Research Update:

Latvian Gas Transmission And Storage Operator Conexus Baltic Grid Rated 'BBB+'; Outlook Stable

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Rating Action Overview

- JSC Conexus Baltic Grid (Conexus) is the sole gas transmission and gas storage operator in Latvia, and generated about €33 million of EBITDA in 2021.
- We assess Latvia's regulatory frameworks for gas transmission and storage as mostly supportive and offering regulatory visibility until at least 2026. This is somewhat balanced by Conexus' relatively small size as well as its large upcoming investment program and aggressive dividend policy, which are likely to deteriorate credit headroom in the next two-to-three years
- Our assessment also reflects the increasing relevance of the company's operations for parent Augstsprieguma Tikls (AST; A-Stable/--) and, indirectly, the Latvian government.
- We assigned our 'BBB+' long-term issuer credit rating to Conexus.
- The stable outlook mirrors that on AST and reflects our assumption that Conexus will maintain credit metrics in line with the current rating, notably S&P Global Ratings-adjusted funds from operations (FFO) to debt above 18% and adjusted debt to EBITDA below 5.0x.

Rating Action Rationale

Conexus is a fully regulated gas transmission and storage operator under frameworks that we view as mostly supportive. This is because:

- The Latvian regulatory framework for gas storage has a five-year regulatory period (2021-2026) and the framework for gas transmission will last three years (2023-2026), although both were only recently created (2021 for storage and 2017 for transmission).
- It is a regulated asset base (RAB)-based methodology that provides cost recovery within two years for storage and the next regulatory period for transmission.
- The weighted-average cost of capital (WACC) is set for the entire regulatory period and is based on a 50/50 split between equity and debt.
- We view the regulator (the Public Utilities Commission) as independent.

This is balanced by the following:

- The RAB doesn't include EU funded, planned, or work-in-progress investments for the transmission framework; though planned investments are included in the storage framework. The allowed revenue is based on the RAB at the end of the last year of the previous period (2020 for storage and it will be 2022 for transmission)
- Excess revenues are returned within one year in the storage framework, leading to some volatility in revenue. Transmission's excess revenues are given back in the next regulatory period, providing for less revenue volatility.

We expect the upcoming regulatory period to increase the WACC to a nominal rate from the currently real rate and the 2022 RAB to incorporate the latest evaluation on assets. This would lead to an increase in Conexus' profitability and better financials than expected; though the question remains as to how much the regulator increase tariffs without social backlash, which we will closely monitor.

Conexus' business is constrained by its size and EBITDA volatility. With annual EBITDA about €30 million, we view the company's business as relatively small compared with that of peers. Still, Conexus benefits from regulatory diversification, owning both the storage and the transmission network. The storage business will become critical to the region and by owning it Conexus isn't affected by current gas prices, since they are fully passed through as part of the regulatory formula. Conexus is also not affected by the stop of gas flows to the Baltics from Russia since April 2022 (though there were some minor inflows from Russia in July 2022). The company also benefits from its integration into the joint unified tariff zone with Estonia and Finland (and Lithuania expected from October 2023), making its area of operations larger than if it were to focus on Latvia only. Its small size and the annual adjustment of revenue established in the storage framework will lead to some EBITDA volatility, notably in 2023, when we expect EBITDA of €20 million-€25 million compared with about €30 million currently.

The large investment program and aggressive dividend policy will weigh on credit metrics. Conexus plans to invest €156 million over 2022-2026 (about €30 million per year) mostly on the Project of Common Interest (PCI) including enhancement of storage and of the Latvia-Lithuania interconnector. Both PCIs are 50% EU funded and EU funds represent 20%-25% of total investment. Other investment includes projects in line with the European Green Deal, such as:

- Testing and injection of renewable gas in the network;
- Commissioning of a 1-megawatt solar power plant at the storage plant;
- Pipeline pressure pump-down technology; and
- Other investment for cybersecurity and maintenance.

Conexus' credit metrics are also constrained by its aggressive and nonflexible dividend policy of distributing at least 90% of its net income, driving discretionary cash flow to debt down toward negative 5% to negative 15% annually. While we estimate S&P Global Ratings-adjusted debt to EBITDA of 4.2x-4.5x over 2022-2026, we believe the company is willing to increase its leverage within the 5x cap stated by its financial policy and covenants. This translates into expected FFO to debt of 18%-23% over 2022-2026, putting Conexus at the higher end of our aggressive financial risk profile category.

We see Conexus as strategically important for majority owner, AST, although insulated from the group. Conexus is 68.46% owned by AST (A-/Stable/--) and 29.06% by MM Infrastructure Investments Europe Ltd. Conexus' operations are critical for Latvia and the region enhancing the importance of the gas utility for AST and indirectly the Latvian government. In addition, since AST became majority shareholder upon the government's request and equity injection in 2019, we believe that the government wants to stay involved in the gas utility. We, however, believe that Conexus is insulated from its parent because:

- Day-to-day operations, financial reporting, and cash management are separated between the two companies.
- There is a separate management board at the Conexus level with three members, none coming from AST.
- Conexus is regulated, and we believe that ultimate decision-making on its strategy rests collectively with its government and its supervisory board.
- The company has a significant minority shareholder (MM Infrastructure).
- Of the seven members in the recently created supervisory board, three were nominated by MM Infrastructure and four were nominated by AST.

As a result, we could rate Conexus up to one notch above our assessment of AST's group credit profile were its stand-alone credit profile higher than our rating on AST.

Outlook

The stable outlook reflects that on parent AST. Moreover, it is based on our expectation that Conexus will maintain FFO to debt of 18%-23% while keeping debt to EBITDA below 5x.

Downside scenario

We could take a negative rating action if one or a combination of the following elements occur:

- Conexus' importance in the AST group weakens.
- We downgrade AST.
- Conexus' FFO to debt falls below 18% or debt to EBITDA exceeds 5x.

Upside scenario

We could upgrade Conexus if we upgrade AST to 'A' from 'A-'. We could revise our assessment of Conexus' stand-alone creditworthiness to 'bbb' from 'bbb-', if its FFO to debt remained well above 23% with debt to EBITDA below 3.5x on a stand-alone basis, although this would not have any positive impact on the final rating.

Company Description

Conexus is the natural gas transmission and storage operator in Latvia. Its operations are split evenly between the transmission and storage activities.

- The 1,190 kilometer-long gas transmission network directly connects Latvia with Lithuania, Estonia, and Russia. Since April 2022, no Russian gas is used in the Baltics, although it transits through the network en route to Kaliningrad.
- In#ukalns is the sole underground gas storage in the region, with a gas capacity of 46 terawatt-hours (TWh; 2.3 billion cubic meters), of which 22 TWh is considered cushion gas.

Established in 2017 following the unbundling of the energy sector, Conexus is now owned 68.46% by AST (the electricity transmission system operator itself is 100% owned by the state of Latvia) and 29.06% by MM Infrastructure Europe, an infrastructure fund headquartered in Japan.

Our Base-Case Scenario

Assumptions

- Conexus' revenues include that from transmission and storage services as well as from the common market area with single entry and exit tariffs across Finland, Estonia, and Latvia.
- No Russian gas flows in Latvia since April 2022, which we view as having no impact for Conexus.
- Annual transmission revenue increasing to over €30 million from 2024, in line with the start of the new regulatory period
- Lower revenue from storage in 2023, as Conexus expects a lower tariff will compensate for revenue overachievement in 2021 and 2022:
- --Storage cycle May 2021-April 2022: €1.8 million.
- --Storage cycle May 2022-April 2023: €3.7 million.
- EBITDA margins of 45%-50% over 2022-2024.
- No immediate impact from recent high gas prices.
- About €156 million in investments over 2022-2026, of which EU funds will cover 20%-25%.
- Aggressive dividend policy, with a payout ratio of no less than 90% of net profit paid in first-half each year.
- Issuance of a €80 million bond in second-half 2022, with our expectation of a 2.5% coupon and maturity of five years.
- €10 million in debt amortization annually.
- Support from the group in case of operational or financial distress.

Key metrics

Conexus Baltic Grid--Key Metrics

	--Fiscal year ended Dec. 31--				
(Mil. €)	2020a	2021a	2022e	2023f	2024f
EBITDA	30.8	33.1	25-30	20-25	25-30
EBITDA margin (%)	57.1	58.7	45-50	45-50	45-50
Capital expenditure	21.9	27.6	25-30	35-40	30-35
Dividends	16.3	84.5	8-12	0-5	0-5
Debt to EBITDA (x)	0.8	3.1	3.5-4.0	4.5-5.0	3.5-4.5
FFO to debt (%)	126.4	30.3	20-25	18-23	18-23
DCF to debt (%)	(11.5)	(83.5)	(10)-(0)	(15)-(5)	(10)-(0)

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

Liquidity

We assess Conexus' liquidity as adequate as of end-June 2022, with sources to uses above 1.2x for the next 12 months. This is further underpinned by the strong relationship the company has with regional banks, as demonstrated with the annual extension of committed lines and addition of bank loans.

We estimate that liquidity sources for the 12 months from June 2022 include:

- No cash; and
- About €54 million undrawn committed lines maturing at year-end 2023.

We estimate that liquidity uses over the same period include:

- About €24 million of debt maturities over the next 12 months;
- A €4 million dividend to be paid in June 2023; and
- Annual capital expenditure of €30 million-€35 million.

Covenants

There is significant headroom for Conexus not to breach covenants over the next two years. They consist of:

- Net debt to EBITDA below 5x.
- A debt service coverage ratio greater than 1.2x; and
- Shareholder's equity ratio exceeding 50%.

Environmental, Social, And Governance

ESG credit indicators: E-3; S-2; G-2

Environmental factors are a moderately negative consideration in our credit analysis of Conexus. Similar to other gas utilities, we view the company's exposure to gas as moderately negative considering the recent geopolitical development in Ukraine and the European pressure to reduce dependence on gas. However, we view Conexus as well placed to mitigate the pressure as the Baltics stopped receiving Russian gas on April 1, 2022, turning toward the U.S. and the imports of liquefied natural gas (LNG) through Lithuania's LNG platform.

Ratings Score Snapshot

Issuer Credit Rating: BBB+/Stable/--

Business risk: Strong

- Country risk: Intermediate
- Industry risk: Very low
- Competitive position: Satisfactory

Financial risk: Aggressive

- Cash flow/Leverage: Significant (medial volatility table)

Anchor: bb+

Modifiers:

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Positive (+1 notch)

Stand-alone credit profile: bbb-

- Group credit profile: a-
- Entity status within group: Strategically important (+2 notches)

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
- 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 | General: Corporate Methodology, 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: 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

- Latvian Transmission Operator AST Upgraded To 'A-' On Improving Liquidity; Outlook Stable, Nov. 12, 2021
- Augstsprieguma Tikls, Feb. 17, 2022

Ratings List

New Rating	
JSC Conexus Baltic Grid	
Issuer Credit Rating	BBB+/Stable/--