12 September 2018 Corporates

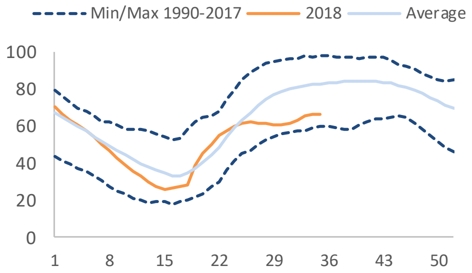
Norwegian Utilities: Debt ratios set to fall faster on higher prices

Norway's vertically integrated hydropower utilities are well placed to trim debt ratios faster than expected in the quarters ahead. Surging power prices could be offsetting lower output after a dry summer and lower grid-segment profitability. In view of Scope Ratings' increased coverage of Norwegian utilities, we take a closer look at some of the current topics and trends in the sector.

Hydrological update – Reservoir level below average, but no drama

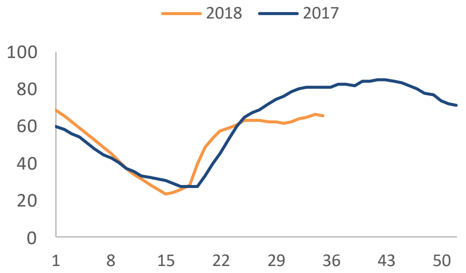
The Hydropower reservoir levels in the Nordic countries stood at 65.2% of total capacity in late August 2018. With approximately 120 TWh of storage capacity (30% of Nordic generation), the hydrological conditions are of importance – and even more in Norway in particular (i.e. >55%). After a dry summer, the reservoir levels in Norway stood at 65.5% of capacity at the end of week 35, which corresponds to 17 pp lower than the seasonal average and only 6 pp above the minimum level registered since 1990. There are regional differences, with the NVE area 3 (middle and northern Norway) at record low levels for the season (i.e. 60%). As seen in figure 1, there has been a slight increase in the reservoir levels in August, helped by above average hydro inflow.

Figure 1: Water-reservoir levels Norway



Source: NVE, Scope

Figure 2: Water-reservoir levels Nordic



Source: NordPool, Scope

Looking at the forecast provided by NVE, there is high probability that the water reservoir levels will remain below average throughout the year and potentially hit record low levels next spring. However, Scope is not overly concerned about the risk of lower future rainfall and expects absolute water levels to be sufficient for market balance in the longer term. Norway also has the possibility of importing power. Scope notes positively that regional differences in water levels are less of a concern for the overall supply situation than some years ago, as grid capacity has improved. However, it could have consequences for an individual company, as the ability to produce higher volumes for companies with low reservoirs levels will be reduced. Then again, the spike in power prices they achieve for the unhedged production affect them positively.

Pricing update: Reservoir levels alone do not explain higher prices

Nordic power prices have increased more than 90% since year end to around EUR 57/MWh at the beginning of September (+70% Y-o-Y), judging by the weekly spot price on NordPool. Though lower hydro reservoirs are factor, rising prices are clearly linked to the sharp increase in coal and CO2 prices on the European continent, where the latter has more than tripled in one year and is at the highest levels since 2008. The sharp increase is driven by the imminent introduction of the EU's Market Stability Reserve, expected to reduce the supply of CO2 allowances. Higher CO2 prices are also triggering increased discussion around fuel-switching, i.e. could see a phase-out of coal faster in selected continental European countries.

Analyst contact

Henrik Blymke
+47 21 62 31 41
h.blymke@scoperatings.com

Media

Matthew Curtin
+49 16 24 36 48 61
m.curtin@scopegroup.com

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Scope Ratings GmbH

Haakon VII's gate 6
0161 Oslo
Phone +47 21 62 31 41

Headquarter

Lennéstraße 5
10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

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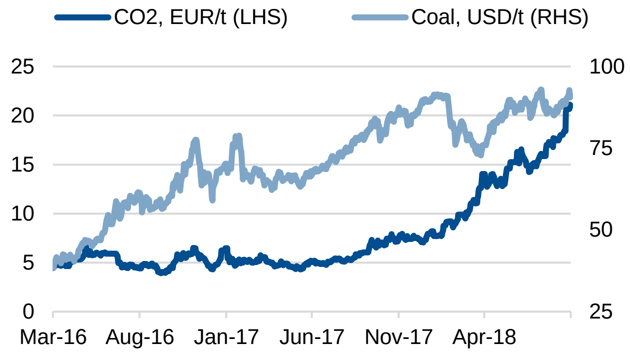
Sharp increase in CO2 prices sparks fuel-shift discussion

Scope notes that the forward curve on NordPool has been lifted sustainably from August 2017. The Q4 price contract hit 7-year high lately amid concerns about supply, with lower nuclear output and a weak hydrological balance compared to normalized levels. As of early September 2018, the forward contracts indicate above EUR 50/MWh until the early spring of 2019.

Dry weather & less wind keeps short-term forecast prices high

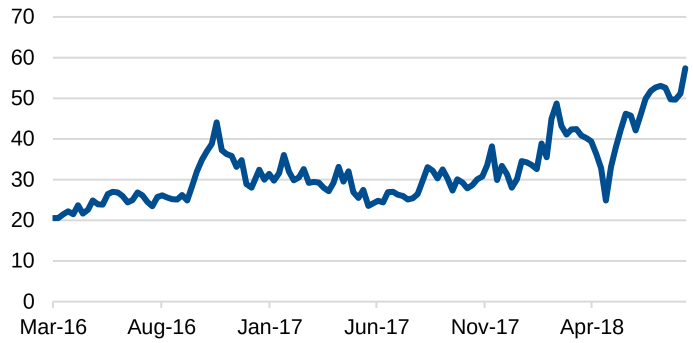
Scope's short-to-medium term expectations for the NordPool power price has also increased in line with the recent movement of the forward curve in the market, and we expect generation companies to benefit from the increased prices, though some companies are partially held back by previous price hedges at lower levels. Scope does favour utilities which use hedging programs to ensure earnings stability in power production units, looking at the hedge percentage of anticipated volume and its dynamic structure.

Figure 3: Coal and CO2 emission price development



Source: Scope / Bloomberg

Figure 4: Weekly Nord Pool spot price (EUR/MWh)



Source: Scope / NordPool

Regulations update for grid operators: Modest changes in Norway, more significant move in Sweden

New legislations could spark new investments and increased equity interest from long-term investors

Scope has previously commented in connection with public utility ratings that tariffs settings under the Norwegian regulatory framework has been stable and reliable and is set to remain so. Below, we highlight some of the recent regulatory changes affecting grid companies and their implications.

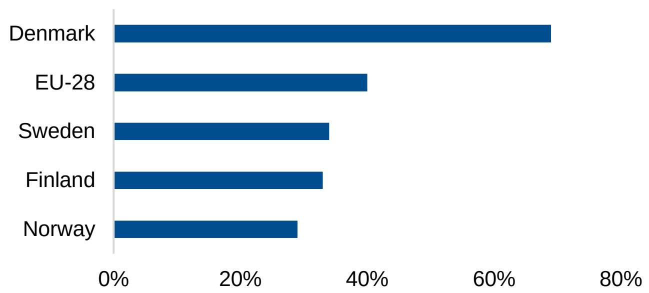
- In June 2018, the Norwegian government proposed to allow insurance companies and pension funds to own more than the 15% (the previous hurdle) in other businesses than so-called "insurance-related businesses". This will give the entities more flexibility to invest in, for example, infrastructure projects and power grids. The new proposal will not have a definitive percentage level, but be approved on a case-by-case basis by the Financial Supervisory Authority. Scope sees this as a positive development for companies eager to find sources of equity investment for their typically heavy capital expenditure programmes.
- Also in June, NVE (The Norwegian Water Resources and Energy Directorate) proposes to change the reference rate used to regulate the permitted income for grid companies by 0.4 percentage point from 2019, and also adjust for a new KILE (i.e. related to a cost element for non-supplied energy to customers). Scope notes that these effects will result in lower return for the grid companies, but believe they are manageable, particularly for efficient and financially healthy grid companies.

Norwegian grid companies profitability to decline…

… and the Swedish grid-paying customers can soon applaud?

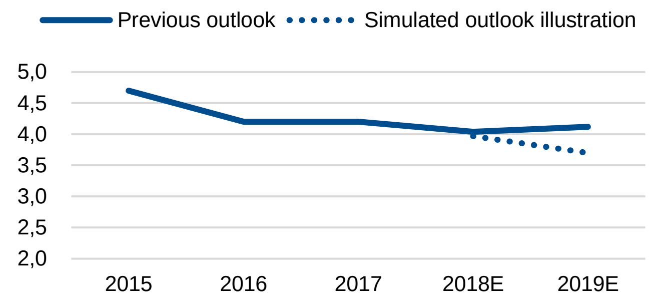
- A more drastic development is the Swedish government proposal in August this year that could reduce permitted income by up to 21% for selected grid companies in Sweden from 2020 through a lower allowed rate of return. Though not all the details are available at the moment, Scope anticipates that this could reduce the investment ambitions of Swedish grid companies, considering the new rate of return would be below the European average. Comparing also the electricity price paid by the consumer, Sweden is paying much less than Denmark for instance, both in terms of absolute price and share of tax (figure 5). The move from the Swedish government to reduce the allowed grid revenue, could be seen as a response to the political pressure on the profitability levels and increased levies some of these companies have seen in recent years.

Figure 5: Share of taxes and levies paid by household consumers for electricity, second half 2017



Source: Eurostat

Figure 6: Average Scope-adjusted debt / EBITDA ratio for selected vertically integrated rated utilities by Scope



Source: Scope

Outlook summary: Nordic utilities look well positioned

Power production segments are gaining larger share of group profitability in vertically integrated companies

Among Scope's Nordic rated vertically integrated utilities, we have seen a clear tendency this year for hydropower production segments to increase their contribution to group earnings compared with the companies' grid operations. The reason is both lower profitability in grid-related businesses and higher profitability in electricity generation, helped by rising prices. With the current power price estimates and changes to the NVE permitted income and KILE calculations, this trend could continue into 2019 for many companies. This might have an impact on an indicative industry rating assessment for vertically rated utilities, but as Scope looks at normalized share of EBITDA levels over time, sustained improvements in prices and profitability would be needed before there would be any material changes. That said, should higher power prices persist, Scope sees the possibility for faster deleverage than previously expected for the utilities it rates[1] (as illustrated in figure 6).

Scope with positive outlook on the utility sector - Nordic utilities attractively positioned

Though higher power prices are likely to give many companies some additional headroom in meeting expected capital expenditure requirements, Scope notes that all companies in our public coverage have a Stable outlook. More broadly, Scope has a positive outlook on the European Utility Sector (see *the 2018 Corporate Outlook: Mature Credit Cycle with Signs of Exuberance*). Further, we would argue that the renewable utility companies in the Nordics are well positioned to benefit from more regulatory changes in EU, such expected higher CO2 allowance prices. In the longer term, we also note Nordic interconnection capacity will have increased by 2020, another benefit for hydropower producers with storage capacity: They can produce and sell electricity when market conditions are most attractive.

[1] *Lyse Energi (BBB+/Stable), Agder Energi (BBB+/Stable), Eidsiva Energi (BBB-/Stable), Glitre Energi (BBB/Stable), BKK (BBB+/Stable).*

Scope Ratings GmbH

Headquarters Berlin

Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main

Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 38 0

Paris

33 rue La Fayette
F-75009 Paris

Phone +33 1 82885557

London

Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 203-457 0 4444

Madrid

Paseo de la Castellana 95
Edificio Torre Europa
E-28046 Madrid

Phone +34 914 186 973

Milan

Via Paleocapa 7
IT-20121 Milan

Phone +39 02 30315 814

Oslo

Haakon VII's gate 6
N-0161 Oslo

Phone +47 21 62 31 42

info@scoperatings.com
www.scoperatings.com

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