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Spotlight On Italian Utilities: Outlook Stable Despite Complex Operating Conditions

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Although the recession of 2009-2014 has officially ended, the operating environment for Italian utilities remains tough. A moderate economic recovery and a shift toward energy efficiency are reducing the demand for power. However, the Italian utilities rated by Standard & Poor's Ratings Services have lost none of the resilience they demonstrated toward the harshest recession in the country's history. For most Italian utilities we rate, this resilience is partly attributable to the share of regulated activities in their business mix, which has enabled stable financial performance despite weak economic conditions.

Overview

- The outlook for our portfolio of regulated utilities in Italy is stable, primarily reflecting the supportiveness and predictability of the regulatory regime.
- We believe that the operating environment for Italian utilities is becoming increasingly complex. Power prices are unlikely to rebound due to oversupply, and a cut in allowed returns on electricity and gas transmission and distribution from 2016 will weigh on profitability.
- However, we anticipate that Italian utilities will maintain a relatively prudent approach toward investments, while keeping a tight rein on costs over 2016-2018.
- In our view, growth opportunities for utilities with exposure to Italy are bound up with mergers and acquisitions (M&A). Increasing M&A activity could affect the ratings in our portfolio, although sizable cost synergies and credit-friendly transaction terms would mitigate this risk.

We believe that the operating environment for Italian utilities is becoming increasingly complex. The expected drop in remuneration for regulated assets from 2016, along with the shallow economic recovery, cast doubt on the profitability of Italian utilities' future investments, on their long-term growth potential, and on their strategic response to changes in demand. We believe that Italian utilities' growth prospects are linked to market consolidation, especially for those operating solely in the domestic market. However, although mergers and acquisitions (M&As) are increasing, we consider that local political resistance toward consolidation will persist.

The Outlook For Our Rated Italian Utilities Is Stable

The stable outlook on the utilities we rate in Italy (see table 1) contrasts with the increasing proportion of negative outlooks on the utilities we rate in the rest of Europe, as well as in the Middle East and Africa. Negative outlooks represent about 20% of the 120 utilities that we rate in EMEA, compared to about 11% in Italy (see chart 1).

Table 1

Italian Utilities--Ratings And Outlooks

Company	Long-term rating	Short-term rating	Outlook
SNAM SpA	BBB	A-2	Stable
Terna SpA	BBB	A-2	Stable

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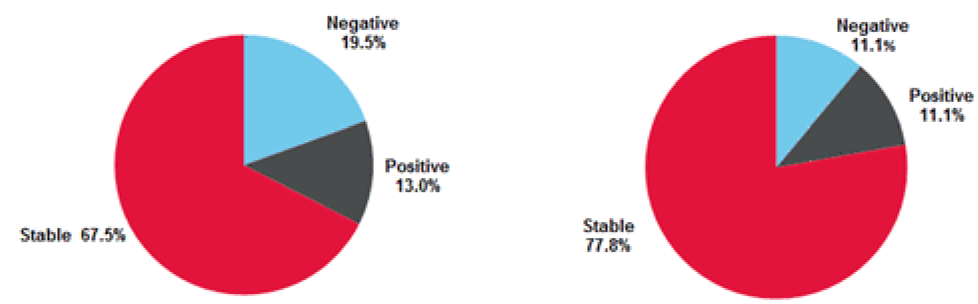
Table 1

Italian Utilities--Ratings And Outlooks (cont.)			
2i Rete Gas	BBB	A-2	Stable
Societa Metropolitana Acque Torino SpA	BBB	--	Stable
Enel SpA	BBB	A-2	Positive
A2A SpA	BBB	A-2	Stable
Hera SpA	BBB	A-2	Stable
Edison SpA	BBB+	A-2	Negative
Acea SpA	BBB-	A-3	Stable

Source: Standard & Poor's 2015.

Chart 1

EMEA Utilities' Outlooks Versus Italian Utilities' Outlooks



Source: Standard & Poor's 2015.

The greater proportion of stable outlooks in Italy is down to the following credit-supportive developments we have observed since last year:

- An end to the economic recession in Italy in the first quarter of 2015, according to quarterly GDP data;
- The stabilization of the outlook on our unsolicited 'BBB-' long-term local and foreign currency ratings on Italy in December 2014;
- The alleviation of fiscal pressure with the termination of the so-called "Robin Hood" tax on regulated utilities' corporate earnings and the remodeling of the taxable income base for IRAP (Imposta Regionale sulle Attività Produttive, or the Italian regional production tax); and
- Political support from the Italian central government for energy market integration.

In addition, since the beginning of the recession in 2009, rated Italian utilities have focused on adapting their cost bases to the changing market environment and rationalizing their investments, which has resulted in positive free cash flow generation and consequently, stable credit metrics. Cost synergies have also been among the drivers for M&As in this period.

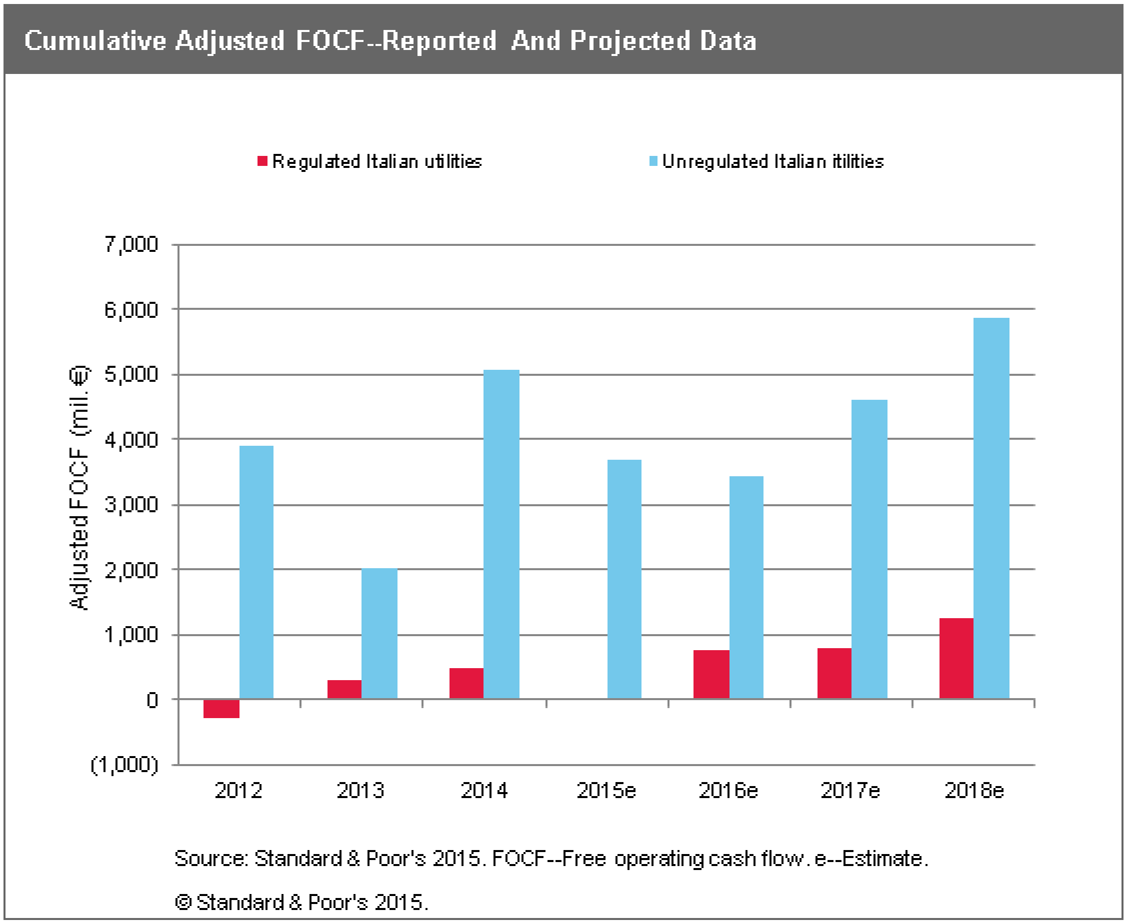
Investments Will Remain Prudent Over The Next Three Years

We believe that the operating environment for Italian utilities is becoming increasingly complex. This is partly because, from 2016, we expect a decline in remuneration for the regulated assets that supported profitability during the 2009-2014 recession. Furthermore, so far, there has been little progress on addressing some of the industry's most pressing issues, namely:

- Overcapacity at thermal power generation plants and uncertainties over the implementation of a capacity payment model (see section below titled "Overcapacity Will Remain A Problem For Thermal Power Plants");
- The time it will take to transition fully to a free power supply market, especially as delays to the current target date of 2018 are likely;
- The lack of a comprehensive regulatory review of the environmental sector, which is a core part of Italian multi-utilities' business; and
- Concession renewal risks in hydro generation and gas distribution, with the start of gas distribution tenders being systematically postponed.

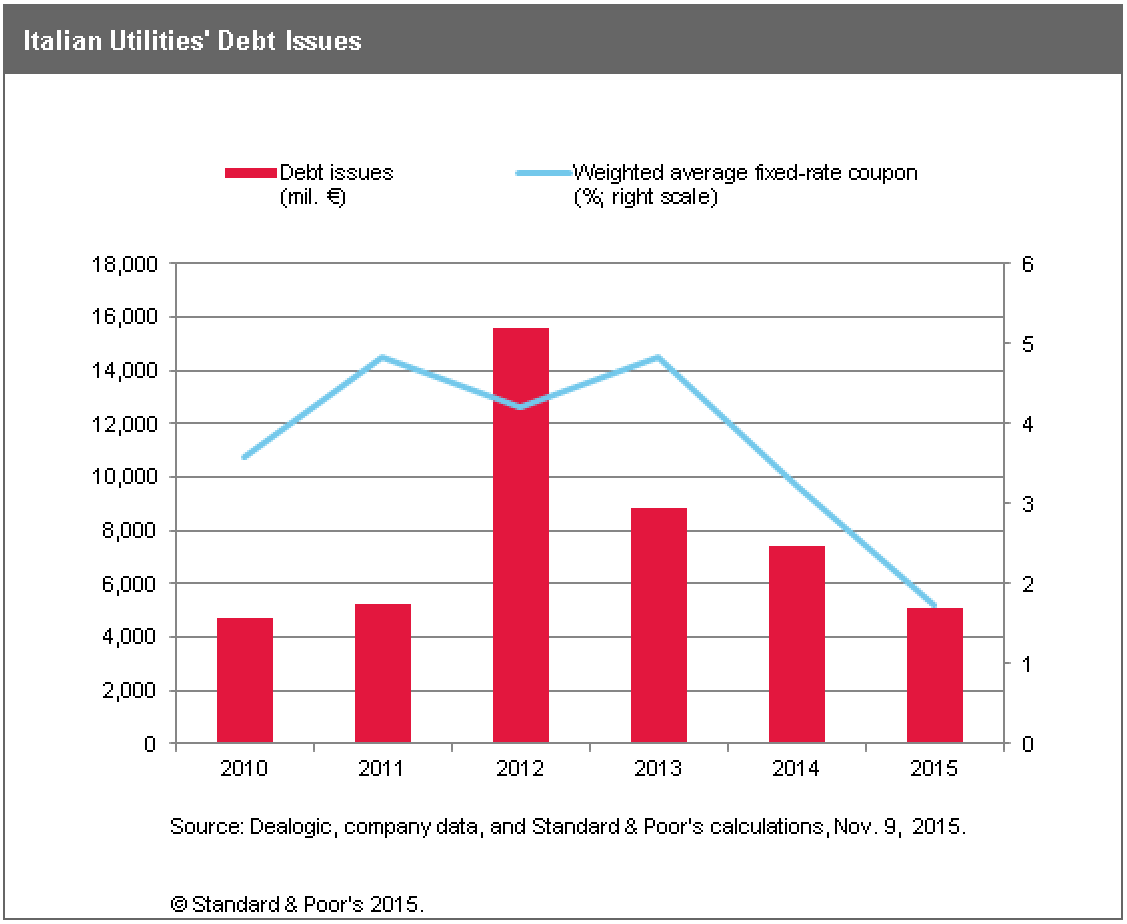
In our view, uncertainties over the returns on investments in a context of low growth pose a major strategic challenge for Italian utilities, particularly those operating solely in Italy. Consequently, we anticipate that Italian utilities will maintain a relatively prudent approach to investments, while keeping a tight rein on costs over 2016-2018. As a result, free cash flow generation remains positive in the base case for our sample of rated utilities (see chart 2).

Chart 2



We believe that prudent investment policies, together with the low cost of bank debt, will constrain bond market activity in 2016, as it has done this year. We expect to see issuers tapping the market mainly for refinancing purposes. In our sample of Italian utilities, just less than €40 billion of debt is due to mature in 2016-2020 (see chart 3).

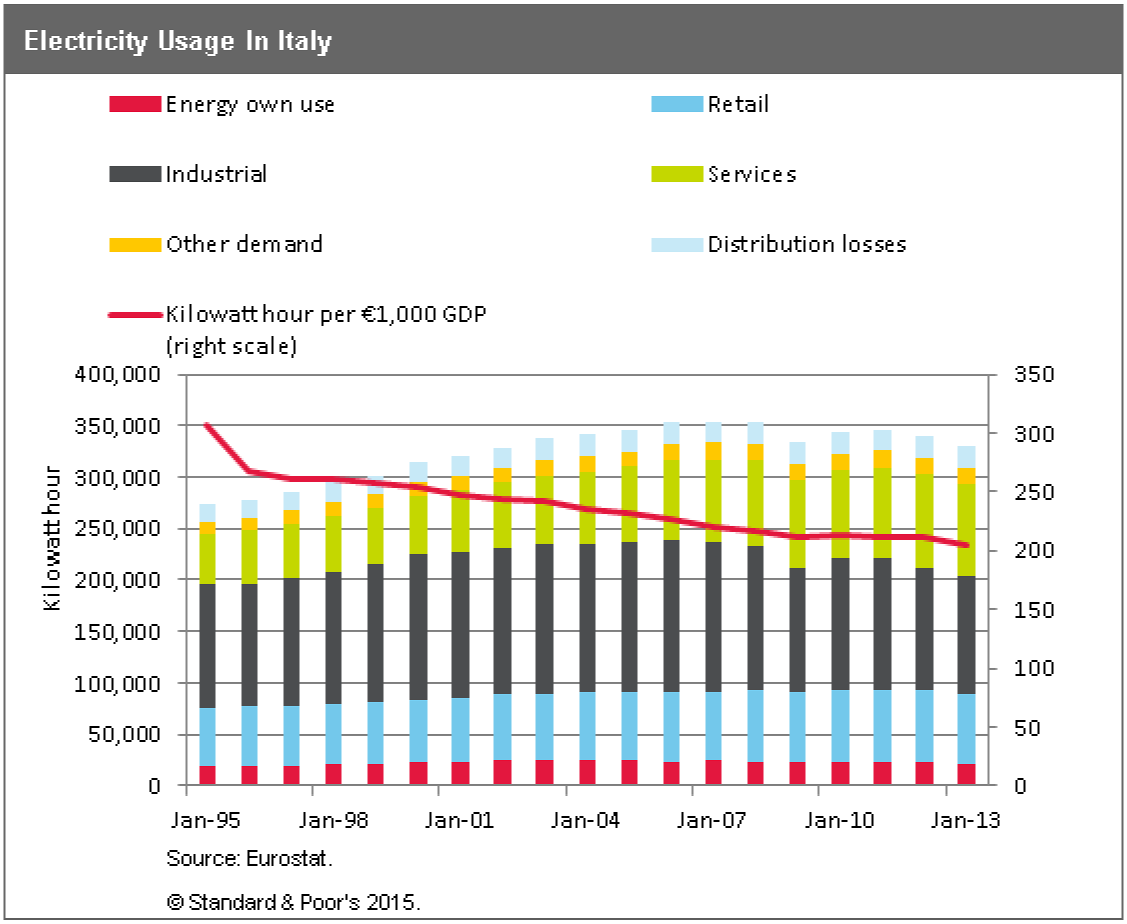
Chart 3



The Correlation Between Economic Growth And The Demand For Power Is Weakening

Italian GDP returned to positive growth for the first time in three-and-a-half years in the first quarter of 2015 (see "Italy's Shallow Recovery," published Sept. 23, 2015). A recovery in the demand for power from July 2015 therefore came as little surprise. However, the once strong correlation between growth in GDP and the demand for power is weakening in Italy, as it is in other European countries (see chart 4). The growing disconnection is essentially the result of a structural decline in energy consumption owing to increased energy efficiency, together with what we perceive to be deindustrialization in Europe, especially in electro-intensive sectors. Therefore we do not expect to see future power and gas volumes recovering quickly to the levels we observed before 2009.

Chart 4



Electricity Usage In Italy

Source: Eurostat.

© Standard & Poor's 2015.

Overcapacity Will Remain A Problem For Thermal Power Plants

Despite signs of a recovery in demand in the summer of 2015, combined cycle gas turbine (CCGT) power production remains uncompetitive. It was only weak hydro conditions in July that allowed combined CCGT plants to operate profitably. However, this situation confirms the ongoing need for CCGT technology in a system where intermittent renewable power generation plays a major role. It also supports the rationale for a "capacity payment model," whereby the remuneration of modern CCGT plants would be fixed, rather than linked to market conditions. Such plants can be employed to compensate for potential deficiencies in supply from renewable energy, and thereby guarantee continuous and reliable service. A capacity scheme would identify and remunerate the most flexible power plants and improve their financial sustainability.

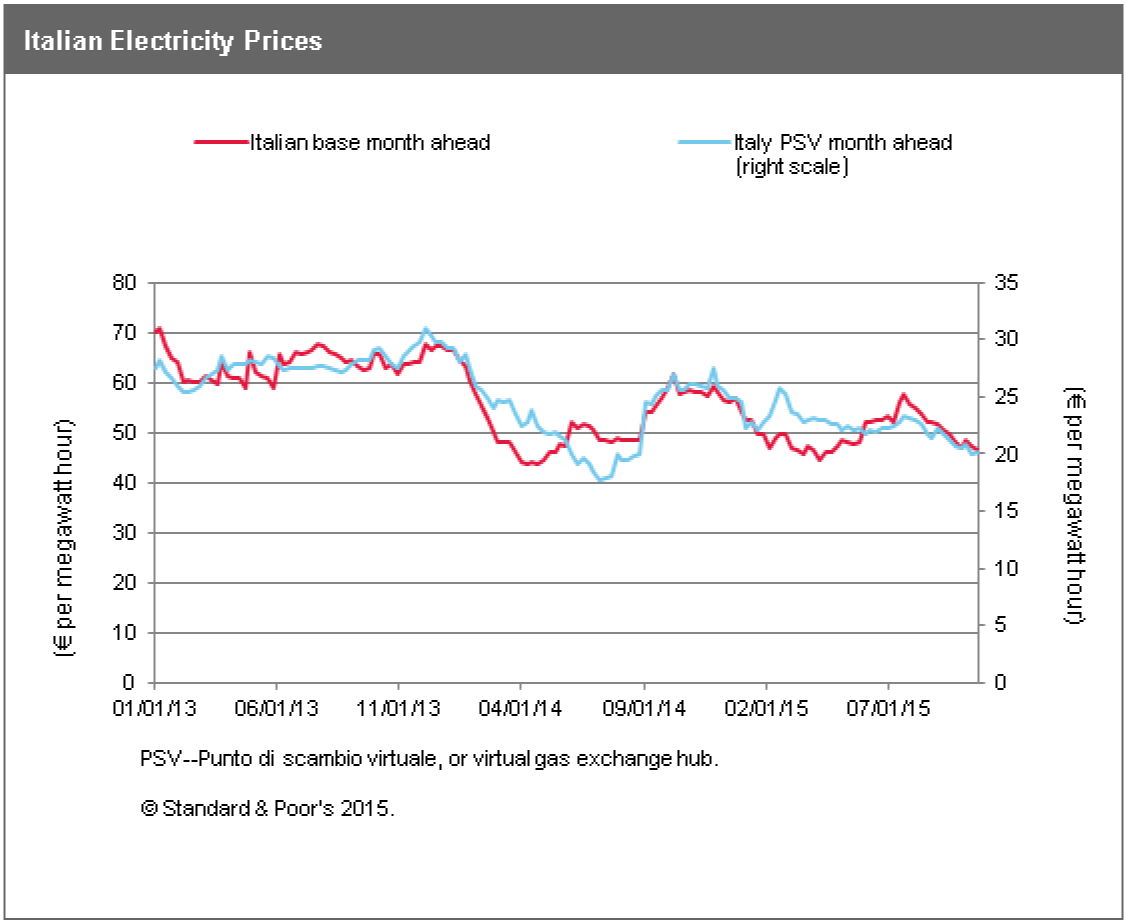
The Italian Ministry of Economic Development approved the capacity payment model on June 30, 2014, with the endorsement of the Italian regulatory authority AEEGSI (Autorità per l'energia elettrica il gas e il Sistema idrico). The aim of the capacity model is to ensure the long-term availability of electricity capacity, to manage any security issues, and ultimately, to ensure that end customers are not subject to hefty price increases.

In recent years, the amount of additional thermal power capacity that has been commissioned in the Italian electricity market has been small, and outweighed by the amount of capacity that has been decommissioned. In 2014, Italy's incumbent generator Enel announced the decommissioning of 13 gigawatts (GW) of thermal capacity, of which it has decommissioned 8 GW to date. We do not expect that a material amount of additional thermal power capacity will be commissioned. According to data from energy information provider Platts, some projects to build CCGT plants and/or convert existing plants to coal-fired from oil-fired production have been approved, but the final decision over whether to start construction in 2017 has not yet been taken. On the other hand, renewable power capacity is set to grow, albeit at a much slower pace than in 2011 and 2012, when photovoltaic capacity grew by about 15 GW and onshore wind by about four GW. At the same time, demand for power remains largely flat, further constraining the demand for thermal power production.

Power Prices Are Unlikely To Recover

In Italy, gas power plants function as the price-setting plants for the market, meaning their marginal costs determine the price of power. As a result, the recent drop in natural gas prices has translated into notably lower power prices. The decline in power prices (see chart 5) has affected hydro power plants the most, as they have very low marginal costs and stable input costs, whereas gas power plants are able to partly offset lower power prices with lower fuel costs.

Chart 5



Flat power demand and thermal capacity oversupply mean that we don't expect a rebound in power prices in Italy from their current level of less than €50 per megawatt (MW) hour over the next two-to-three years. The ongoing addition of small amounts of renewable power capacity is pushing less efficient power plants down the merit order and making the price-setting plant more efficient. This is placing additional pressure on future power prices.

Our forecast assumes flat carbon dioxide (CO_2) prices. Support for higher CO_2 prices seems lacking, although we understand that the forthcoming climate conference, COP 21, will highlight that, while EU countries are on track to meet 2020 CO_2 emissions reduction targets, they are likely to miss those in 2030 unless governments implement additional measures. Although CO_2 pricing is not COP 21's principal objective, we believe that drawing attention to the issue of CO_2 emissions targets will refocus attention on pricing. CO_2 emissions are currently priced at €8 per tonne, with Thomson Reuters forecasting an increase to €25 per tonne by 2026, based on the EU Emissions Trading System reform package implemented in July this year.

CCGT plants' earnings remain under pressure (see charts 6 and 7). Because the plants are not in constant use, their fixed costs are not covered. Without a long-term solution for these plants' financial sustainability, CCGT generators are redoubling their efforts to reduce their fixed-cost bases. The recent agreement between A2A and Sorgenia SpA for the mutual use of their power generation plants for a period of five years is evidence of CCGT generators' efforts to achieve cost synergies by managing their plants more efficiently.

Chart 6

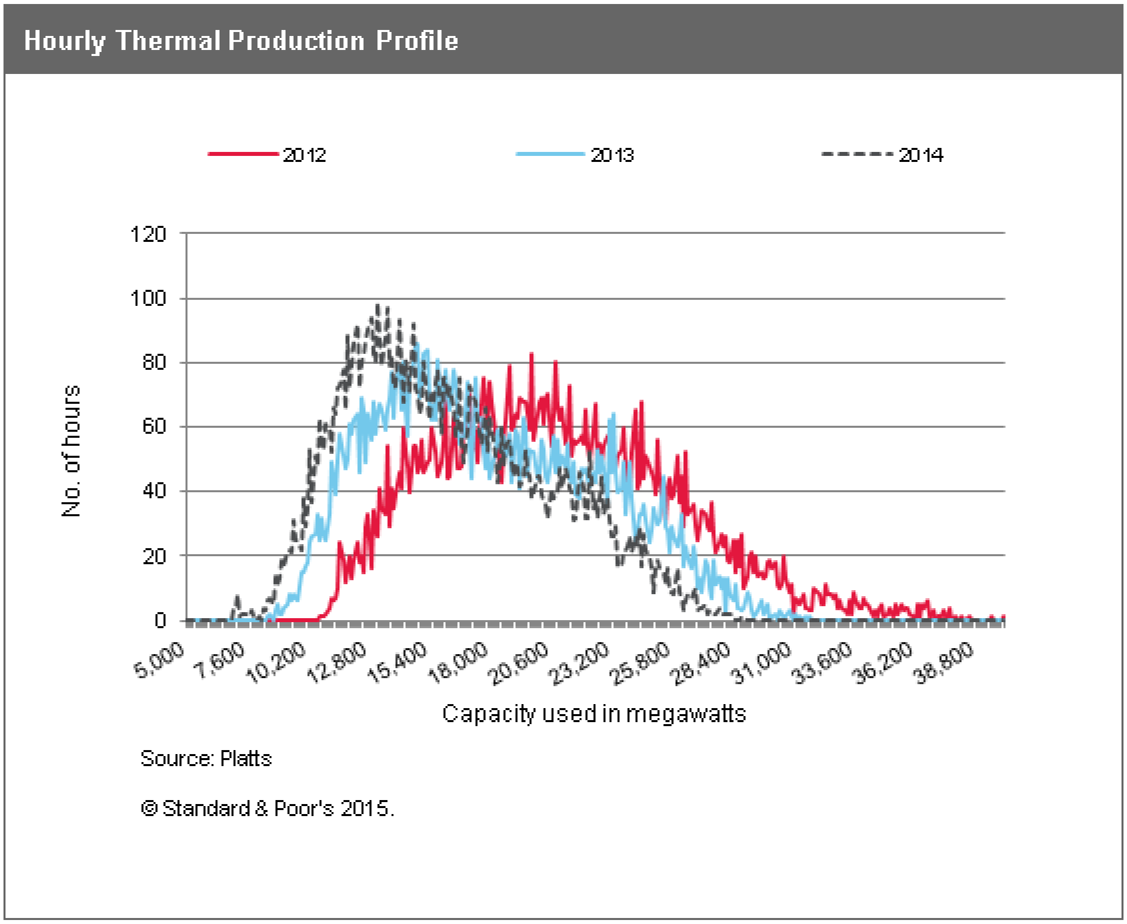
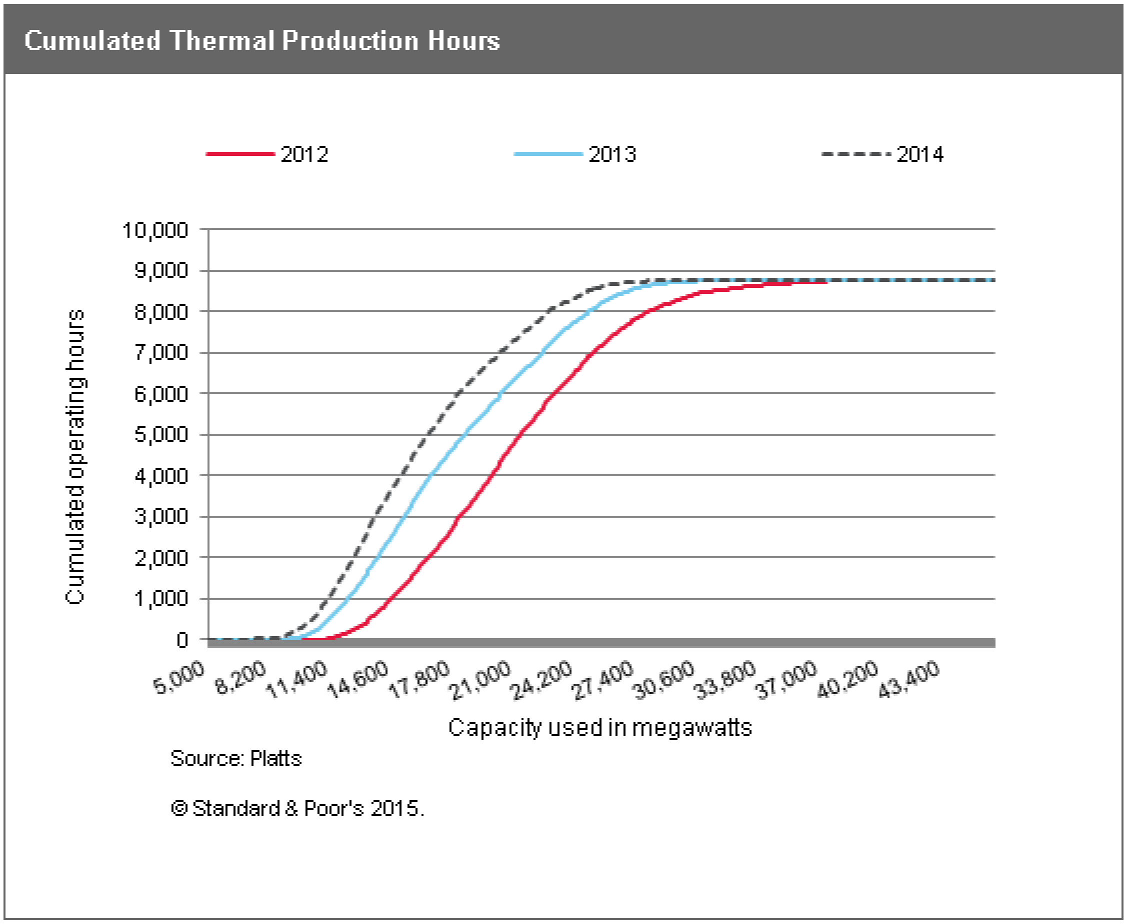


Chart 7



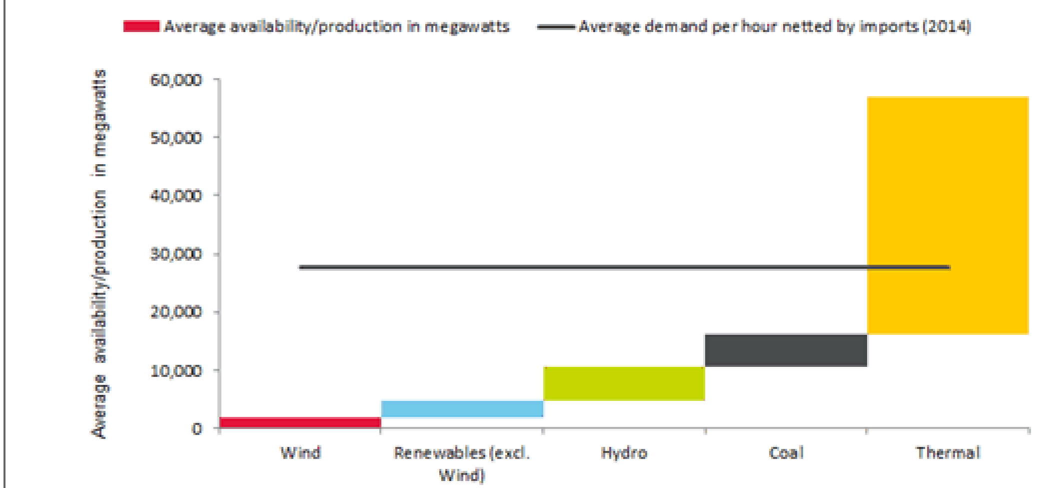
If the capacity payment model is implemented, efficient CCGT plants with certain technical features would be remunerated for their total costs. This would improve their margins. However, we remain cautious about whether the scheme can be implemented effectively, because in Europe there is no common approach to the use of capacity remuneration schemes to ensure supply in a market where intermittent renewable energy sources are increasing. Germany, for example, is moving toward an "energy-only" market, which remunerates plants for the amount of time they are running. A single interconnected European power market is unlikely to coexist with nationally sponsored capacity markets.

The European Commission's state aid sector enquiry into national capacity mechanisms is likely to challenge, if not postpone, the deployment of the capacity payment model in Italy with negative consequences for gas generators like A2A, Sorgenia, and Edison, because without this model, they would continue to incur losses in current market conditions. At the same time, Enel--which produces 27.2% of Italy's electricity, mainly from coal--does not advocate the introduction of the capacity model, considering it to be inefficient and distortive of long-term price signals.

However, we believe that further slippage of CCGT plants down the merit order is likely, albeit to a modest extent, as the potential for additional wind and hydro capacity is limited (see chart 8). We believe that only solar energy could make a difference to the merit order, but after a huge increase in capacity over 2010-2013 on the back of incentives, the addition of new capacity has slowed this year. Less than 20% of the initial forecast of 1 GW of capacity per year is due to be realized in 2015, with residential installations accounting for most of this amount. Declining equipment costs and new business models in the photovoltaic industry could further support solar capacity growth in Italy among small-to-midsize enterprises, but funding constraints may hold back development.

Chart 8

Average Hourly Demand Versus Capacity



Source: Platts.

Whether there is a role in this market for utilities remains unclear, especially as Italy's increasingly decentralized power market requires that new business models differ from traditional utility frameworks and competencies. We are more confident about the prospect of consolidation of solar generation capacity in response to the need to adapt to different market conditions. For example, Enel is focusing increasingly on integrating renewable energy generation and the management of smart grids--digital electricity grids that enable producers and consumers to communicate.

The Remuneration Of Regulated Assets Is On A Downward Trend

In total, we estimate a €500 million-€700 million decline in revenues for our rated utilities in Italy from 2016, due to a cut in the allowed returns for the transmission and distribution of electricity and gas from 2016. We believe the decline in revenues will lower margins and weaken credit metrics, especially for utilities that only undertake regulated activities. However, our base case already reflects lower remuneration of regulated assets. Therefore, barring any surprises in the regulator's final decision--which we deem unlikely based on the consultation paper published Oct. 29, 2015--we see no risk of downward revisions in the regulated utilities' financial risk profiles. However, we do expect to see a decline in profitability, possibly bringing historically high levels in line with those of other European utilities.

The decline in allowed returns follows a comprehensive review by AEEGSI of the fair remuneration of capital (see table 2). The comprehensive review precedes the start of the new six-year regulatory period in 2016 for the weighted average cost of capital (WACC). Despite the likely decline in remuneration, we are not inclined to revise our assessment of the Italian regulatory framework yet. This is because we don't believe that the regulator is departing substantially from its existing approach. In our view, the regulator's second consultation paper acknowledges that negative real interest rates will persist, and that the gradual convergence of regulatory systems in Europe is necessary.

The regulator's review of the fair remuneration of capital focuses on the WACC to ensure that it no longer depends on the specific market circumstances in the period in which it was determined and reassessed. The WACC will still be assessed on a real pre-tax basis, but will no longer reflect nominal risk-free and specific inflationary parameters, and will be based on real long-term interest rates (see table 2). The regulator is due to make a final decision on WACC at the beginning of December.

Table 2

Regulator's Key Assumptions

	Existing values	Proposed values as of Oct. 29, 2015	Value/range
Risk-free rate	Average of Italy's 10-year sovereign yield in 12 months prior to review	Real interest rate with a 0.5% floor, reflecting the 12-month average of 10-year sovereign of 'AA-' rated countries with a 0.5% floor	0.50%
Equity risk premium	Historical average (4%)	Historical total market return in 1900-2014 (5%), based on 50/50 weight of geometric (3.5%) and arithmetic average (6.6%)--risk-free rate	4.5%
Country risk premium (CRP)	Currently incorporated in nominal rates	AEEGSI proposes to set this at 1%	1.0%
ß	Long-term historical average	Sector-specific assumption based on at least two-year historical average	N/A
Leverage	Debt/(debt + equity): 37.5%-47.0% depending on sector	As existing, to be reviewed at interim review in two years	N/A
Cost of debt	Risk-free rate + 0.45% debt risk premium	Risk-free + 0.5% CRP + 0.45% debt risk premium	1.6%-1.9% (real pre-tax)
Tax	35.7% tax rate (27.5% tax shield)	Reflects impact of lower fiscal pressure	Tax rate: 34.0%-34.4%. Tax shield: 27.5%

Source: AEEGSI. N/A--Not applicable.

Proposed Changes To The WACC

The regulator is considering basing the risk-free rate on the 12-month average of the real yields on government bonds issued by France, Belgium, Netherlands, and Germany, which have 'AA' ratings, and introducing a corrective factor that would set a floor at 0.5%. The market risk premium would track the difference between the historic real total market return minus the risk-free rate, and would be stable over six years. The country risk premium would no longer be embedded in Italian nominal rates, but a defined component of the cost of equity and debt, and be set at 1.0%.

The nominal cost of debt would be the sum of the risk-free rate; a country risk premium of 0.5%--the difference between Italian utilities and utilities in highly rated countries; and a debt risk premium of 0.45%. The regulator is planning to align real interest rates, market risk premium, and country risk premium across the different infrastructure businesses. These parameters should be set for six years starting 2016, with a potential reset every two-to-three years depending on specific triggers. The remaining parameters, beta (a component of the WACC formula), and leverage, should reflect the diversity in the risk profiles of different infrastructure businesses, and would be reviewed at the end of their respective regulatory periods.

Power transportation and distribution are undergoing a comprehensive review of allowed returns that encompasses the WACC and other sector-specific parameters (see table 3). The entity that we consider will be most affected by this review is Terna. It appears to us that the whole system of incentives for investments in power transmission is under question, which suggests that the regulator is taking a more selective view of the investments necessary to upgrade Italy's power distribution infrastructure. The remuneration of investments will likely transition from an input- to an output-based approach, potentially leading to the loss of remuneration for works in progress. Our base case for Terna already factors in the aforementioned risk, and therefore we do not anticipate any unforeseen slippage in its credit metrics.

Table 3

Gas And Power WACC And Regulatory Period End

	Gas				Power	
	Transportation	**Distribution**	**Storage**	**Regasification**	**Transporation**	**Distribution**
End of regulatory period	Dec. 2017	Dec. 2019	Dec. 2018	Dec. 2017	Dec. 2015	Dec. 2015
Real pre-tax WACC	6.3%	6.9%	6.0%	7.3%	6.3%	6.4%

Source: AEEGSI. WACC--Weighted average cost of capital.

Overall, we believe that the regulator is trying to strike a fair balance between the interests of regulated companies and operators, final users, and investors. Based on the latest consultation paper, we don't see the regulator's proposal as posing any risk to regulatory stability, visibility, or consistency, but as acknowledging that energy infrastructure in Italy is maturing and investments need to be selective in order to avoid unnecessary costs for end users. We also take a positive view of the proposed transition--albeit no earlier than 2019--to a total expenditure from an operating expenditure approach toward the remuneration of investments, in line with the U.K.

Low Commodity Prices Make Power Supply More Profitable

We have seen the EBITDA margins of Italian utilities' supply businesses doubling since 2012. The margins of our rated utilities currently fall into a 4%-7% range. The increase is due to a combination of factors, including low commodity prices, the ongoing transition from a "protected" to a "free" market, and, to a lesser extent, improving cost-to-serve ratios (the cost of serving one client measured in euros per client).

However, we don't believe this trend is sustainable in the long term. This is because higher margins tend to attract new entrants to the supply market, which now counts more than 350 participants according to AEEGSI. So far, the reduced cost of producing power has not resulted in a similar reduction in power prices for customers. We anticipate that, even in the generally protected Italian market, the average customer will become more sensitive to the price and quality of service. We see this trend in other traditionally protected markets such as Austria, where customer churn rates are rising, driven by lower contract prices. Switch rates are rising in Italy by high single digits.

We believe that Italian utilities companies will compete with each other not only on product offerings, but also on the cost of back-office functions. Consequently, we believe that in future, a competitive supplier will need to have a large client base because back-office costs are relatively high. In our view, this will favor large suppliers like Enel (17.9% of the market in 2014 according to AEEGSI data), Edison (10.8%), and Eni SpA (5.3%), which will be able to incur higher client acquisition costs than smaller players. We believe it is for this reason that we haven't seen any large acquisitions geared at obtaining portfolios of customers. The most significant acquisition of this kind could have been the sale by Germany-based utility E.ON SE of some of its Italian assets earlier this year, including its portfolio of 700,000 clients, but it cancelled the transaction.

Although the protected market in Italy should come to an end in 2018, delays are likely. The suppliers we rate focus on retail clients as opposed to large industrial consumers. Retail clients provide greater revenue stability and lower default risk, which together partly offset lower volumes. These clients are still relatively sensitive to local branding and are easier to retain, although we believe this would be less the case in an openly competitive market.

M&A Activity Is On The Rise

We see growth opportunities for utilities with exposure to Italy bound up with M&A activity. Moreover, we believe that persistently challenging market conditions and tougher regulation may reduce shareholder returns at smaller utilities and support the rationale for consolidation. Increasing M&A activity (see table 4) may affect our ratings and outlooks on the Italian utilities, but the impact will depend on the transaction terms, and we will assess it on a case-by-case basis.

Table 4

Increasing M&A In The Italian Utility Space In 2015

Announced date	Status	Target	Acquirer
N/A	Pending	AIMAG	HERA / ESTRA
Nov. 9, 2015	Pending	LGH	A2A SpA
Aug. 6, 2015	Pending	Hydro Generation	ERG SpA
April 28, 2015	Pending	SEL SpA	Azienda Energetica SpA
March 31, 2015	March 31, 2015	EGPNA Renewable Energy Partners	General Electric Co.
Jan. 16, 2015	March 17, 2015	4.3 megawatts of photovoltaic projects	Solar Power Inc.

Source: Bloomberg, Standard & Poor's. N/A--Not applicable.

In the upstream power supply segment, we expect most M&As to arise from consolidation in Italy's maturing renewable energy sector, mainly solar, where Enel represents an attractive offtaker. For example, Enel and Italy's largest infrastructure fund F2i Fondo Italiano per le Infrastrutture (F2i) recently agreed on a joint venture to pool 210 MW of photovoltaic solar plants owned by Enel and F2i in Italy. In contrast, market fundamentals in the conventional upstream power supply segment are not supportive of M&A. Consequently, we do not expect to see many transactions after E.ON's sale of its coal and gas-fired generation assets to the Czech Republic's Energetický a Pr#myslový Holding, a.s. (EPH) and its hydro generation assets to Italy's ERG group.

We consider that, in the main, gas distribution, integrated water services, and energy-related businesses such as waste treatment will stimulate M&A for multi-utilities like A2A, Hera, Acea, and Iren. Hera is most active in this respect, with the integration of its acquisitions of AcegasAps, and AMGA Udine already complete. Hera continues to explore external growth opportunities, albeit smaller than the aforementioned acquisitions, to expand its multiregional presence in North-East Italy and to strengthen its leadership in the environmental sector. A2A is exploring opportunities in its home region of Lombardy, while Acea is looking at the consolidation of its water business in central Italy. However, to date, political opposition from municipal shareholders has prevented the realization of these plans, and broader political sponsorship of utilities consolidation has failed to overcome this resistance.

Investments Alone Cannot Guarantee Future Growth

We do not foresee the improved economic outlook for Italy necessarily leading to a strong rebound of investment in the Italian utilities sector. This is because of falling returns on investment, particularly in the regulated energy sector. We expect that Italian utilities will continue to focus on efficient cost management, with growth prospects mainly associated with M&As. The risk of rating changes as a direct result of M&A activity could be mitigated by sizable cost synergies and credit-friendly transaction terms.

Related Criteria And Research

Related research

- Italy's Shallow Recovery, Sept. 23, 2015

We have determined, based solely on the developments described herein, that no rating actions are currently warranted. Only a rating committee may determine a rating action and, as these developments were not viewed as material to the ratings, neither they nor this report were reviewed by a rating committee.

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