WEDNESDAY, 14/09/2022 - Scope Ratings GmbH

Scope downgrades Uniper's issuer rating to BBB-/Negative

The rating action reflects weakened business and financial risk profiles amid retaliatory measures against Western countries by Russia, which outweigh the positive impact on Uniper's issuer rating from its status as a government-related entity.

The latest information on the rating, including rating reports and related methodologies, is available on this **LINK**.

Rating action

Scope Ratings GmbH (Scope) has downgraded Uniper SE's issuer rating to BBB-/Negative from BBB+ under review for a possible downgrade. Concurrently, Scope has downgraded the senior unsecured debt rating to BBB- from BBB+ and the short-term debt rating to S-3 from S-2.

Rating rationale

Following the placement of Uniper's BBB+ rating under review for a possible downgrade on 14 March 2022, several risk factors have materialised.

Since 14 June, Gazprom has reduced gas supplies via the Nord Stream 1 pipeline so that Uniper received only 20%-40% of the contractually committed gas volumes. To ensure security of supply for its customers, Uniper started procuring substitution volumes at significantly higher prices. However, Uniper has been unable to pass on these additional costs to its contractual counterparties, resulting in a significant negative impact on earnings and liquidity. Based on price levels and the loss in volumes, Uniper began to accumulate daily losses in the mid-to-high double-digit million euro range. The rapidly deteriorating financial situation prompted Uniper to withdraw its 2022 financial outlook on 29 June and to enter into discussions with the German government on possible stabilisation measures. On 8 July, Germany's legislature adopted amendments to the Energy Security Act (EnSiG), which, among other things, establishes a regulatory framework for the stabilisation of gas importers hurt by the energy crisis. On the same day, Uniper submitted a formal application for stabilisation measures to the German government.

On July 22, the German government, Uniper and Fortum agreed on the key points of a stabilisation package for Uniper. The agreed measures are based on three pillars: limiting losses through a cost pass-through mechanism, securing liquidity by increasing KfW credit lines from EUR 2bn to EUR 9bn as well as ensuring financial stability through a direct equity injection from the German government of approximately EUR 0.3bn (representing around a 30% stake) and a mandatory convertible instrument of up to EUR 7.7bn. The agreement also foresees that the German government stands ready to provide further support (backstop solution) in case replacement cost losses that cannot be offset by operating profits from Uniper's other businesses exceed EUR 7bn. The stabilisation measures are subject, inter alia, to regulatory approvals, in particular a state-aid approval from the European Commission.[1]

Scope observes growing economic pressure exerted on Western countries and companies, including their operations in Russia. Russian government has already imposed capital controls restricting dividend and other payments from Russian entities to foreign investors. As the Russian government continues to respond to international sanctions, Scope believes that further restrictions or legal changes regarding foreign ownership of Russian assets are likely. Uniper is the majority owner of the

Russian company PAO Unipro with an 83.73% stake. Russian operations accounted for around 20% of Uniper's EBITDA in 2021. Uniper plans to exit Russia by disposing of its stake in Unipro as soon as it is feasible.

Gas and power prices have reached unprecedented levels in most of Europe, which led to significantly increased margining requirements at Uniper, further absorbing its liquidity. The impact mainly stems from the Nordic power division, where the spread between power (short position) and CO_2 allowances (long position) has widened significantly. To limit the margining impact, Uniper has reduced its hedging and trading activities, exposing a higher share of future cash flows to price volatility.

Also, an explosion at the Freeport LNG natural gas export terminal in the USA in June 2022 led to a temporary shut-down of the facility and a planned partial operation until the year-end. This results in expected losses to Uniper in mid-to-high triple-digit million euro range.

The above developments have significantly weakened Uniper's business risk profile and especially its financial risk profile. The negative impact is mainly related to the long-term contracts (LTCs) with Gazprom. The recent events have shown that the LTCs with Gazprom are subject to unilateral changes and breaches that have severe financial consequences for Uniper. LTCs with Gazprom represent around 200 TWh of 370 TWh of long-term gas supply contracts within Uniper's gas midstream business.

The LTCs with Gazprom expose Uniper to major risks which are not fully mitigated by the surcharge to pass through 90% of the replacement costs. Uniper is seeking to significantly reduce remaining risks from 2024 by adjusting its gas portfolio on the supply and sales sides. Scope expects these risks to remain until i) the contracts are terminated (which is accompanied by risk of litigation); ii) the contracts expire (contracts run until the 2030s); or iii) sales contracts are adjusted such that price and volume risks are transferred to Uniper's customers (e.g. via shorter-term price indexation) or absorbed by the German government or other third parties. Considering the size and share of Gazprom LTCs in Uniper's gas portfolio, Scope expects the portfolio to shrink and remain below current levels for a prolonged period, even though the company is actively working on alternative gas supplies, primarily liquefied natural gas (LNG). Also as part of the strategy to make its energy supplies more diversified and secure, Uniper is seeking alternative energy sources such as the production and import of green hydrogen. These projects could only be meaningful in the credit rating assessment once relevant cash flows reach a critical size, which is likely only in the medium or long term.

Further, Scope conservatively excluded Russian operations from its assessment due to the intended disposal of the stake and the significantly increased risk of the inability to extract value, as evidenced by restrictions to repatriate cash from Russia as well as the economic pressure exerted on Western countries and companies. This has also negatively affected Uniper's business risk profile, primarily through the loss of its well-shielded market position in the regulated Russian power market, the weaker geographical diversification and profitability (partly offset by reduced exposure to the volatile Russian rouble), as well as the financial risk profile (missing cash flow). Any potential disposal proceeds will be considered in the rating case once realised.

From a financial perspective, gas curtailment losses reached EUR 3.8bn between 14 June and 17 August. As market prices increased even further and after Gazprom indefinitely shut down the Nord Stream 1 pipeline at the end of August, daily losses have reached around EUR 100m and margining

Stream 1 pipeline at the end of August, daily losses have reached around EUR 100m and margining requirements have surged. This prompted Uniper to apply for an extension of the KfW facility by a further EUR 4bn to EUR 13bn in total.[2] In the absence of remedy measures, accumulated losses that cannot be offset by operating profits from Uniper's other businesses will exceed EUR 7bn by the end of September 2022. Scope believes the German government will introduce further measures as indicated in the stabilisation package. However, these potential measures have to be specified and implemented. Scope understands that additional measures should avoid a further dilution of existing shareholders' stakes. In case these measures are implemented in a way that Uniper no longer accumulates gas curtailment losses, total annual EBITDA may reach positive EUR 1.0bn-1.5bn in 2023-2024.

In the absence of additional remedy measures, Scope expects curtailment losses to reduce progressively in 2023 and 2024. This reduction will be helped by the surcharge, the narrowing gap between the expected market and LTC prices, and the initiated gas portfolio restructuring. The latter should be supported by the broader reform of the wholesale gas contract architecture together with the German government in the context of Germany's energy diversification objectives. Depending on the performance of other businesses, total EBITDA is likely to turn positive in 2024. The substantial losses in 2022, as well as the likely losses in 2023, which will depend on government measures that are still to be defined, indicate weak credit metrics.

Scope notes that margining receivables and liabilities grew significantly from EUR 0.9bn and EUR 0.2bn respectively at YE 2020 to EUR 7.9bn and EUR 0.8bn respectively at YE 2021. Based on the significant increase in margining requirements and their more than temporary nature, Scope decided to reflect them in its adjusted debt calculation, whereby margining liabilities are treated fully as debt and margining receivables are treated as a near-cash item with a discount of 25% to account for the comparatively low liquidity. Scope-adjusted debt/EBITDA, considering this change, is 1.1x in 2019 and 1.3x in 2020 compared with previous 1.0x and 1.6x respectively.

Despite the significant deterioration in internal cash generation, Scope continues to assess Uniper's liquidity as adequate. This view is primarily based on the EUR 13bn in external funding provided by the KfW, and the EUR 8bn in loans and guarantees provided by Fortum.

Scope now views Uniper as a government-related entity as per its Government Related Entities Rating Methodology. Scope believes that Uniper is instrumental to the government in ensuring the security of energy supplies and functioning energy markets. Uniper is the largest gas importer and operator of gas storage facilities in Germany, accounting for more than 20% of both total gas demand and total storage capacity. The company is also one of the country's largest power plant operators (installed capacity of more than 9 GW) and supplies gas and electricity to more than 400 of the around 900 municipal utilities (Stadtwerke). Gas and electricity play a central role in Germany's energy-intensive economy as well as in household heating. Scope also believes that Uniper is likely to receive further support from the German government.

Following the issuance of new shares, the German government is expected to own around 30% of the company's shares. The preliminary terms of the mandatory convertible instrument will ensure that the German government can maintain at least a 30% stake. The stake may increase should Fortum not exercise its option to take over parts of the mandatory convertible instrument from the German government. As a shareholder, the German government will be adequately represented on Uniper's supervisory board. The stake of 30% provides the government with the right to block important corporate decisions.

corporate decisions.

Scope believes that the German government (**[rated AAA/Stable by Scope]**) has a 'high' capacity to provide support. Scope also believes that the German government has a 'high' willingness to provide support. This view is based on i) Uniper's systemic relevance for German gas and electricity markets, implying high risk for the functioning energy markets and the security of energy supply should the company default; ii) The scope of legislative changes and the speed at which these have been enacted; iii) The recent extension of the KfW facility from EUR 2bn to EUR 13bn; and iv) The government's readiness to provide further support in case replacement cost losses that cannot be offset by operating profits from Uniper's other businesses exceed EUR 7bn, as foreseen by the stabilisation package. This results in a rating uplift of three notches of Uniper's standalone credit quality.

Scope does not incorporate any further rating impact from the shareholder structure. Despite its majority ownership of Uniper, Fortum does not have direct control.

Outlook and rating-change drivers

The Negative Outlook reflects the risk that the adverse market environment will continue to negatively impact Uniper's operations and financial results. The Outlook also reflects the remaining uncertainty regarding the already agreed but still-to-be-defined government stabilisation measures, specifically, whether they will be implemented in a timely fashion and will be sufficient to preserve credit quality (i.e. absorb the impact of adverse market conditions).

A rating downgrade could be considered if stabilisation measures were not implemented in a timely fashion or were insufficient to preserve the credit quality, e.g. in case of severe operational or liquidity issues. A negative rating action could also be considered if Scope's perception of the potential government support had weakened.

Scope could revise the Outlook back to Stable if the risks related to the adverse market environment reduced meaningfully and if the still-to-be-defined additional stabilisation measures were sufficient to preserve credit quality and were implemented in a timely fashion.

Long-term and short-term debt ratings

Driven by the rating action on the issuer rating, Scope has also downgraded the senior unsecured debt rating to BBB-. Scope notes increased complexity and volatility in the capital structure that could alter recovery expectations for senior unsecured debt in the future.

The short-term debt rating has been downgraded to S-3, primarily due to the significant deterioration in internal cash generation capacity.

Credit rating driver references

1. Agreement on Uniper Stabilisation Package
2. Uniper fully uses existing KfW credit facility and applies for extension of KfW credit facility

Stress testing & cash flow analysis

No stress testing was performed. Scope Ratings performed its standard cash flow forecasting for the company.

Methodology

The methodologies used for these Credit Ratings and/or Outlooks, (General Corporate Rating Methodology, 15 July 2022; European Utilities

Rating Methodology, 17 March 2022; Government Related Entities Rating Methodology, 6 May 2022), are available on https://scoperatings.com/governance-and-policies/rating-governance/methodologies.
Information on the meaning of each Credit Rating category, including definitions of default, recoveries, Outlooks and Under Review, can be viewed in 'Rating Definitions – Credit Ratings, Ancillary and Other Services', published on https://www.scoperatings.com/governance-and-policies/rating-governance/definitions-and-scales. Historical default rates of the entities rated by Scope Ratings can be viewed in the Credit Rating performance report at https://scoperatings.com/governance-and-policies/regulatory/eu-regulation. Also refer to the central platform (CEREP) of the European Securities and Markets Authority (ESMA): http://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml. A comprehensive clarification of Scope Ratings' definitions of default and Credit Rating notations can be found at https://www.scoperatings.com/governance-and-policies/rating-governance/definitions-and-scales. Guidance and information on how environmental, social or governance factors (ESG factors) are incorporated into the Credit Rating can be found in the respective sections of the methodologies or guidance documents provided on https://scoperatings.com/governance-and-policies/rating-governance/methodologies.
The Outlook indicates the most likely direction of the Credit Ratings if the Credit Ratings were to change within the next 12 to 18 months.

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Lead analyst: Marlen Shokhitbayev, Director
Person responsible for approval of the Credit Ratings: Henrik Blymke, Managing Director
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CONTACT INFO

Marlen Shokhitbayev
Analyst

m.shokhitbayev@scoperatings.com

Olaf Tölke
Team leader

o.toelke@scoperatings.com

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