Spotlight: Fortum's Exposure to Gas Market Disruption

Company Ready to Face Challenges; Only Extreme Scenarios Would Threaten Rating

> "Fortum's positive 2021 results, with very low net leverage, put the company in a strong position to face fresh uncertainties in the energy markets. The group is highly exposed to Russian gas but would only suffer rating pressure under the extreme scenario that all Russian gas supply stops and there is no government intervention."
>
> Fitch Ratings

Russia's invasion of Ukraine poses several uncertainties for Fortum Oyj (BBB/Stable), especially related to the company's Russian business and the gas supply activity of subsidiary Uniper, which is heavily dependent on Russian gas supply. However, the company has strengthened materially its balance sheet in the last 18 months and is well-positioned to face the challenges.

Fitch Ratings therefore believes that Fortum can preserve its 'BBB' rating, unless Russian gas flow stops completely and there is no government action to regulate the gas business. We see the combination of the two things as very unlikely as of now.

High Exposure to Russian Gas, Moderate Operations in Russia

Both Fortum and Uniper have moderate exposure to assets in Russia. Russian business represented around 20% of group EBITDA until 2021. We will deconsolidate this business going forward since we believe it will no longer be strategic for the group, regardless of potential access to cash.

This implies slightly worse credit ratios but potentially higher debt capacity, since the Russian business was one of the riskiest activities of the group.

The group is also heavily exposed to Russian gas supply through Uniper, which we see as the key threat to the rating currently. However, our base case assumes that the supply will reduce in line with EU targets but not stop completely. Even if supply were to completely stop, we would expect government intervention to protect the companies from huge losses.

Based on our simulations, Fortum could preserve its rating even assuming no or a very low EBITDA contribution from Uniper for around two years.

Strong Financial Structure, Rapid Action on Liquidity

Fortum posted very strong results in 2021, which translated into robust funds from operations (FFO) and free cash flow (FCF) generation of EUR3.0 billion and EUR2.5 billion, respectively. This has been coupled with disposal proceeds of around EUR4 billion from divestments of non-core assets.

These developments were materially better than our previous rating-case expectations, resulting in FFO net leverage of 1.1x in 2021, compared to a negative rating sensitivity of 3.0x. This large headroom is a key consideration for the lack of rating action.

Related Research

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Increased Russian Gas Supply Risks Put Pressure on EU Utilities (March 2022)

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Moderate Exposure to Russian Assets

Fortum has moderate exposure to assets in Russia, both directly and through its subsidiary Uniper. The company reported net assets in Russia with a book value of EUR5.5 billion as of end-2021. This includes a loan from Uniper to Nord Stream 2 AG for around EUR1 billion, which the company has decided to fully write off.

Russian activities generated about 20% of the group's consolidated EBITDA until 2021; a contribution that was visible and predictable due to capacity payment mechanisms. However, the group's Russian activities are heavily focused on thermal generation, conflicting with Fortum's strategic focus on the transition to low-carbon energy. Russian activities also had a lower debt capacity compared with the rest of the group (around 2.0x, compared with the 3.0x FFO net leverage negative sensitivity applied to the entire group).

Both Fortum and Uniper have stated that they will not make any new investments in Russia and will not transfer money to Russian subsidiaries until further notice.

Fitch, in assessing Fortum's rating, will now deconsolidate the Russian business from the group's financials and credit ratios, to reflect the crisis and because Fitch believes that such activities will no longer be strategic for the group, regardless of the future political scenarios.

Under our previous rating case (a 'normal' FX scenario), this would imply deconsolidation of around EUR600 million of EBITDA on average through the rating horizon and EUR100 million of capex, while debt deconsolidation would be negligible. Such deconsolidation would negatively affect credit ratios but could be positive for the group's business profile due to the higher risks of the deconsolidated activities, despite the reduction in geographical diversification.

Disruption Has Far-Reaching Implications

Assuming deconsolidation of the Russian business, in the short term the key risk for the group is related to the gas supply and midstream business of Uniper. The company has a very large amount of long-term gas import contracts – 370 terrawatt hours (TWh)/year – of which Gazprom represents around 200TWh/year.

Uniper has announced that it will not enter into new long-term gas contracts with Russian suppliers but will while continue with existing long-term gas import contracts from Russia to secure supply.

For the time being, gas is flowing normally from Russia, which should allow the group to post good results in 1Q22 after a very strong 2021.

We see two potential scenarios for remainder of 2022. In the first, Russian gas flows normally but the EU tries to minimise its use of such supply, consistent with its target of reducing Russian gas imports by two thirds in one year.

In the second scenario, Russian gas stops flowing completely as a consequence of sanctions or counter-sanctions.

The first scenario is our current base case. This would be very challenging for Uniper but would also bring some opportunities, since the reduction of Russian supplies would need to be replaced by other gas sources, biomethane and – to the extent possible – by hydrogen projects. In this respect, Uniper has recently resumed its plans to build a liquefied natural gas (LNG) terminal in Wilhelmshaven, Germany, and is one of the key European participants in the hydrogen value chain.

Although it is very difficult to estimate Uniper's EBITDA under this base scenario, we do not expect the group's rating to be at risk in this situation.

In fact, based on our simulations, even assuming a consolidated EBITDA of EUR1.5 billion for the entire Fortum group for 2022-2023 (essentially cutting entirely Uniper's contribution) and with the very conservative assumption of unchanged capex and dividends, FFO net leverage would remain well below our rating sensitivity of 3.0x.

The second scenario would put Uniper and other key gas suppliers in the EU in an unprecedented situation. It is not clear at this stage whether such a situation would trigger a force majeure application for some or all of Uniper's supply contracts. In the event of force majeure, the company would not be legally obliged to continue supply, meaning some other public entity would have to step in to ensure security of supply.

However, even in the absence of a force majeure trigger, Uniper has stated that it expects the trigger of a state of emergency under the German legal framework, with the German regulator Federal Network Agency (BNetzA) stepping in as the emergency authority for demand-side oversight and intervention, in coordination with and monitored by EU authorities. In this scenario, Uniper would be released from its obligation to procure substituting gas volumes in the market but would lose its supply margins, in our view.

All in all, the scenario of Uniper bearing the losses to substitute Russian gas through purchases in the spot market seems unlikely, and we see this scenario as the only one that would drive a downgrade, based on current knowledge.

We agree with the company's expectation that governments would intervene and that the EU would need to show coordinated action in such a scenario. It is unlikely that the burden would be entirely left on gas utilities, especially as they are now investing in making Europe less dependent on Russian gas; one of EU's strategic aims.

Finally, the group has some intrinsic hedging, especially related to hydro and nuclear electricity generation, which should benefit from strong prices. Uniper will likely experience some disruption for a couple of years but the company should find medium-term opportunities across all businesses related to Russian gas substitution (mainly LNG, storage, biomethane, hydrogen, energy efficiency), even if the execution risk of such a transition would be material and capex-intensive, in our view.

Proactive Approach to Liquidity

Surging commodity prices in 2021 triggered very high margin requirements from Fortum's commodity hedging activities, creating a liquidity need of EUR 7.4 billion. Fortum has proactively managed such margin payments, resorting to short-term financial debt (which increased by EUR5.4 billion in 2021), and using its own cash resources based on robust operating cash flow. Fortum secured EUR5 billion of revolving credit facilities (RCFs) in January 2022, which remain unused as of mid-March.

Considering the above factors, Fitch assesses Fortum's liquidity position as adequate, with short-term debt comfortably covered by available sources of liquidity. In addition, we consider the net margining assets as largely liquid, since these cash collaterals have to be returned to the company once hedges expire. We expect a substantial cash inflow of EUR4.5 billion-5.0 billion in 2022, resulting from the settlement of margin receivables. In addition, the company is increasingly moving its hedging positions to non-margining counterparties to avoid further liquidity constrains, although the switch mostly relates to industrial counterparties since financial institutions largely trade using margining and collaterals.

Liquidity Analysis

Liquidity at end-2021	(EURm)
Liquid funds	7,545
Available committed credit lines	400
Short-term financial debt	-8,389
Additional credit facilities signed in early 2022	**5,000**
Uniper RCF maturing in April 2022	2,000
Fortum RCF maturing in April 2022 with one three-month extension option	3,000
Net margining assets at end-2021	**8,178**
Total cash inflow expected in 2022	**4,500-5,000**

Source: Fitch Ratings

Very Low Leverage, Good 2021 Performance

Fortum's 2021 results reflect outperformance in its clean-generation business and Uniper's global commodities segment, both gaining from soaring energy commodity prices. Fortum's strong profits in its clean-generation business reflects higher power prices and record-high nuclear and higher hydro volumes. Uniper's higher earnings in its commodity trading business relate to its international portfolio, with greater demand for LNG in Asia and sales of gas and electricity at high price levels in the US.

The exceptionally strong performance also translated into robust FFO and FCF generation of EUR3.0 billion and EUR2.5 billion respectively. Uniper has also recorded substantial disposal proceeds (EUR4 billion) from its divestments of non-core district heating (DH) assets (including the 50% shareholding in Stockholm Exergi and the DH business in the Baltics), while it has cancelled its strategic reviews of the Polish DH business and consumer solution business.

Fortum's FFO net leverage decreased to 1.1x in 2021; demonstrating strong deleveraging versus 2020 (2.7x).

Fortum – Net Debt Calculations

(EURm)	2020[a]	2021
Interest-bearing liabilities (as reported)	10,662	17,220
Excluding lease debt	-1,055	-1,075
Margining liabilities[b]	331	985
Gross debt (Fitch-adjusted)	**9,938**	**17,130**
Liquid funds	-2,308	-7,545
Collateral arrangement securities	-432	-549
Margining receivables[b]	-1,131	-5,485
Net debt (Fitch-adjusted)	**6,067**	**3,538**
FFO	**2,134**	**3,011**
FFO net leverage (x)	**2.7**	**1.1**

[a] Fortum consolidated Uniper into its financial statements as of 31 March 2020, i.e. in Fortum's 1Q20 figures Uniper was still included as an associated company.
[b] Fitch treats Fortum's margining asset and liabilities as cash and financial debt, respectively. For 2021 we only consider 60% of the EUR8bn margin receivable as liquid (i.e. to be cashed-in earlier than 12 months)
Source: Fitch Ratings

High Prices Beneficial for Hydro, Nuclear Asset Base

We believe that Fortum's clean generation activity helps strengthen group EBITDA during extreme volatility. This division reported EBITDA of around EUR900 million in 2020, rising to around EUR1.3 billion in 2021, with the increase mainly due to higher achieved prices (EUR42.8/megawatt hour (MWh) versus EUR34.8/MWh in 2020), and generation volumes (46.8TWh versus 43.3TWh in 2020).

At end-2020 the company indicated that it had sold 75% of its 2021 outright production at EUR33/MWh, so moderately benefitted from the healthy spot market in 2021, having worked on the physical optimisation of volumes.

We believe the possibility of achieving EBITDA of EUR1.0 billion-1.5 billion from Nordics clean generation under moderate prices is a key strength because such activity does not expose the company to clawback risks due to excess profits.

For 2022, Fortum has currently hedged 75% the outright production at EUR34/MWh, so is in a very similar situation and we expect the division to achieve a similar level of EBITDA compared to 2021. For 2023, Fortum has hedged 50% of outright production at EUR31/MWh.

The long-awaited commissioning of the Olkiluoto 3 nuclear plant in Finland could have a negative impact on spot market prices. However, the company expects that external interconnectors of the entire Nordics electricity area will reach 13GW by summer 2024, from 8.2GW in 2021, opening new export opportunities for its utilities, including in Finland.

The company has recently decided to apply for a new operating licence for both units at the Loviisa nuclear power plant until the end of 2050. The plant provided 10% of Finland's electricity generation in 2021. Fortum estimates that capex until 2050 will be around EUR1 billion, with cumulative electricity generation of up to 170TWh.

Decreasing Long-Term Coal Exposure Confirmed

Fortum had direct carbon dioxide (CO_2) emissions of 68.7 million tonnes in 2021, of which 57% originated from Russian power and heat production while 42% were within the EU and UK emissions trading system (ETS).

Fortum is committed to becoming carbon-neutral in European generation by 2035, and in all group operations (i.e. including Russia) by 2050. Based on its decarbonisation commitment, Uniper aims to end coal-fired power generation in the UK by 2024, in the Netherlands by 2029, and in Germany by 2038.

Fortum's power generation capacity of 47GW in 2021 included a coal fleet capacity of 9GW (7GW excluding Russia), of which 8GW belong to Uniper. Fortum aims to rapidly reduce the share of coal in its power generation, while Uniper aims to exit coal-fired generation in Europe and develop new business on those sites.

The German government's coalition deal had aimed to accelerate the phase-out of coal to 2030 from 2038. However, Russia's invasion of Ukraine now means now means that ensuring supply for the coming winter and subsequent years has become the absolute priority of European countries. The German Chancellor has pledged to diversify the country's energy needs away from Russian gas (currently representing around half 50% of total supply), while the EU aims to reduce Russian gas imports by two thirds before the end of the year.

We believe it is plausible that Germany can partially replace Russian gas with coal in the short term. For instance, RWE AG (BBB+/Stable) announced in its 4Q21 earnings call in March 2022 that it is reviewing coal-fired power units that have been shut down or are due to be decommissioned.

Uniper commissioned its Datteln 4 coal-fired power plant at the end of May 2020, which led to a significant increase in power-generation volumes in its European generation segment in 2021. Uniper currently expects to operate the plant until 2038, although this is subject to permitting risk since its development plan was declared invalid by the Higher Administrative Court, without allowing for an appeal. The court decision is not yet legally binding.

We see the potential return of coal-fired generation in Germany as only a short-term effect and we do not expect material upside from this for Fortum and Uniper. We expect both companies to maintain their strategic focus on achieving their climate targets.

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