13 JAN 2025

Fitch Downgrades Poland's PGE to 'BBB'; Outlook Stable

Fitch Ratings - Warsaw - 13 Jan 2025: Fitch Ratings has downgraded PGE Polska Grupa Energetyczna S.A.'s (PGE) Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDRs) to 'BBB' from 'BBB+'. The rating Outlook is Stable. A full list of rating actions is below.

The downgrade reflects our projections of PGE's net leverage increasing to above our negative sensitivity of 3.0x in the medium term, due to a large capex plan, largely for energy transition. The downgrade also incorporates a weakening of PGE's competitive position in Polish electricity generation, due to structural changes, including the growth of renewables that reduces PGE's lignite- and coal-fired power generation volumes. This reduces PGE's profitability, which is exacerbated by the fixed cost base of its lignite mines.

The Stable Outlook reflects PGE's projected net leverage being commensurate with the new rating, the solid share of regulated distribution in its EBITDA and a gradually improving electricity generation mix. We currently do not assume a spin-off of its lignite and coal assets.

Key Rating Drivers

Financial Trajectory Drives Downgrade: Under our rating case we forecast funds from operations (FFO) net leverage to increase to 3.8x in 2026, from 1.9x estimated for 2024 and 1.0x in 2023 and to an average 3.7x in 2027-2028. This is mainly driven by its large capex plan. We expect net leverage to remain within the new rating's sensitivities.

Weakening of Business Profile: The downgrade also incorporates a weakening of PGE's competitive position in the Polish electricity generation market, due to structural changes, including the growth of renewables which, given their priority dispatch, reduces the volumes of PGE's lignite- and coal-fired power generation. This, together with declining clean dark spreads, reduces PGE's profitability, which is exacerbated by the fixed cost base of its lignite mines, given the lack of domestic regulatory mechanisms to cover these losses.

Large Capex Pressures FCF: We expect negative free cash flow (FCF) in 2024-2028, driven by significant capex, averaging PLN14 billion a year, which is a sharp increase from the average of PLN7 billion in 2021-2023. The investment plan is consistent with the group's focus on energy transition, with about 25% of it allocated to offshore and 10% to renewable growth capacity. About 30% will be aimed at investments in distribution networks, with the remainder on flexible generation and heating.

Offshore Wind Farm Projects: PGE aims to implement offshore wind farm projects with Orsted A/S

(BBB+/Stable) in a 50-50 JV, including Baltica 2 (1,498 MW by 2028) and Baltica 3 (1,045 MW by 2030). Under our rating case, we assume that the final investment decision relating to Baltica 2 will take place in early 2025, and the project will be financed 50%-50% by Orsted and PGE. For PGE's share, about 25% would be in the form of equity and the remaining 75% in the form of project-finance debt.

Offshore Wind Projects Consolidated: Fitch consolidates project finance loans for Baltica 2 in PGE's debt quantum. This is because we believe the project is strategically important for PGE and the country. We therefore expect PGE to be committed to Baltica 2 in the event of cost overruns or delays, with likely support from the company in case of need.

Regulated Income in Distribution: The rating reflects the high share of regulated electricity distribution with good predictability in PGE's EBITDA (41% in 2021-2023 and projected at about 60% in 2025-2028). A higher weighted-average cost of capital (WACC) plus reinvestment premium is the primary driver of projected solid results in distribution. Fitch expects WACC to average 10.85% in 2025-2028, compared with 11.75% in 2024 and 8.51% in 2023, thereby supporting PGE's large planned investments in the distribution grid and the segment's growth in profitability.

Conventional Generation Under Pressure: We project a deterioration in the profitability of coal-fired assets in the medium term, due to a decline in electricity prices and increasing CO2 costs, which will put the clean dark spread under pressure. Fitch assumes that secured capacity payments will partly compensate worsened margins on generation in 2025-2028, but will be insufficient to fully cover costs.

New Gas Units Boost Profits: PGE has been developing new gas generation sources with new combined-cycle gas turbine (CCGT) units in Gryfino commissioned in 3Q24 (capacity of nearly 1.36 GWe) and nearly 900MWe to be operational in Rybnik in 2027. Both projects have 17-year capacity payments agreements, which will significantly improve the segment's result from 2025 and from 2027, respectively.

Capex to Improve Generation Mix: Ongoing investments in gas-fired generation, renewables, and also, starting from 2025, the first offshore wind project, will gradually improve PGE's electricity generation mix. This is likely to lead to higher debt capacity when the company is more advanced in the implementation of its energy transition plan.

Weaker Coverage: In view of rising debt and a still high interest-rate environment, Fitch forecasts PGE's FFO interest cover to weaken to an average of 5x in 2025-2028, from 11.8x in 2023, which is its negative rating sensitivity.

Standalone Approach: Fitch applies its Government-Related Entities (GRE) Rating Criteria in its analysis of PGE as the Polish state (A-/Stable) holds a 60.86% stake in the company. Based on the GRE Criteria, we rate PGE on a standalone basis.

Derivation Summary

PGE's close peer group includes three other electricity-focused integrated utilities in Poland, TAURON Polska Energia S.A. (BBB-/Stable), ENEA S.A. (BBB/Stable) and Energa S.A. (BBB+/Stable; Standalone

Credit Profile of 'bbb-'), and Hungary's largest electricity and gas utility MVM Zrt. (BBB/Stable).

PGE is the largest integrated utility in the Polish peer group, with large power generation capacity mainly based on lignite and coal and substantial operations in the distribution grid. 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 larger hard coal-fired generation than these two utilities.

All 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 a higher exposure to coal.

Key Assumptions

Fitch's Key Assumptions within our Rating Case for the Issuer

- Electricity prices for generation at an average of PLN537/MWh in 2025-2028

- Revenue from capacity payments averaging around PLN3.1 billion a year over 2025-2028

- WACC in distribution on average at 10.85% in 2025-2028, compared with 11.75% in 2024

- Total capex at about PLN61 billion over 2025-2028, including PGE's 50% stake in Baltica 2 project

- Continuation of a no-dividend policy

RATING SENSITIVITIES

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade

- Deterioration of credit ratios, including FFO net leverage above 3.7x and FFO interest cover below 5x 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

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 a substantially lower carbon footprint of the generation fleet

- FFO net leverage below 3x on a sustained basis, supported by management's conservative financial policy

Liquidity and Debt Structure

At end-September 2024, PGE had PLN8.5 billion of unrestricted cash and equivalents and PLN13 billion of committed credit lines, excluding facilities expiring in the following 12 months. This compared with short-term debt maturities of PLN0.8 billion and PLN5.8 billion of Fitch-projected negative FCF in the next 12 months from October 2024.

Issuer Profile

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

MACROECONOMIC ASSUMPTIONS AND SECTOR FORECASTS

Click here to access Fitch's latest quarterly Global Corporates Macro and Sector Forecasts data file which aggregates key data points used in our credit analysis. Fitch's macroeconomic forecasts, commodity price assumptions, default rate forecasts, sector key performance indicators and sector-level forecasts are among the data items included.

ESG Considerations

PGE has an ESG Relevance Score of '4' for Energy Management and GHG Emissions & Air Quality, 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.

The highest level of ESG credit relevance is a score of '3', unless otherwise disclosed in this section. A score of '3' 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. Fitch's ESG Relevance Scores are not inputs in the rating process; they are an observation on the relevance and materiality of ESG factors in the rating decision. For more information on Fitch's ESG Relevance Scores, visit https://www.fitchratings.com/topics/esg/products#esg-relevance-scores.

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Rating Actions

ENTITY/DEBT	RATING			RECOVERY	PRIOR
PGE Polska Grupa Energetyczna S.A.	LT IDR	BBB	Downgrade		BBB+
	LC LT IDR	BBB	Downgrade		BBB+
	Natl LT	A+(pol)	Downgrade		AA(pol)
• senior unsecured	LT	BBB	Downgrade		BBB+
• senior unsecured	Natl LT	A+(pol)	Downgrade		AA(pol)
PGE Sweden AB (publ)					

ENTITY/DEBT	RATING			RECOVERY	PRIOR
• senior unsecured	LT	BBB	Downgrade		BBB+

RATINGS KEY	OUTLOOK	WATCH
POSITIVE	⊕	⬘
NEGATIVE	⊖	⬙
EVOLVING	◎	◆
STABLE	▣	

Applicable Criteria

Corporate Rating Criteria (pub.06 Dec 2024) (including rating assumption sensitivity)

Corporate Recovery Ratings and Instrument Ratings Criteria (pub.02 Aug 2024) (including rating assumption sensitivity)

Government-Related Entities Rating Criteria (pub.09 Jul 2024)

National Scale Rating Criteria (pub.22 Dec 2020)

Sector Navigators – Addendum to the Corporate Rating Criteria (pub.06 Dec 2024)

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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