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Research Update:

Finland-Based Fingrid Outlook Revised To Positive On Improving Profits And Credit Ratios; 'A+/A-1' Ratings Affirmed

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Table Of Contents

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Overview

- Finnish electricity transmission system operator (TSO) Fingrid Oyj's operating profit and credit measures have gradually improved over the past few years.
- Proposed changes in the calculation of the company's allowed regulatory return from 2016 will likely increase its earnings, possibly leading to stronger credit measures.
- We are therefore revising our outlook on Fingrid to positive from stable and affirming our 'A+/A-1' and 'K-1' ratings.
- The positive outlook reflects the possibility of an upgrade within the next two years if Fingrid's credit measures continue to strengthen on a sustainable basis.

Rating Action

On Oct. 26, 2015, Standard & Poor's Ratings Services revised its outlook on Finnish electricity TSO Fingrid Oyj to positive from stable. At the same time, we affirmed our 'A+/A-1' long- and short-term corporate credit ratings and 'K-1' Nordic regional scale rating on the company.

Rationale

The outlook revision stems from the improving trend in Fingrid's profits and credit measures. Fingrid's operating profits have increased over the past few years following tariff increases that have also helped strengthen its credit measures. For example, the ratio of funds from operations (FFO) to debt was 17.5% in 2014, compared with 10% in 2011.

In addition, the regulator has proposed changes to the calculation of electricity network operators' allowed regulatory return from 2016, which we believe will translate into even higher earnings for Fingrid. In our view, this could lead to continued improvement in credit measures toward the higher end of the range for an "intermediate" financial risk profile.

We view Fingrid's business risk profile as "excellent," mainly based on our view that Finnish TSOs operate under a strong regulatory framework, which regulates virtually all of Fingrid's operations. We view the regulatory framework as stable and predictable, and the current methodology for calculating allowed profit has been in place since 2005, with only minor adjustments. We note that the regulator has proposed some modifications for the regulatory periods 2016-2019 and 2020-2013, which on aggregate should be positive for network operators (including distribution networks).

Also, the framework allows for good cost recoverability, in our view, which should improve following the suggested increase in the weighted average cost of capital (WACC). This would subsequently boost network operators' allowed return for the next regulatory period. Fingrid's allowed profit under the regulatory framework covers all operational costs, with the exception of incentives embedded in the regulation that can be positive or negative, although with a limited impact. Furthermore, Fingrid operates an efficient grid, as shown by several international benchmarking studies, which should put it in a good position to meet the regulator's expectations.

Since 2011, when the Finnish government became its majority owner, Fingrid has gradually increased its tariffs and, in turn, its return on capital to 7.5% in 2014 from 4% in 2011. Compared with that of other regulated utilities, Fingrid's profitability is, however, relatively volatile. Although the regulatory framework defines the company's profits, some elements, such as congestion revenues, are difficult to predict, creating short-term volatility that we see as a relative weakness. However, for the regulatory periods 2016-2019 and 2020-2023, congestion revenues will be excluded from the allowed-profit calculation, which will likely provide stability to the annual tariff-setting process.

Fingrid's "intermediate" financial risk profile reflects relatively modest leverage, low cash flow volatility, and our forecast of FFO to debt of about 18%-20% on average over the next few years. Fingrid has implemented a significant investment program in recent years. However, we expect it will invest about €150 million-€170 million annually over the next few years--significantly less than the €227 million invested in 2013. At the same time, the company has been increasing tariffs to bring profits to the level allowed under the regulatory framework. This, together with relatively high congestion income, improved FFO to debt to 17.5% in 2014 from 9.9% in 2011. The tariff increases are somewhat offset by increasing dividend payouts in line with the company's revised dividend policy, which states that substantially all of the parent company's profits should be distributed as dividends. However, the company would also consider the economic conditions, its near-term investment needs, and the prevailing financial targets when making its decision. We assume a further increase in FFO to debt after the proposed increase in the allowed regulatory return takes effect from 2016.

In our base case for Fingrid, we assume:

- An increase in tariffs and the allowed regulatory return in 2016, based on the proposed changes in the regulatory framework, primarily related to the WACC.
- Net investments of about €170 million annually in 2015 and 2016.
- Annual dividends corresponding to substantially all of the parent company's net profit, in line with the dividend policy.

Based on these assumptions, we arrive at the following credit measures:

- FFO to debt of 17%-18% in 2015 and 18.5%-20.5% in 2016.
- Debt to EBITDA of about 4.2x-4.6x in 2015 and 3.8x-4.2x in 2016.

The 'A+' long-term rating on Fingrid includes one notch of uplift from its 'a' stand-alone credit profile, based on our opinion that there is a "high" likelihood that Finland's government would provide timely and sufficient extraordinary support to Fingrid in the event of financial distress.

In accordance with our criteria for government-related entities, we base our view of a "high" likelihood of extraordinary government support on our assessment of Fingrid's:

- "Strong" link with the Finnish government, which owns 53% of the shares (partly through the National Emergency Supply Agency), with 71% of the voting rights; and
- "Very important" role as Finland's monopoly TSO, given its clear strategic importance for the government in ensuring electricity transmission stability and development of the transmission grid.

Liquidity

The short-term rating is 'A-1'. We assess Fingrid's liquidity position as "adequate," as defined in our criteria. We consider that Fingrid's liquidity sources will exceed its funding needs by 1.1x in the next 12 months and that sources will exceed uses even if EBITDA declines by 10%.

Furthermore, we believe that the company has a sound relationship with its banks, a satisfactory standing in credit markets, and prudent risk management. In addition, Fingrid's revolving credit facility is free from financial covenants that could prevent drawings.

Principal liquidity sources:

- €109 million in cash and marketable securities as of June 30, 2015;
- Access to an undrawn €250 million committed revolving credit facility, maturing in April 2018; and
- Projected FFO exceeding €200 million for the next 12 months.

Principal liquidity uses:

- Short-term debt maturities of €224 million as of June 30, 2015;
- Annual investments of about €170 million; and
- Annual dividends above the €65 million paid in the first half of 2015.

Outlook

The positive outlook reflects the possibility of an upgrade within the next two years if we believe that Fingrid's credit measures will continue to improve on a sustainable basis. This could derive from increased earnings as a result of positive modifications to the regulatory framework from 2016, including the calculation of the allowed regulatory return. Based on our current assessment of Fingrid's business risk profile, we consider an FFO-to-debt ratio sustainably at about 20% to be consistent with a higher rating.

We could also raise the ratings if, in our view, the likelihood of extraordinary government support had increased to "very high," for example, because the government strengthened its control over Fingrid through materially increased ownership or other means.

We could revise the outlook to stable if we believe it is unlikely that Fingrid's credit measures would strengthen on a sustainable basis, for example due to increased capital expenditure or significantly higher dividend payouts.

Ratings Score Snapshot

Corporate Credit Rating: A+/Positive/A-1

Business risk: Excellent
- Country risk: Low
- Industry risk: Very low
- Competitive position: Strong

Financial risk: Intermediate
- Cash flow/Leverage: Intermediate

Anchor: a

Modifiers
- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: a

Sovereign rating: AA+
- Likelihood of government support: High (+1 notch from SACP)

Related Criteria And Research

Related Criteria
- Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014

- Standard & Poor’s National And Regional Scale Mapping Tables, Sept. 30, 2014
- National And Regional Scale Credit Ratings, Sept. 22, 2014
- Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Corporate Methodology, Nov. 19, 2013
- Corporate Methodology: Ratios and Adjustments, Nov. 19, 2013
- Methodology: Industry Risk, Nov. 19, 2013
- Group Rating Methodology, Nov. 19, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 7, 2013
- Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

Related Research

- Country Risk Assessments Update: July 2015, July 8, 2015
- Why Finnish Electricity Networks Have A Strong Regulatory Advantage, Dec. 2, 2014
- Standard & Poor's Assigns Industry Risk Assessments To 38 Nonfinancial Corporate Industries, Nov. 20, 2013

Ratings List

Ratings Affirmed; Outlook Action

	To	From
Fingrid Oyj		
Corporate Credit Rating	A+/Positive/A-1	A+/Stable/A-1

Ratings Affirmed

Fingrid Oyj	
Nordic Regional Scale	K-1
Senior Unsecured	A+
Commercial Paper	A-1

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