the domestic grid, although cross-border capacity experienced some minor disruptions due to technical failures.

On the back of these high import and export volumes, Finland also occasionally became a separate price area. This was caused by cross-border capacity constraints. Nordel, the joint organization of Nordic transmission system operators has identified cross-border capacity constraints between Finland and Sweden as one of the key bottlenecks in the Nordic transmission system. On the other hand, Fingrid and Svenska Kraftnät, the Swedish transmission system operator, have, in their initial study, concluded that the new cable connection to be constructed alongside the existing Fenno-Skan cable is viable. Fingrid's share of the investment is estimated at €120 million. The final investment decision is expected in early 2005.

Electricity losses accounted for 1.86% of the volume transmitted in 2003, which is low for the industry.

Table 1 Fingrid Oyj Operating Statistics					
	--Year ended Dec. 31--				
	2003	**2002**	**2001**	**2000**	**1999**
Number of employees	218	210	204	270	273
Number of customers	100	100	100	100	98
Operations and maintenance excluding depreciations (Mil. €)	155.6	129.7	105.7	96.8	91.6
Transmission operations (network of 400, 220, and 110 kilovolt lines)					
Units transmitted (TWh)	66.6	62.0	59.9	64.7	59.0
System peak demand (GW)	14.0	13.5	13.3	13.2	13.1
Total transmission lines (kilometers)	13,879	13,841	13,843	13,843	13,693
Underground lines/total lines (%)	0	0	0	0	0
Transmission energy losses (%)	1.9	1.5	1.2	1.5	1.5
Average transmission revenues (€ cents/kWh)	0.255	0.255	0.253	0.259	0.277
Average operations and maintenance costs excluding depreciations (€ cents/kWh)	0.212	0.211	0.176	0.15	0.155
TWh--Terawatt-hours. GW--Gigawatts. KWh--Kilowatt-hours. N.A.--Not available.					

Stable growth market environment and increased transmission capacity.

Electricity consumption growth in Finland has historically been steady at about 2% per year, and the macroeconomic environment is favorable, with 1%-2% growth expected in the medium term. The 1,300 MW of interconnection transmission lines with Russia, owned by Fingrid, are fully reserved and used by electricity importers, and they provide additional supply to the transmission market.

In fiscal 2003, Fingrid's turnover increased to €299 million from €273 million in 2002, owing partly to the very high electricity spot prices throughout 2003, which led to higher-than-usual turnover in the system balance operations. Although the new tariff agreement for the coming period, 2005-2007, has not yet been finalized, no increases are expected unless the Fenno-Skan investment takes place. According to the draft agreement, however, tariffs could, if necessary, be increased by about 3% in 2006 and another 3% in 2007. The removal of cross-border tariffs within the ETSO area is expected to have only minor impact on Fingrid.

Operating profit in 2003 was almost the same as in 2002, at €90 million compared with €91 million. This underlines the stability of Fingrid's operations. Operating profits should remain stable over the next couple of years, even if, as expected, tariffs negotiated for 2005-2007 stay at the 2003 level. Even if the Fenno-Skan investment goes ahead, its financial impact is expected to be relatively limited.

Fingrid's grid networks are well scaled for domestic transmission needs, and represent a significant strategic and economic asset. The level of import versus export generally depends on the supply of hydropower in the Nordic market.

Light-handed regulation of Fingrid's natural monopoly operations.

Finland's regulatory regime is flexible and underpins the ratings on Fingrid. Electricity transmission and distribution are natural monopolies, regulated and monitored by the Energy Market Authority, an independent government agency. The regime is, however, undergoing minor reforms, which could ultimately result in a more diligent evaluation of network tariffs. Although the objective of the reforms is to establish a methodology for tariff evaluation, the material rules of the Electricity Act regarding reasonable pricing will remain unchanged. The impact on Fingrid is expected to be limited.

In 2004, following an investigation, the Energy Market Authority concluded that Fingrid's tariffs had complied with Electricity Market Act's requirements over the last three to four years. The basic rule allows network companies to cover their costs and make reasonable ROE, and tariff increases do not need to be sanctioned. Within the current regulatory framework, transmission tariffs are decided by the board of directors following discussions with customers. There is no regulation of capital expenditure. Fingrid is also allowed to cover the costs of operating its emergency reserve gas turbines through revenues from power system operations, because the maintenance of emergency reserve capacity is considered part of the utility's system responsibility.

According to the tariff agreement, exceptional adjustments could take place at Fingrid's discretion in the event of force majeure or other significant events beyond Fingrid's control (such as increased financial costs). Cross-border transmission tariffs within ETSO have been abolished, but cross-border tariffs to Russia are expected to remain in the medium term. This is expected to have a minor impact on Fingrid. In 2003, all transit capacity from Russia was sold. On the Russian side, the electricity company RAO UES of Russia (B/Positive/--) is responsible for export and transmission arrangements.

Current grid service contracts, valid for 2002-2004, were negotiated at the end of 2001, and came into force on Jan. 1, 2002. The terms for the new agreement have yet to be concluded but contain no significant changes.

Financial Policy: Moderately Aggressive

Setting aside the flexible regulation and stable revenue base, Fingrid's financial profile could be considered weak. At the end of the first quarter of 2004, total debt to capital was 79% including capital notes (65% when treating the capital notes as equity; see "Capital structure and financial flexibility" below). Although Fingrid's capital structure is bordering on aggressive, its financial policy is characterized by prudent risk management: currency risks are fully hedged, and interest-rate risk is adjusted to the three-year grid-service contract period. In addition, the company has diversified funding sources and a well-spread maturity profile, and has adequate back-up lines for liquidity purposes. Derivatives are used for hedging purposes only.

Fingrid's shares are not listed, and institutional investors have made their investment in Fingrid with the aim of a safe and stable dividend. A five-year fixed-margin dividend level was decided at the time of Fingrid's formation, and it is reset at the end of each period. The dividend is 1.5% over the five-year Finnish government bond. Over the next five years, the payout ratio is projected to average about 30% (treating the interest on capital notes as dividend).

Financial Profile

Profitability and cash flow.

Fingrid's profitability is weak but stable, reflecting the voluntary tariff policy adopted by the utility. Fingrid aims to improve cost efficiency further through its strong position in negotiations with external contractors for maintenance and new construction, and through refined operation methods and maintenance scheduling. The cost of power transmission losses remains subject to variations in the volatile and highly competitive Nordic electricity market. Fingrid has, however, hedged about 100% of expected energy losses for the remaining tariff period, ending 2004.

Operating profit is expected to remain at about €85 million-€90 million per year, while profit before tax is expected to improve and trend up to €50 million from €40 million over the next five years, due to lower debt costs. This assumes unchanged tariffs in nominal terms, increasing depreciation charges, and an annual 1%-2% increase in transmission volumes. The pretax interest coverage ratio is expected to improve to at least 2.9x over the next five years, from 2.1x in 2003. Of the €168 million of capital loans outstanding, €138 million will be redeemed in 2007 and €30 million in 2009.

Interest payments on capital notes, averaging about 16% of expected total interest expenses over the next five years, are deferrable.

The level of Fingrid's debt depresses cash flow debt coverage ratios, but the regulatory and tariff regimes provide the utility with flexibility. In the medium term, FFO to debt is expected to average a weak 11%, compared with 9% in 2003, and FFO coverage of interest expenses is expected to average more than 4.0x, compared with 3.1x in 2003, due to reduced interest expenses. The planned redemption of €137 million in capital loan debentures in 2007 could improve the ratio in the longer term. Cash flow is expected to more than cover capital expenditure (including the €120 million Fenno-Skan investment), at an average of about 140% over the next five years. Other than Fenno-Skan, Fingrid has no major investment plans in terms of domestic grid enhancements over the forecast period to 2008. Ongoing investments are expected to average €45 million-€50 million per year for the same period, with depreciation averaging about €55 million-€65 million.

The Finnish corporate tax system allows tax-deductible excess depreciation, and Fingrid will use this to minimize tax payments and smooth out net results. This allocation enables the utility to build up an untaxed reserve, which will allow it to maintain a stable dividend policy. This build-up is expected to continue over the next five years. In addition, the corporate tax rate will fall to 26% in 2005 from 29%.

Table 2 Fingrid Oyj Profitability*					
	--Year ended Dec. 31--				
Income statement (Mil. €)	**2003**	**2002**	**2001**	**2000**	**1999**
Gross revenues	299	274	242	236	235
Operating expenses (excluding DD&A)	156	130	105	99	92
Depreciations and amortizations	53	53	52	49	47
EBITDA	146	147	138	140	145
Interest incurred	44	44	41	44	48

Net interest incurred	41	41	41	41	46
Net income	38	39	34	37	2
Earnings protection					
Pretax interest coverage (x)	2.1	2.1	2.1	2.1	2.1
Net pretax interest coverage (x)	2.2	2.2	2.1	2.1	2.1
EBITDA interest coverage (x)	3.3	3.4	3.4	3.2	3.0
Total debt/EBITDA (%)	7.0	7.3	7.5	7.4	7.5
Return on average equity (%)	14.4	15.3	14.9	17.4	18.1
Annual expenditure growth (excluding DD&A; %)	48.4	23.7	6.1	7.9	4.7
Total operating expenditures/revenues (%)	43.3	47.3	43.3	41.9	39.0
*Treating 100% of preferred capital notes (PCNs) as debt, and 100% of interest on PCNs as dividend.					

Table 3 Fingrid Oyj Cash Flow*					
	--Year ended Dec. 31--				
Cash flow (Mil. €)	**2003**	**2002**	**2001**	**2000**	**1999**
Net income	38	39	34	37	34
Depreciation	53	53	52	49	47
Funds from operations (FFO)	92	100	94	96	95
Preferred dividends	11	11	11	11	9
Common dividends	7	7	7	7	7
Net cash flow (NCF)	74	82	75	78	78
Net capital expenditures (capex)	42	48	47	35	30
Discretionary cash flow	30	(12)	(5)	62	27
Cash flow adequacy					
Capex/average total capital (%)	3	4	4	3	2
NCF/capex (%)	176	171	159	224	260
NCF/capex and net acquisitions (%)	180	171	159	224	74
FFO/average total debt (%)	9	9	9	9	9
FFO/average net debt (%)	10	10	9	9	9
FFO interest coverage (x)	3.1	3.3	3.3	3.2	3.0
FFO net interest coverage (x)	3.2	3.5	3.3	3.3	3.1
*Treating 100% of preferred capital notes (PCNs) as debt, and 100% of interest on PCNs as dividend.					

Capital structure and financial flexibility.

Fingrid's leverage is very high, at about 79% in the first quarter of 2004, including capital notes (65% excluding capital notes). This is, however, expected to fall to about 70% over the next five years due to moderate investment needs and the early redemption of €137 million of capital notes. The utility issued €137.9 million in 30-year capital notes in 1997, and €30 million in 30-year debentures of a capital loan nature in November 1999. Standard & Poor's considers both these instruments to be preferred capital notes with deep subordination, rated 'A-'--three notches below the issuer credit rating on Fingrid--because principal and interest can be deferred even after the maturity of the notes if there are insufficient distributable reserves. Any deferred interest or principal will remain Fingrid's liability, however, and repayment will continue to be deferred until the liabilities have been repaid in full out of distributable reserves. The utility has significant reliance on these instruments, with the ratio of preferred capital to total preferred capital and equity at about 38%. If all the capital notes were treated as equity, Fingrid's leverage would decrease to about 65% as of the end of the first quarter 2004.

Although Fingrid's financial flexibility is restricted by its high leverage and dividend payout policy, this is offset by a flexible regulatory regime that allows for tariff increases and by a deferrable capital expenditure program. Fingrid's policy is to cover short-term debt with a cash balance and backup facilities. The utility is tapping the domestic and international money and capital markets, and has established domestic and international CP and MTN programs. In 2004, the US$600 million Euro CP program was withdrawn and replaced by €600 million Euro CP program. Fingrid uses its syndicated revolving credit facility as a backup for short-term debt. Fingrid has a €750 million MTN program, which is used as a long-term funding source.

Fingrid's liquidity position is sound. At the end of the first quarter of 2004, the company had €125 million in cash and marketable short-term securities. The €400 million multicurrency revolving credit facility expiring December 2007, together with cash and liquid assets, serves as backup for short-term use. Cash flow generation in 2004 is expected to be sufficient to cover planned capital expenditure for the year. There are no material financial covenants or material adverse change clauses in the existing credit agreements.

Table 4 Fingrid Oyj Capital Structure*					
	--Year ended Dec. 31--				
Balance sheet (Mil. €)	**2003**	**2002**	**2001**	**2000**	**1999**
Cash and short-term financial investments	105	101	64	52	60
Net plant	1,036	1,032	1,033	1,038	1,039
Total assets	1,369	1,379	1,338	1,337	1,358
Short-term debt	209	178	250	336	265
Long-term debt	820	893	785	697	822
Common equity	275	269	242	221	199
Total capitalization	1,304	1,339	1,277	1,254	1,286
Balance sheet ratios (%)					
Short-term debt/total capital (%)	16	13	20	27	21
Long-term debt/capital (%)	63	67	61	56	64
Common equity/total capitalization (%)	21	20	19	18	16
Total debt/total capitalization (%)	79	80	81	82	84
Net debt/total capitalization (%)	77	80	81	82	84
Treating 100% of preferred capital notes (PCNs) as debt, and 100% of interest on PCNs as dividend.					

Rated Peer Comparison

Table 5 Fingrid Oyj Peer Comparison					
	Fingrid Oyj	**Statnett SF**	**Eltra amba**	**Elkraft System amba**	**Elkraft Transmission amba**
Corporate credit rating	AA-/Stable/A-1+	AA+/Stable/A-1+	AA/Stable/A-1+	AA/Stable/A-1+	AA-/Positive/A-1+
Year of data	2003	2003	2003	2003	2003
Country	Finland	Norway	Denmark	Denmark	Denmark
Type of operations	Transmission and system operator	Transmission and system operator	Transmission and system operator	System operator	Transmission operator
Financial policy	Moderately aggressive	Moderate	Moderate	Moderate	Moderate
Transmission volume (TWh)	67	148	21	14.2	14.2
Grid network length (kilometers)	14,000	10,300	1,000	N.A.	565
Financial statistics (Mil. €)					
Gross revenue	299	678	865	462	38
EBITDA	144	215	55	5	31
Funds from operations (FFO)	92	142	7	14	25
Total assets	1,369	1,237	694	313	351
Total debt	1,029	682	256	190	138
Net debt	924	543	246	180	138
FFO interest coverage (x)	3.1	4.2	2.0	3.8	4.9
FFO/net debt (%)	10	25	3	10	16
Total debt/total capital (%)	79	55	44	98	45
TWh--Terawatt-hours. N.A.--Not available.					

Group E-Mail Address

InfrastructureEurope@standardandpoors.com