European Utilities Outlook 2021

The credit outlook for European utilities remains stable. Pandemic highlights sector's resistance to outside shocks. Focus turns to diversifying funding to cope with lingering economic fallout and meet high capex needs.

European Utilities, Scope Ratings GmbH, 2 February 2021

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| Bloomberg: RESP SCOP

Executive summary

The Covid-19 pandemic has highlighted the resistance of European utilities to outside shocks and volatile markets given their role as indispensable suppliers of electricity and natural gas. However, the sector cannot entirely escape the drag on the European economy from lockdowns and other coronavirus-related restrictions which at times have throttled industrial output: utilities face lower achieved power prices – despite active hedging - and heightened customer risks. Integrated utilities and grid operators also have hefty capital-spending commitments, so corporate treasurers will need to use all the funding tools at their disposal to ensure credit ratings are not put at risk.

The main trends we expect for 2021 are:

- Downward pressure on power prices in 2021 and 2022 from the lag-effect of weak commodity prices last year, though impact will be short-lived as highlighted by fast price recovery in most markets.
- Weakness in power prices will be at least partially offset by improving demand as economies recover, higher prices of commodity inputs, and the phasing out of nuclear and coal capacity.
- Smaller energy suppliers are on the ratings watch-list, particularly if exposed to vulnerable industrial companies and small and medium-sized enterprises (SMEs) on the customer side.
- Upgrading and expanding power grids and integrating increasing renewable-energy capacity will ensure capital expenditure requirements remain high. Scheduled capex for the sectors stands at slightly more than EUR 100bn this year.
- High levels of capex will make equity-linked funding a priority: hybrids, shareholder loans, share issues. We also expect to see increased asset rotation and more scrutiny of shareholder remuneration.
- Pressure on public finances after the emergency fiscal support for business and households in 2020 could open more room for privatisation as governments look at ways to finance a post-pandemic recovery.
- Utilities will exploit investor appetite for sustainability-linked securities by issuing more green bonds and hybrids to meet capex commitments and contribute to Europe's "green" post-pandemic recovery.

We expect credit quality to remain solid on average in 2021. Ratings headroom will shrink with continuously high capex and temporary pressure on operating cash flow. Utilities facing the most ratings pressure will most likely counter it by issuing hybrid debt, scaling back shareholder remuneration and deferring some capex.

Figure 1: Ratings distribution of Scope's current coverage of European utilities (number of issuer ratings)

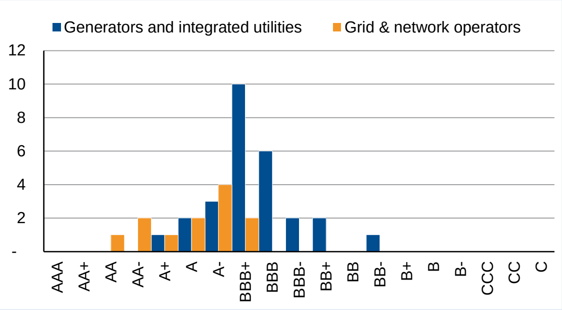
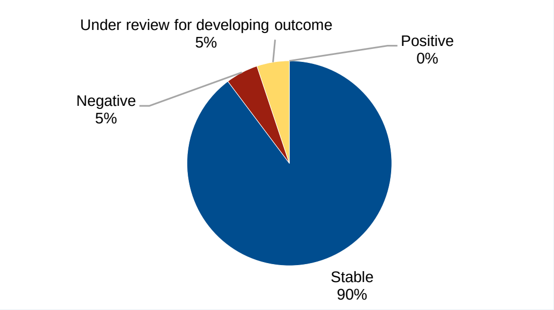


Figure 2: Distribution of rating outlooks as of Jan 2021



Source: Scope Ratings (39 European utilities rated by Scope)

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Scope Corporates Sector Ratings

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Key trends for 2021

Integrated utilities show resilience; pure-play suppliers face highest risk

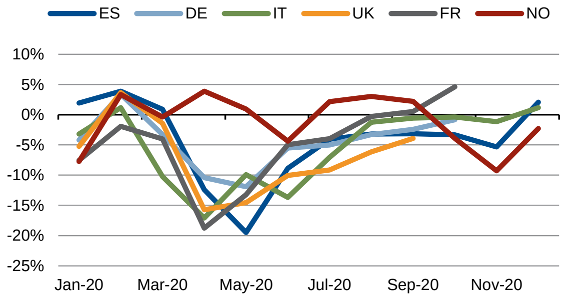
Power generators and suppliers typically hedge procurement and supply, so they had built-in protection against the Covid-19 shock in 2020. However, the lingering economic fallout from the pandemic in reducing consumption of electricity and natural gas will take its toll in the current year and in 2022. Such a delayed effect is due to the large forward hedging activities of most European utilities with a large share of pre-pandemic European power output/procurement. Utilities such as Uniper SE (rated BBB+/Stable), Enel SpA, Engie SE, Iberdrola SA, Vattenfall AB and Fortum Oyj had hedged 50-70% of 2021 volumes before the coronavirus shock.

Lower energy demand from nationwide lockdowns and the throttling of industrial production – in addition to milder temperatures in continental Europe, ample water reservoirs in the Nordics and a record in wind generation volumes – knocked achievable spot and forward prices sharply lower. However, average forward prices have not hit the troughs seen in 2014 and 2016 despite the uneven and uncertain pace of the recovery in industrial output – industry is Europe's biggest consumer of electricity – and the broader European economy.

We expect prices to recover faster than demand due to constraints in electricity supply from the gradual phasing out of nuclear and coal capacity. Another favourable factor is the settling of carbon dioxide prices near a floor of EUR 25/ton now that the European emissions trading system seems to have matured. Power prices will still take a few years to return to 2019 levels (that were closed in 2018) considering that electricity demand has fallen by 4-5% on average, with gas demand down 7-8%.

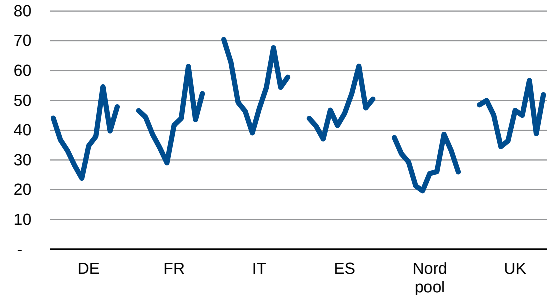
Pressure on integrated utilities' balance sheets should remain modest for the time being. Leverage will trend slightly upwards though the shift looks temporary. Incumbent European utilities have plenty of liquidity. Smaller pure-play suppliers primarily serving industrial and commercial clients are less well placed: investors need to watch them closely in 2021 as they are vulnerable to lower absolute demand, reduced average pricing and diminished cash intake when customers find it harder to pay bills or are unable to pay at all. Some may have been caught on the wrong foot regarding energy procurement. While power providers with high retail exposure are in comparatively safe territory, others face increases in bad debts (receivables write-downs) and a squeeze on working capital.

Figure 3: Electricity demand 2020 vs 2019 in selected markets (yoy change)



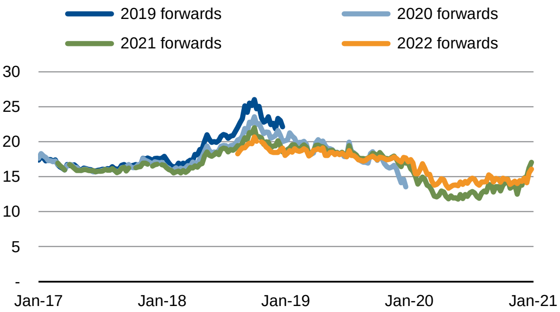
Source: Scope Ratings based on grid operators' data

Figure 4: Average prices 1Y forwards baseload in major markets (curves show price development between 2012 and 2020 in EUR/MWh except for the UK in GBP/MWh) – Highest prices logged in in 2018



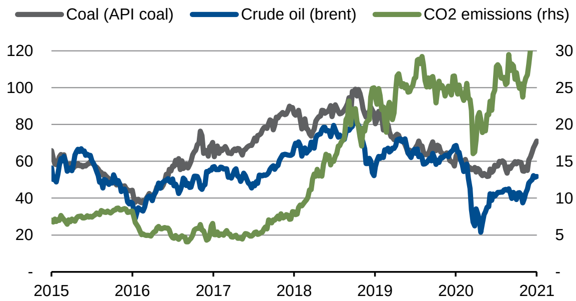
Source: Bloomberg, Scope Ratings

Figure 5: Dutch TTF Gas Forwards (EUR/MWh)



Source: Bloomberg, Scope Ratings

Figure 6: Commodity prices (coal in USD/ton, crude oil in USD/barrel, CO2 in EUR/ton)



Source: Bloomberg, Scope Ratings

Grid operators resistant to crisis; face challenge of rising capex

Once again, regulated grid operators have shown their macroeconomic resilience with broadly robust operating performance over the recent quarters despite the material drop in the amount of energy distributed in many European markets. This is widely linked to tariff structures focused on load rather than on transmitted and distributed volumes. The phenomenon was impressively on display in the operating performances last year at Italy's Terna SpA (rated A-/Stable) and Snam SpA and Spain's Red Eléctrica SA. While other grid operators such as French gas grid operator Teréga SA or Spanish gas grid company Enegás SA performed less well, the operators will recover unearned revenues, with some delay, through likely future tariff adjustments.

Europe's grid operators also face an increasingly heavy capex burden for extending and upgrading transmission corridors and strenghtening distribution grids, underlined by the need to integrate steadily growing renewable energy capacity – particularly by linking up offshore windfarms to mainland networks – and the experience of recent blackouts. Around 20% of the sector's EUR 100bn in scheduled capex will be spent on grids in 2021. Delaying necessary investment is no longer an option if European countries are going to keep the lights on.

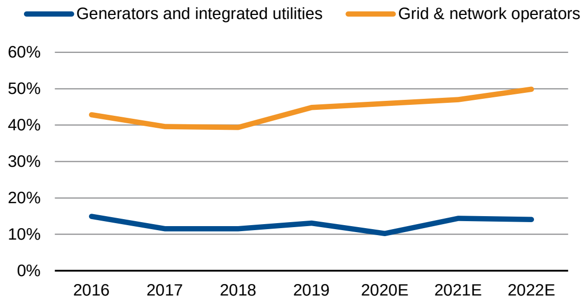
Relative capex levels are rising inexorably (see **Figure 7**), particularly for National Grid, Terna, TenneT, RTE, Elia. Operating cash flow often lags behind, insufficient to cover the capital spending. In such cases, the grid operators have less rating headroom as they fund new projects. We see plenty of evidence from multiple grid operators that management is still determined to use external funding that would weigh on the credit rating as little as possible. Netherlands-based TenneT NV, for example, has turned to hybrids bonds to minimise the impact of rising capex on leverage ratios. Enexis, another Netherland-based firm, raised a subordinated shareholder loan from its sub-sovereign shareholders. Italy's Terna is considering various options including a first-time hybrid issue. Netherlands-based Stedin Diensten BV is preparing shareholders for an equity injection. We are confident that companies will focus squarely on preserving the strong credit quality typical of the sector.

No scaling back of investments

The scale of capex facing Europe's utilities from investing in power grids and expanding renewables is such that it will burden free operating cash flow (FOCF) for years. The sector will turn increasingly to debt capital markets for funding even as treasurers seek to preserve solid credit quality (see **Figure 8**).

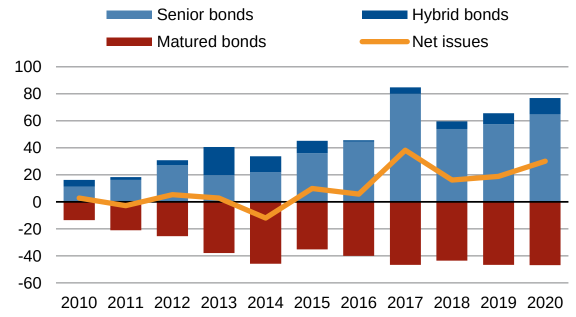
Integrated utilities - particularly pan-European incumbents such as Iberdrola, EDF, Enel, Engie - are also under pressure to increase capex, partly to defend their market positions in electricity generation and distribution from the encroachment of integrated oil & gas companies and financial investors. Utilities are big users of hybrid bonds – making up 16% of the sector's overall debt capital market funding in 2020 with large issues from Engie, Iberdrola, Electricité de France SA, Enel, EnBW AG, Energias de Portugal SA. We believe treasurers will use the full financing toolkit in 2021, including rotating assets and recommending conservative shareholder remuneration, to protect credit quality as far as possible. At government regulated entities (GREs), management will turn to sub-sovereign and sovereign shareholders to bear their share of capex-related funding. One consequence might be that privatisation returns to the policy-making agenda as governments arbitrage between the urgent short-term spending needed to ensure a strong post-pandemic economic recovery and the heavy, longer-term funding needs of the energy sector, particularly as it adapts to tougher environmental regulations.

Figure 7: Capex/revenues



Source: Scope Ratings (39 European utilities rated by Scope)

Figure 8: Growing need for external capital market bond financing with a rising share of hybrid debt (EUR bn)



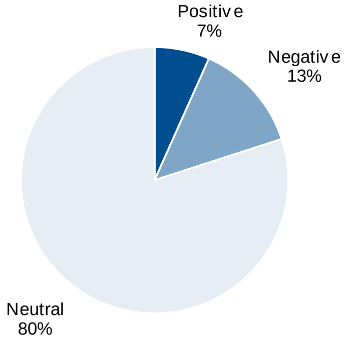
Source: Bloomberg, Scope Ratings

Limited pressure on sector's credit quality

The utilities' widely defensive characteristics are largely mirrored in the rating action that we have conducted since March 2020 when the pandemic hit Europe. We recorded only four negative rating actions, such as lowering the rating outlook or executing a rating downgrade. Negative rating actions were predominantly related to weaker forecasts for integrated utilities and energy suppliers, particularly those not hedged or with longer-term exposure to more vulnerable customer groups.

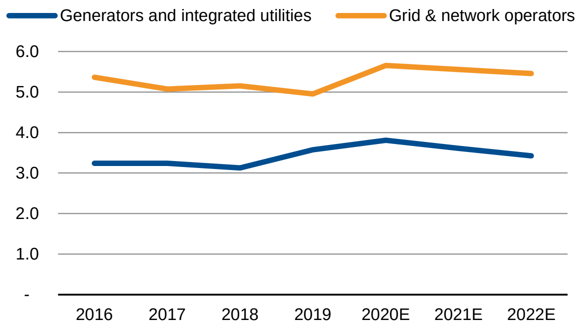
Overall, only 5% of the 39 rated utilities in our coverage have a Negative outlook, with the majority of utilities in our ratings coverage affirmed with a Stable outlook. This reflects our belief that a price- and volume-related deterioration of credit metrics in 2020 and 2021 will be temporary. The sector can withstand temporary pressure on FOCF and greater indebtedness during the current capex phase, given the likely recovery of investments in the foreseeable mid-term future. As such, negative rating actions in 2021 will tend to be the exception than the rule, unless Europe faces an extended period of lockdowns with a prolonged adverse impact on industrial production and commercial activity. In this bearish scenario, utilities would have to contend with more downward pressure on prices, volumes and difficulty in collecting receivables.

Figure 9: Rating action directions in 2020



Source: Scope Ratings

Figure 10: Leverage (Scope-adjusted debt/EBITDA)

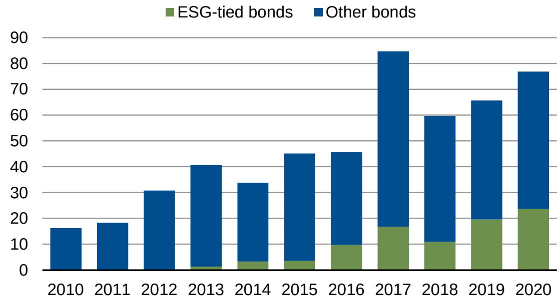


Source: Scope Ratings (39 European utilities rated by Scope)

More sustainability-linked funding as Europe pushes for "green recovery"

Green bonds issued by utilities are no longer the main source of ESG-related debt instruments, but they do currently make up around 40% of the total. European utilities placed about EUR 25bn of green and ESG-linked capital market debt in 2020, around one third of newly issued capital market debt placed by the sector. Among the biggest issuers were TenneT, Terna , EnBW, Alliander, Enexis, Engie, Vattenfall, E.ON SE, Gruppo Iren SpA. Smaller companies in the sector were also active, such as Spain's Audax Renovables SA and France's Neoen SA and Voltalia SA in addition to small Norwegian utilities in Scope's coverage: (Lyse (rated BBB+/Stable), Akershus Energi (rated BBB/Negative), Agder Energi (rated BBB+/under review for developing outcome), Eidsiva Energi (rated BBB+/Stable), Glitre (rated BBB/under review for developing outcome), BKK (rated BBB+/Stable)). We see accelerating investor interest in sustainability-linked securities "pulling" European utilities to issue more green and ESG-tied bonds as the companies' investment focus tightens on renewables – generation and grid integration – and other sustainable-energy initiatives including innovations such as hydrogen-based power generation.

Figure 11: Green/ESG debt taking major share of utilities' debt capital market funding (EUR bn)



Source: Bloomberg, Scope Ratings

The regulatory climate remains a crucial factor for the sector as the European Commission proceeds with its "green deal" and overarching aim of making Europe "carbon-neutral' by 2050. Environmental projects will be an important part of the EUR 750bn Next Generation EU post-pandemic recovery plan, with 25% of all funding earmarked for climate-change mitigation. Much of the investment will come from the private sector, so governments will be keen for utilities to fund much of their capex using a green or ESG label. Such stimulus could back scheduled investments for renewables and grid assets in Western Europe and trigger new investment predominantly in Central and Eastern European economies that are lagging behind the leaders in green energy in Western Europe such as Denmark and Germany.

Annex: Related research and ratings

How green is green? The challenge of tracking environmental footprints of corporate bond issuers, published Feb 2021, available here

Oil & gas credit outlook 2021: more resilient sector keeps costs in check; ESG pressure mounts, published Jan 2021, available here

Sovereign Outlook 2021: global growth recovers amid high debt; changing fiscal, monetary frameworks, published Dec 2020, available here

Investors must assess fundamental value to capture stress resilience of merchant projects, published Dec 2020, available here

Scope places Agder Energi's BBB+ issuer rating under review for a developing outcome, published Dec 2020, available here

European corporates: creditors, taxpayers bear Covid-19 financial burden; will shareholders in 2021?, published Dec 2020, available here

Scope places Glitre Energi's BBB issuer rating under review for a developing outcome, published Dec 2020, available here

Scope changes the Outlook to Negative from Stable on Akershus Energi's BBB issuer rating, published Dec 2020, available here

Scope assigns A-/Stable issuer rating to Tensio AS, published Nov 2020 available here

Scope assigns BBB-/Stable first-time issuer rating to Italian utility Green Network S.p.A., published Nov 2020, available here

Scope affirms A-/Stable issuer rating of Italy's Terna SpA, published Nov 2020, available here

Scope affirms its BBB-/Stable issuer rating on Encavis AG, published Oct 2020, available here

Scope affirms its BBB+/Stable issuer rating on BKK, published Aug 2020, available here

Scope affirms BB+/Stable issuer credit rating of Hungary-based utility ALTEO Energiaszolgáltató Nyrt, published Jul 2020, available here

Scope affirms BBB+/Stable issuer rating on German power and gas company Uniper SE, published May 2020 available here

Lyse's telecoms business helps mitigate negative effects of lower power prices, published May 2020, available here

Scope affirms BBB+/Stable rating on Eidsiva Energi AS, published Mar 2020, available here

European utilities' credit outlook stable; industry disruption poses longer-term threat, published Mar 2020, available here

European utilities outlook 2020: ESG-linked debt to become increasingly standard for sector funding, published Feb 2020, available here

European electricity: Renewables-based PPAs transform sector, published Oct 2019, available here

Governments, utilities face emissions, investment opportunities, challenges from electric-car boom, published Sep 2019, available here

Germany's grid operators face growing multibillion-euro investment challenge, published Mar 2019, available here

Germany's coal exit: Mixed medium to-long term implications, published Jan 2019, available here

Predators and prey: European utilities caught up in fierce fight for region's energy assets, published Aug 2018, available here

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