16 JAN 2024

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

Fitch Ratings - Warsaw - 16 Jan 2024: 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 income from distribution, and quasi-regulated income from capacity payments. It also incorporates projected leverage within our rating sensitivities despite a large capex plan.

The key rating constraint is PGE's large share of electricity generated from lignite and coal, which leads to a high carbon footprint and exposes the company to high CO2 costs. Based on our projections PGE's financial performance will be weighed down by coal-fired conventional generation in the medium term as we currently do not assume a spin-off of coal-fired generation or any other form of additional support for those assets, except the existing capacity payments.

Key Rating Drivers

Regulated Income in Distribution: PGE's credit profile continues to benefit from stable electricity distribution, which has lower business risk and greater cash flow predictability than conventional generation, renewables and supply. The higher weighted-average cost of capital (WACC) at 8.5% in 2023, up from 5.8% in 2022, is a primary driver of estimated solid results in distribution in 2023, despite a 4% decrease in the volume of distributed energy in 9M23. We expect results to further strengthen in 2024 when WACC will be above 10%. Fitch expects WACC to be slightly lower in the medium term, on average at 10% in 2025-2027, supporting PGE's large planned investments in the distribution grid.

Distribution Grid Acquisition: The acquisition of PKP Energetyka S.A., the Polish distribution system operator responsible for distribution of electricity to the traction network, in April 2023, has further strengthened PGE's business profile via an increased share of regulated revenue and better cash flow visibility. We estimate the acquisition to have increased PGE's EBITDA by about PLN1 billion in 2023.

We expect increased EBITDA of the distribution segment, the PKP Energetyka acquisition and weaker profitability of coal-fired generation to increase the share of regulated EBITDA to above 60% in 2023-2028 from 36% in 2017-2022. PGE acquired 100% of PKP Energetyka for PLN1.9 billion and took over its PLN4.5 billion debt.

Weaker Profitability for Conventional Generation: We expect substantial deterioration in the profitability of coal-fired assets in the medium term. Our rating case assumes lower wholesale energy prices in this period with broadly stable fuel and increasing emission allowances prices, which will put the clean dark spread of coal-fired assets under pressure. Fitch assumes revenue from the capacity market will partly compensate worsened margins on electricity sales, but insufficient to fully cover costs, unless some new support mechanisms are implemented by the state to balance its costs.

The government may also implement some solutions to reduce the burden of coal-fired generation from state-controlled utilities to enable their energy transition, although no details are currently available.

No 2024 Contributions by Generators: Following the recent changes in regulations PGE, like other energy groups, has ceased to pay contributions to the Price Difference Fund from January 2024 (PLN4.8 billion of contributions paid in 9M23), while wholesale energy prices are set by the market. The caps on energy prices for households, local governments, municipal and small companies will be maintained till end-June 2024, together with the compensation mechanism for supply companies for selling energy at the reduced price. Over 2023 there were no delays in payments of compensation due to a monthly settlement mechanism.

New Gas Units Boost Profits: PGE has been developing new gas generation sources with new combined-cycle gas turbine (CCGT) units in Gryfino to be commissioned in 2024, which will increase PGE's capacity by nearly 1.36 GWe and by nearly 900MWe 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, and mitigate the plants' cash flow exposure to gas and CO_2 prices.

Offshore Wind Farm Projects: PGE aims to implement offshore wind farm projects with Orsted A/S (BBB+/Negative) in a 50-50 JV, including Baltica 2 (1,498 MW) and Baltica 3 (1,045 MW). Under the rating case, we assume that the investment decision relating to Baltica 2 will take place in 2024, being financed 50% by Orsted and 50% by PGE. Out of the latter 30% would be equity from PGE and the remaining 70% in the form of project-finance debt.

Negative Free Cash Flow (FCF): We expect negative free cash flow (FCF) in 2023-2027 (on a cumulative basis), driven by significant capex averaging PLN11.4 billion annually in 2024-2027, especially in distribution and development of new generation sources, including gas, renewables and offshore wind projects by project finance. We do not expect PGE to distribute dividends during its heavy investment cycle.

Weaker Coverage: We expect funds from operations (FFO) net leverage to rise to 2.1x on average in 2024-2027 from an estimated 1.8x in 2023 and a net cash position in 2022. Due to rising debt and a high interest-rate environment, Fitch forecasts PGE's FFO interest cover to weaken to 7x in 2024 and further to 5.7x on average in 2025-2027 (19x in 2022), versus our negative sensitivity of 6x.

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, which are TAURON Polska Energia S.A. (BBB-/Stable), ENEA S.A. (BBB/Stable) and Energa S.A. (BBB+/Stable), and Hungary's largest electricity and gas utility MVM Zrt. (BBB/Negative).

PGE is the largest integrated utility among 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 Tauron and Energa.

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 are 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 at an average of PLN720/MWh in 2023-2027

- Revenue from capacity payments averaging around PLN3.0 billion a year over 2023-2027

- WACC in distribution on average at 10.3% in 2024-2027, up from 5.8% in 2022

- Total capex at about PLN56 billion over 2023-2027

- PGE's equity contributions to the Baltica 2 project increased by 20% to incorporate potential cost overruns and delays

- 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

Liquidity and Debt Structure

Adequate Liquidity: At end-September 2023, PGE had PLN12.8 billion of unrestricted cash and equivalents and PLN7 billion of committed credit lines, excluding facilities expiring in the following 12 months. This compared with short-term debt maturities of PLN4 billion and PLN8.4 billion of Fitch-projected negative FCF in the next 12 months from October 2023.

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.

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+	Affirmed		BBB+
	LC LT IDR	BBB+	Affirmed		BBB+
	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)					

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

RATINGS KEY	OUTLOOK	WATCH
POSITIVE		
NEGATIVE		
EVOLVING		
STABLE		

Applicable Criteria

Corporate Rating Criteria (pub.03 Nov 2023) (including rating assumption sensitivity)

Corporates Recovery Ratings and Instrument Ratings Criteria (pub.13 Oct 2023) (including rating assumption sensitivity)

Government-Related Entities Rating Criteria (pub.12 Jan 2024)

National Scale Rating Criteria (pub.22 Dec 2020)

Sector Navigators – Addendum to the Corporate Rating Criteria (pub.03 Nov 2023)

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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