

Credit Opinion: [Latvenergo](#)

Latvenergo

Riga, Latvia

Ratings

Category	Moody's Rating
Outlook	Negative
Issuer Rating	Baa3

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Key Indicators

Latvenergo

	2007	2006	2005	2004
EBITA Margin %	6.2%	11.5%	11.6%	15.1%
RCF / Net Debt	25.3%	30.2%	31.0%	38.1%
FFO Interest Coverage	8.2x	10.0x	12.5x	12.4x
RCF / Capex + Investments	36.5%	64.3%	68.1%	52.7%
Debt to Book Capitalisation	31.7%	45.3%	41.8%	36.5%
FFO / Net Debt	27.5%	32.0%	35.1%	41.0%

Note: For definitions of Moody's most common ratio terms please see the accompanying User's Guide

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Opinion

Corporate Profile

AS Latvenergo ("Latvenergo") is a dominant, vertically-integrated 100% state-owned utility in Latvia with a total electricity generation capacity of 2,067 MW, representing around 95% of the total Latvian capacity. Latvenergo's main power plants comprise two Combined Heat and Power (CHP) plants in Riga and three hydro-power plants on the River Daugava. All power plants were built during the Soviet era, and Latvenergo is currently finalising a large-scale investment programme for upgrading and reconstructing the CHP plants.

Rating Rationale

In accordance with Moody's rating methodology for Government Related Issuers ("GRI"), Latvenergo's rating incorporates uplift for potential government support to its standalone credit quality. This is expressed by Moody's as a Baseline Credit Assessment (BCA) of 11 (on a scale of 1 to 21, where 1 represents the lowest risk and 11 is equivalent to a Ba1). The uplift to the BCA, currently at one notch, results from the credit quality of its government shareholder and Moody's assessment of high probability of government support in the event of financial distress as well as high default dependence (i.e. degree of exposure to common drivers of credit quality).

On 27 April 2009, Moody's downgraded Latvenergo's long-term rating to Baa3 with negative outlook following the downgrade of the Latvian government's long-term rating to Baa3 with negative outlook.

When assessing Latvenergo's BCA, Moody's applies its Rating Methodology for Global Regulated Electric Utilities.

The following factors represent key drivers in determining the rating.

ASSESSMENT OF BUSINESS RISK PROFILE

The BCA has been lowered to 11 (equivalent to Ba1) from 10 (equivalent to Baa3), to reflect the increased risks to Latvenergo's credit profile of operating in an economy that is undergoing a severe economic adjustment likely to involve a significant economic contraction. While Latvenergo provides a core service, Moody's believes the potential of significant economic shocks negatively impacting Latvenergo's credit profile has increased and is not considered commensurate with an investment-grade credit profile. Such risks could include greater risk of non-payment by customers, decreased consumption levels, and political and/or economic pressure to reduce electricity prices. Although not considered probable within the near term, a devaluation of the Latvian lat could cause a significant deterioration in credit metrics, given Latvenergo's large foreign currency debt burden and its exposure to electricity import prices. Therefore, this remains a meaningful risk in light of the current economic circumstances.

The BCA of 11 is further underpinned by the company's medium-risk business profile as the dominant vertically-integrated utility in Latvia that generates up to 90% of its earnings from regulated activities. However, the business risk assessment also incorporates Latvenergo's exposure to both volatile hydropower conditions and import price volatility as Latvia imports around 35% of its electricity consumption. In addition, the BCA reflects the execution risks associated with the large capex needed to maintain the momentum of the modernisation programme of its ageing assets, which is expected to result in weakening debt protection measures.

Given its positioning as a near-fully regulated company, the regulatory and political framework is of key importance in our assessment. The Latvian regulatory framework relating to the four-point classification for the Supportiveness of Regulatory Environment (SRE) assessment generates a 3, within a framework of 1-4, where 1 - such as the UK system - is the most predictable. Although assessed as SRE3, mainly due to its lack of track record, the Latvian regulatory regime has historically proved its readiness to both support the company's investment efforts and reflect growing input and operating costs in the final electricity tariff. However, Moody's notes that the historically benign regulatory approach might come under political and social pressure under the current adverse economic development, as evidenced in other Central and East European countries. Furthermore, Moody's notes the recent decision by the regulator to reject Latvenergo's application for an increase of network tariffs. As the ability to recover costs associated with operating and investing into infrastructure is vital for the company's financial strength, potential adverse trend in regulation might create a further negative pressure on BCA.

After a partial liberalisation of the Latvian energy market in 2008, up to 5% of the market share was taken by Latvenergo's competitors, mainly by Estonian energy incumbent Eesti Energia. Moody's expects a limited impact on Latvenergo's credit profile as long as the scope of market share decrease stays within the scale of Latvia's electricity import and does not impact Latvenergo's electricity generation.

ASSESSMENT OF FINANCIAL RISK PROFILE

The historically strong position of the company within its BCA has been supported by the company's strong financial profile, as reflected in solid debt coverage metrics and good cash flow generation. However, strong cash flow generation, enabled by the historically benign regulatory regime, has been outpaced in recent years by increasing leverage raised to finance the sizeable capital investment programme mainly focused on reconstruction of the CHP generation assets. Moody's considers that the investment programme is likely to weaken Latvenergo's financial profile, and also poses considerable execution risk.

The recent adverse macroeconomic development in Latvia and the Baltic region poses significant threats to Latvenergo's performance and financial profile. The anticipated decrease in electricity demand based on forecasts of significant GDP contraction is likely to impair Latvenergo's performance and any potential devaluation of the Latvian local currency (LVL), which is currently pegged to the euro, would have a severe negative impact on Latvenergo's financial profile.

Although the current debt level is reasonable for a utility company and the maturity profile is favourable with less than 5% of the debt due within two years, Latvenergo is highly exposed to potential devaluation of the Latvian currency as all its debt is euro-denominated. A potential release of the peg to the euro followed by devaluation would result in significant negative pressure on Latvenergo's credit metrics through sizeable losses and steep leverage rise due to revaluation of the euro-denominated debt. Increasing interest expenses and debt repayments would negatively impact the currently strong cash flow generation and cause debt protection credit metrics to weaken further.

Furthermore, a gas purchase, which price is indirectly correlated to foreign currency and represent 20%-25% of total operating expenses, and the foreign currency denominated import of electricity needed to cover up to 30% of domestic consumption would amplify the negative impact of potential devaluation on Latvenergo's financial performance. Although prompt adjustment of tariffs, significant reduction of capital investments and limited dividend demands would help to partially offset this negative impact, Moody's cautions that a stressed scenario of devaluation above the Maastricht criteria (15%) would create significant downward rating pressure on Latvenergo's BCA and, potentially, its rating.

The current rating and outlook does not incorporate the future financial impact of Latvenergo's participation on the

planned construction of a new nuclear power plant in neighbouring Lithuania. Moody's perceives the project to be outside the rating horizon as a number of unresolved regulatory, environmental and ownership issues have to be negotiated with authorities at both national and EU levels. Additionally, appropriate inter-governmental and government support agreements need to be concluded before any final commitments, including financing, are made.

OTHER GRI FACTORS

The assumption of high support reflects Latvenergo's position as a joint stock company 100% owned by the Ministry of Economy of the Republic of Latvia. The country's current Energy Law states that Latvenergo is an entity of national strategic importance and should not be privatised, although political debate on this subject may recur in the medium term. Moody's believes that the State would expect the company to function as a standalone entity and the company charter determines that "the state bears no responsibility for the obligations of the company". Nonetheless, in view of its strategic importance and with no current prospect of privatisation, we assume high support. The high level of default dependence reflects Latvenergo's significant exposure to the Latvian economy and high level of foreign currency denominated debt.

Liquidity Profile

The satisfactory liquidity position of Latvenergo is supported by strong cash flow generation and solid headroom under both short- and long-term committed credit lines implemented over the past few years. The portfolio of currently drawn credit lines shows a manageable maturities profile, with repayments due within two years representing less than 5% of the total outstanding amount. Although Latvenergo has historically fulfilled all the financial covenants included within the loan documentation of some credit lines, Moody's cautions that under an adverse scenario of high devaluation, the company's liquidity profile might come under pressure from potential covenant breaches and worsening of the currently favourable debt maturity profile. Although the sizable investment programme is discretionary to some extent, Moody's notes that it may cause the currently solid liquidity position to come under pressure, which is expected to result in negative Free Cash Flow in the coming years.

Rating Outlook

The negative outlook on Latvenergo's Baa3 issuer rating reflects the negative outlook on Government's of Latvia Baa3 rating.

What Could Change the Rating - Down

A multi-notch downgrade of Latvenergo's BCA would be needed to prompt a downgrade of its Baa3 rating, assuming unchanged levels of government support and dependence and government rating. However, any devaluation of the local currency above the level of Maastricht criteria would likely result in a significant weakening of Latvenergo's BCA creating strong downward pressure on its current rating. The magnitude of such pressure would be further elevated if the planned capital investments and dividend payouts are not adjusted accordingly or approved tariffs do not reflect development of costs.

As applied through Moody's GRI rating methodology a standalone, one-notch downgrade of the Latvian government rating would prompt a consequent downgrade of Latvenergo's rating, assuming the levels of government support and dependence remain unchanged.

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