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Fitch Affirms Poland's PGE at 'BBB+'; Outlook Stable

Fitch Ratings - Warsaw - 24 Jan 2023: Fitch Ratings has affirmed PGE Polska Grupa Energetyczna S.A.'s (PGE) Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDRs) at 'BBB+' with a Stable Outlook. A full list of rating actions is below.

The affirmation reflects PGE's business profile as the largest Polish integrated electric utility and a high proportion of regulated and quasi-regulated income from distribution and capacity payments, respectively. The key rating constraint is the company's large share of electricity generated from lignite and coal, which leads to the high carbon footprint of PGE's generation fleet and exposes the company to high CO2 costs.

We project that a large capex plan will increase PGE's net leverage in 2023-2026, which however should remain solid for the current rating.

Key Rating Drivers

Distribution Supports Credit Profile: The ratings of PGE reflect its focus on regulated distribution activity, which is characterised by lower business risk and greater cash flow predictability than conventional power generation. The introduction of premiums for investment needs on top of the base value of weighted average cost of capital will drive the increase of return on the regulated asset base (RAB) above 8.0% in 2023 from 5.8% in 2022. Together with a growing RAB and higher operating expenditure (opex) allowances, this will boost distribution performance from 2023.

Distribution Grid Acquisition: We expect the share of regulated EBITDA to further increase to 45% in 2023-2026 (36% in 2017-2022) following the acquisition of the Polish distribution system operator responsible for distribution of electricity to the traction network, PKP Energetyka S.A. As a result of the acquisition we expect PGE's RAB to rise about 16% to PLN22 billion and the volume of distributed electricity by 11% to almost 42TWh, based on 2021 pro-forma figures. The transaction should close in 2Q23 and will be positive for the business profile given the increased share of regulated revenues and better cash flow visibility.

Increase in Leverage: We expect funds from operations (FFO) net leverage to rise to 2.3x in 2023 from an estimated negative net debt position in 2022. This reflects a modest improvement in EBITDA in 2023 tempered by the recently introduced generation and supply caps by the Polish government, coupled with a substantial increase in capex and also the acquisition price for PKP Energetyka. In the medium term, we project FFO net leverage to remain within our rating sensitivities, supported by improved EBITDA from 2024, but weighed down by the ambitious capex plans.

Price Cap for Generators: We expect the recently implemented price cap for generators to limit the profitability of renewable assets that could benefit from high market prices and to put pressure on conventional generation units considering their high fixed costs and substantial inflation. The government introduced a maximum price for energy generators that will vary by energy source and among individual units, as the formula considers the fuel, CO2 cost, and effectiveness of each plant. If the selling price is above the limit, the generator will pass on the additional revenue to a special fund created to finance capped tariffs for end-customers. The price cap applies from December 2022 throughout 2023.

Capex to Boost CCGT Output: Our rating case forecasts PGE's capex to average PLN11.3 billion annually in 2022-2026, with the highest amounts being directed at distribution, renewables and conventional generation, including new combined cycle gas turbine (CCGT) Dolna Odra and Rybnik power plants. We expect the new CCGT units to increase PGE's capacity by 1.36GW by end-2023 and by nearly 900MW in 2027. Both projects have 17-year capacity payments agreements, which will significantly improve the segment's result from 2024 and from 2027 and mitigate the plants' cash flow exposure to gas and CO2 prices.

Shift to Renewables: PGE aims to increase renewable capacity by 6.5GW in 2030 from about 1.2GW at end-2021, investing in onshore and offshore wind, and photovoltaics. We expect the share of renewables in EBITDA to increase to on average 21% in 2022-2026 (10% in 2019-2021). Under the new business model, once the spin-off of the coal-fired assets is completed, the renewable segment will become even more important with its EBITDA share growing towards 50% in the medium-to-long term.

Introduction of Supply Cap: The government introduced a cap on supply prices from November 2022 throughout 2023 at 2022 levels for households with annual consumption of up to 2MWh during 2023, and at PLN693/MWh above this limit, and at PLN785/MWh for SMEs, public utility entities, and farmers. We assume no delays in payments of granted compensation due to a monthly settlement mechanism.

Spin-Off to Benefit: Fitch has not included the planned divestment of PGE's lignite mines and lignite- and coal-fired power plants to a state-controlled National Agency for Energy Security (NABE) in its rating case as the key transaction terms, including the price and payment terms, have not yet been agreed on. Fitch believes the divestment will have a positive impact on PGE's business profile, allowing the company to focus on electricity distribution and renewable generation, and improve its debt capacity.

Standalone Approach: Fitch applies its Government-Related Entities (GRE) Rating Criteria in its analysis of PGE as the Polish state (A-/Stable) holds a 60.68% stake in the company. Based on the GRE Criteria we rate PGE on a standalone basis. We assess status, ownership and control links as strong, but support track record as weak, the socio-political impact of a default as moderate and financial implications of a default for the Polish government as weak.

Derivation Summary

PGE's close peer group includes the three other electricity-focused integrated utilities in Poland, which are TAURON Polska Energia S.A. (Tauron; BBB-/Stable), ENEA S.A. (BBB/Negative) and Energa S.A. (BBB+/Stable), and Hungary's largest electricity and gas utility MVM Zrt (BBB/Negative).

PGE is the largest company among the Polish peer group and has the lowest leverage. It derives most of its EBITDA from electricity generation and has a high share of lignite in its generation fuel mix, which provides the company with some cost advantage over hard coal-fired peers such as Tauron and ENEA. Rising CO2 prices could diminish this cost advantage if not accompanied by high hard coal prices, given the higher carbon footprint of lignite than hard coal.

Tauron's and Energa's business profiles benefit from a dominant share of regulated distribution in EBITDA, which provides good cash-flow visibility when conventional generation is under pressure. ENEA has a lower share of regulated distribution than Tauron and Energa and which is comparable to PGE's. ENEA also has larger hard coal-fired generation than Tauron and Energa, but controls a profitable mining business.

All of the companies benefit from capacity payments, which improve revenue visibility, although PGE benefits from more significant amounts due to its larger lignite- and coal-fired fleet.

MVM has better integration and business diversification than PGE, ENEA and Tauron, which are focused on a specific line of business, such as electricity generation or distribution, and also have higher exposure to coal. MVM's balance sheet and working-capital are highly exposed to changes in gas inventories due to seasonality and changes in gas prices. This results in a higher volatility of MVM's leverage than peers'. Also, MVM's net debt and leverage at year-end is higher than when gas inventories are lower during the course of the year.

Key Assumptions

Fitch's Key Assumptions Within Our Rating Case for the Issuer:

- Electricity prices for generation capped at an average PLN711/MWh in 2022-2026

- Revenue from capacity payments averaging around PLN2.77 billion a year over 2022-2026

- Weighted average cost of capital in the distribution segment on average 8.2% in 2023-2025, up from 5.8% in 2022

- Total capex and acquisitions at PLN60 billion over 2022-2026

- Continuation of a no-dividend policy

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

- A more resilient business profile, for example, due to a persistently high share of regulated or quasi-regulated income in EBITDA and substantially lower carbon footprint of the generation fleet

- FFO net leverage below 2x on a sustained basis, supported by management's conservative financial policy

Factors that could, individually or collectively, lead to negative rating action/downgrade:

- Deterioration of credit ratios, including FFO net leverage above 3x and FFO interest cover below 6x on a sustained basis, for example, due to deteriorated margins in generation, lower generation volumes or large investments

- Expansion in higher-risk business segments such as coal-fired generation or coal mining

Best/Worst Case Rating Scenario

International scale credit ratings of Non-Financial Corporate issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

Liquidity and Debt Structure

Adequate Liquidity: At end-September 2022 PGE had PLN11.1 billion of unrestricted cash and equivalents and PLN1.2 billion of committed credit lines, excluding facilities expiring in the following 12 months. This compared with short-term debt maturities of PLN2.2 billion and PLN7.9 billion of Fitch-projected negative free cash flow (FCF) after acquisitions in the next 12 months starting from October 2022.

A PLN2 billion loan signed in December 2022 with the European Investment Bank (dedicated to investments in the distribution segment in 2022-2025) improves the liquidity profile of PGE in 2023. However, adequate liquidity during 2023, under Fitch's approach, given PGE's large negative FCF is contingent on renewal of credit lines, obtaining additional funding or receiving proceeds for the asset spin-off to NABE.

Issuer Profile

PGE is the largest Polish integrated electric utility. The main areas of operations are electricity generation, electricity distribution, lignite mining as well as electricity supply. PGE's shares are listed on the Warsaw Stock Exchange, but a controlling shareholding is held by the Polish government.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG Considerations

PGE has an ESG Relevance Score of '4' for GHG emissions & air quality and energy management, due to the dominant share of carbon-intensive lignite and hard coal in its electricity generation mix. This has a negative impact on the credit profile, and is relevant to the ratings in conjunction with other factors.

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

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Rating Actions

ENTITY/DEBT	RATING			RECOVERY	PRIOR
PGE Polska Grupa Energetyczna S.A.	LT IDR	BBB+	Affirmed		BBB+
	LC LT IDR	BBB+	Affirmed		BBB+

ENTITY/DEBT	RATING			RECOVERY	PRIOR
	Natl LT	AA(pol)	Affirmed		AA(pol)
• senior unsecured	LT	BBB+	Affirmed		BBB+
• senior unsecured	Natl LT	AA(pol)	Affirmed		AA(pol)
PGE Sweden AB (publ)					
• senior unsecured	LT	BBB+	Affirmed		BBB+

RATINGS KEY	OUTLOOK	WATCH
POSITIVE		
NEGATIVE		
EVOLVING		
STABLE		

Applicable Criteria

Corporate Rating Criteria (pub.28 Oct 2022) (including rating assumption sensitivity)

Corporates Recovery Ratings and Instrument Ratings Criteria (pub.09 Apr 2021) (including rating assumption sensitivity)

Government-Related Entities Rating Criteria (pub.30 Sep 2020)

National Scale Rating Criteria (pub.22 Dec 2020)

Sector Navigators: Addendum to the Corporate Rating Criteria (pub.28 Oct 2022)

Applicable Models

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Corporate Monitoring & Forecasting Model (COMFORT Model), v8.1.0 (1)

Additional Disclosures

Solicitation Status

Endorsement Status

PGE Polska Grupa Energetyczna S.A.	EU Issued, UK Endorsed
PGE Sweden AB (publ)	EU Issued, UK Endorsed

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