

Global Credit Research - 16 Dec 2011

Warsaw, Poland

Ratings

Category	Moody's Rating
Outlook	Stable
Issuer Rating	A3

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Key Indicators

PGE Polska Grupa Energetyczna S.A.[1]	9/30/2011	12/31/2010	12/31/2009	12/31/2008	12/31/2007
(FFO + Interest) / Interest Expense	91.1x	25.7x	22.3x	12.7x	11.7x
FFO / Net Debt	1374.5%	1400.9%	-356.0%	88.9%	118.1%
RCF / Net Debt	852.0%	1039.8%	-301.6%	81.4%	113.1%
FCF / Net Debt	-196.4%	110.2%	-92.9%	11.6%	29.2%
EBIT margin	16.5%	20.7%	24.5%	14.2%	9.7%

[1] Standard adjustments in accordance with "Rating Methodology: Moody's Approach to Global Standard Adjustments in the Analysis of Financial Statements for Non-Financial Corporations, Part 1, Part 2 and Part 3." In addition, Moody's adjusts for one-time items.

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 no. 1 among Polish power companies and no. 14 among European utilities (based on installed capacity). PGE is currently approximately 70% owned by the Government of Poland (A2, stable outlook), with the remainder in free float. PGE is involved in all major activities associated with the production, distribution and supply of electricity, with the exception of managing the high-voltage grid, which is the responsibility of 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, generation from renewable sources, wholesale trade, distribution and retail sales. With 13.1 gigawatts (GW) of electricity generation capacity and over 5 million customers supplied, PGE accounts for more than 40% of electricity generated in Poland and 26% of electricity distributed.

Recent Developments

Commissioning of Belchatow Unit 14

On 28 September 2011, PGE commissioned the Belchatow Unit 14, a 858 megawatt (MW), single-turbine, lignite-fired generation unit. With net efficiency of 42% and CO2 emissions 0.9 ton/megawatt hour (MWh), the new unit supports PGE's strategic effort to upgrade its aging generation asset base, increase efficiency and lower relatively high average CO2 emissions. After the commissioning, capacity at the Belchatow plant (currently the largest thermal power plant in Europe) increased to 5,354 MW, with the total generation capacity of PGE Group reaching 13.1 GW.

Sale of Polkomtel

PGE's already strong financial profile and liquidity has been further supported by proceeds of around PLN3.2 billion (EUR 0.7 billion) from the sale of its 21.85% stake in Polkomtel, one of three largest telecom operators in Poland. On 9 November 2011, shareholders of Polkomtel (PGE, PKN Orlen, KGHM, Wegelokoks and Vodafone) signed an agreement with Spartan Capital Holdings Sp. z o.o. (a special purpose vehicle

controlled by Mr. Zygmunt Solorz-Zak) for the final sale of 100% of the shares in Polkomtel. As the book value of PGE's share was PLN1.3 billion (EUR 290 million), the consolidated 2011 financial results will reflect a capital gain of PLN1.66 billion (EUR 370 million).

Rating Rationale

PGE's issuer rating of A3 with a stable outlook reflects the company's leading position in Poland's energy sector, supported by strong financial performance with low leverage and a solid liquidity position. PGE's solid business profile as a vertically integrated utility could be further strengthened if its acquisition of Energa S.A. is completed. However, PGE's rating is constrained by (i) a sizeable capital expenditure (capex) programme; (ii) high average CO2 emissions of its generation base; (iii) the need to cover the cost of the potential acquisition of Energa; and (iv) the relatively unpredictable levels of compensation for termination of long-term power purchase agreements (PPAs). PGE's rating incorporates a one-notch uplift for potential support from its owner, the Government of Poland (A2 stable).

Rating Drivers

Given its 69.29% ownership by the government of Poland, PGE falls within the scope of our rating methodology for government-related issuers (GRIs). In accordance with the methodology, PGE's A3 issuer rating incorporates uplift for potential government support to its standalone credit quality. We express this 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 PGE's majority shareholder, the Government of Poland, and our assessment of there being a strong probability of government support in the event of financial distress, as well as very high level of default dependence (i.e., degree of exposure to common drivers of credit quality).

When assessing PGE's BCA, we apply our 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. We believe that the difference between the methodology grid outcome and the actual BCA will narrow in the future as the challenging capex programme planned by PGE weakens the company's financial profile and to a large extent consumes its currently sizeable cash reserves. However, credit metrics falling persistently and materially below the levels of funds from operations (FFO) interest coverage of 6.0x, funds from operations (FFO)/net debt of 40% and retained cash flow (RCF)/net debt of 30% would not be seen as commensurate with the BCA level of 8 (equivalent to a Baa1 rating).

RATING FACTOR 1 - Market Assessment, Scale and Competitive Position

While we would expect the acquisition of Energa to add 2.8 million customers to PGE's current customer base of more than 5 million and to increase its asset base of EUR 12.9 billion (as of the end of 2010) by approximately EUR 2.7 billion, it would not justify a higher score for the "Size and Scale" sub-factor than the current Baa. With EUR 5.2 billion in sales in 2010 and a total generation capacity of 13.1 GW, PGE enjoys a leading position in Poland's electricity market. PGE has market shares of 41% in terms of generation and 26% based on distribution. Indeed, the latter could potentially increase by an additional 16% as a result of the acquisition. Therefore, the company scores a solid A for the "Competitive Position and Market Structure" sub-factor. The remainder of the market is divided among two other major energy groups (Tauron and Enea), which are focused mainly on electricity distribution and retail sales, although have some generation capacities. Foreign energy groups (EDF, RWE, CEZ, etc) represent up to 20% of electricity generation capacity in Poland and 15% of the country's electricity distribution market.

RATING FACTOR 2 - Cash Flow Predictability and Business Model

PGE's Baa score for the "Fuel Strategy and Mix" sub-factor reflects the high proportion of CO2-intensive coal-based generation (lignite 67%, hard coal 26%) in the company's fuel mix. Although PGE's generation mix is in line with the average in the Polish market and large reserves of relatively cheap coal are readily available, such a high concentration on coal will require the purchase of additional CO2 permissions, exposing the company to a significant cost disadvantage. Although Poland will continue to receive free CO2 permissions after 2013, the allocated quota will gradually decrease to zero by 2020, requiring significant investments in renewable sources to fulfil EU energy directives and diversify the fuel mix to avoid high CO2 costs.

Despite PGE recently acquiring two smaller on-shore wind projects with a total capacity of 108 MW (expected to be commissioned in 2012), we would expect the company to increase the proportion of low CO2 generation in its generation mix only gradually. We perceive PGE's strategic goal to achieve 1 GW of on-shore wind capacity by 2015 and 1 GW of off-shore capacity by 2020 to be rather ambitious. As a result of this, and the fact that PGE's nuclear power generation project (please see below) is in its infancy, we do not expect the company's score under the "Fuel Strategy and Mix" sub-factor to improve in the medium term.

PGE's solid A score for the "Degree of Integration and Hedging Strategy" sub-factor reflects the company's (i) well-balanced, vertically integrated profile, with a sizeable retail customer base, which we would expect to be further strengthened by the acquisition of Energa; and (ii) coverage of the whole electricity spectrum (with the exception of the high-voltage network), from lignite mining, generation, wholesale, distribution to supply and retail.

On 15 September 2010, PGE signed a Share Purchase Agreement with the Polish Ministry of Treasury to buy 84.19% of the shares in Energa S.A. The Polish Office of Competition and Consumer Protection blocked the acquisition by issuing a negative decision in January 2011, which was appealed by PGE. Although the verdict of the Court of Competition and Consumer Protection is expected in 2012, we expect that a final decision regarding the acquisition will be prolonged. In our view, the acquisition of Energa, whose activities focus mainly on electricity distribution and supply and generation from renewable sources, would strengthen PGE's business profile by increasing its downstream vertical integration and balancing its currently long generation position. Furthermore, it would increase the contribution of regulated activities to PGE's cash flow generation and slightly improve the company's generation mix by adding renewable generation sources.

PGE's B score for the "Capital Requirements and Operational Performance" sub-factor is constrained, mainly by the company's sizeable capex programme, which we anticipate will reach PLN46.2 billion (EUR 10.3 billion) by 2015. PGE will need to significantly increase its investment activity over the coming years in order to deliver such an ambitious capex plan, which will require the company to almost double the level of its annual investments compared with its historical annual investments of PLN4-4.5 billion (EUR 0.9-1 billion). Such a significant increase could not only exert pressure on PGE's financial profile and liquidity, but could also stretch its technical and managerial capacities and pose a significant execution risk.

PGE's capex plan 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) investments into distribution networks. Additionally, as referenced above, given that it is 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 the country. 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 affect the company's credit quality and become relevant to the stability of its rating.

As the Polish electricity market is almost fully liberalised, the regulated activities of electricity distribution and supply to households, which we perceive to be low risk, contribute only moderately to PGE's overall profitability and result in the company scoring Baa for the "Contribution from Low-/High-Risk Businesses" sub-factor. However, we expect the acquisition of Energa, which is predominantly focused on electricity distribution and supply, to increase the contribution of regulated activities to PGE's EBITDA. Assuming the acquisition of Energa was completed, we would expect its impact on PGE's score for this sub-factor to be marginal, given the overall size of PGE. 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

PGE's Baa score for the "Financial Policy" sub-factor reflects the relatively new requirement on the company to balance the interests of both shareholders and creditors, given that the Polish government reduced its share in the company to 69.29%. Although the proceeds of the government's initial public offering (IPO) of shares in PGE and successful sale of its non-core activities strengthened the capital structure of the company, we note that its increased dividend payouts and purchase of minority stakes in subsidiaries from the state depleted these proceeds significantly.

RATING FACTOR 4 - Financial Strength Metrics

Based on historical financials, PGE reports a strong financial performance, with low leverage and debt coverage metrics well above the current BCA category. PGE managed to raise up to PLN6 billion (EUR 1.5 billion) of new equity through the IPO and PLN3.29 billion (EUR 0.74 billion) from the sale of Polkomtel. Those proceeds enabled the company to optimise its debt portfolio and achieve a positive net cash position. The company's operating results (excluding power purchase agreement (PPA) compensations) improved during the first nine months of 2011, with revenues increasing by 12%, EBITDA by 23% and net income by 7%. The generation and distribution segments represented the main contributors to PGE's growing EBITDA as volume of electricity generated by PGE increased, supported by growing electricity prices and higher distribution tariffs.

However, we would expect PGE's strong financial profile to weaken over the medium term, mainly due to its sizeable capex plan, which could result in a significant increase in leverage. Furthermore, if approved by the Polish Office of Competition and Consumer Protection, the acquisition of Energa would limit PGE's financial flexibility and would require additional capex for the upgrade and extension of Energa's distribution networks. Although we regard PGE's financial profile and liquidity position as sufficiently strong to absorb the PLN7.5 billion (EUR 1.68 billion) acquisition of Energa, we caution that over the medium term, the development of PGE's financial profile will be dependent on the company's ability to adjust its future capex plan and indebtedness according to the development of its operating performance, cash flow generation and dividend payout. Furthermore, we have assumed that there will be no significant benefit from potential synergies associated with the Energa acquisition. This is because PGE's execution of any significant restructuring measures could be constrained, at least in the short to medium term, by the existence of long-term employment guarantees and the company's commitment to keep Energa as a standalone entity.

PGE is exposed to limited foreign exchange (FX) risk, as only a small portion (below 20%) of its debt is denominated in foreign currency. Although currently not material, PGE's FX risk could increase in the future, as the company may need to raise substantial amounts of debt in international markets to cover its ambitious capex plan. Should this happen, we would expect PGE to implement suitable policies to mitigate such risk.

We note that the Polish law on termination of PPAs, approved in 2007, aimed to establish a mechanism to determine 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 the cost structure of generators, it is difficult to predict future revenues and cash flows related to this mechanism. Furthermore, there are ongoing disputes between PGE and the Polish regulatory office regarding the amount of retrospective annual adjustments to compensation. This introduces further uncertainty with regard to when PGE will receive cash under this compensation mechanism and may result in some volatility in the company's financial performance. Although the compensation payments continue to gradually decrease, we caution that if PGE's financial performance were to become reliant on this cash flow stream to meet the minimum financial parameters mentioned above, its rating could come under pressure.

In 2011, PGE started to sell the majority of its generated electricity and procure electricity needed to cover the supply to its customers on the power exchange. Because of this, PGE's reported levels of consolidated revenues and expenses have increased (31% revenue increase in the first nine months of 2011). As a result, the company's profitability margins have decreased in relative terms despite the increase in profitability in real terms. Reported EBITDA margin decreased to 27% in third quarter 2011 from 30% during same period in the previous year. However, if we do not factor in the impact of the change of trading mechanism, PGE's EBITDA in third quarter 2011 increased to 34%.

OTHER GRI FACTORS

The strong support assigned to PGE reflects its critical role within the Polish energy sector as the largest vertically integrated electric utility, its strategic importance to the overall Polish economy and the fact that it represents one of the largest employers and contributors to the state budget. Although no direct state guarantees are currently provided, we believe that the Polish government recognises the strategic importance of PGE, which is reflected by the nomination of the company as a main partner for building nuclear-based generation capacity in Poland. Despite a gradual reduction in the state's share in PGE to 69.29%, we believe that the Polish government expects to retain its controlling stake in the company over 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, sizeable cash reserves accumulated from the IPO and divestments, a comfortable debt maturity profile and sufficient headroom under its committed credit lines. However, we would expect the company's liquidity profile to weaken if the acquisition of Energa materialises, as this will consume most of PGE's cash reserves. In addition, PGE's sizeable capex programme will continue to require substantial financing, resulting in negative free cash flow and increased leverage.

Although PGE's current leverage is low compared with those of its peers, we would expect the company to follow prudent liquidity and debt management policies as its reliance on market access for new debt funding increases with the implementation of its capex programme. Furthermore, PGE's debt maturity profile reflects increased repayments in 2012, representing refinancing risk. We further note that PGE's liquidity and leverage profile is dependent on relatively unpredictable compensation payments for termination of long-term PPAs.

Rating Outlook

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

What Could Change the Rating - Up

Despite PGE's strong historical financial metrics, we do not expect upward rating movement in the medium term. This reflects (i) the pressure that is likely to be exerted on PGE's debt protection metrics by the planned increase in leverage to fund the company's ambitious capex programme; and (ii) the high level of event risk associated with the necessary restructuring measures that need to be executed.

What Could Change the Rating - Down

Although currently strongly positioned, PGE's rating could come under pressure, should its financial metrics sustainably weaken due to, for example: (i) weak electricity prices and consumption; (ii) material increases in capex or acquisitions, without offsetting balance-sheet measures; (iii) higher-than-expected dividend payments; or (iv) significant operating or restructuring underperformance.

Rating Factors

PGE Polska Grupa Energetyczna S.A

Unregulated Utilities	Aaa	Aa	A	Baa	Ba	B	Caa
Factor 1: Market Assessment, Scale & Competitive Position (25%)							
a) Size and Scale				X			
b) Competitive Position and Market Structure			X				
Factor 2: Cash Flow Predictability of Business Model (25%)							
a) Fuel Strategy and Mix				X			
b) Degree of Integration and Hedging Strategy			X				
c) Capital Requirements and Operational Performance						X	
d) Contribution from Low/High Risk Businesses				X			
Factor 3: Financial Policy (10%)							
a) Financial Policy				X			
Factor 4: Financial Strength Metrics (40%) [1][2]							
a) (CFO Pre-W/C + Interest) / Interest Expense (3 year Avg)	19.2x						
b) (CFO Pre-W/C) / Debt (3 year Avg)	297.1%						
c) RCF / Debt (3 year Avg)	247.1%						
d) FCF / Debt (3 year Avg)	50.0%						
Rating:							
a) Indicated BCA from Grid			6 (A2)				
b) Actual BCA Assigned				8 (Baa1)			

Government-Related Issuer	Factor
a) Baseline Credit Assessment	8 (Baa1)
b) Government Local Currency Rating	A2
c) Default Dependence	Very High
d) Support	Strong

[1] Standard adjustments in accordance with "Rating Methodology: Moody's Approach to Global Standard Adjustments in the Analysis of Financial Statements for Non-Financial Corporations, Part 1, Part 2 and Part 3." In addition, Moody's adjusts for one-time items. [2] As of 12/31/2010 (2008-2010 average); Source: Moody's Financial MetricsTM



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