

FITCH UPGRADES FINLAND'S FINGRID TO 'A+'; OUTLOOK STABLE

Fitch Ratings-Milan/London-21 November 2016: Fitch Ratings has upgraded Finnish utilities company Fingrid Oyj's Long-Term Issuer Default Rating (IDR) to 'A+' from 'A' and senior unsecured rating to 'AA-' from 'A+'. The Outlook on the IDR is Stable. Fitch has affirmed the Short-Term IDR at 'F1'.

The upgrade reflects the good earning visibility until end-2023, the favourable mechanism for the determination of the allowed profits, in particular a higher return on capital and the favourable treatment of congestion income and the strengthening of the company's financial profile in 2015-2016.

We expect funds from operations (FFO) net adjusted leverage to be compatible with 'A+' rating in the next four years, with some uncertainty only after 2020, as the rolling 10-year average of Finnish government bond yield, one of the allowed return drivers, gradually declines. The coverage and the regulatory asset base (RAB) ratios are comfortably positioned for the rating.

KEY RATING DRIVERS

Favourable Regulatory Framework

In Fitch's opinion the regulatory environment in Finland is among the most supportive in EMEA. The key strengths of the Finnish regulatory settlement include Fingrid's independence to set tariffs and capex programme, limited risk of tariff under-recovery, the independence of the regulator from political influence as well as a long track record from ex-ante regulation.

The current level of pre-tax nominal weighted average cost of capital (WACC) above 6% allows Fingrid to earn adequate returns on its RAB. However, we expect the WACC to gradually decline as the risk-free rate is defined as the highest of the 10-year Finnish government bond yield observed on average in the previous year (April-September) or in the previous 10 years.

Favourable Treatment of Congestion Income

Fingrid receives a congestion income strictly related to the price differential between Finland and other Nordpool price areas (mostly Sweden). This is now being treated as an added item on top of allowed profits from 2016, while in the previous regulatory period it was included in the regulatory allowance calculation.

Cash received from the congestion income is not of restricted use for Fingrid; however, based on EU regulation a corresponding amount must be used for reducing cross-border congestions or it should be treated as regulated income. There are no time constraints for the usage of congestion income and historically Fingrid has been consistently able to spend the amounts received.

Low Risk of Under-performance

Fingrid benefits from an ability to pass on its operational costs to tariffs as the efficiency requirements embedded in the allowed profit have only negligible financial impact. The company has been consistently ranked among the most efficient transmission system operators in global peer studies, demonstrating strong operational efficiency.

Tariff-setting Autonomy

Fingrid can define the transmission tariffs for the customers, within the limits of the maximum allowed profit defined by the authority for each period. This allows Fingrid to have a more direct control over the pattern of its results, potentially limiting cash flow volatility in single years.

In the regulatory period 2012-2015 the company over-recovered versus the allowed profits defined by the regulator (particularly in 2015). Therefore in 2016 Fingrid has set a lower tariff versus the maximum allowed and we expect tariffs to edge closer to the maximum allowance from 2017.

Low Capex, Aggressive Dividends

Fitch expects capex to be lower than in the previous regulatory period, averaging around EUR110m over 2016-2023. Capex peaked in 2013 at EUR229m due to the completion of the Estlink 2 interconnector and reserve power capacity. Fingrid's ongoing investment programme is focused on the reinforcement of the Finnish high-voltage transmission grid. The company has significant flexibility in scheduling most of the investments.

We expect Fingrid's dividend payments to reflect both increased allowed profits and a policy to distribute substantially all the profits as dividends. This leads to significantly higher dividend payments compared with the previous regulatory period.

Parent and Subsidiary Linkage

The current rating does not incorporate any uplift for parental support. The Finnish government (AA+/Stable) holds a controlling stake in Fingrid (53.2% of shares, 70.9% of voting rights) and in 2016 it has defined a minimum level of shareholding of 50.1% in the company. However, Fingrid operates on an entirely commercial basis, with no meaningful legal links or recent tangible support received from its majority owner. Therefore our ratings only reflect the standalone profile of the company.

DERIVATION SUMMARY

Fingrid's rating of 'A+' is currently the highest that Fitch assigns to a regulated network in Europe. The company benefits from a benign regulatory framework, which includes the possibility to set its own tariffs in the context of the allowed profits defined by the authority. This is a peculiarity across European networks. Fingrid's financial leverage is lower than most of the peers such as Terna (BBB+/Stable) and National Grid Electricity Transmission (A-/Stable). Red Electrica (A/Stable) has a similar level of leverage, but lower rating due to less mature regulatory framework (on top of the constraints related to sovereign). No country-ceiling, parent/subsidiary or operating environment aspects impacts the rating.

KEY ASSUMPTIONS

Fitch's key assumptions within our rating case for the issuer include:

- Fingrid to achieve maximum regulatory allowed profit over 2017-2023; 2016 profit EUR59m lower than allowed profit due to compensation of over-recoveries from the previous price control
- Gradually declining EBITDA from 2018, reflecting the impact of low interest rates on regulatory WACC (10-year average sovereign bond yield is expected to decrease)
- Congestion income not included in EBITDA or FFO as it is excluded from allowed profits
- Average capex of about EUR110m over 2016-2023
- Average dividend payments of EUR96m across 2016-2023

RATING SENSITIVITIES

Future Developments That May, Individually or Collectively, Lead to Positive Rating Action

- An upgrade is unlikely reflecting the sector profile. However, evidence of stronger links with the parent (e.g. tangible government support) may be positive for the rating.

Future Developments That May, Individually or Collectively, Lead to Negative Rating Action

- FFO adjusted net leverage above 4.7x, net debt/RAB above 45%, FFO interest coverage falling below 6.5x on a sustained basis.

LIQUIDITY

Healthy Liquidity

Fingrid's funding position is adequate to cover operating requirements, capital expenditure and debt maturities of about EUR144m in 2017. Fingrid has a financial policy in place to hold cash and undrawn credit facilities to cover a minimum of 110% short-term debt.

The company's liquidity profile is further supported by predictable operating cash flows and a well-diversified debt maturity profile (less than 30% of total debt maturing in any given year). In December 2015 Fingrid signed a new five-year EUR300m revolving credit facility containing two one-year extension options, undrawn at end-September 2016, when the readily available cash stood at EUR172m. We expect Fingrid to generate positive free cash flow of about EUR44m throughout 2017.

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Additional information is available on www.fitchratings.com. For regulatory purposes in various jurisdictions, the supervisory analyst named above is deemed to be the primary analyst for this issuer; the principal analyst is deemed to be the secondary.

Applicable Criteria

Criteria for Rating Non-Financial Corporates (pub. 27 Sep 2016)

<https://www.fitchratings.com/site/re/885629>

Parent and Subsidiary Rating Linkage (pub. 31 Aug 2016)

<https://www.fitchratings.com/site/re/886557>

Recovery Ratings and Notching Criteria for Utilities (pub. 04 Mar 2016)

<https://www.fitchratings.com/site/re/878227>

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