Uniper Downgraded To 'BBB-' On Exposure To Russia, Fortum Affirmed At 'BBB'; Outlooks On Both Negative

May 16, 2022

(Editor's Note: On May 17, 2022, we republished this article, previously published May 16, 2022, to include sections that were omitted due to a technical issue. The corrected version follows.)

- Uniper procures more than 50% of its gas from long-term contracts with Gazprom, and its above-average exposure to Russia is weakening its business profile, especially since Russia's recent decree forcing purchasers to pay in rubles shows that the trading relationship is subject to unilateral changes.
- In addition, Uniper's Russia-based power generation subsidiary Unipro is currently subject to capital control mechanisms that could prevent Uniper from repatriating cash from Russia.
- We believe structural changes to the market in the medium to long term imply more volatile gas prices; pressure on operating margins; increased working capital requirements; and, weaker demand. We also expect net margin collateral requirements, already at €4.5 billion as of March 30, 2022, versus €290 million on March 30, 2021, will continue to challenge liquidity management.
- Because Uniper represents about 50% of Fortum's consolidated EBITDA, we view Fortum group's net business strength as having declined; we assume Fortum will divest its Russian activities, although the details and timing of a potential transaction remain uncertain. For now, the consolidated business risk profile remains satisfactory, but we will monitor Fortum's asset portfolio and capital allocation in the coming months, and potentially reassess it if we believe the group's actions do not mitigate business risks.
- We have therefore lowered our rating on Uniper to 'BBB-' from 'BBB' and affirmed our 'BBB/A-2' ratings on Fortum.
- We benchmark Uniper's 'bbb-' stand-alone credit profile (SACP) against funds from operations (FFO) to debt of 45%. We have revised our FFO to debt threshold for Fortum to above 40% from 35%, reflecting increased business risk. Both benchmarks could be subject to revision depending on the evolution of each entity's asset base.
- The negative outlooks on Uniper and Fortum reflect our view that the risk of significant gas market disruptions will not dissipate in the short term. In addition, we regard the long-term earnings visibility of Uniper's asset portfolio as weakening, and that the current market and geopolitical conditions expose Uniper's business position to significant risks. For Fortum, we also see a risk that credit ratios could deteriorate, mainly due to potential funding needs at

Uniper. In addition, we lack clarity on Fortum's long-term business mix.

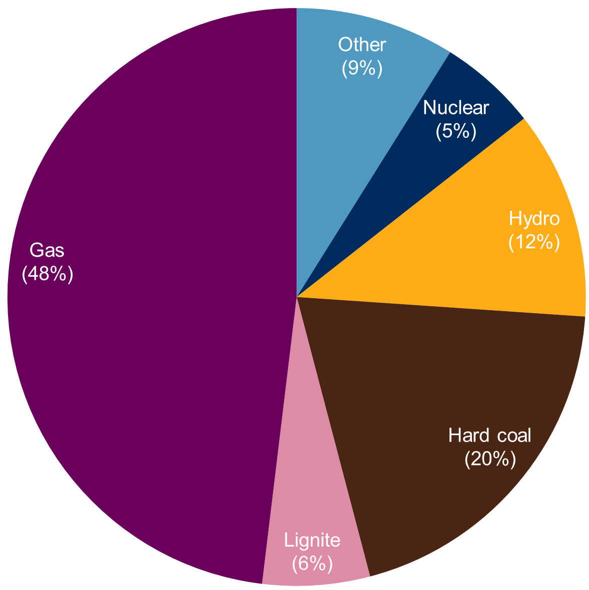
NEW YORK (S&P Global Ratings) May 16, 2022--S&P Global Ratings today said it has lowered its long-term rating on Uniper SE to 'BBB-' from 'BBB'. It also affirmed its 'BBB/A-2' long- and short-term ratings on Fortum Oyj. The outlooks on both entities are negative.

The ratings on both entities were removed from CreditWatch with negative implications, where they were placed on March 14.

We believe Uniper's business risk profile has weakened as a result of the ongoing Russian-Ukraine conflict, leading to a one-notch downgrade. We see exposure to Gazprom as material and one of Uniper's weakest business links, since the contractual relationship between Gazprom and its trading partners is subject to unilateral changes, which could compromise gas supply. Gazprom provides about 200 terrawatt hours (TWh) of Uniper's 370 TWh of yearly gas procurement under long-term contracts, most of which are binding until at least 2030, and we believe the Russia-Ukraine conflict will make renegotiating or terminating contracts more complex, in the context of Europe's intention to reduce its gas exposure to Russia. We estimate Uniper's direct exposure to Russia at about 30% of EBITDA, which is significantly larger than for peers such as EnBW or Engie, which are also to some degree exposed to Russia, albeit with no direct presence in the country. We don't envisage a scenario where the status before the conflict is restored, in view of Europe's stated vulnerability to an interruption of Russian gas flows. We therefore expect a structural shift in the European gas market, where supply from Russia will decline over the medium term, forcing Uniper to find other procurement sources while most likely also facing a decline in demand. In addition, because of capital control mechanisms imposed by Russia, Uniper is currently restricted from repatriating cash from its Russia-based subsidiary Unipro. During the first quarter of 2022, Uniper wrote down to zero the €405 million goodwill on its Russian power generation assets, and impaired non-current assets by €466 million. We believe these impairments reflect increasing risks related to these assets. Uniper also wrote off the principal and accrued interest of about €1 billion on a loan granted to Nord Stream 2.

The ongoing energy crisis raises questions about Uniper's long-term strategy, which we capture in our negative outlook. We believe Uniper's 31.6 gigawatt (GW) power generation portfolio is unfavorably positioned, since close to 65% of its gross capacity (excluding the Russian assets) corresponds to thermal generation, which will run on scarcer, more expensive coal and gas. This may make it more difficult for the company to lock in margins, thereby likely introducing earnings volatility. An additional concern is that, in the current environment, the timeframe for Uniper to phase out its German coal capacity is uncertain, which in our view makes accelerating portfolio transformation more difficult in the short term. As the ongoing crisis evolves, we cannot rule out the possibility that the German government may put coal exit tenders on hold, or request recently retired plants to re-open, depending on security-of-energy-supply considerations. That said, we recognize that Uniper's assets will remain critical for Germany's large and energy-intensive industries, and that Uniper intends to stick to its intended phase-out schedule.

Uniper's Installed Capacity By Technology
As of March 30, 2022



Source: Uniper. S&P Global Ratings.

Since Uniper represents about 50% of Fortum group, we believe the weakening of Uniper's business risk profile also weighs on Fortum. We reflect this by revising the rating threshold of FFO to debt to 40% from 35%. In our view, Fortum group's remaining assets are robust, since we believe that Fortum's Nordic fossil-free generation portfolio (including hydro and nuclear) is reliable and well placed on the merit order, and should generate sound cash flows. Fortum's hydropower plants generate about 15 TWh in the Nordics, and nuclear almost 11 TWh. Additionally, we believe that Fortum's stake (25.8%) in Teollisuuden Voima Oj (TVO), with its nuclear power plant OL3 carrying 1,600 megawatts of installed capacity, would support cash flows when the plant starts regular electricity production, currently expected in September. Fortum is the offtaker of TVO's electricity output in proportion of the cost of production, in accordance with the Finnish "mankala" approach.

In our view, Fortum's intention to exit Russia could partly mitigate pressure on its credit quality but we lack details on the execution of a potential transaction. In 2021, Russia-based assets, including Unipro, represented almost €750 million of Fortum's EBITDA or about 20% of the group's reported comparable EBITDA. Divesting the Russian operations would likely partly offset the group's deteriorating business quality. This would depend on the specifics of a potential divestment and, importantly, the reallocation of capital. We also believe Fortum and Uniper will have difficulty in agreeing favorable deals, since we expect demand for such assets will be limited given their location and Russia's capital control mechanisms, which reduce the pool of potential buyers significantly. Fortum's Russian asset base, including Unipro, is sizable and a material part of the group's consolidated operations. It consists of 15.5 GW of electricity capacity and 10.2 GW of heat capacity. In 2021, the Russian assets generated about 19 TWh of heat, and about 72 TWh of electricity, which represented almost 40% of Fortum group's total generation of 188 TWh that year. We understand Fortum intends to divest 4.7 GW of thermal generation capacity and 7.6 GW of heat capacity in Russia (excluding Unipro). A potential transaction would also need to comply with current sanctions, which could cause delays, or lock any proceeds received for the assets in Russia. Disposal of the Russian assets could lead us to revise our financial thresholds for the current ratings if it comes with clarity on the long-term prospects for Fortum group's business mix.

The German government appears willing to support system-relevant companies within the energy sector, including Uniper, but only in an extreme scenario. We believe Germany is making significant progress in preparing to absorb a sudden stop of Russian gas. Our opinion is reinforced by the proposed revision to the Energy Security Act ("Energiesicherungsgesetz"), which was passed at the Bundestag on May 13, 2022, and is expected to take effect by June 1, 2022, once approved by the Bundesrat. This law would provide a mechanism for gas suppliers to transfer incremental gas procurement costs to end customers, provided that the second or third level of the German Gas Emergency Plan is activated. We understand this mechanism should mitigate part, if not all, of gas suppliers' exposure to higher re-procurement costs. In addition, we consider that the government would be ready to provide some degree of focused support to a part of Uniper's business to keep its operations going and avoid systemic risk to the industrial sector. However, we don't believe the government has a commitment to support our current rating on Uniper. The government has already demonstrated support for Uniper through a €2 billion liquidity line from KfW. As such, we expect Uniper will have sufficient government credit lines available. This alleviates our concerns about short-term liquidity, particularly since Uniper may need to post additional margin collateral and fund working capital cash outflows to fill its storage facilities under Germany's new gas-storage regulation (although the ultimate obligation is with Trading Hub Europe). We do not treat Uniper as a government-related entity (GRE) because the government support is currently limited to liquidity lines, which we account for in our rating on an ongoing basis. An additional reason not to treat Uniper as a GRE is that we believe the revised Energy Security Act aims to allow the market to continue functioning and thereby minimize the need for systemic financial support, with direct equity support and active management only being considered as an optional last resort. This reduces the likelihood of direct government intervention, in our view.

We expect larger liquidity needs for Uniper over 2022, which we believe the wider Fortum group will help it cover. On April 8, 2022, the German government approved the Gas Storage Act ("Gasspeichergesetz"), which aims to ensure that gas storage is at 80% as of Oct. 1, 90% as of Nov. 1, and 40% as of Feb. 1, starting this year. As a result of the new law and higher prices than in 2021, we expect Uniper's working capital outflows to increase significantly compared with last year as it purchases gas to fill its 5.6 billion cubic meters (bcm) of storage capacity in Germany. However, we note that the ultimate obligation to fill gas storage capacities lies with the gas system operator Trading Hub Europe. Operators, such as Uniper, fill their storage capacity on market-based principles (summer-winter spread) and have an additional incentive to do so via tenders. Therefore, we don't expect Uniper to compromise its financial position as a result of this bill. In addition, the downgrade of Uniper will result in the need for significant additional margin collateral. We expect Uniper will continue posting higher initial margin collateral; however, we forecast that the unwinding of variation margins on settled positions will result in a net cash inflow over the next year. Furthermore, we believe the German government will continue providing liquidity support if needed. We forecast Uniper's liquidity sources to uses will be at least 1.2x over the next 12 months. We also believe that Fortum will continue to support Uniper's liquidity if needed, based on the €8 billion of liquidity lines put in place in December 2021. In addition, we view Fortum's recent success in securing short-term facilities in the capital market as positive. Since the group's liquidity needs have increased, we expect Fortum to pursue the extension of its €1.75 billion revolving credit facility, which matures in June 2023.

For the wider Fortum group (including Uniper), the implications of a partial or full interruption of Russian gas supply go beyond the EBITDA generated from the sale of Russian gas. In our current base case, we assume that Russian gas will continue flowing to Germany, implying that gas payments in May from German suppliers will be commensurate with outstanding European sanctions on Russia and with Russia's requirements. If this does not materialize, it could affect our ratings on Uniper and Fortum. Germany imported about 55 bcm of its 100 bcm gas needs from Russia in 2021. In the first quarter of 2022, the share of gas from Russia declined to 40% of total gas imports from 55% the previous year, and Germany intends to reduce this further, to 30% by the end of 2022. Notwithstanding this trend, if gas flows are interrupted in the short term, there are no viable sources to fully replace gas from Russia, such as alternative gas or liquefied natural gas suppliers. This means that gas curtailment would lead to extreme price volatility and wide imbalances between gas demand and supply. This will likely trigger the third step in Germany's emergency plan for gas, which states that under such circumstances the German regulator (BNetzA) would have to step in to control demand and supply. We understand that, when this happens, all operators would be relieved from their contractual obligations to deliver gas, since the regulator decides the priority of gas delivery. A significant share of Uniper's gas delivery contracts are subject to margining payments until the moment of physical delivery. Under a gas-curtailment scenario, the timing and circumstances under which Uniper would be able to recover such margin positions, which we understand stood at €4.5 billion (across all commodities), on a net basis, on March 30, 2022, are unclear to us. Beyond liquidity risks, which we believe are diminishing as margins gradually flow back, and because government support has already been provided through liquidity lines, we consider that Uniper would have to record a significant financial loss if it is unable to recover such positions. An additional source of concern is that such margins are partly financed with debt, either on Uniper's own books or Fortum's. Even if there is a legal case to recover such margins, the timing would also be relevant for Uniper's liquidity position. We see Uniper as more exposed than the rest of the sector because of the size of these positions relative to its balance sheet, although we acknowledge that other utility companies are similarly exposed to contracts subject to margin calls.

Outlook

The negative outlooks on Fortum and Uniper reflect our view that the risks in the European gas market resulting from the ongoing Russia-Ukraine war are unlikely to recede in the short term. We still believe that the risk of a cut of Russian gas flow, and related financial ramifications, are difficult to quantify, given the significant size of Uniper's operations, and extremely volatile gas prices.

Downside scenario

We expect to maintain negative rating outlooks until these geopolitical uncertainties have dissipated. Any major disruption of gas supply in Europe would result in immediate pressure on the ratings, but the ultimate impact would depend on measures put in place by both companies or their respective governments, to mitigate the risks.

We would lower our ratings if Fortum's FFO to debt fails to remain above 40% and Uniper's FFO to debt above 45%. However, we could revise both ratio thresholds in the short term, depending on our reassessment of the relative strength of each entity's business risk profile as it evolves.

Because we assess Uniper as a core subsidiary of Fortum, we equalize our rating on Uniper with our assessment of Fortum's SACP, if Uniper's SACP is at the same level as Fortum's or lower. If Uniper's SACP is higher than Fortum's, we cap the rating on Uniper at that on Fortum, which includes an uplift for support from the Finnish government. Therefore, a downgrade of Uniper would only follow a downward revision of our SACP assessment, in conjunction with a similar action on Fortum's SACP.

Company Description

Fortum: Fortum is the third largest power generator in Europe and Russia, with about 50 GW of installed capacity. In 2021, Fortum reported EBITDA of €3,817 million. The company was founded in 1998 and is headquartered in Espoo, Finland. As of Dec. 31, 2020, the main shareholder is the Finnish government, with 50.76% of the share capital. Fortum has about 8,000 employees, and about 20,000 including Uniper before the announcement that it plans to divest its Russian assets. In addition to its strong position in generation, Fortum is the third largest carbon dioxide (CO_2)-free generator in Europe because of its zero-to-low CO_2-emission fleet, with 45% of its generation assets being CO_2-free. Fortum engages in the generation and sale of electricity and heat in the Nordic countries, Poland, and Central Europe. It operates under five segments: Generation (34% of 2021 EBITDA), City Solutions (8%), Consumer Solutions (3%), Russia (10%), and Uniper (45%). Fortum owned 78.0% of Uniper as of Dec. 31, 2021, increased from 76.1% at the end of 2021.

Uniper: Uniper is an international, diversified energy company that operates in more than 40 countries and has about 11,500 employees. Its operations include power generation, commodity trading, energy storage, energy sales, and energy services. Its core markets are Germany, Russia, the U.K., Sweden, the Netherlands, and North America. The company owns and operates a well-diversified power generation portfolio, including facilities running on fossil fuels such as gas (15.2 GW as of Dec. 31, 2021), coal (8.2 GW), hydroelectric (3.7 GW), Swedish nuclear (1.7 GW), and other (2.8 GW). It has a total generation capacity of 31.6 GW, of which one-third is in Russia. In 2021, Uniper produced 109.1 TWh of electricity, of which 54% stemmed from gas and 24% from carbon-free hydroelectric and nuclear generation. Uniper was created in 2016 from the spinoff of the gas and power activities of E.ON SE. Fortum owns about 78% of Uniper.

Liquidity

We view the consolidated Fortum group's liquidity as adequate. This is based on our estimate that its liquidity resources, including cash, FFO, and facility availability, will cover expected cash outflow by more than 1.3x in the 12 months started Jan. 1, 2022.

Fortum's liquidity, as of Dec. 31, 2021, remains supported by the group's access to capital markets and sound relationships with lenders, which was demonstrated over December 2021-January 2022 with the signing of new bank facilities at short notice. Moreover, alongside long-term credit lines, Fortum has access to shorter-term credit facilities, and its debt documents do not contain any financial covenants.

In our liquidity calculation, we include Uniper's KfW line of €2 billion, since the main liquidity need is at Uniper. The KfW line matures by end of April 2023, and there are strong indications that it will be extended given the purpose for which it was put in place.

Principal liquidity sources of the group as of Dec. 31, 2021:

- Our estimate of cash and cash equivalents of about €6.9 billion;
- Access to €2.9 billion of undrawn facilities maturing after 12 months (including Uniper's €2 billion KfW facility);
- Positive cash FFO, which we estimate will near €2.3 billion in the next 12 months;
- Working capital inflows from confirmed unwinding of variation margins of €2.6 billion; and
- Asset sale proceeds of about €1.1 billion related to Fortum Oslo Varme AS.

Principal liquidity uses for the group as of the same date:

- About €5.4 billion of debt maturing in the next 12 months;
- Capital expenditure of about €1.5 billion;
- Working capital outflow of about €4 billion; and
- Dividends of about €1 billion in the next 12 months.

Ratings Score Snapshot

	Fortum	Uniper
Issuer Credit Rating	BBB/Negative/A-2	BBB-/Negative/--
Business risk:	Satisfactory	Fair
Country risk	Low	Low
Industry risk	Moderately high	Moderately high
Competitive position	Satisfactory	Fair
Financial risk:	Intermediate	Modest
Cash flow/leverage	Intermediate	Modest
Anchor	bbb-	bbb-
Modifiers:		
Diversification/Portfolio effect	Neutral (no impact)	Neutral (no impact)
Capital structure	Neutral (no impact)	Neutral (no impact)
Financial policy	Neutral (no impact)	Neutral (no impact)
Liquidity	Adequate (no impact)	Adequate (no impact)

	Fortum	Uniper
Management and governance	Fair (no impact)	Fair (no impact)
Comparable rating analysis	Neutral	Neutral
Stand-alone credit profile:	bbb-	bbb-
Group credit profile	bbb-	bbb-
Entity status within group		Core
Related government rating	AA+	Not applicable
Likelihood of government support	Moderate (+1 notch from SACP)	Not applicable

ESG credit indicators

- Fortum: E-4, S-2, G-3
- Uniper: E-4, S-2, G-3

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: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- 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
- Criteria | Corporates | Industrials: Key Credit Factors For The Unregulated Power And Gas Industry, March 28, 2014
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, 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

Ratings List

Downgraded; CreditWatch/Outlook Action

	To	From
Uniper SE		
Issuer Credit Rating	BBB-/Negative/--	BBB/Watch Neg/--
Senior Unsecured	bbb-	bbb
Ratings Affirmed; CreditWatch/Outlook Action		
Fortum Oyj		
Issuer Credit Rating	BBB/Negative/A-2	BBB/Watch Neg/A-2
Senior Unsecured	BBB	BBB/Watch Neg