



Moody's Investors Service

Rating Action: **Moody's assigns Ba2 rating to Lenenergo; outlook stable**

Global Credit Research - 18 Nov 2009

London, 18 November 2009 -- Moody's Investors Service has today assigned a Ba2 corporate family rating (CFR) to JSC Lenenergo ("Lenenergo"), the Russian electricity distribution grid business focusing on the St. Petersburg region. The rating outlook is stable. At the same time, Moody's Interfax Rating Agency, which is majority owned by Moody's, assigned a Aa2.ru national scale credit rating ("NSR") to the company.

According to Moody's and Moody's Interfax ("Moody's"), the Ba2 global scale rating reflects the company's global default and loss expectation, while the Aa2.ru NSR reflects the standing of the company's credit quality relative to its domestic peers.

Moody's notes that Lenenergo's Ba2/Aa2.ru ratings incorporate: (i) the higher risk of the company's regulated grid monopoly business in Russia compared to the generally low business risk profiles of its peers in developed markets; (ii) the company's financial profile and liquidity, which are challenged by its large investment programme; and (iii) some degree of shareholder/state support available to the company given its advantageous shareholder structure and its strategic role in the economy of the St. Petersburg region, one of the wealthiest regions in Russia. The company's higher business risk is attributed to the developing regulation and framework of the Russian power sector and, more broadly, to the country's immature business environment.

Lenenergo's ratings positively reflect its position as the monopoly distribution grid business in the St. Petersburg region, which is highly populated, strategically important and demonstrates a lower-than-average reduction in electricity demand in the 2009 crisis environment, whilst remaining one of the regions that will be the first to benefit from a future economic recovery. The ratings also take into account some level of support from MRSK-Holding, the state-related controlling shareholder of Lenenergo, and from the government of the city of St. Petersburg (rated Baa2/stable), the second-largest shareholder owning a blocking stake. Also, the rating reflects the relatively supportive tariff regulation, which recognises the importance of Lenenergo's business for regional development, with the expected introduction in the short term of a RAB (Regulatory Asset Base)-based regulation which is expected to lead to tariff increases in order to support the company's ability to invest in its asset base. More broadly, the RAB-based regulation should contribute to the transparency and stability of the tariff regulation framework. Lastly, the ratings reflect additional opportunities to support margins and cash flow generation based on connection charges, until the RAB-based regulation is implemented.

However, Moody's notes that Lenenergo's ratings are constrained by the company's exposure to the developing Russian distribution grid sub-sector regulation, as well as some uncertainties surrounding the sub-sector consolidation under the MRSK-Holding management. The ratings are also constrained by additional risks from Russia's immature operating environment and the company's large investment programme to increase capacity and renovate its significantly outdated assets, which will drive the company's leverage up and expose it to material execution risks. Furthermore, another rating constraint is the risk that pressure on the company's liquidity may increase in the still tight financial markets due to its limited flexibility in delaying investments and large external funding needs.

Moody's notes that the new RAB-based regulation has yet to be fully introduced and that it will take several years before the independence of the economic regulation from political interference in Russia and its fairness and predictability can be tested. However, Moody's has also considered that, due to Lenenergo's strategic importance to the region, the regulatory authorities are likely to continue to be responsive to the company's large investment needs, particularly in the upcoming period of transition towards the new tariff regulation. Indeed, in 2005, the authorities decided to introduce connection charges mainly for new and expanding businesses, which created an additional revenue source that is less politically sensitive compared to common transmission revenue. Accordingly, despite uncertainties surrounding the introduction and parameters of the new RAB-based regulation for the company, Moody's currently does not expect the upcoming introduction of the regulation to weaken the company's operating cash flow compared to the current cost-plus-based regulation. However, the agency remains concerned about whether the new regulation can reasonably strengthen Lenenergo's cash flow generation and hence about the company's

ability to finance its investments without raising a substantial amount of debt in the short to intermediate term. In the current weak economic environment, a sustainable high level of growth in tariffs may not be implemented, given the high political sensitivity of such increases.

If fully implemented, Lenenergo's ambitious 2009-2011 investment programme of approximately RUB55 billion will result in the company becoming increasingly free cash flow negative. Lenenergo will thus need to achieve sustainable cash flow growth to limit the deterioration in its financial profile. The company's 2008 interest and debt coverage metrics were relatively strong, with FFO/Interest and FFO/Net Debt at 8.0x and 69.3%, respectively, factoring in sizeable cash inflow from connection charges. Moody's notes that this inflow from connection charges has been severely affected in the current economic environment and is expected, in any case, to decrease gradually going forward following the introduction of the RAB-based regulation.

Moody's has factored into Lenenergo's ratings the expectation of deterioration in the company's credit metrics compared to the levels achieved in 2008 due to its investment programme, which could leave the company with a limited cushion within its rating category. However, Moody's expects Lenenergo to be able to limit any deterioration of its financial profile within this rating category, based on the support from its major shareholders, the state-controlled MRSK-Holding and the government of St. Petersburg. Both shareholders are expected to be able to (i) help the company adjust its investment plans to available funding and reasonably prudent leverage targets, and (ii) facilitate its access to external funding to retain an appropriate liquidity profile. Moody's factors a one-notch uplift into the company's Ba2 rating for the support from its shareholders.

Moody's notes that the company's liquidity is being pressured by: (i) significant investment needs; (ii) a limited track record of advance arrangements for committed back-up facilities; and (iii) potentially challenged financial covenants. Furthermore, a sizeable portion (40%) of its debt of RUB11 billion, excluding finance lease obligations, as of the middle of 2009, will mature over the next 12 months, putting additional pressure on the company's liquidity position. Being a monopoly business, Lenenergo is required to attract bank resources under time-consuming tender procedures, which may additionally limit its financial flexibility going forward. According to the company's management accounts as of the middle of 2009, its cash and cash equivalents and shortly expected advances under the connection agreements covered nearly 60% of its short-term debt obligations. However, as Lenenergo is finalising new credit line agreements with Russian state-owned banks, Moody's believes all its debt obligations over the next 12 months should be covered by the end of November 2009.

More generally, Moody's notes that the company's liquidity position will depend on its actual capex over the next 12 months, as well as its ability to address its refinancing issues reasonably in advance. In Moody's view, the liquidity pressures are currently accommodated under the company's rating due to the above-mentioned support from shareholders.

The rating outlook is stable as Moody's believes that the company has sound and prudent plans to develop and adjust its business in close interaction with its shareholders taking into account the availability of funding, tariff evolution and the wider economic environment. Moody's expects Lenenergo to manage its financial profile and liquidity in line with the current rating category based on support from its large shareholders.

No upward pressure on the ratings is expected in the current developing and untested regulatory environment in the Russian distribution grid sub-sector.

However, negative pressure on the company's ratings could result from (i) weakening support from the shareholders, (ii) a negative shift in the developing regulatory regime and deteriorating margins, or (iii) failure to adjust investment plans to tariff decisions and hence limit deterioration of the company's financial profile, with total FFO interest coverage falling materially and persistently below 3.0x and FFO/Net Debt below mid-teens. Furthermore, an inability to address refinancing issues and/or challenged covenants reasonably in advance could negatively impact the ratings.

The principal methodology used in rating Lenenergo was Moody's rating methodology for Regulated Electric and Gas Networks, published in August 2009 and available on www.moodys.com in the Rating Methodologies sub-directory under the Research & Ratings tab. Other methodologies and factors that may have been considered in the process of rating this issuer can also be found in the Rating Methodologies sub-directory on Moody's website.

Headquartered in the city of St. Petersburg, Lenenergo is one of Russia's largest regional power distribution grid companies, focused on the St. Petersburg region. The company services a territory of 87,400 sq km with a population of 6.2 million people. Lenenergo is a regulated monopoly, whose electricity transmission revenues accounted for around 65% of its 2008 total revenues of RUB17.9 billion. The largest shareholder of Lenenergo is the state-controlled MRSK-Holding, which holds 50.31% of the company's voting shares. A blocking stake of 25.16% in the company is owned by the government of the city of St. Petersburg.

NATIONAL SCALE RATINGS

Moody's Interfax Rating Agency's National Scale Ratings (NSRs) are intended as relative measures of creditworthiness among debt issues and issuers within a country, enabling market participants to better differentiate relative risks. NSRs in Russia are designated by the ".ru" suffix. NSRs differ from global scale ratings, as assigned by Moody's Investors Service, in that they are not globally comparable to the full universe of Moody's rated entities, but only with other rated entities within the same country.

ABOUT MOODY'S AND MOODY'S INTERFAX

Moody's Interfax Rating Agency (MIRA) specialises in credit risk analysis in Russia. MIRA is controlled by Moody's Investors Service, a leading provider of credit ratings, research and analysis covering debt instruments and securities in the global capital markets. Moody's Investors Service is a subsidiary of Moody's Corporation (NYSE: MCO). Further information is available at www.moody's.com.

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