FitchRatings

Fitch Affirms Teollisuuden Voima Oyj at 'BBB-'; Outlook Stable

Fitch Ratings-Warsaw/London-28 September 2018: Fitch Ratings has affirmed Teollisuuden Voima Oyj's (TVO) Long-Term Issuer Default Rating (IDR) and senior unsecured rating at 'BBB-' and Short-Term IDR at 'F3'. The Outlook on the Long-Term IDR is Stable.

The affirmation reflects the approaching completion of the Olkiluoto 3 (OL3) nuclear power plant, the settlement agreement between TVO and OL3 plant supplier consortium (Areva NP, Areva GmbH and Siemens AG (A/Stable) and Areva SA, fully owned by the French state). It also incorporates an improved power price environment and hence value creation for TVO's shareholders. The settlement agreement reduces several uncertainties during final stages of the OL3 construction, such as TVO's final investment costs and the supplier consortium having sufficient funds to complete the project.

TVO continues to benefit from demonstrated strong support from its shareholders, evidenced through arrangements for fixed and variable cost coverage as well as committed shareholder loans covering part of the funding.

KEY RATING DRIVERS

OL3 Nears Commissioning: The construction of the 1,600 MW OL3 nuclear power plant nears commissioning as additional critical milestones, such as cold and hot functional tests, have been successfully completed this year. The project has experienced a 10-year delay and substantial cost overruns resulting in the total project cost increasing to EUR5.5 billion from the originally planned EUR3.4 billion. The delay has been negative for TVO's cash flows as the company has to service debt related to OL3 without a cost pass through to shareholders in the construction phase. Cash flows will improve after the OL3 completion when TVO's shareholders' full cost coverage of OL3, including interest costs and asset depreciation, starts. Together with capex returning to maintenance levels after the OL3 completion, this should allow TVO to start deleveraging.

OL3 Settlement Reduces Risks: As a result of the settlement in March 2018, TVO will receive compensation of EUR450 million from the supplier consortium companies, and at the same time the supplier consortium companies will be entitled to receive an incentive payment of up to EUR150 million upon timely completion of the OL3 project. The settlement further specifies additional penalties paid by the supplier consortium in case of further delays beyond the end of 2019 (capped at EUR400 million), and also includes an undertaking and trust mechanism by supplier consortium to secure funds for completion of the project, including all guarantee periods.

The settlement reduces OL3's production costs by about EUR1/MWh (and average production costs of TVO's three units by about EUR0.5/MWh), which allows moderately better value creation for TVO's shareholders.

Improvement in Power Prices: Value creation for TVO's shareholders, which is one of the key rating considerations, has improved as Nordic power prices have shown some signs of recovery from the low levels in 2015 and 2016. TVO's average production costs will increase to close to EUR30/MWh after the commissioning of OL3 (mostly due to higher depreciation and interest costs) from current about EUR 20/MWh. This compares with Finnish area futures electricity prices of around EUR35/MWh for 2020-2021.

Not-for-Profit Nuclear Generator: The ratings reflect TVO's position as a not-for-profit Finnish nuclear generator, producing at-cost electricity for the company's six shareholders. TVO's largest shareholder (with 58.3%) is Pohjolan Voima Oyj (PVO), a not-for-profit generator owned by a consortium of Finnish industrials (mainly pulp and paper companies UPM-Kymmene Oyj and Stora Enso Oyj (BBB-/Stable)) and utilities. Its second-largest shareholder (with 25.8%) is Fortum Power & Heat Oy, a 100% owned subsidiary of Fortum Oyj (BBB/Stable).

Strong Shareholder Support: TVO's standalone rating benefits from demonstrated strong support from the company's shareholders, evidenced through arrangements for fixed and variable cost coverage and shareholder loans covering part of the funding. In December 2017, TVO's shareholders decided to increase the shareholder loan commitment by EUR150 million partly to support TVO after an additional delay of the OL3 project announced at that time. As a result, undrawn shareholder loan commitments increased to EUR350 million supporting the company's liquidity.

No Merchant, Volume Risk: TVO has no direct wholesale electricity price or volume exposure, as its shareholders are the at-cost off-takers of the electricity produced. Shareholders have an incentive to keep costs low and to off-take their proportion of the energy due to the large fixed costs they have to cover according to TVO's articles of association. If a shareholder fails to cover annual fixed costs (80% of total costs paid one month in advance, which also includes debt instalments falling due annually) and variable costs (around 20% of costs) in proportion to their off-take, TVO would cut the electricity supply and sell the electricity to another shareholder or onto Nord Pool.

Low Political Risk: Finland has a supportive regulatory environment for the construction of nuclear power plants, given the country's concerns over security of supply (TVO is a key generator of base-load electricity in Finland - its nuclear plant accounts for roughly 16% of Finnish total electricity consumption), the need for reasonably-priced electricity for its energy-intensive industries, and stringent EU CO2 emission requirements driving the phase-out of thermal plants. After the completion of the OL3 plant planned for September 2019, the electricity produced by TVO will cover about 30% of the country's demand.

The Finnish government has recently approved the extension of the operating licences for the Olkiluoto 1 and 2 plant units by 20 years to 2038.

DERIVATION SUMMARY
As TVO is a not-for-profit company, Fitch considers traditional leverage or coverage ratios, which are weak compared with other European utilities such as Fortum (BBB/Stable) or Vattenfall AB (BBB+/Stable), as less relevant for the ratings than for utilities operating on a fully commercial basis. In 2017, TVO's funds from operations (FFO) after cash interest paid was negative and FFO interest cover was below 1x as interest expense related to OL3 debt in the construction phase is not covered by shareholders but capitalised.

Compared with many other European utilities, TVO's ratings are constrained by asset concentration risk, as almost all electricity production is from a single nuclear power plant. This is mitigated by TVO's solid operational and safety record as TVO's nuclear power units are some of the most efficient in the world, with an outstanding safety record partly due to strict Finnish safety standards. In addition, TVO's rating is supported by demonstrated strong support from shareholders.

KEY ASSUMPTIONS
Fitch's Key Assumptions Within Our Rating Case for the Issuer
- Fitch calculates projected EBITDA and credit ratios hypothetically in a profit-making scenario, assuming that TVO is able to sell its electricity output at market prices instead of at-cost prices. This measures the incentive for shareholders to maintain their at-cost off-takes, as well as the theoretical dividend that would instead be paid in a profit-making scenario.
- OL3 fully operational from September 2019.
- Average production costs of TVO to increase close to EUR 30/MWh in the first few years of OL3 operations, from around EUR21/MWh in 2017 (with OL1 and OL2 only).
- Finnish area prices of around EUR35/MWh in 2020-2021.

RATING SENSITIVITIES
Developments That May, Individually or Collectively, Lead to Positive Rating Action
- Structural long-term improvement in power price environment leading to enhanced value creation at TVO for its shareholders.
- Significantly higher equity funding.

Developments That May, Individually or Collectively, Lead to Negative Rating Action
- TVO's production costs significantly exceeding Finnish area prices on a sustained basis when OL3 is completed, leading to value destruction at TVO for its shareholders.
- Evidence of reduced support from shareholders (e.g. equity ratio falling towards the covenant level of 25%) or structural changes in the Mankala principle undermining the strength of shareholder support.
- Substantial OL3 delays leading to additional costs exceeding the EUR400 million penalty cap agreed in a settlement with the consortium companies.
- Any adverse regulatory or fiscal changes.
- A decline in operating performance, safety issues and significantly reduced liquidity reserves.

LIQUIDITY

Adequate Liquidity: Cash and cash equivalents as at end-June 2018 amounted to EUR102 million. Committed undrawn credit facilities amounted to EUR1,400 million, resulting in sufficient total liquidity to cover for 2018-2019 debt repayments of EUR767 million. In addition, the company has committed and undrawn shareholder loans of EUR350 million allocated to OL3 project costs if needed. The group's overall liquidity is considered adequate. After OL3 comes online and shareholders start to cover full costs (including interest costs and asset depreciation), total debt is projected to start declining gradually.

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Summary of Financial Statement Adjustments
- A standard multiple of 8x was applied to operating leases
- Fair value of cross currency swaps reflected in adjusted debt.

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Additional information is available on www.fitchratings.com

Applicable Criteria

Corporate Rating Criteria (pub. 23 Mar 2018) (https://www.fitchratings.com/site/re/10023785)
Corporates Notching and Recovery Ratings Criteria (pub. 23 Mar 2018) (https://www.fitchratings.com/site/re/10024585)
Parent and Subsidiary Rating Linkage (pub. 16 Jul 2018) (https://www.fitchratings.com/site/re/10036366)
Sector Navigators (pub. 23 Mar 2018) (https://www.fitchratings.com/site/re/10023790)

Additional Disclosures

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