FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Tauron at 'BBB-'; Outlook Stable

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Fitch Ratings - Warsaw - 01 Oct 2024: Fitch Ratings has affirmed TAURON Polska Energia S.A.'s (Tauron) Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDRs) at 'BBB-'. The Outlooks are Stable. A full list of rating actions is below.

The affirmation reflects the continuing dominant share of regulated and predictable electricity distribution in Tauron's business profile, solid market position and projected leverage within rating guidelines. Tauron'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: The ratings reflect the high share of regulated electricity distribution with good predictability in Tauron's EBITDA (69% in 2021-2023 and averaging 71% over our forecast period of 2024-2028) and the company's position as the largest electricity distributor in Poland covering southern, densely populated regions.

The higher weighted-average cost of capital (WACC) plus reinvestment premium at 10.48% in 2024, up from 8.48% in 2023, is a primary driver of projected solid results in distribution in 2024. Fitch expects WACC to be slightly lower in the medium term, at about 10% on average in 2025-2028, supporting Tauron's large planned investments in the distribution grid and segment's growth in profitability.

Generation Under Pressure Long Term: We project a deterioration in the profitability of coal-fired assets 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 2024-2025, translating into about PLN430 million of EBITDA for the generation segment, including heat in 2024 and about PLN275 million in 2025 based on our projections.

Capacity Market Support: From 2026, Fitch assumes capacity market revenue only for Tauron's coal units that have secured revenues from existing capacity contracts. Despite potential temporary derogations under the European Commission's Electricity Market Design reforms related to coal units that do not meet the emission criteria of 550 g CO2/kWh, Fitch anticipates no extra capacity payments for Tauron's 200 MW class units from 2026 to 2028, except for the two units, which have valid capacity agreements until 2028. Fitch assumes those assets will be maintained for energy security reasons but operating at technical minimums.

No Coal-Fired Spin-Off: Fitch has not included any divestments of the company's coal-fired power plants in its rating case as the National Energy Security Agency process has been cancelled with no alternative process yet proposed by the government.

Supply Profits Shifted to 2025: The new tariff for households implemented from 1 July 2024 until the end of 2025, which replaced the previous higher tariffs aimed for 2024. The company reported a loss on the sale of electricity to customers of tariff group G, estimated at approximately PLN216 million, which will affect EBITDA in 2024. However, the loss will be fully compensated by revenue from this group of customers in 2025, translating into above-average EBITDA in this segment in 2025. The caps on energy prices for households maintained in H124, together with the compensation mechanism for supply companies, were profit-neutral for Tauron, like other energy groups.

Negative Free Cash Flow: We expect free cash flow (FCF) to remain negative in 2024-2028 and focused on the distribution and renewables segments. We do not expect Tauron to distribute dividends during its heavy investment cycle.

Increasing Leverage: We forecast funds from operations (FFO) net leverage at 3.4x in 2024 (up from 2.6x in 2023) and gradually rising close to our negative rating sensitivity (FFO net leverage below 4.5x) by 2026-2027. Fitch notes Tauron's flexibility in adjusting its capex outlays, particularly in renewables, where the majority of capex is uncommitted from 2026 and can easily be reduced or postponed. This flexibility allows Tauron to maintain financial leverage commensurate with the rating in case operating cash flows are lower than expected.

Standalone Approach: Fitch applies its Government-Related Entities (GRE) Rating Criteria in its analysis of Tauron as the company is 30.06%-owned and effectively controlled by the Polish state (A-/Stable). We assess decision-making and oversight as 'Strong', given the Polish state's effective control. We assess the remaining GRE factors, precedents of support, preservation of government policy role and contagion risk as 'Not Strong Enough', resulting in a support score of 5 and consequently in Tauron being rated on a standalone basis.

DERIVATION SUMMARY

Tauron's close peer group includes the three other electricity-focused integrated utilities in Poland: PGE Polska Grupa Energetyczna S.A. (PGE; BBB+/Stable), ENEA S.A. (BBB/Stable) and Energa S.A. (BBB+/Stable).

Tauron and Energa have comparable business profiles, benefiting from the large share of regulated distribution in EBITDA, which provides good cash flow visibility. Both companies' credit profiles are also supported by inflows from capacity payments that improve revenue visibility, although Tauron benefits from more significant amounts due to its larger coal-fired fleet. However, Tauron has a greater share of hard-coal fired generation in its business profile, which is currently under pressure.

As a result, we assess that Energa has a more sustainable business profile, which is reflected in its higher debt capacity, with a negative rating sensitivity of 5.0x for its 'bbb-' Standalone Credit Profile (SCP) compared with 4.5x for Tauron. Energa's IDR is equalised with that of its parent, ORLEN S.A. (BBB+/Stable).

PGE is Poland's largest utility company and has the lowest leverage among the peer group. It derives most of its EBITDA from electricity generation and has a high share of lignite in the generation fuel mix. ENEA has a lower share of regulated distribution than Tauron and Energa and higher exposure to hard coal-fired generation. The maximum leverage sensitivity for ENEA's 'BBB' rating is 3.0x.

KEY ASSUMPTIONS

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

- Average electricity prices of 486 PLN/MWh in 2024-2028

- Annual revenue from capacity payments at average PLN852 million in 2024-2025 and PLN436 million in 2026-2028

- WACC in the distribution segment of about 10% on average in 2024-2028

- Capex of PLN35 billion over 2024-2028, reflecting capex flexibility, particularly in renewables, in a scenario of our conservative assumptions for profitability

- No dividend payments in 2024-2028

RATING SENSITIVITIES

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

- FFO net leverage below 3.5x on a sustained basis

- A more diversified fuel generation mix and substantially lower carbon footprint, for example, through divestment or decommissioning of coal-fired power plants, or investments in renewable generation

- Increased focus on regulated and quasi-regulated business in capex and overall strategy

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

- FFO net leverage above 4.5x and FFO interest cover below 4.5x on a sustained basis, for example, due to weaker than expected EBITDA, higher capex or acquisitions, or reinstatement of dividends

- Weakening of the business profile, for example, due to a material reduction in the share of regulated or quasi-regulated business in total EBITDA, substantial delays in implementation of the decarbonisation strategy, or increased exposure to higher-risk businesses

LIQUIDITY AND DEBT STRUCTURE

Adequate Liquidity: At end-June 2024, Tauron had PLN336 million of Fitch-calculated readily available cash and cash equivalents, along with PLN5.7 billion of available committed credit facilities maturing in more than one year. These resources were against short-term debt PLN1.9 billion at end-June 2024, as well as Fitch-expected negative FCF of about PLN2 billion in the next 12 months, driven by capex. In September 2024, Tauron signed an agreement for a bond issuance programme of up to PLN3 billion, which increases its funding options. Consequently, we expect the company to maintain sufficient liquidity over the next 12 months.

Adequate Covenant: At end-June 2024, Tauron's net debt to EBITDA ratio was 2.1x. This is well within the company's main debt covenant, which permits a net debt/EBITDA ratio of up to 3.5-4.0x, depending on financing agreement.

ISSUER PROFILE

Tauron is the second-largest electric utility in Poland by EBITDA. The company is focused on electricity distribution, which is complemented by electricity generation and supply.

SUMMARY OF FINANCIAL ADJUSTMENTS

Fitch-adjusted debt calculation included guarantees for the ECSW gas-fired power plant joint venture.

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

TAURON has an ESG Relevance Score of '4' for GHG Emissions & Air Quality due to the dominant share of hard coal in its electricity generation mix, which is carbon-intensive and under regulatory pressure in the EU, which has a negative impact on the credit profile, and is relevant to the rating[s] in conjunction with other factors.

TAURON has an ESG Relevance Score of '4' for Energy Management due to the dominant share of hard coal in its electricity generation mix, which is carbon-intensive and under regulatory pressure in the EU, which has a negative impact on the credit profile, and is relevant to the rating[s] 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.

RATING ACTIONS

ENTITY / DEBT	RATING			PRIOR
TAURON Polska Energia S.A.	LT IDR	BBB- Rating Outlook Stable	Affirmed	BBB- Rating Outlook Stable
	ST IDR	F3	Affirmed	F3
	LC LT IDR	BBB- Rating Outlook Stable	Affirmed	BBB- Rating Outlook Stable
	LC ST IDR	F3	Affirmed	F3
	Natl LT	A(pol) Rating Outlook Stable	Affirmed	A(pol) Rating Outlook Stable
senior unsecured	LT	BBB-	Affirmed	BBB-
subordinated	LT	BB	Affirmed	BB
subordinated	Natl LT	BBB(pol)	Affirmed	BBB(pol)

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Corporate Hybrids Treatment and Notching Criteria (pub. 12 Nov 2020)

National Scale Rating Criteria (pub. 22 Dec 2020)

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

Sector Navigators – Addendum to the Corporate Rating Criteria (pub. 21 Jun 2024)

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

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

APPLICABLE MODELS

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

Corporate Monitoring & Forecasting Model (COMFORT Model), v8.0.3 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

TAURON Polska Energia S.A.	EU Issued, UK Endorsed

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The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Fitch also provides information on best-case rating upgrade scenarios and worst-case rating downgrade scenarios (defined as the 99th percentile of rating transitions, measured in each direction) for international credit ratings, based on historical performance. A simple average across asset classes presents best-case upgrades of 4 notches and worst-case downgrades of 8 notches at the 99th percentile. For more details on sector-specific best- and worst-case scenario credit ratings, please see Best- and Worst-Case Measures under the Rating Performance page on Fitch's website.

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