



Moody's Investors Service

Credit Opinion: PGE Polska Grupa Energetyczna S.A.

Global Credit Research - 02 Sep 2009

Poland

Ratings

Category	Moody's Rating
Outlook	Stable
Issuer Rating	A3

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Key Indicators

PGE Polska Grupa Energetyczna S.A.

	Dec-2008	Dec-2007	Dec-2006
EBITA Margin	13.7%	9.9%	10.7%
RCF / Net Debt	79.0%	112.5%	89.5%
FFO Interest Coverage	11.9x	11.4x	10.8x
RCF / Capex+ Investments (net of disposals)	85.3%	142.4%	143.5%
Debt to Book Capitalisation	20.1%	19.4%	19.1%
FFO / Net Debt	86.5%	117.6%	96.8%

Note: For definitions of Moody's most common ratio terms please see the accompanying [User's Guide](#).

Opinion

Corporate Profile

PGE Polska Grupa Energetyczna S.A. ("PGE") is a holding company for a vertically-integrated energy group, the PGE Group, which ranks number one among Polish power companies. Currently 100% owned by Polish government (A2, stable outlook), PGE covers all major activities involved in electricity production, distribution and supply (with the exception of the highest and high voltage grid covered by a separate state-owned company, PSE-Operator S.A.). PGE's core operations comprise five business lines, including lignite mining & conventional electricity and heat generation, renewables, wholesale trade, distribution and retail sales. With 56.1TWh of generated electricity and 5 million customers supplied, PGE accounted for over 40% of electricity generated in Poland and 26% of electricity distributed.

Rating Rationale

Given its 100% ownership by the government of Poland, PGE falls within the scope of Moody's rating methodology for government-related issuers (GRIs). In accordance with the methodology, PGE's A3 issuer rating incorporates an uplift for potential government support to its standalone credit quality. This is expressed by Moody's as a Baseline Credit Assessment (BCA) of 8 (on a scale of 1 to 21, where 1 represents the lowest risk and 8 is equivalent to a Baa1 rating). The uplift to the BCA, currently at one notch, results from the credit quality of its government shareholder and Moody's assessment of medium probability of government support in the event of financial distress, as well as high default dependence (i.e. degree of exposure to common drivers of credit quality).

PGE's BCA of 8, representing the company's credit quality before taking into account any support from the state, is underpinned by following positive factors: (i) PGE's leading position in Poland's energy sector, a market that is currently relatively closed with electricity prices lower than in neighbouring Germany and thus with potential of positive price developments as further market integration is achieved; (ii) well balanced vertical integration, as PGE covers (with the exception of the high voltage grid) the whole spectrum of the electricity sector; (iii) solid operational performance of its overall younger generation fleet than the rest of Polish market; and (iv) strong historical financial performance supported by low leverage and a solid liquidity position. However, PGE's current business profile is constrained by (i) high exposure to CO2 stemming from its coal-based generation capacities (coal represents almost 95% of PGE's fuel mix); (ii) a large capital investment programme focused on upgrading and expanding current generation units and diversification towards renewable energy sources required by EU directives; (iii) an expected weakening of its currently strong financial profile mainly due to its sizeable capex programme, which demands a significant leverage increase; and (iv) relatively unpredictable proceeds from compensation for termination of long-term Power Purchase Agreements (PPAs).

When assessing PGE's BCA, Moody's applies its Rating Methodology for Global Unregulated Utilities and Power Companies, which identifies key areas of focus for assessing the relative fundamental credit quality of unregulated utility companies. Based on historical financial performance, the methodology indicates a BCA of 6, two notches above the assigned BCA of 8. Moody's expects that the difference between the outcome and the actual BCA will narrow in the future as the assigned rating factors in the challenging capex programme planned by PGE and the associated expected deterioration in financial profile. However, credit metrics falling persistently and materially below the levels of FFO Interest Cover of 6x, FFO/Net Debt of 40% and RCF/Net Debt of 30% would not be seen by Moody's as commensurate with the BCA level of 8 (equivalent to a Baa1 rating).

Rating Drivers

RATING FACTOR 1 - Market Assessment, Scale and Competitive Position

With EUR5 billion in sales in 2008, EUR12 billion in assets, total generation capacity of 12.4GW and 5 million customers, PGE enjoys a leading position in Poland's electricity market - representing a 42% share in generation and 26% share in distribution. The remaining market is divided among three other major energy groups, which are focused mainly on distribution with some generation capacities, and several foreign energy groups (EDF, RWE, CEZ, Vattenfall, etc), which represent up to 20% of generation capacities and 16% of distribution.

RATING FACTOR 2 - Cash Flow Predictability and Business Model

PGE's fuel mix is heavily based on coal, mainly made up of lignite (68%) and hard coal (26%). PGE's mix is in line with the average fuel mix in the Polish market and large reserves of relatively cheap coal are readily available. However, such a high concentration on coal will represent a significant capex need for PGE in renewable sources to fulfil EU energy directives and to diversify the fuel mix to avoid high CO2 costs. Although Poland will continue to receive free CO2 permissions after 2013, the allocated quota will be gradually decreasing to zero by 2020. The need to purchase missing permissions could expose PGE to a significant cost disadvantage in the future compared to the European average fuel mix. PGE represents a well balanced, vertically-integrated electric utility. With the exception of a high-voltage network, it covers the whole electricity spectrum, from coal mining, generation, wholesale, distribution to supply and retail.

PGE's generation fleet is, on average, younger than other energy groups in Poland, with over 75% of the generation units having an end of technical life after 2025. With the exception of the older units, PGE's generation assets outperform most of its Polish competitors.

PGE's sizeable capex programme, which will reach PLN39 billion (EUR9.5 billion) between 2009 and 2012, is mainly focused on (i) upgrading existing generation units due to technical obsolescence and the need for environmental upgrades, (ii) construction of new generation capacities to replace old units that are being gradually decommissioned, and (iii) relatively sizeable investments into renewable energy to fulfil EU directives. Additionally, as the strongest energy group in Poland, PGE has been chosen by the Polish government as a main partner for creating a nuclear energy segment and building the first nuclear power plant in Poland. This could stretch PGE's financial capacity, as well as significantly increase its execution risk, but it will take several years for the risks associated with the planned development of nuclear capacity to impact PGE's credit quality and become relevant for the purpose of rating stability.

As the Polish electricity market is almost fully liberalised, the regulated activities, which are perceived by Moody's as low risk activities contribute around 20% to the group's revenues and 10% of operating profit derived mainly from distribution activities and sales to household customers. However, being solely focused on the domestic market, PGE's business profile is not constrained by any significant exposure to high risk countries.

RATING FACTOR 3 - Financial Policy

As the Polish government has announced its intention to issue new shares via the stock exchange and as it reduces its share in PGE to 85% from 100%, the financial policy of PGE will need to balance the interests of both stockholders and creditors. Although the IPO proceeds are primarily aimed at strengthening PGE's capital structure, Moody's cautions that a portion of the proceeds might be used to support the state budget in the current adverse macroeconomic environment, as evidenced by an increase in dividends from 2008 profits recently imposed by the government.

RATING FACTOR 4 - Financial Strength Metrics

Based on past financials, PGE reports strong financial performance, with debt coverage metrics well above the current BCA category. However, PGE's strong financial profile is expected to weaken mainly due to its sizeable capex plan, which could result in a significant increase in leverage. PGE is exposed to limited FX risk, as only a small portion (below 15%) of its debt is denominated in foreign currency. Although currently not material, the FX risk might increase in the future, as the company may need to raise sizeable debt in international markets to cover its ambitious capex plan, in which case Moody's would expect PGE to implement suitable policies to mitigate such risk.

The Polish law on termination of PPAs, approved in 2007, aimed to establish a mechanism to derive the level of stranded costs and respective compensation that the generators should receive. As the level of compensation is dependent on the development of electricity prices and cost structure of generators, it is difficult to predict future revenues and cash flows; this dependence also introduces some uncertainty into the projection of PGE's future financial performance.

OTHER GRI FACTORS

Medium support reflects PGE's strategic importance to Poland as a leading vertically-integrated electric utility. Although no direct state guarantees are currently provided, Moody's believes that the state recognises the strategic importance of PGE, which is reflected in the nomination of PGE as a main partner for building nuclear-based generation capacities in Poland. Despite Poland's latest intention to partially privatise PGE through an IPO, the government expects to retain its controlling stake in PGE in the long term. The high level of default dependence reflects PGE's significant exposure to the Polish economy, as almost all its revenues and

cash flows are generated from domestic activities and have a high level of correlation to common drivers of credit quality.

Liquidity Profile

PGE's solid short-term liquidity position benefits from strong cash flow generation, a comfortable debt maturity profile and sufficient headroom under its committed credit lines. However, Moody's expects PGE's liquidity profile to weaken in the medium term, as the sizeable capital investment programme will continue to consume most of its available funds and will result in negative free cash flow and increased leverage. Although PGE's current leverage is low compared to its utility peers, Moody's expects PGE to follow prudent liquidity and debt management policies as reliance on market access for new debt funding increases with the implementation of the investment programme. Furthermore, PGE's currently favourable debt maturity profile shows repayment accumulation in 2010 and 2012 as the company's bonds mature, representing increased refinancing risk. Moody's further notes that PGE's liquidity and leverage profile is dependent on proceeds from a successful IPO, planned for late 2009, as well as the future development of relatively unpredictable proceeds from compensations for termination of long-term power purchase agreements (PPAs).

Rating Outlook

The stable outlook reflects Moody's expectation that PGE will remain the leading electric utility in Poland and the company's significant financial flexibility to deal with the challenges of its corporate development and investment plans in the medium term. However, Moody's cautions that rating stability over the longer term will ultimately depend on PGE's ability and willingness to adjust its ambitious capital investment programme according to the development of its operating and financial performance.

What Could Change the Rating - Up

An upgrade of the BCA by one notch could lead to an upgrade of PGE's rating, assuming the sovereign rating as well as the support and dependence factors remain unchanged.

Despite strong historical financial metrics and given the expected pressure on the debt protection metrics exerted by the planned rise in leverage to fund the company's ambitious capital investment programme (EUR9.5 billion between 2009 and 2012) and high event risk associated with the necessary restructuring measures to be executed, no upward movement in the rating is expected in the medium term.

An upgrade of Poland's rating by one notch, assuming no change in the level of support and default dependence, would not impact PGE's A3 rating.

What Could Change the Rating - Down

To sufficiently cover the debt service and continue achieving the strong debt coverage metrics, PGE's future performance needs to be supported by strong electricity prices, no major shrinkage of electricity consumption and successful restructuring measures bringing synergistic effects.

Downward pressure could be exerted on PGE's rating if (i) PGE's capital investment plan proves to be overly ambitious in relation to the company's future performance (mainly if adversely impacted by weak electricity prices, significant shrinkage of electricity demand or unsuccessful execution of restructuring efforts), or if (ii) any large one-time dividend payout is deemed unjustified in relation to cash flow generation strength, which would result in material and persistent weakening of financial metrics below the levels of FFO Interest Cover of 6x, FFO/Net Debt of 40% and RCF/Net Debt of 30%.

Rating Factors

PGE Polska Grupa Energetyczna S.A.

Unregulated Utilities	Aaa	Aa	A	Baa	Ba	B	Caa
Factor 1: Market Assessment, Scale and Competitive Position (25%)							
a) Size and scale (15%)				x			
b) Competitive position and market structure (10%)			x				
Factor 2: Cash Flow Predictability of Business Model (25%)							
a) Fuel strategy and mix (5%)				x			
b) Degree of integration and hedging strategy (5%)			x				
c) Capital requirements and operational performance (5%)						x	
d) Contribution from low/ high risk businesses (10%)				x			
Factor 3: Financial policy (10%)				x			
Factor 4: Financial Strength - Key Financial Metrics (40%)							
a) CFO pre-WC + Interest / Interest (10%)		x					
b) CFO pre-WC / Debt (12.5%)	x						
c) RCF / Debt (12.5%)	x						

d) FCF / Debt (5%)		x				
Rating:						
a) Methodology Implied Senior Unsecured Rating				A2		
b) Actual Senior Unsecured Rating				Baa1		



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