2020 European Utilities Outlook

The credit outlook for European utilities is stable. Robust commodity prices are benefiting electricity generators and suppliers. Grid operators face rising capex. Green and sustainability-linked funding is increasingly the norm.

Corporates, Scope Ratings GmbH

Executive summary

The credit outlook for the European utilities sector in 2020 is stable, unchanged from a year ago. Robust commodity prices (spot and hedged for one or two years) are providing some cushion for the performance of integrated utilities. Higher capital expenditure will strain free operating cash flow at grid and network operators, at least temporarily. While the sector faces lingering political and regulatory risks, companies' access to cheap funding, much of which is sustainability-linked, will facilitate new investment and refinancing.

The main trends we expect for 2020 are:

- Cash flow will stabilise at electricity generators and suppliers, helped by improved, to a large extent hedged, commodity prices, leaving ample financial headroom in terms of in-house leverage limits or conditions for triggering credit-rating downgrades.
- Utilities will increasingly benefit from the reshuffling of their generating assets in recent years toward more efficient and less carbon-intensive electricity output, ensuring that any new greenfield investment or mergers and acquisitions will not significantly drain cash flow.
- Rapid growth in green and sustainability-linked finance will help utilities to tap a large pool of investors to fund capex.
- Political intervention in the sector remains a risk, related to government concerns not just about environmental protection but also foreign ownership of strategic assets and security of supply.
- Industry outsiders such as oil and gas major and financial investors, will continue to invest in the electricity sector - through M&A or organic growth.
- Grid operators have revised upwards their capex programmes to meet the growing cost of Europe's transition. Higher capex will eat into free operating cash flow. Low interest rates and growth in the regulated asset base should ensure only a moderate impact on credit quality.

Credit quality will remain solid on average in 2020 for Europe's integrated utilities and grid/network operators. Leverage – our most important credit ratio – will likely remain in line with expectations for current ratings despite political and capex pressures.

Figure 1: Median leverage – Scope-adjusted debt/Scope-adjusted EBITDA – within peer group

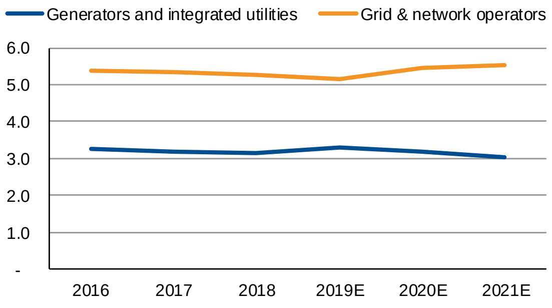
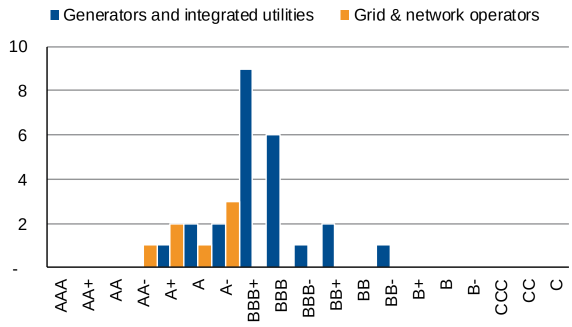


Figure 2: Rating distribution of Scope's current coverage of European utilities



Source: Scope Ratings (31 European utilities rated by Scope)

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Key themes for 2020

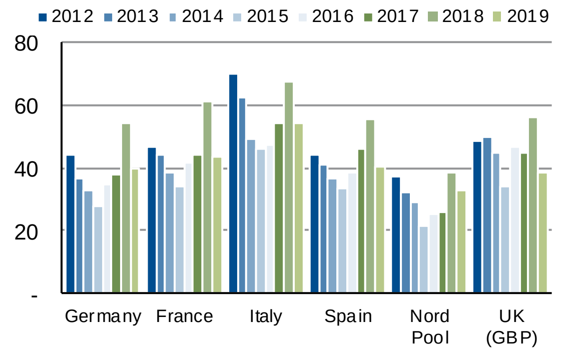
Continued favourable pricing environment for generators/suppliers

Europe's electricity generators and suppliers will continue to benefit this year from multiple factors that improved profit margins and cash flow in 2019: asset rotation – aimed at enhancing low-CO_2 generation capacities – their expanded regulated or contracted business, and robust spot and hedged electricity and gas prices. Commodity prices may be lower than in the past year (figures 3 and 4), but they will be better than the 2016/17 trough, except in the UK.

Sustained high CO_2 prices – likely within a range of EUR 20-30 a ton against EUR 5/ton in 2017 – and first closures of coal and nuclear power plants should provide a floor for hedged prices this year, thereby providing some protection against deteriorating cash flows. For the utilities' trading divisions, getting hedging strategies right, particularly their timing, remains crucial given increasingly volatile power output and prices.

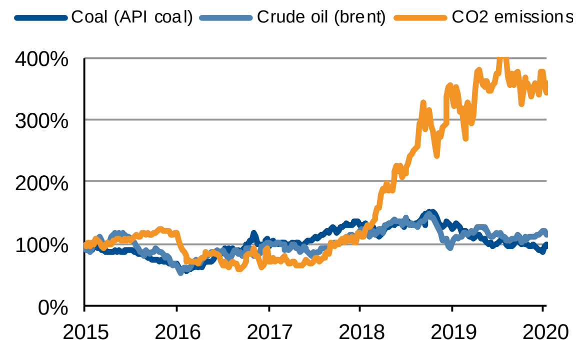
Leverage – our most important credit measure – should remain stable in 2020. Improving or at least stable operating cash flows and digestible capex needs – as measured by an average capex/revenue ratio of between 10-20% (see Figure 5) – signal the robust credit quality of integrated and supply utilities (see Figure 1).

Figure 3: Average prices 1Y forwards baseload (EUR/MWh) in major markets



Source: Bloomberg, Scope Ratings

Figure 4: Robust commodity prices (Jan 2015 = 100%)



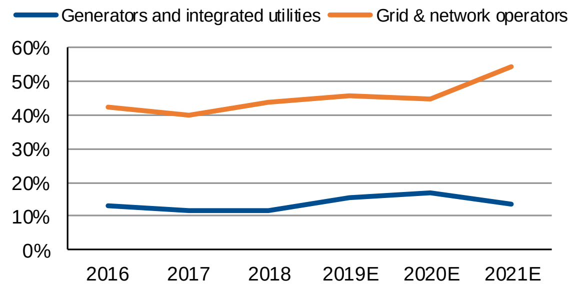
Source: Bloomberg, Scope Ratings

Investment needs continue to pressure free operating cash flows of regulated grid operators

Integrated utilities are no strangers to massive capex commitments, but investment requirements for regulated grid operators are stacking up. Guaranteeing an uninterrupted expansion of renewables-based electricity supply and connecting the growing number of offshore wind parks to the grid requires heavy investment for transmission grid operators. Distribution grid operators are also under pressure to upgrade and modernise their existing infrastructure to cope with renewables-related volatility in electricity supply, e-mobility and decentralised generation (also read Scope's research study: Grid operators face growing multibillion-euro investment challenge, March 2019). All Europe's major power transmission grid operators have increased their capex planned for the years ahead:

- France's grid operator RTE plans increased investment of EUR 33bn for next 15 years, equivalent to roughly EUR 2bn a year against previous annual capex of EUR 1.3bn.
- German grid operators (TenneT-TSO Germany, 50Hertz, Amprion and TransnetBW) have increased expected aggregate expansion capex to EUR 52bn by 2030 from EUR 33bn planned previously. Even more investment in Germany is now likely after regulatory approval for the construction of another north-west long-distance high-voltage cable.
- Italy's Terna (rated A-/Stable) increased its 5-year investment plan by 20% to EUR 6.2bn from EUR 5.3bn to integrate renewable energy supplies.

Figure 5: Capex/revenues



Source: Scope Ratings (31 European utilities rated by Scope)

Such a hefty increase in capex, visible in the sub-sector's rising average capex-to-revenue ratio (Figure 5), is eating into the grid operators' free operating cash flows. However, we see no significant drag on credit quality in the short-term. Grid operators typically have high leverage ratios (Figure 1) while today's accommodative financing conditions clearly help. Given the bankability of expansion capex and the implementation of green or sustainability-linked debt instruments as the norm in utilities financing, grid operators will likely remain in good financial shape.

Political intervention beyond environment concerns

Utilities have long proved to be a playing field for politicians in Europe, and 2020 will prove to be no exception. Environmental considerations, such as the phasing of nuclear and coal in certain markets, or efforts to ensure energy affordability have typically driven political intervention in the past. We now see intervention taking the form of new regulations and politically motivated changes in ownership which might have a short- to medium-term impact on credit quality.

1) Trade-off between protectionism and privatisation

Possible changes in shareholder structures and the shifting role of sovereign or sub-sovereign shareholders in the industry are the most relevant for credit rating. How the trade-off between protectionism and privatisation plays out for major utilities – primarily those with important electricity, gas and water infrastructure assets – is not clear. The presence or absence of a sovereign or sub-sovereign shareholder can lead to rating upgrades or downgrades. Much depends on whether there is a single majority shareholder or a consortium of shareholders with the capacity and willingness to provide extraordinary financial support, if needed, to the utility or utilities which they control.

Not all government-related shareholders are willing to financially support the utilities they own given often stretched central- and local-government budgets and expectations of possibly reduced future dividend income from the companies in question. Potentially diminished state shareholder support for grid operators such as TenneT, RTE or GasNet, Eneco could result in downward pressure on their ratings. In contrast, government-related shareholders in Belgium-based Elia demonstrated their support for the utility by backing its most recent capital increase.

If privatisation can imply downward pressure on credit quality, protectionism or bringing utilities back under the control of central or municipal government – something that is possibly on the agenda in Italy, Spain and the UK – could hold out the promise of rating upgrades. Here much depends on the credit quality of the government-related shareholder/s compared with the utility on a standalone basis. This issue might be critical for privatised electricity, gas and water infrastructure operators in countries where government is intent to warding off non-European investors from acquiring "strategic" energy assets. Such was the case in Germany with utility 50Hertz.

While the short-term rating impact from such re-nationalisation or "re-municipalisation" could be positive, the medium-term impact might not be, depending on the implications for regulated tariffs and cost control at the utility itself.

2) Regulation: a mixed blessing for electricity sector

Regulation remains a blessing and a curse for the sector. The focus in 2020 will be on regulators' changes to how utilities are remunerated for grid/network usage and the functioning of capacity markets.

Regulators will continue to tighten the thumbscrews on the 'adequate' weighted average cost of capital on invested capital (regulated asset base) in line with low borrowing rates and the desire to provide incentives for improving operating efficiency. Tighter regulatory oversight will turn out to be less beneficial for regulated grid/network operators compared with the recent "golden past". However, any fair adaptation of tariffs to market conditions will not upset the average credit quality of regulated entities. Slight tariff cuts can to a certain extent be offset by an increasing RAB, better financing conditions and continued efficiency gains. Drastic regulatory changes as proposed by the Spanish regulator CNMC last summer – we remember Spain's retroactive cuts on renewable energy tariffs – will likely prove an exception in Europe.

Energy transition and renewables

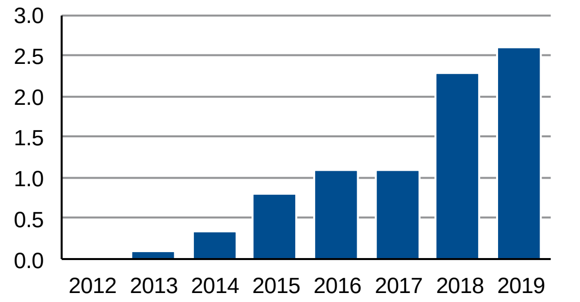
Integrated utilities and IPPs are continuing to contribute their share of Europe's long-term environmental commitments, particularly the EU's 2030 renewables targets (32% against around 19% in 2019E). Utilities are focusing on renewable-energy projects as they continue to transform portfolios, ramping up investment in electric-vehicle infrastructure and boosting investment in new technology, such as innovative storage. Major integrated utilities such as Iberdrola, Enel, EDP, Engie, Statkraft have signalled their continued investment plans in greenfield investments. Independent power producers (IPPs) such as Germany's Encavis (rated BBB-/Stable) or French Neoen continue to boost their generation portfolios with the help of comparatively cheap funding, thereby biting into the market shares of integrated power utilities.

Overall, the impact on free operating cash flow remains broadly neutral compared with previous years as:

- investment volumes are down from the peaks prior to 2017 and balanced against improved operating cash flows; and
- cheap and, mostly green funding sources, are not significantly weighing on credit metrics. And greenfield investments in renewables or acquisitions of IPP's projects or portfolios can quickly help utilities pay off additional debt.

Integrated utilities without the financial leeway for new investment can increasingly engage in power purchase agreements with IPPs to procure and supply cleaner energy, thereby improving their environmental credentials. While PPAs (with utility's and non-utilities as off-takers) should give a further boost to IPPs and developers of renewables projects, such agreements will pose an increasing threat to power suppliers. As capital-intensive companies – such as chemicals, pharmaceuticals, railways, data centres – increasingly turn to offtake agreements – so-called Corporate PPAs – with generators, these deals will in the medium-to-long term weaken the position of power traders/suppliers as the intermediaries between generators and consumers (see also Scope's research European electricity: Renewables-based PPAs transform sector, October 2019).

Figure 6: Corporate PPAs for renewable capacities (in GW) in Europe – only PPAs with non-energy off-takers



Source: Bloomberg New Energy Finance, Scope Ratings

External sector disruption to continue

The steadily increasing involvement of industry outsiders such as oil and gas majors as well as financial investors – which often obtain better financing conditions than utilities – in energy infrastructure remains a hot topic in 2020. We expect further landmark deals with oil and gas majors or financial investors on the bidder's side. While financial investors simply look for investments which promise the payment of recurring dividends or profits, oil and gas firms seek increasing diversification and 'forward integration', particularly in light of volatile oil and gas markets. Investing in electricity assets could provide a buffer against the potential volatility in the core business or broaden their access to retail rather than industrial customers. These companies are also laying long-term plans for what might replace their core business if and when hydrocarbons start playing a significantly less important role in economic activity.

The most prominent oil and gas major disrupting the utility's landscape is Anglo-Dutch company Shell which officially announced its plans to become the world's largest electricity company by 2035 through owning or purchasing 61 GW of power capacity. To show its intent, Shell backed a bid for Dutch electricity supplier Eneco in 2019 though it lost out to a EUR 4.1bn rival joint offer from Mitsubishi Corp. and Japanese utility Chubu Electric Power.

Utilities can ill afford to stay out of the merger game for risk of losing market share despite a natural reluctance to overpay for assets and embark on mergers (also read Scope's research study: More predators than prey as deal-making pushes asset prices higher, August 2018). Utility executives have to balance natural reluctance to overpay for assets or undertake mergers with the risk of losing market share to new entrants. Lost market share might be to the detriment of their credit quality in the long term, either in itself or because that then forces management into M&A deals at a later date in more unfavourable circumstances. It is a difficult trade-off between "staying in the game" and accepting prices which might not pay off in the medium term.

Figure 7: Recent landmark deals from utility outsiders

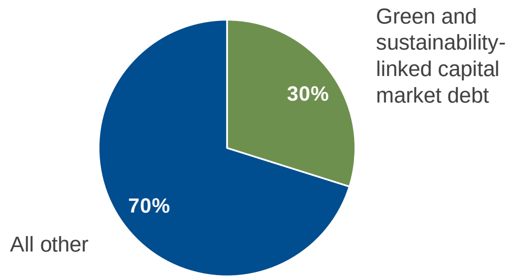
Target	Bidder	Date
402 MW offshore farm (80%)	Consortium of KGAL and CommerzReal	Q1 2019
600 MW offshore farm (100%)	Consortium of Total, Ørsted and Elicio	Q1 2019
NovEnergia II	Total Eren – subsidiary of Total SA	Q1 2019
GasNet in the Czech Republic (50.04%)	Consortium led by Macquarie Infrastructure and Real Assets	Q2 2019
Alpiq Holding Ltd (26.98%)	CSA Energy Infrastructure Switzerland (Credit Suisse)	Q2 2019
23 onshore wind farms from EDP Renovaveis (51%)	J.P. Morgan Asset Management	Q2 2019
East Anglia ONE offshore wind farm	Green Investment Group	Q3 2019
Eneco	Consortium between Mitsubishi Corporation and Japanese utility Chubu Electric Power Co Inc	Q4 2019

Source: EY, KPMG, Scope Ratings

Sustainability-linked financing providing flexibility beyond green bonds

Utilities remain one of the driving forces behind the further growth in green finance. Utilities across all sub-segments from generation, transportation and distribution to supply are continuously widening the options for investors looking for 'sustainable' investment. Examples include Italy's grid operator Terna (rated A-/Stable) which is using green bonds and green credit facilities; Germany's independent power producer Encavis (rated BBB-/Stable) issued a green Schuldschein; Norway's municipal utilities BKK (rated BBB+/Stable) and Eidsiva Energi (rated BBB+/Stable) issued green bonds.

Figure 8: European utilities' usage of green-labelled capital market debt (bonds and hybrids) in 2019 (measured by issued volume)



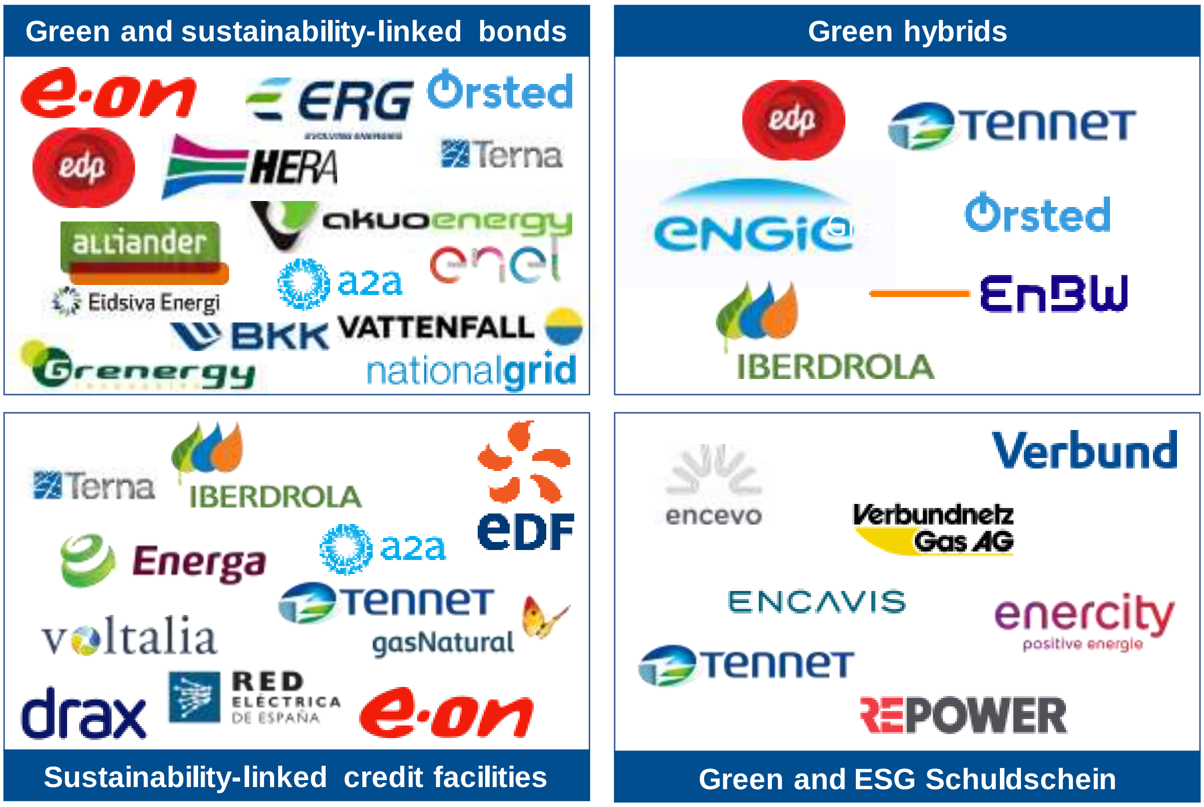
Source: Bloomberg, Scope Ratings

Overall, around EUR 20bn of the roughly EUR 65bn capital market debt issued by European utilities in 2019 (30%) has carried the green or sustainability label. We expect that this share will significantly increase in 2020, bolstered by the wide investor demand of such financing instruments and the increasing establishment of ‘green bond frameworks’ for most utilities.

Green-labelled financing is open to any industry, but experience from last year shows how well-placed utilities are to attract investors with bonds, hybrids, Schuldschein loans or bank facilities linked to environmental, social and green (ESG) factors. The utilities earmark such funds for investment in sustainable projects such in renewable energy, energy storage, energy-efficiency, e-mobility by issuing securities whose features, primarily interest rates, are linked to key performance indicators (KPI) such as carbon-emission reductions or water conservation metrics.

The latter ESG-linked facilities may provide more flexibility than the green loans since the use of the facilities is not limited to a specific green investment - on the contrary, they can be used for general corporate purposes. As ESG-linked debt facilities may be more rewarding for the issuers in terms of pricing according to sustainable performance, they may become the preferred financing tool over “green” debt. The question remains whether utilities which rely increasingly on green finance can do so without sacrificing their financial performance. Meeting ESG-linked KPIs that serve as covenants in loan/bond agreements in return for a reduced coupon requires utilities to incur up-front costs – new investment or setting up new efficiency programs – which might exceed potential interest savings and reputational gains.

Figure 9: Recent green and sustainability financing instruments



Source: Scope Ratings

Annex I: Related research

“European electricity: Renewables-based PPAs transform sector”, published October 2019 available here

“Europe’s energy transition: TenneT privatisation, RTE capex plans show grid finance challenge ahead”, published September 2019 available here

“Power, oil & gas executives look beyond dazzle of electric cars: interview with Scope Ratings”, published September 2019 available here

“Mobility transition and utilities: Governments, utilities face emissions, opportunities, challenges from electric-car boom”, published September 2019 available here

“Grid operators face growing multibillion-euro investment challenge”, published March 2019 available here

“Germany’s coal exit: Mixed medium to long-term implications”, published January 2019 available here

“European utilities outlook 2019: Political, regulatory risk moves centre stage”, published December 2018 available here

“More predators than prey as deal-making pushes asset prices higher”, published August 2018 available here

“European utilities outlook 2018: leaving behind the trough”, published November 2017 available here

“Commodity Rebound – Past the Trough”, published November 2017 available here

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