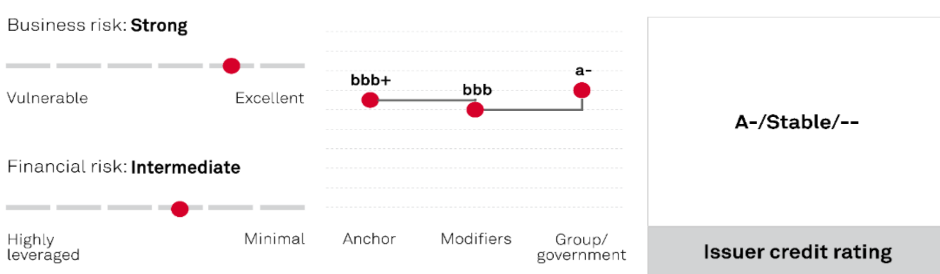
Augstsprieguma Tikls

August 28, 2023

Ratings Score Snapshot



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Credit Highlights

Overview

Key strengths	Key risks
Monopoly position as owner and operator of Latvia's high voltage electricity transmission grid, and owner of about 68% of Latvia's gas transmission and storage operator (TSO).	Smaller business than European peers' (about €40 million EBTDA).
Operates under a regulatory framework we view as supportive, with the current regulatory framework running from July 2023 to December 2025.	Volatility in metrics driven by congestion revenue and dividends from its subsidiary Conexus Baltic Grid (Conexus) affecting S&P Global Ratings-adjusted debt and EBITDA, respectively
High likelihood of support from the Latvian government, which leads us to apply two notches of support to the stand-alone rating.	High capital expenditure (capex) program to synchronize with Europe, with little regulatory asset base (RAB) build-up as part of the funds (about 40%) is coming from the EU, which will not contribute to RAB

Augstsprieguma Tikls (AST) is the sole TSO for electricity in Latvia. AST fully owns and operates the electricity transmission network in Latvia. In addition, it owns 68.46% of Conexus, the sole gas transmission and storage operator in Latvia. We view Conexus as an insulated subsidiary of AST because of its operational, management, and regulatory autonomy. AST's small size compared with other EU TSOs constrains the rating.

We see the framework under which AST operates as credit supportive. The Latvian regulatory framework methodology for electricity transmission was redesigned in 2021. It follows a revenue cap RAB methodology that provides more transparency and predictability than the previous cost-plus framework. The 2021-2022 energy crisis led to some adjustments to the newly created framework that we view as positive for AST's credit quality. The current regulatory period started on July 1, 2023, with updates that include:

- An average 30% tariff increase following the rise in costs by 26%, raising allowed revenue to €95 million from €75 million.
- Approval for AST to use about €62.1 million from accumulated congestion income over second-half 2023 to year-end 2025 to cover increased operating expense and stabilize reported EBITDA.
- Lengthening the period by one year to December 2025; at this point Latvia will be fully desynchronised from the BRELL system (Belarus, Russia, Estonia, Latvia, and Lithuania). and synchronized with Continental Europe.
- RAB set at €432.7 million over July 2023-December 2025 (RP2) from €418 million over January 2021-June 2023 (RP1).
- Weighted-average cost of capital (WACC) stable at 2.72% for RP2 from 2.65% for RP1.

Congestion income will continue accruing until 2025. This comes from discrepancies in prices over two price zones. In the EU It is regulated and must be used to cover investment to reduce bottlenecks. In the Baltics, electricity prices in Latvia are close to those In Lithuania but are usually higher than Estonian prices. There are currently three interconnections with Estonia; the first one was recently repaired; the second is set to be fully repaired by end of 2024; and the third is currently fully operational. We therefore expect congestion income to continue accruing up to €200 million-€205 million at year-end 2025 until the repair of the second LV-EE transmission line is complete, after which we expect the balance of congestion income to start decreasing. The €200 million-€205 million accumulated total deferred revenue expected at year-end 2025 include allocated funds for capex that started to amortize and unallocated funds (allocation to be decided).

We view congestion income as credit neutral as it leads to some significant volatility in metrics while improving AST's liquidity. In 2022, some regulators, including the Public Utilities Commission of Latvia (PUC), allowed congestion income to be used to cover increased market-based expenditure. At end of 2022, AST received €152.2 million of congestion income, of which €78 million was used to offset congestion-related expenses, €36.5 million to stabilize the EBITDA and the remaining €37.7 million was accrued in deferred income in AST's liabilities. As part of the new regulatory period, the PUC has approved the use of €62.07 million over second-half (H2) 2023 to end-2025 of accrued congestion income, at AST's discretion.

AST will undergo a large investment program that is partially mitigated by EU funds. The company will invest more than €350 million over 2023-2025 to strengthen its electricity network to synchronize the country with Continental Europe and reduce congestion, as well as disconnect completely from Russia. About 40% of total investments will be EU-funded, and the remainder will be either debt-funded, notably using the €30 million bank loan to be contracted in 2024, or financed by yet unallocated accrued congestion income and AST's undistributed profits

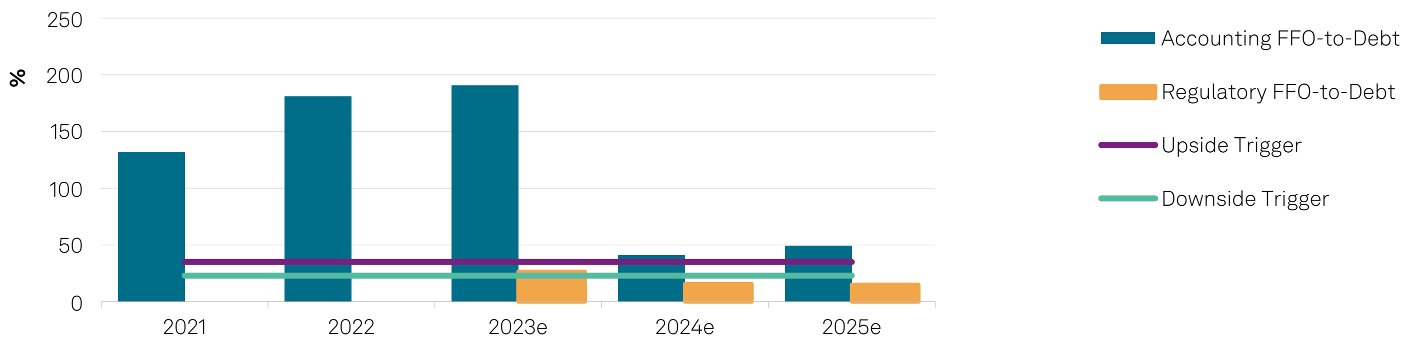
The volatility of AST's adjusted EBITDA comes from dividends from 68.46% owned Conexus, which we view as insulated from the group. We believe Conexus is insulated from the rest of the group and therefore treat it as an equity affiliate, adjusting AST's reported EBITDA with dividends received from Conexus for the following reasons:

- Day-to-day operations, financial reporting, and cash management are separated between the two networks;
- Conexus is regulated, and we believe that ultimate decision-making on CBG strategy rests collectively with its government and private investor shareholders, and is executed through AST's and CBG's strategic goals and governance directions;
- Conexus has a significant minority shareholder (MM Infrastructure Investments Europe Ltd.) with two members part of the recently created supervisory council, which has the final decision on all Conexus -related matters;
- AST appointed four members of the current supervisory council, itself comprising seven members. Of the seven members, two are AST employees, one is from the Ministry of Finance, and four are independent;
- AST's dividends to the government are calculated on the group's pretax net income including dividends from Conexus, not on a consolidated basis; and
- Although Conexus is consolidated under AST's International Financial Reporting Standards (IFRS) reports and therefore falls by default under AST's bonds, we believe that Conexus is a profitable business with limited debt, and is therefore very unlikely to need any support from AST.

As per Conexus 's dividend policy of distributing 90% of the previous year's net income, we expect AST's S&P Global Ratings-adjusted EBITDA to be composed, on average, by 10%-15% of dividends from Conexus. Changes in dividends received could materially affect AST's funds from operations (FFO) to debt and lead to significant volatility In AST's metrics.

AST currently has limited rating headroom. The company's metrics strongly benefit from congestion income building its cash base therefore reducing the net debt and leading to IFRS FFO to debt above 60% until end-2025. However, we expect the effect of congestion income to neutralize over time and our assessment of AST's metrics excludes the impact of congestion income. This leads to FFO to debt over 2024-2025, below our 23% threshold, although recovering once the new regulatory period starts in January 2026 and the accrued balance of congestion income starts to reduce.

Congestion income has a temporary effect on FFO-to-Debt



Source: S&P Global Ratings

AST is fully owned by the Latvian government, which leads us to apply two additional notches of support to stand-alone rating. Our 'A-' rating on AST reflects our view that the government would support the company in case of distress (leading us to apply a two-notch uplift above the stand-alone credit profile [SACP]). We do not anticipate any changes in the ownership given the company's important role for Latvia: to ensure a stable electricity supply, and to reach synchronization with Europe and reduce its reliance on Russia.

Outlook

The stable outlook reflects that we expect stable and predictable cash flows from AST's regulated transmission activities, with accounting FFO to debt above 60% over the medium term (corresponding to regulatory FFO to debt around 15%-23%). Cash inflows from congestion income provide a significant liquidity buffer.

Downside scenario

We could downgrade AST if we revised downward the SACP. This could occur if FFO to debt fell below 23% without recovery prospects, which could result if regulations did not enable cost pass-through, although we consider this unlikely. A one notch downgrade of the sovereign would not automatically lead us to downgrade AST.

Upside scenario

We view an upgrade as unlikely given AST's small size, the short track record of its operations, and the current regulatory regime. Longer term, an upgrade would be consistent with FFO to debt above 35% within a stable power price environment, coupled with a combination of some of the following factors:

- A track record of the regulatory framework providing cost recovery;
- Strong buildup of the RAB, supporting regulated revenue;
- More clarity on financial policy; and

- The company's commitment to business and financial behavior consistent with a higher rating.

A one-notch upgrade of the sovereign would not necessarily lead us to upgrade of AST.

Our Base-Case Scenario

Assumptions

- A 30% average tariff increase starting July 2023 until December 2025 with a fixed WACC of 2.72% and electricity prices trending below the €160/MWh threshold set in the methodology.
- Reported EBITDA expected to remain around €40 million-€50 million over RP2 with the approval of up to €65 million accrued congestion revenues to be used over 2023-2025 to cover the increase in costs.
- Capex expected to increase over RP2, peaking at about €180 million-€190 million in 2024; although co-financed up to 40% by EU funds.
- A 64% dividend payout ratio from 2023 onward. The dividend calculation is based on the previous year's net income including the dividend received from Conexus.
- Interest rate of 0.5% based on the sole €100 million bond maturing in Jan 2027 in the capital structure. Interest rate of 4.5% for the €30 million bank loan to be contracted to partially cover capex in 2024.
- Conexus remains an insulated subsidiary of AST, and although it is consolidated under IFRS, we treat it as an equity investee for our analytical purposes (so that S&P Global Ratings-adjusted EBITDA and FFO for AST only includes dividends from Conexus).

Key metrics

Augstsprieguma Tikls--Forecast summary

Period ending	Dec-31-2021	Dec-31-2022	Dec-31-2023	Dec-31-2024	Dec-31-2025
(000s €)	2021a	2022a	2023e	2024f	2025f
Revenue	130,790	303,189	180,000-200,000	200,000-220,000	170,000-190,000
EBITDA	93,864	46,990	50,000-55,000	60,000-65,000	45,000-50,000
Funds from operations (FFO)	91,147	46,760	50,000-55,000	60,000-65,000	45,000-50,000
Capital expenditure (capex)	31,978	30,958	70,000-80,000	180,000-190,000	80,000-90,000
Dividends	8,000	29,143	7,000-10,000	10,000-13,000	15,000-18,000
Debt	69,133	25,836	10,000-20,000	80,000-100,000	60,000-80,000
Adjusted ratios					
Debt/EBITDA (x)	0.7	0.5	0-0.5	1.0-1.5	1.0-1.5
FFO/debt (%)	131.8	181.0	250-300	60-70	60-70

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Company Description

AST is the only electricity TSO in Latvia. The group owns 5,602 kilometers of power lines and 140 substations. AST transmits approximately 9 terawatt hours (TWh) of electricity throughout Latvia and neighboring countries--including Estonia and Lithuania --through seven interconnections (three with Estonia and four with Lithuania). The interconnector with Russia has been unused since May 2022 because there are no trade flows with Russia and Belarus. By 2025, AST aims to have synchronized with Europe and disconnected Latvia from the Russian power system. Established in 1939 and fully owned by the Latvian Ministry of Climate and Energy since February 2023, the AST group is now composed of the electricity TSO and 68.46% of the gas TSO (Conexus). That said, we view Conexus as an insulated part of the AST group in our analysis of AST, and therefore adjust metrics as if it were an equity affiliate.

Peer Comparison

Augstsprieguma Tikls--Peer Comparisons

	Augstsprieguma Tikls	REN-Redes Energeticas Nacionais SGPS S.A.	Fingrid Oyj	Zapadoslovenska energetika a.s.	Madrilea Red de Gas S.A.U.
Foreign currency issuer credit rating	A-/Stable/--	BBB/Stable/A-2	AA-/Stable/A-1+	A-/Stable/--	BBB-/Stable/A-3
Local currency issuer credit rating	A-/Stable/--	BBB/Stable/A-2	AA-/Stable/A-1+	A-/Stable/--	BBB-/Stable/A-3
Period	Annual	Annual	Annual	Annual	Annual
Period ending	2022-12-31	2022-12-31	2022-12-31	2022-12-31	2021-12-31
Mil.	EUR	EUR	EUR	EUR	EUR
Revenue	303	588	1,841	1,991	184
EBITDA	47	461	253	243	139
Funds from operations (FFO)	47	340	193	191	107
Interest	1	53	22	19	29
Cash interest paid	0	43	21	19	26
Operating cash flow (OCF)	35	592	991	79	110
Capital expenditure	31	121	267	108	13
Free operating cash flow (FOCF)	4	470	724	(29)	97
Discretionary cash flow (DCF)	(25)	326	591	(117)	97
Cash and short-term investments	92	365	733	48	41
Gross available cash	92	365	733	48	41
Debt	26	2,014	323	747	920
Equity	448	1,518	720	313	433

Augstsprieguma Tikls--Peer Comparisons

EBITDA margin (%)	15.5	78.4	13.8	12.2	75.3
Return on capital (%)	2.3	6.2	11.2	17.5	9.2
EBITDA interest coverage (x)	70.5	8.7	11.6	12.7	4.8
FFO cash interest coverage (x)	203.5	8.8	10.0	11.3	5.1
Debt/EBITDA (x)	0.5	4.4	1.3	3.1	6.6
FFO/debt (%)	181.0	16.9	59.7	25.6	11.6
OCF/debt (%)	135.1	29.4	307.0	10.6	11.9
FOCF/debt (%)	15.3	23.4	224.2	(3.9)	10.5
DCF/debt (%)	(97.5)	16.2	183.0	(15.7)	10.5

Liquidity

We assess AST's liquidity as adequate because we expect liquidity sources to cover uses by more than 1.1x over the 12months starting June 30. 2023. The adequate liquidity is further underpinned by AST's sound relationship with banks, as demonstrated by its ability to successfully contract bank loans and overdraft facilities at a good price. AST's strong standing in the credit market was also demonstrated by the recent bond issuance of €100 million for 5.25 years at 0.5% in October 2021.

Principal liquidity sources

1. Cash and cash equivalents of about €92 million;
2. Cash FFO of about €45 million-€50 million over the next 12 months; and
3. A €10 million undrawn facility to be used to finance working capital swings.

Principal liquidity uses

4. About €100 million of capex;
5. Dividends of about €5 million-€10 million; and
6. No debt maturity until 2027.

Covenant Analysis

Requirements

AST has significant headroom under the three covenants from its overdraft facility:

- Debt service coverage ratio greater than 1.2x;
- Equity greater than 25%; and
- Debt to EBITDA less than 6x.

Environmental, Social, And Governance

ESG factors have no material influence on our credit rating analysis of AST. The company's main focus is on Latvia’s electrification and synchronization with continental Europe. AST is also focused on reducing Latvia's exposure to Russian electricity.

Group Influence

AST is the electricity TSO of the AST Group, composed of 100% of AST and 68.46% of Conexus Baltic Grid, the Latvian gas transmission network (itself comprising gas TSO and gas storage activities). However, we analyze AST on a stand-alone approach, including dividends from Conexus treated as an equity affiliate.

Government Influence

Our assessment of a high likelihood of support from the Latvian government underpins our 'A-' rating. AST is the government's strategic asset as the owner and operator of the country's power transmission network and majority owner of the gas transmission network, Conexus, with 68.46% of capital. We factor in two notches of uplift to the 'bbb' SACP for AST to derive the rating. This is because we believe the government of Latvia (A+/Negative/A-1) is highly likely to provide timely and sufficient extraordinary support to AST in the event of financial distress. Our assessment is based on AST's:

- Very important role as the backbone of the energy system, which cannot be easily replaced. In addition, AST is the vehicle through which the government implements its energy policy, notably relating to the 2025 target of disconnection from Russia, the synchronization of the Baltic and Scandinavian power markets, and the acquisition of Conexus as per the government's plan.
- Strong link with the government, mostly driven by the government's full ownership of AST. Privatization is unlikely because the full historical ownership of Latvenergo (now AST and Latvenergo) is embedded in law. In addition, most of AST's supervisory board comprises members of the finance ministry, who define the company's strategy and are involved in major decisions, notably after the regulator's approval of the 10-year investment plan.

We expect the government to be willing and able to support AST in case of financial distress, as highlighted by the 'A+/Negative/A-1' sovereign rating.

Rating Component Scores

Foreign currency issuer credit rating	**A-/Stable/--**
Local currency issuer credit rating	**A-/Stable/--**
Business risk	**Strong**
Country risk	Intermediate
Industry risk	Very Low
Competitive position	Satisfactory
Financial risk	**Intermediate**
Cash flow/leverage	Intermediate
Anchor	**bbb+**
Diversification/portfolio effect	Neutral (no impact)
Capital structure	Neutral (no impact)
Financial policy	Neutral (no impact)
Liquidity	Adequate (no impact)
Management and governance	Fair (no impact)
Comparable rating analysis	Negative (-1 notch)
Stand-alone credit profile	**bbb**

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010

Related Research

- Three Northern European TSOs Ratings Affirmed As Congestion Income Is Broadly Credit Neutral; Outlooks Remain Stable, April 14, 2023
- Eastern Europe | Credit Resilience Despite Increasing Affordability Concerns, Jan. 13, 2023
- Eastern European Utilities Handbook 2023, Jan. 5, 2023

Ratings Detail (as of August 11, 2023)*

Augstsprieguma Tikls	
Issuer Credit Rating	A-/Stable/--
Issuer Credit Ratings History	
12-Nov-2021	A-/Stable/--
12-Aug-2021	BBB+/Positive/--
16-Feb-2021	BBB+/Stable/--
Related Entities	
JSC Conexus Baltic Grid	
Issuer Credit Rating	BBB+/Stable/--

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings credit ratings on the global scale are comparable across countries. S&P Global Ratings credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.