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Research Update:

Finnish Electricity Grid Operator Caruna Networks Affirmed At 'BBB'; Outlook Stable

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Rating Action Overview

- Finland's electricity regulator's final decision for the 2024-2031 regulatory period, published Dec. 29, 2023, includes updates to the methodology to value the regulated asset base (RAB) and to parameters to calculate the weighted average cost of capital (WACC).
- Although the RAB and WACC both increased as of Jan. 1, 2024, the changes to the methodology imply slower growth of the RAB for the new regulatory period and lower remuneration than in our previous forecasts.
- To mitigate the impact, Caruna will recover an accumulated regulatory deficit of €143 million, supporting EBITDA of €350 million-€360 million in 2024-2027, while lower capital expenditure (capex) and dividends should keep funds from operations (FFO) to debt higher than 9% over that period.
- We therefore affirmed our 'BBB' rating on Caruna.
- The stable outlook indicates that we expect Caruna to continue operating with significant headroom above our 9% FFO-to-debt threshold.

Rating Action Rationale

The Energy Authority's final decision (FD) for the 2024-2031 regulatory period suggests slower growth of asset valuations. This regulatory period started on Jan. 1, 2024. The FD includes three main elements that could have a significant credit impact on Finnish distribution networks:

- The current asset base will be frozen at the 2024 unit price, with no adjustment for inflation at the end of the period.
- Unit prices for investments will be adjusted by inflation each year during the 2024-2031 regulatory period, and based on the average construction cost incurred by the industry during the investment period. Network operators will know final unit prices only at the end of the period, rather than at the beginning as was the case previously. We see this as a weakness, since it increases the uncertainty of the investment and therefore may affect distribution system operators' (DSOs') capex plans, possibly resulting in lower-than-expected spending,

despite the government's carbon neutral goal by 2035.

- Unlike in the October 2023 proposal, the regulatory WACC remains based on median parameters and not on quartiles. It is confirmed at 7.37% for 2024 compared with the previously expected 6.9%.

As a result of the FD, Caruna's RAB as of Jan. 1, 2024, has increased to €2.8 billion--up 19% versus that on Jan. 1, 2023--based on unit prices in 2022. This has, in effect, increased Caruna's allowed income by 5% to €469 million. That figure is lower than our previous forecasts of €500 million-€550 million, which were based on our previous expectation of inflation-boosted RAB from Jan. 1, 2024.

A large regulatory deficit should help stabilize EBITDA over 2024-2027 We expect Caruna to report a €143 million regulatory deficit as of year-end 2023, which is to be recovered before year-end 2027. This deficit comes from actual revenue in the previous period being lower than allowed income, per the regulation. We therefore expect Caruna to increase tariffs (up to the 8% annual cap) to recognize about €40 million as revenue annually until year-end 2027. This should translate into revenue of €500 million-€530 million annually. Moreover, we anticipate lower costs for Caruna because we expect Fingrid to waive grid fees annually over the regulatory period. Although grid costs are passed through to end users under the regulatory framework and would be recovered, we expect lower costs to increase Caruna's EBITDA margins toward 70% from 65% in the last regulatory period, translating into annual EBITDA of €350 million-€360 million, up from €310 million-€330 million over 2021-2023.

Board-approved remedy measures should keep FFO to debt higher than 9% over our forecast period through 2027. As of Jan. 31, 2024, the board has approved measures to enable Caruna to maintain the FFO-to-debt ratio above 9% in line with the company's financial policy. This includes cutting capex by 50% to €70 million-€80 million annually and cancel ordinary dividends in 2024 and 2025. We however expect about €65 million of interest on the shareholder loan to be paid over 2024-2027. We view these steps as positive, since they allow discretionary cash flow to turn moderately positive, to €90 million-€110 million from negative €50 million to negative €100 million and FFO to debt to improve to 11.0%-11.5% by year-end 2026.

Outlook

The stable outlook reflects our expectation that Caruna's EBITDA and FFO will not decline significantly despite the regulatory changes. This is because Caruna has a regulatory deficit accumulated from previous years that it will use to smooth the related negative impact. We also expect Caruna will adjust its shareholder distributions to protect credit metrics and therefore expect FFO to debt will comfortably exceed 9% and debt to EBITDA stand at about 8x, which we consider commensurate with a 'bbb' stand-alone credit profile.

Downside scenario

We could lower the rating it FFO to debt falls below 9% without signs of recovery. This could stem from higher-than-anticipated investments without appropriate remuneration, or increasing shareholder remuneration that consumes a large part of the company's cash flows. Prolonged underperformance compared to the unit prices that reduces Caruna's efficiencies could also lead to rating pressure, since it would weaken the strength of the business in our view.

Upside scenario

Rating upside would require a change in financial policy that supports stronger credit ratios, such as FFO to debt higher than 12% on a sustainable basis.

Company Description

Caruna Networks Oy is a Finnish electricity DSO that was founded in 2014 as a spin off from Fortum. It is Finland's largest power DSO with about 20% of the power distribution market, followed by Elenia with 10%-15%.

Caruna distributes electricity to about 732,000 customers throughout its 88,500 kilometer-long network in its respective regions as of June 2023. It is composed of two companies Caruna Oy and Caruna Espoo Oy. The former operates in mostly rural areas, requiring high investments due to the large network to repair, and the latter, Caruna Espoo operates in urban areas with a high number of consumers. At year-end 2022, the average underground cabling rate for Caruna was 62% (60% for Caruna Oy and 81% for Caruna Espoo).

Caruna is owned by Finnish mutual pension insurance company Elo (7.5%), as well as international investors KKR (40%), Ontario Teachers' Pension Plan Board (40%), and AMF Pension (12.5%).

Our Base-Case Scenario

Assumptions

- Inflation in Finland of 1.3% in 2024, 1.5% in 2025, and 1.6% in 2026.
- A revenue increase upon reassessment of the asset base for the new period started Jan. 1, 2024, and higher WACC.
- Full use of the €150 million accumulated deficit estimated at year-end 2023 during 2024-2027.
- An average EBITDA margin of about 70% for 2024-2027, up from about 65% in the previous regulatory period. This comes from no haircut on EBITDA, since the parameters for the new regulatory period have been decided, and lower costs because Fingrid should waive six months of tariffs annually for the foreseeable future.
- Average annual depreciation of about €125 million-€130 million over the next three years.
- Annual capex of €70 million-€80 million, down from €145 million-€150 million, and mostly related to maintenance. This is due to the new RAB valuation method, which reduces flexibility to invest despite increasing needs in Finland.
- No dividends in 2024-2025 as decided by the board, although the annual payment of €65.8 million in interest on the shareholder loan remains.
- Interest payments in line with the annual weighted-average interest rate of 2.5%.
- No major working capital swings.
- No acquisitions.

Key metrics

Caruna Networks Oy--Key Metrics*

	--Fiscal year ended Dec. 31--				
Mil. €	2021a	2022a	2023e	2024f	2025f
EBITDA	325	314	330-350	350-400	350-400
EBITDA margin (%)	64.9	64.8	65-70	70-75	65-70
Funds from operations (FFO)	240	254	250-300	250-300	250-300
Capital expenditure	139	126	100-150	50-100	50-100
Free operating cash flow (FOCF)	46	47	50-100	150-200	150-200
Shareholder distribution**	152	102	150-200	50-100	50-100
Debt	2,546	2,538	2,500-3,000	2,500-3,000	2,000-2,500
Debt to EBITDA (x)	7.8	8.1	7.5-8.0	7.0-7.5	6.5-7.0
FFO to debt (%)	9.4	10.0	9.5-10.0	10.5-11.0	11.0-11.5

*All figures adjusted by S&P Global Ratings. **Includes interest on the shareholder loan. a--Actual. e--Estimate. f--Forecast.

Liquidity

We assess Caruna's liquidity as strong. We anticipate that available liquidity sources will exceed expected cash outflows by more than 1.5x over the next 12 months and by more than 1.1x over the subsequent 12 months. We also expect sources will cover uses even if EBITDA were to decline by 30% compared with our base case, and that Caruna will retain significant headroom under the financial covenants.

In our assessment of liquidity, we also factor in our view of Caruna's solid relationships with local banks, in line with its strong position in Finland and ownership of important infrastructure. We also regard Caruna will likely be able to absorb high-impact, low-probability events without refinancing.

Principal liquidity sources for 12 months from Dec. 31, 2023:

- Cash and equivalents of about €50 million;
- €210 million available under a committed revolving credit facility (RCF) and an overdraft maturing in November 2025; and
- Cash FFO that we estimate at about €270 million.

Principal liquidity uses for 12 months over the same period:

- Amortization of about €35 million of the loan from Nordic Investment Bank and €140 million to repay drawings on the RCF;
- Capex of about €80 million, down from our previous forecast of about €150 million;
- Annual payment of interest on the shareholder loan of about €65 million, which we treat as dividends; and
- No ordinary dividends.

Covenants

Although we do not rate Caruna under our criteria for structurally enhanced debt, the company has several covenants that protect bondholders. Importantly, a breach of the financial covenants will not automatically mean a default. Instead, lock-up covenants prohibit shareholder distributions if FFO to senior debt drops below 5% or if FFO to interest on senior debt falls below 1.7x. In either case, there will be a 12-month standstill period, during which there will be no enforcement of security, and the 12-month liquidity facility should cover scheduled debt payments.

The financing structure includes covenants stipulating the following ratios:

- FFO to senior debt no lower than 4%; and
- FFO to interest on senior debt no lower than 1.2x.

The documentation also includes lock-up covenants for shareholder distributions, stipulating, among other ratios:

- FFO to interest on senior debt of at least 1.7x (12 months backward and forward);
- FFO to senior debt of at least 5% (12 months backward and forward); and
- FFO to senior debt of at least 5.5% (36 months forward).

Under current operations, we don't expect Caruna to breach any covenants.

Ratings Score Snapshot

Issuer Credit Rating	BBB/Stable/--
Business risk:	Excellent
Country risk	Very low
Industry risk	Very low
Competitive position	Strong
Financial risk:	Aggressive
Cash flow/leverage	Aggressive
Anchor	bbb
Modifiers:	
Diversification/Portfolio effect	Neutral
Capital structure	Neutral
Financial policy	Neutral
Liquidity	Strong
Management and governance	Neutral
Comparable rating analysis	Neutral
Stand-alone credit profile:	bbb

Related Criteria

- Criteria | Corporates | General: Methodology: Management And Governance Credit Factors For Corporate Entities, Jan. 7, 2024
- Criteria | Corporates | General: Corporate Methodology, Jan. 7, 2024
- 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
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- 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

- Finnish Networks' Rating Headroom Could Shrink On 2024-2031 Regulatory Update, Dec. 8, 2023
- Caruna Networks Oy, Jan. 13, 2023

Ratings List

Ratings Affirmed	
Caruna Networks Oy	
Issuer Credit Rating	BBB/Stable/--