Media Release

Taiwan Power Co. Assigned 'twAAA/twA-1+' Issuer Credit Ratings; Outlook Stable

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Overview

- We believe the Taiwan government is almost certain to provide timely financial support to Taipower if needed, given the company's critical role supplying sufficient and reliable electricity to the nation.
- We expect the consistent implementation of a tariff setting mechanism under the Electricity Act will stabilize Taipower's profitability, while the company's strong refinancing capability and interest coverage should offset a slight increase in debt leverage amid rising capital expenditure over the next two years.
- We are assigning our 'twAAA' long-term and 'twA-1+' short-term issuer credit ratings on Taipower. At the same time, we assigned our 'twAAA' issue credit rating on the company's outstanding senior unsecured corporate bonds.
- The stable outlook reflects the stable outlook on S&P Global Ratings' sovereign rating on the Taiwan.

Rating Action

On June 25, 2018, Taiwan Ratings Corp. today assigned its 'twAAA' long-term and 'twA-1+' short-term issuer credit ratings to integrated power company, Taiwan Power Co. (Taipower). The outlook on the long-term rating is stable. At the same time, we assigned our 'twAAA' issue ratings on Taipower's outstanding senior unsecured corporate bonds.

Rationale

The ratings on Taipower reflect our view that the Taiwan government is almost certain to provide timely financial support to the company if needed, given its critical role to supply sufficient and reliable electricity to support the country's highly industrialized economy. The ratings also represent our view that the Taiwan government will maintain its ownership and tight control over Taipower over the next three to five years.

We expect Taipower to maintain its critical role in the economy over the next decade because of its position as the island's sole integrated electric power provider--a role that by law no other entity in the country can undertake. In addition, Taipower's power grid is isolated, thereby preventing the possibility of importing electricity. As a result, we believe Taipower is so critical to the country's highly industrialized economy and households that the government is unlikely to take any risk with regard to interruptions in Taipower's operations. We also expect the government to ensure Taipower's financial viability to minimize the financial risk.

Additionally, Taipower is the largest corporate bond issuer in Taiwan with its outstanding bond issues accounting for 21% of the island's total corporate bonds as of the end of 2017. We believe any stress on Taipower's credit profile would lead to unbearable risk to its operations for the government and have a significant systemic effect on Taiwan's economy and financial markets.

Furthermore, we expect Taipower to maintain an integral link with the government of Taiwan, which owns 94% of the company without any prospect of privatization over the next decade. We believe the Taiwan government has a strong influence over the company's strategic and business plans through the appointment of important managerial positions and board members, and any debt default by Taipower would significantly undermine the government's reputation.

We also believe the government has a strong incentive to maintain dominant ownership of Taipower in order to implement its key policies, including providing stable and cheap electricity and promoting renewable energy. The nation's Electricity Act rules that power transmission, distribution and retailing should remain state owned. We believe this demonstrates the government's long-term strategy and minimizes the likelihood of Taipower's privatization over the next decade. That is because any privatization would be subject to the approval of Taiwan's Legislative Yuan and an assessment of its impact on the island's power supply.

Taipower's stand-alone credit profile (SACP) reflects an improving regulatory environment and the company's stabilizing profitability because of several factors. These include the consistent implementation of the current tariff setting mechanism authorized by the Electricity Act, Taipower's monopoly market position in power transmission, distribution and retailing, near monopoly in power generation, and adequate operating efficiency. Nonetheless, we expect Taipower's cash flow to remain somewhat volatile due to caps on tariff adjustments and deviations in actual fuel costs from the projection applied for tariff adjustments.

In addition, we expect Taipower's debt leverage to remain high and constrain improvement in its SACP. That is because regulatory returns will be insufficient to support rising capital expenditures over the next two to three years, in our view.

Our base case scenario for Taipower forecasts the current regulatory framework to allow the company to generate sufficient return on its investments with good transparency and predictability on tariff setting. The regulatory environment for Taipower has improved since 2015 with regular adjustments on tariffs now based on fuel-price fluctuations. We expect the formalization of the framework, including the establishment of the Electricity Tariff Examination Council, to improve regulatory stability. In addition, the current tariff-setting scheme allows Taipower to recover all capital costs and adequate returns. The return on tariff base of 3%-5% set by the government is sufficient for Taipower to generate sufficient capital to reinvest while maintaining adequate capital structure, in our opinion. This rate of return compares favorably with Taipower's long-term debt funding costs of generally below 2%.

We expect Taipower to remain the only integrated power company in Taiwan over the next decade because the Electricity Act rules that power transmission and distribution should remain a monopoly. Although the Act allows renewable energy generators to sell directly to end users, we expect Taipower to maintain a near complete monopoly in electricity retailing. In addition, we believe Taipower will continue to provide more than 70% of power generation over the next five years because the government is responsible for maintaining sufficient power supply. We also expect the company to maintain adequate operating efficiency, evidenced by its continuously improving key indicators such as transmission losses that improved to 3.82% in 2017 from 4.76% in 2011.

However, the current tariff setting mechanism will still cause material volatility in Taipower's cash flow because of caps on tariff adjustments and the deviations of actual fuel costs from projected costs used for tariff setting. The Electricity Act caps tariff adjustments, either upward or downward, at 3% every six months or 6% a year, regardless the changes in Taipower's operating costs. The law calls for the establishment of an independent reserve fund to absorb the insufficient tariff adjustments and deviations from cost projections, through Taipower injecting excess profits into or withdrawing from the fund on deficits. Taipower has instead built a reserve item on its balance sheet to manage the deviations. Such a mechanism cannot absorb Taipower's cash flow volatility, in our view, because there will be no actual impact on cash flow regardless of the company's actual profitability being higher or lower than the regulatory return.

In addition, Taipower's financial conditions will be subject to the government's energy policy, which given the potential for change introduces an element of volatility. Meanwhile, there is no regulation that the government must compensate Taipower for such changes, including the recent decision not to commission the operator's fourth nuclear power plant. Nonetheless, we expect the government will take action to help Taipower minimize the impact of policy changes on its balance sheet and recover some or all costs, albeit with some uncertainty over the extent of such remediation.

We also believe there remains significant risk of political intervention to upset the consistent implementation of the existing tariff setting scheme, particularly during periods of high fuel prices. This could lead to further weakening in Taipower's cash flow and debt leverage based on the government's policy priority to curb inflation.

We expect Taipower's capital expenditure to rise materially over the next two to three years mainly for adding new thermal and renewable power generation to replace retiring thermal nuclear power plants and increase the nation's power reserve margin. That is despite the likelihood of significant private investment in offshore wind power over the same period. This, together with insufficient tariff adjustments on rising fuel costs could further weaken Taipower's cash flow and debt leverage if fuel costs remain elevated over the next two to three years.

We expect the company's ratio of funds from operations (FFO) to debt to decline slightly to 7.0%-8.5% in 2018-2020, down from 9.2% from 2017. However, we believe the company's strong access to capital markets and prevailing low interest rates slightly alleviate the leverage risk. We believe Taipower will be able to refinance its maturing debts without any difficulty. In addition, Taipower enjoys very low interest rates backed by its status as one of the most important government-related entities in Taiwan, resulting in the company's strong interest coverage, despite its high leverage.

Our base-case scenario assumes the following:

- Taiwan's real GDP to grow by 2.7% in 2018 and 2.6% in 2019, with power demand growing slower than GDP at about 2%. The electricity consuming tech sector will be the main driver for growth, while global warming will also lead to an increase in power demand for air conditioning.
- The current tariff adjustment scheme will remain in 2018-2020 and the return on tariff basis will be 5% over the next three years, given Taipower's accumulated losses on its balance sheet.
- Average tariffs will increase by about 4.5% in 2018, 3.5% in 2019, and 1.9% in 2020, reflecting rising fuel costs.
- Aggregate revenues to grow 5%-7% in 2018 and 4%-6% in 2019.
- Fuel costs, including those of independent power producers, to increase by about 20% year on year in 2018 and 2% in 2019-2020. This results in an all-in cost increase of 10% for Taipower in 2018, with about 1% increases in 2019-2020.
- Other operating and maintenance costs to grow by a low-single digit each year.
- Adjusted EBITDA margin will decrease to 25%-27% in 2018 from 32% in 2017, and improve to 27%-30% in 2019-2020, because of tariff adjustments and the assumption of relatively stable fuel prices.
- Taipower's capital expenditures to increase to New Taiwan dollar (NT$) 110 billion-NT$120 billion in 2018, NT$140 billion-NT$160 billion in 2019, and about NT$200 billion in 2020--mainly for new thermal and renewable power capacity to replace retiring thermal and nuclear power plants.
- The effective interest rate to remain relatively flat over the next two years.

Based on these assumptions, we arrive at the following credit measures:

- Ratio of debt to EBITDA of 8.5x-9.5x in 2018 and 8.0x-9.0x in 2019-2020.
- Ratio of FFO to debt of 6.5%-8.5% in 2018 and 7.5%-9.5% in 2019-2020.
- FFO cash interest coverage of 7.0x-9.0x in 2018 and 9.0x-11x in 2019-2020.

Liquidity

We assess Taipower's liquidity as adequate. We believe that Taipower has sufficient cash flow to meet its needs over the next 12 months factoring in maintenance capital expenditures and ongoing government support in the form of the company's access to the local capital markets. We believe Taipower's ratio of liquidity sources to uses will be 1.1x-1.3x in 2018.

The liquidity profile incorporates our view that liquidity sources will continue to exceed uses even if Taipower's EBITDA were to decline by 10%. It also reflects our view that the company has a sound business relationship with banks based on its very low interest rates on its bank loans and unsecured corporate bonds. We do not expect Taipower to encounter difficulties in renewing its short-term debts, establishing new bank loan facilities and issuing new corporate bonds, given its strong credit standing underpinned by its status as one of the most important government related entities in Taiwan. In addition, Taipower's debts do not carry any financial covenants.

Principal Liquidity Sources:

- Cash and short-term investment: NT$3 billion as of the end of 2017
- FFO: about NT$95 billion in 2018
- Working capital inflow of NT$6 billion in 2018
- Ongoing government support, in the form of credit facilities mainly from state banks and domestic bond issuance: about NT$347 billion to cover refinancing needs in 2018.

Principal Liquidity Uses:

- Debt maturities: NT$347 billion in 2018
- Maintenance capital expenditure: about NT$18 billion in 2018
- No cash dividend payout in 2018

Outlook

The stable outlook on Taipower reflects the stable outlook on the assigned by S&P Global Ratings. The outlook also reflects our view that Taipower's critical role and integral link to the Taiwan government will not change over the next few years because of Taipower's critical mission to provide stable electricity supply at a competitive tariff through the country's isolated power grid.

We believe the government's tolerance on electricity supply risk is minimal because the country's technology-heavy economy relies strongly on a stable and cost-competitive power supply. We also expect Taipower's SACP to remain stable over the next two years because of the continued implementation of the existing tariff setting mechanism, and the company's strong refinancing capability with modest interest coverage.

Downward scenario

We could lower the long-term rating on Taipower if S&P Global Ratings lowers its sovereign ratings on Taiwan. Although unlikely over the next two to three years, we could also lower the rating if we believe that Taipower's importance to or relationship with the Taiwan government has weakened materially. Such a scenario could reflect more aggressive market liberalization that breaks Taipower's monopoly in power transmission, distribution and retailing, or a significant reduction in government ownership.

Rating Score Snapshot

Issuer Credit Rating: twAAA/Stable/twA-1+

Note: All scores are in comparison with global obligors.

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

Financial risk: Aggressive
- Cash flow/Leverage: Aggressive

Anchor: twa-

Modifiers
- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: twa-
- Sovereign rating: AA-
- Likelihood of government support: Almost certain (+6 notches from the SACP)

Related Criteria

- General Criteria: Group Rating Methodology - November 19, 2013
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions - March 25, 2015
- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings - March 28, 2018
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009
- Criteria - Corporates - Utilities: Key Credit Factors For The Regulated Utilities Industry - November 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers - November 13, 2012
- General Criteria: Country Risk Assessment Methodology And Assumptions - November 19, 2013
- General Criteria: Methodology: Industry Risk - November 19, 2013
- Criteria - Corporates - General: Corporate Methodology - November 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments - November 19, 2013
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers - December 16, 2014
- General Criteria: National And Regional Scale Credit Ratings - September 22, 2014
- Understanding Taiwan Ratings' Rating Definitions, www.taiwanratings.com - November 18, 2014

(Unless otherwise stated, these articles are published on www.standardandpoors.com, access to which requires a registered account)

Ratings List

Ratings Assigned; Outlook

	To	From
Taipower Power Co.		
Issuer Credit Ratings	twAAA/Stable/twA-1+	Not rated
Senior Unsecured Corporate Bonds Issue Rating	twAAA	Not rated