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Research Update:

Finland-Based Fingrid Upgraded To 'AA-/A-1+' On Improved Profits And Credit Ratios; Outlook Stable

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Overview

- Modifications to the regulatory model will increase allowed return for Finnish electricity transmission system operator (TSO) Fingrid Oyj, as well as make profits more stable.
- These changes, combined with a modest capital spending program, also support strengthened credit measures for Fingrid.
- We are therefore raising our ratings on Fingrid to 'AA-/A-1+' from 'A+/A-1'.
- The stable outlook reflects our assumption that Fingrid will remain strategically important to the Finnish government as Finland's monopoly TSO, with steady and predictable underlying earnings supported by a favorable regulatory framework.

Rating Action

On Oct. 28, 2016, S&P Global Ratings raised its long- and short-term corporate credit ratings on Finnish electricity transmission system operator (TSO) Fingrid Oyj to 'AA-/A-1+' from 'A+/A-1'. The outlook is stable. At the same time, we affirmed our 'K-1' Nordic regional scale rating on Fingrid.

We also raised our issue ratings on Fingrid's senior unsecured debt to 'AA-' from 'A+' and our local currency short-term issue rating on the company's commercial paper to 'A-1+' from 'A-1'.

Rationale

The upgrade primarily stems from the positive impact on Fingrid's earnings from modifications in the regulatory model for TSOs in Finland. These changes have increased Fingrid's allowed regulatory return, and made it more stable. Thanks to these changes, alongside previous tariff increases and the company's modest capital spending program, Fingrid has seen an improvement in its credit measures, which we believe should be sustainable. We forecast, for example, funds from operations (FFO) to debt of at least 20% over 2016-2018, compared with 18% on average over 2013-2015.

Fingrid's business risk profile, in our opinion, is underpinned by a strong regulatory framework, which regulates virtually all of Fingrid's operations. We view the regulatory framework as stable and predictable, and the current methodology for calculating allowed profit has been in place since 2005, with only minor adjustments. The regulator approved some modifications for the regulatory periods 2016-2019 and 2020-2023, which on aggregate have been positive for network operators (including distribution networks).

Also, the framework allows for good cost recoverability, in our view, which has improved recently following the approved increase in the weighted average cost of capital (WACC). The main change is related to the risk-free rate applied, which will be the higher of the 10-year average or past year (April-September) average of the Finnish government 10-year bond yield. This would increase the WACC and subsequently boost network operators' allowed return for the current regulatory period 2016-2019. Fingrid's allowed profit under the regulatory framework covers all operational costs, with the exception of incentives embedded in the regulation that can be positive or negative, although with a limited impact. Furthermore, Fingrid operates an efficient grid, as shown by several international benchmarking studies, which should put it in a good position to meet the regulator's expectations.

In addition, the recent regulatory changes excluded congestion revenues from the allowed-profit calculation for the regulatory periods 2016-2019 and 2020-2023. We think this stabilizes the annual tariff-setting process and reduces volatility of Fingrid's profitability, which we assess as a strength.

Fingrid's financial risk profile benefits from low cash flow volatility, and we forecast improved FFO to debt at about 20%-23% on average over the next few years on the back of the positive changes to the regulatory model from the beginning of 2016. Credit measures also benefit from a more modest capital spending program in the next few years. We expect Fingrid to invest about €130 million-€150 million annually over the next few years--significantly less than the €227 million invested in 2013--and gradually declining in the current regulatory period horizon. At the same time, the company has been increasing tariffs (by an average 14% and 7% starting 2016 and 2017, respectively) to bring profits to the level allowed under the regulatory framework.

The tariff increases are somewhat offset by rising dividend payouts--€90 million paid in 2016 versus €65 million paid in 2015--in line with the company's revised dividend policy, which states that substantially all of the parent company's profits should be distributed as dividends. However, the company also considers the economic conditions, its near-term investment needs, and the prevailing financial targets when making its decision.

In our base case, we assume:

- Tariffs and allowed regulatory return increasing in 2016 following changes in the regulatory framework, primarily related to the WACC, however, still compensating for the excessive profits caused by the higher-than-expected congestion income in 2015. The grid service fee increase was approved at an average of 14% starting in 2016 and 7% starting in 2017.
- Net annual investments of about €150 million in 2016 and €130 million in 2017.

- Annual dividends corresponding to substantially all of the parent company's net profit, in line with the company's dividend policy. In 2016, dividends paid were €90 million.

Based on these assumptions, we arrive at the following credit measures for 2016 and 2017:
- FFO to debt of 20%-23%.
- Debt to EBITDA of about 3.3x-4.0x.

The long-term rating on Fingrid includes one notch of uplift from its 'a+' stand-alone credit profile (SACP), indicating our opinion that there is a high likelihood that Finland's government would provide timely and sufficient extraordinary support to Fingrid in the event of financial distress. We base this view on Fingrid's:
- Strong link with the Finnish government, which owns 53% of the shares (partly through the National Emergency Supply Agency), with 71% of the voting rights; and
- Very important role as Finland's monopoly TSO, given its clear strategic importance for the government in ensuring electricity transmission stability and development of the transmission grid.

Liquidity

We assess Fingrid's liquidity position as adequate, based on our estimate that Fingrid's liquidity sources will exceed its funding needs by 1.1x in the next 12 months and that sources will exceed uses even if EBITDA declines by 10%. Furthermore, we believe that the company has a sound relationship with its banks, a satisfactory standing in the credit markets, and prudent risk management. In addition, Fingrid's revolving credit facility is free from financial covenants that could prevent the company from drawing it.

Principal liquidity sources:
- €80 million in cash and marketable securities as of June 30, 2016;
- Access to an undrawn €300 million committed revolving credit facility, maturing in December 2020; and
- Projected FFO of about €220 million for the next 12 months.

Principal liquidity uses:
- Short-term debt maturities of €320 million as of June 30, 2016, including €70 million of outstanding commercial paper;
- Annual investments of about €150 million (though flexible and subject to availability of financing); and
- Annual dividend of substantially all of the net income for 2016 to be paid in the first half of 2017. As a comparison, Fingrid paid €90 million in 2016, which was 73% of net income for 2015 reported under Finnish accounting standards, although we understand the dividend could be flexible if needed.

Outlook

The stable outlook reflects our assumption that Fingrid will remain strategically important to the Finnish government as Finland's monopoly TSO, with stable and predictable underlying earnings supported by a favorable regulatory framework. Based on this, we anticipate no pronounced changes in Fingrid's SACP. As such, we anticipate that the ratio of FFO to debt will remain at least 18%.

Upside scenario

We could raise the ratings on Fingrid if we saw further improvement of the company's SACP, likely driven by a strengthening of the company's financial risk profile, for example, if FFO to debt improved sustainably to above 23%. This could be a result of low capital spending and modest dividends. We could also upgrade Fingrid if we positively reassessed our view of the likelihood of extraordinary government support, a scenario we currently regard as unlikely.

Downside scenario

We could lower the ratings if we revised down Fingrid's SACP to 'a' resulting from the deterioration of credit measures, with FFO to debt falling below 18% with no signs of recovery. Any unexpected material negative changes to the regulatory framework, for example to the allowed return, could prompt a negative impact on our business risk assessment, and subsequently to the ratings.

Ratings Score Snapshot

Corporate Credit Rating: AA-/Stable/A-1+

Business risk: Excellent
- Country risk: Low
- Industry risk: Very low
- Competitive position: Excellent

Financial risk: Intermediate
- Cash flow/Leverage: Intermediate

Anchor: a+

Modifiers
- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)

- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: a+

Sovereign rating: AA+
- Likelihood of government support: High (+1 notch from SACP)

Related Criteria And Research

Related Criteria
- General Criteria: S&P Global Ratings' National And Regional Scale Mapping Tables - June 01, 2016
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers - December 16, 2014
- Criteria - Corporates - Utilities: Key Credit Factors For The Regulated Utilities Industry - November 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments - November 19, 2013
- General Criteria: Methodology: Industry Risk - November 19, 2013
- General Criteria: Group Rating Methodology - November 19, 2013
- Criteria - Corporates - General: Corporate Methodology - November 19, 2013
- Criteria - Corporates - General: 2008 Corporate Criteria: Rating Each Issue - April 15, 2008
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers - November 13, 2012
- General Criteria: Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers - May 07, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions - November 19, 2013
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions - March 25, 2015
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating - October 01, 2010
- General Criteria: National And Regional Scale Credit Ratings - September 22, 2014

Ratings List

Upgraded

	To	From
Fingrid Oyj		
Corporate Credit Rating	AA-/Stable/A-1+	A+/Positive/A-1
Senior Unsecured	AA-	A+
Commercial Paper	A-1+	A-1

Ratings Affirmed

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Fingrid Oyj
 Corporate Credit Rating
 Nordic Regional Scale                 --/--/K-1
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