Research Update:

Zapadoslovenska Energetika 'A-' Rating Affirmed; Outlook Stable

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Rating Action Overview

- Slovakia-based regulated utility company Zapadoslovenska energetika a.s. (ZSE) posted strong operating performance in 2021, and benefits from over 90% of its earnings being generated from regulated activities.
- We expect ZSE's financial performance to deteriorate in 2022 because of higher energy prices due to the company bearing the cost of losses in distribution tariffs, which will lead S&P Global Ratings-adjusted funds from operations (FFO) to debt to dip to around 20% in 2022 from around 30% in 2021.
- That said, we expect network losses to be recovered by 2023/2024 thanks to the cost recovery mechanism embedded in the regulatory framework in Slovakia. As a result, over the next few years, we expect FFO to debt to remain well above 18%, which is our threshold for the current rating.
- We have affirmed our 'A-' ratings on ZSE and on its senior unsecured debt.
- The stable outlook reflects our forecast of continued stable and predictable earnings and cash flow from what we see as ZSE's relatively low risk regulated distribution business.

Rating Action Rationale

The new settlement mechanism for network losses introduced by the regulator in 2021 will result in adjusted FFO to debt to decrease to around 20% in 2022. In January 2021, the Regulatory Office for Network Industries (RONI; the Slovak energy regulator) introduced a new settlement mechanism for network losses for all the electricity distribution companies in Slovakia, which depressed ZSE's EBITDA in 2021 and 2022. We expect S&P Global Ratings-adjusted EBITDA to decrease by about €30 million in 2021 and an even higher impact in 2022 due to still-increasing power prices, which will lead our adjusted FFO to debt to decrease to about 20% in 2022 from about 30% in 2021. The regulator changed the losses clearing price to spot, while retaining the tariffs based on T-1 forward index. The sharp increase in 2021's commodity prices resulted in a large gap between ZSE's tariff and the actual spot price (above €100 per megawatt hour) with a negative financial impact of around €30 million. We saw an even further increase in commodity prices from the beginning of 2022 resulting in a bigger gap between ZSE's 2022 tariff set by the regulator and the actual spot price, and we therefore forecast a bigger hit to ZSE's EBITDA in 2022. ZSE will effectively recover those extra costs via its tariff, but only after a two-year delay. The effects of that delay on results in 2021 and 2022 will be particularly strong given the current energy market conditions. This correction mechanism is embedded in regulation, therefore the recovery is certain. We understand that from 2023, the mechanism for network losses will revert to the original mechanism (price of losses in the tariff based on the forward index) hence we do not expect any more volatility in ZSE's credit metrics.

ZSE will continue to benefit from high regulatory visibility in Slovakia despite regulatory risk being at its peak. Around 90% of ZSE's 2021 profits are generated from fully regulated power distribution activities in Western Slovakia. We regard the regulatory framework as supportive and transparent, ensuring highly predictable earnings for operators over the 2017-2021 regulatory period. The period has been extended by one year and will reset following 2022. We are unclear on regulated earnings beyond that timeframe. However, we expect the regulator to somewhat lower the weighted-average cost of capital (WACC) allowance as it has done previously under its framework to allow for sufficient financial support (for instance, in 2017, it increased tariffs despite the Slovak government's strong opposition). Furthermore, we consider potential remedy measures by ZSE as mitigating factors. Aside from the five-year regulatory resets, every year, RONI sets and publishes the WACC at the end of June, based on publicly disclosed parameters; for 2022, RONI lowered the pre-tax WACC to 5.09% from 5.65%. Our base-case scenario reflects the impact.

The anticipated integration of ZSE and VSE could bring operational upside to the group. On April 8, 2022, E.ON SE (BBB/Stable/A-2) and the Slovak Republic (A+/Negative/A-1), represented by the Ministry of Economy, entered into the consolidation agreement, to consolidate ZSE and Vychodolosvenska Energetika Holding a.s. (VSE; not rated). VSE is a natural monopoly in power distribution in eastern Slovakia and also supplies electricity and gas; it is 49% owned by E.ON and 51% owned by the government of Slovakia. In 2020, it posted EBITDA of around €127 million and reported debt stood at €232 million. We expect the anticipated transaction to close in fourth quarter (Q4) 2022. Upon fulfilment of the conditions preceding transaction completion, ZSE will become VSE's sole shareholder. We will monitor the transaction to ascertain how it might affect ZSE's business and financial risk but overall, we would expect the transaction to have a modest positive impact due to economies of scale and lower leverage at the VSE level.

Outlook

The stable outlook reflects our forecast of continued stable and predictable earnings and cash flow from what we see as ZSE's relatively low risk regulated distribution business. We also anticipate that the utility will maintain its very strong retail supply position in its service area and will remain shielded against the current energy crisis.

Downside scenario

We could lower the rating on ZSE if we took a similar rating action on Slovakia and--at the same time--revised downward the utility's stand-alone credit profile (SACP) by one notch, assuming our view of extraordinary state support for ZSE does not change. We could also lower the rating if we revised the SACP downward by two notches.

We could consider revising the SACP if, for example, there were unexpected negative changes to the regulatory framework, the deficit resulting from network losses settlement on spot payments were not compensated under regulatory mechanisms in a timely manner, or ZSE's operating or capital investment costs were higher than the regulator allows. We could also revise downward the SACP if the utility's credit metrics weakened, notably if adjusted FFO to debt fell below 18% without any prospect of recovery. This could occur if the company adopted more aggressive shareholder policies in terms of leverage tolerance or dividend payouts.

Upside scenario

We see an upgrade as unlikely because ZSE has a stable cash flow profile combined with its aggressive financial policy. We could raise the rating on ZSE if we upgraded Slovakia, or if ZSE posted an adjusted FFO-to-debt ratio sustainably above 28%, assuming our view of the likelihood of extraordinary government support did not change.

Company Description

ZSE is the sole distribution system operator (DSO) in the relatively wealthy service area of Western Slovakia and has a very strong position as the region's electricity supplier. It is the largest of three regional DSO providers in the country (ZSE, Stredoslovenska energetika [SSE], and VSE). E.ON holds 49% of the shares in ZSE, the Western Slovakia distribution company; EP Infrastructure holds 49% of the shares in SSE, the distribution company operating in Central Slovakia; and E.ON AG holds 49% of the shares in VSE, the Eastern Slovakia distribution company. The remaining shares at each DSO are held by the state. Although ZSE is 51% state-controlled, the company's operations and strategy are sufficiently autonomous.

In 2021, ZSE distributed 9.9 terawatt-hours (TWh) of electricity throughout Western Slovakia (compared with 9.4TWh in 2020) and supplied 6.3 TWh of the power and 3.5TWh of gas.

At year-end 2021, ZSE posted EBITDA of €247 million (S&P Global Ratings-adjusted: €264 million) and financial debt of €657.7 million (S&P Global Ratings-adjusted: €678.4 million), which leads to our adjusted FFO-to-debt ratio of about 30%.

Our Base-Case Scenario

Assumptions

- Slovakia real GDP growth of 4.7% for 2022, 3.9% for 2023, 2.4% for 2024.
- Regulatory visibility and high predictability of earnings from ZSE's distribution activities until the end of the current regulatory period (December 2022). We lack regulatory visibility beyond then, but expect a moderate adjustment on regulatory variables sufficient for the rating.
- Pre-tax WACC set at 5.09% for 2022 (5.65% in 2021).
- Change to the methodology in the regulation related to network losses from January 2021 resulting in weaker EBITDA in 2021 and 2022, recovering with a two-year lag.
- The residual unsettled 2019 Renewable Energy Systems deficit of €5 million to be collected

over four years (2022-2025).

- We do not consider any earnings contribution by noncore operations of the 436-megawatt Malzenice combined-cycle gas turbine power plant.
- Investment plan, supported by organic growth (mainly network enhancement projects and connections), to increase to €120 million-€130 million for 2022 and 2025. We exclude investments related to Malzenice from 2022.
- Dividend payout of about 100%, although this is flexible according to rating and liquidity considerations.
- Average cost of debt of 2.3% over 2022-2023.
- Anticipated merger between ZSE and VSE to close in Q4 2022.

Key metrics

Zapadoslovenska Energetika --Key Metrics*

	--Fiscal year ended Dec. 31--				
Mil. €	**2020a**	**2021a**	**2022e**	**2023f**	**2024f**
EBITDA	256.9	264.9	180-190	240-250	270-80
Debt	586.9	678.4	680-690	680-690	680-690
Funds from operations (FFO)/debt (%)	35.7	30.0	19-21	25-27	30-32
Capital expenditure	125	136	120-130	110-120	120-130

*All figures adjusted by S&P Global Ratings. a--Actual. e--Estimate. f--Forecast.

Liquidity

We assess the company's liquidity as adequate. ZSE has solid relationships with banks; the refinancing of €315 million of debt in 2018 demonstrated the company's high standing in credit markets. ZSE's reputation is further enhanced by the ongoing benefit of its state ownership and prudent financial policy. On this basis, we expect annual cash flow, the group's cash position, and committed credit facilities will cover expected cash outlays--mainly capital expenditure and dividends--by above 1.2x over the next 12 months.

We anticipate the company will have the following principal liquidity sources as of March 31, 2022:

- Undrawn committed credit facilities of €20 million and €8.3 million both maturing in October 2023 available for the next 12 months;
- Newly signed revolving credit facilities totaling €100 million maturing in Q2 2023; and
- Our forecast that ZSE will generate approximately €144 million of cash FFO annually.

We anticipate the company will have the following principal liquidity uses as of March 31, 2022:

- No debt maturities in the next 12 months;
- Capital investments related to network activities of about €120 million-€130 million in the next 12 months; and

- Dividend payments of approximately €90 million.

Covenants

We understand that the euro medium-term note program does not contain any covenants. However, ZSE's liquidity credit facilities are subject to early repayment if we lower the rating to speculative grade ('BB+' and below). Still, we do not anticipate that the company will need to resort to these facilities because its cash flows are normally more than adequate to cover investment needs, and dividends are discretionary.

Issue Ratings - Subordination Risk Analysis

Capital structure

ZSE's financial debt comprises senior unsecured debt at the parent level.

Analytical conclusions

The issue rating on the debt is 'A-', in line with the issuer credit rating, because no significant elements of subordination risk are present in the capital structure.

Ratings Score Snapshot

Issuer Credit Rating	**A-/Stable/-**
Business risk:	Strong
Country risk	Intermediate risk
Industry risk	Very low risk
Competitive position	Satisfactory
Financial risk:	Intermediate
Cash flow/leverage	Intermediate
Anchor	a-
Modifiers:	
Diversification/Portfolio effect	Neutral
Capital structure	Neutral
Financial policy	Neutral
Liquidity	Adequate
Management and governance	Satisfactory
Comparable rating analysis	Neutral
Stand-alone credit profile:	a-
Related government rating	A+/Negative/A-1
Likelihood of government support	Moderately High

ESG credit indicators: E-2, S-2, G-2

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
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- 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
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, 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

Ratings List

Ratings Affirmed	
Zapadoslovenska energetika a.s.	
Issuer Credit Rating	A-/Stable/--
Senior Unsecured	A-

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; or Stockholm (46) 8-440-5914