European utilities outlook 2019: Political, regulatory risk moves centre stage

Scope Ratings lowers its credit outlook on European utilities to Stable from Positive. European power generators face a resurgence in political and regulatory risk in 2019 just as the rebound in commodity prices, responsible for improving profitability and leverage ratios of most power generators in recent years, is set to level off. Regulated grid and network operators remain better off despite the continued burden on free cash flows from heavy capex programmes.

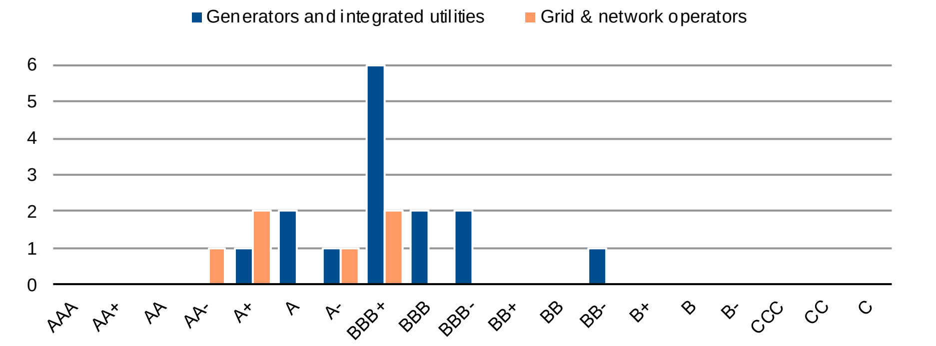
Scope has identified the following trends working for and against the business-risk and financial-risk profiles of European utilities in 2019:

Improved prospects for power generators in higher (hedged) wholesale prices
An end to the sector's multibillion-euro asset-rotation programme as operators have refocused portfolios
More financial headroom relative to in-house leverage targets or rating downgrade triggers
No short-term impact from growth in electric-vehicle use (see excursus)
Re-emergence of political headwinds, from greater protectionist government policy to tightening environmental regulation, notably for coal and nuclear
Transmission system operators (TSOs) still face heavy capex programmes
M&A activity from sector outsiders: taking market share, driving up valuations

Conclusion on credit quality and ratings

European utilities' credit quality will remain solid on average as shown by the distribution of credit ratings among companies covered by Scope. Most power generators have succeeded in preserving credit quality amid multibillion-euro asset-rotation programmes, aimed largely at enhancing low-CO2 generation capacities and their regulated or contracted activities. Such improvements in cashflow profiles are reflected in the ratings. Significantly lower wholesale prices are a threat to future cash flow, though only likely after 2020 when utilities' recent hedges run out. Grid and network operators face continued heavy capital expenditure, resulting in many cases in negative free cash flow. This should be just temporary until compensating regulated tariff increases kick in. Stricter environmental regulations, a more nationalist tone to energy policy, and overly ambitious growth strategies, particularly if based on M&A given growing competition for power assets in Europe, are factors which risk squeezing credit metrics in the year ahead.

Figure 1: Rating distribution of Scope's current coverage of European utilities*



* Includes 21 public and private ratings

Source: Scope

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Asset rotation and improved commodity prices coming to fruition

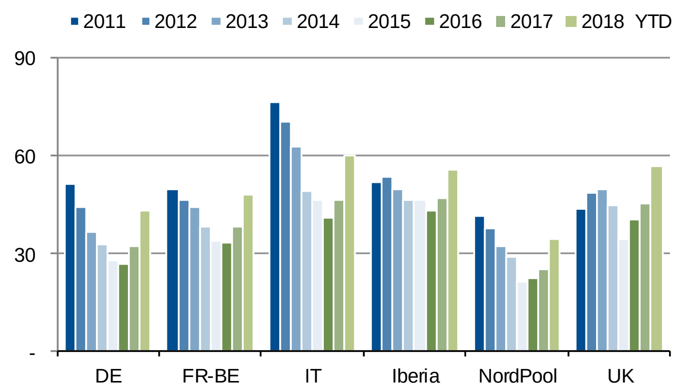
Power generators to benefit from improved hedged and unhedged priced

Improved margins and operating cash flows should finally become visible in 2019 for those generators which suffered most from volumes which had been hedged in 2016/17 at comparatively low prices, a reflection of the lagging impact of the rebound of commodity prices and consequently 1- and 2- year forward prices for electricity. See also Scope's study: Commodity Rebound – Past the Trough. Power generators in the German, Austrian and Nord Pool markets, whose power prices have been squeezed most over the past few years, will particularly benefit (see figure 2).

Hedging become more important and challenging

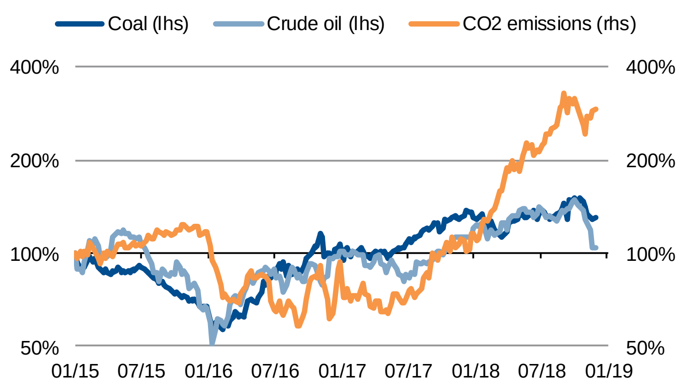
Looking at the slowdown of global economic growth and the lack of extra stimulus for underlying energy commodities such as coal and crude oil, we deem further price hikes as unlikely. We believe that volatility of power prices will increase further with the growing share of unregulated renewables which may push out conventional generation capacities out of the merit order -. Hence, hedging strategies and particularly the timing of hedging will become more challenging. The positive news, however, is that even a significant deterioration of wholesale power prices in 2019 would impact the generators' balance sheets with a time lag of 1-2 years as prices for 2019 and 2020 are widely hedged.

Figure 2: Average prices 1Y forwards baseload (EUR/MWh) in major markets



Source: Bloomberg, Scope

Figure 3: Rebound of commodity prices (crude oil, API coal, CO_2 certificates) Jan 2015 = 100%



Source: Bloomberg, Scope

Rising and unplanned outages of baseload capacities underpinning need of capacity market

Increased price volatility as a result of fluctuations in the merit order due to renewables but also unplanned outages of baseload capacities such as nuclear in Belgium and France should underpin the importance of capacity market schemes across Europe, primarily in Germany, France and Belgium.

Increased capex continue to burden transmission

Pressure from heavy investments only temporary

Regulated utilities, notably electricity TSOs, will remain burdened by the heavy investment programmes for grid expansion, required to cope with increasingly volatile current, cross-border flows and integrating new offshore capacities (see Figure 5). As a result, free operating cash flows will remain negative for many grid operators. The impact on credit ratios will remain limited considering regulated tariff increases will kick as the most important European jurisdictions allow for a timely compensation of such investments through increasing the size of the regulated asset base and covering most if not all of rising costs. Grid/network operators' credit quality will remain strong as companies benefit from the excellent bankability and credit conditions for new assets. Scope expects no major credit threat to regulated TSOs and distributors (DSOs).

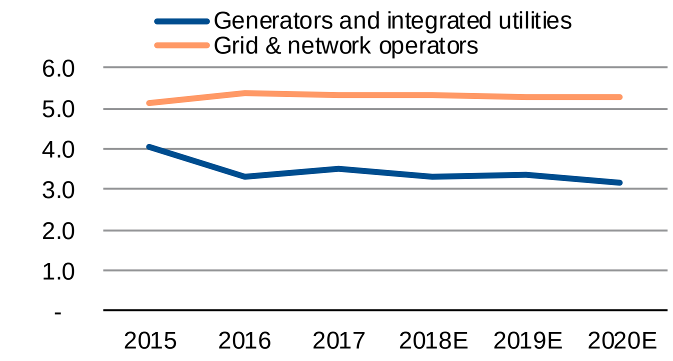
Downside limited from regulatory resets

New regulatory periods are due to begin in 2019 in Germany, Austria and Spain for electricity grids and for gas networks in Portugal, with lower returns on invested capital expected in each country. Such resets of eligible returns on invested capital are to some extent offset by the steady growth of the applicable regulatory asset bases. Given the steadily increasing importance of grid stability, we believe there is political willingness to allow relatively generous returns for the sector compared with power generation and supply.

Cash flows support some headroom against negative rating actions

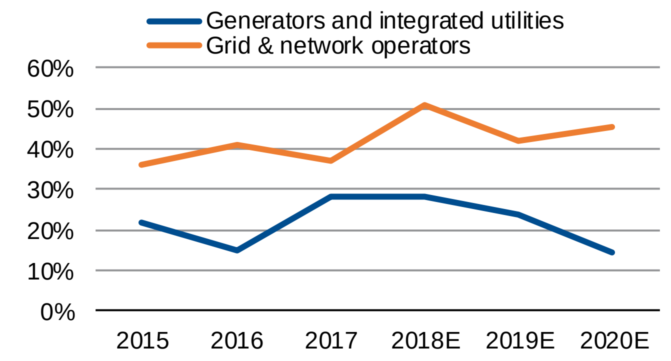
Overall, Scope believes that credit ratios will remain solid. Particularly, the more volatile power generators have understood how to tackle fluctuations in commodity prices and have built up some headroom against potential negative rating actions. We also believe that both regulated and unregulated/integrated utilities will keep a close eye on maintaining positive free operating cash flows and keeping control on leverage, visible already in the increasingly common issuance of hybrid debt as in the case of Elia, Engie, EDF, Enel, Iberdrola and Alliander in 2018.

Figure 4: Median leverage - Scope-adjusted debt/Scope adjusted EBITDA - within Scope's peer group



Source: Utilities covered by Scope

Figure 5: Median capex/revenues ratio within Scope's peer group



Source: Utilities covered by Scope

Political headwinds blowing stronger than tailwinds

Resurgence of 'green' issues again come to the detriment of European utilities

Europe's utilities sector faces a resurgence of political and regulatory risk after a few years of respite from interventionist government policies. A combination of more nationalist or protectionist approaches to energy policy in some European countries and the EU's determination to meet its commitments to reduce CO2 emissions could weigh on credit quality. Here are the main risks:

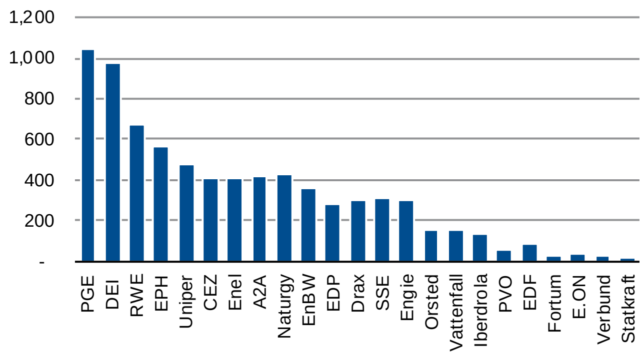
- The EU has adopted a tighter binding renewable-energy target of 32% for 2030, up from the previous goal of 27%, without setting priorities for how future power will be generated or issuing tenders for new capacity;
- Various EU members have pledged to phase out coal power ('Powering Past Coal Alliance') and some are actively discussing how to abandon coal, such as Germany whose plan is scheduled to be announced in February 2019;
- Discussions continue about the safety and perceived need for reduced dependency on nuclear reactors in Belgium and France, the two European countries which both derive more than half their electricity from atomic power;
- EU countries are considering limiting which power plants can take part in capacity schemes according to stricter CO2 emission criteria;
- Uncertainty about future setup of capacity market schemes;
- Price caps are again on the agenda. Popular concerns about rising electricity prices and utilities profits, may empower regulators, such as Ofgem in the UK, to impose price caps;

- The rush of foreign-investor interest, particularly from state-controlled entities, in European infrastructure assets, notably in the energy sector, has already led some European governments to re-assess the strategic importance of the energy sector. Preventing foreign takeovers or re-nationalising energy companies may deter foreign investment in the sector.

Headwinds coupled with uncertainty for capex allocation

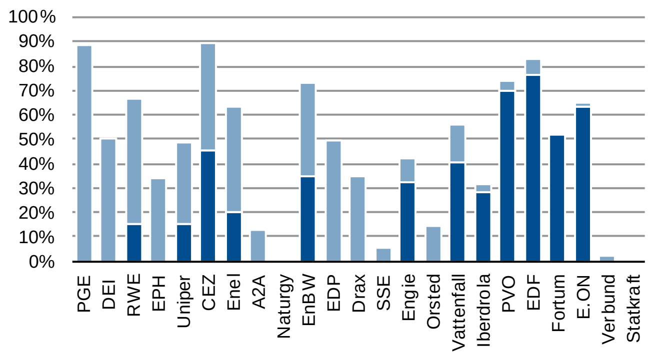
Rising political and regulatory risks have a double impact. As well as putting off some potential investors, they raise the risks for existing investors who may discover they have mispriced energy assets, resulting in lower-than-expected returns if not losses. Most at risk are utilities holding the heavy CO2-emitting assets (see Figure 6) and those exposed to nuclear and coal generation (see Figure 7).

Figure 6: Carbon intensity of European generation portfolio (gCO2e/kWh in 2017)



Source: companies, Scope

Figure 7: Relative exposure to nuclear and coal within European generation portfolio (as % of generation volume 2017)



Source: Bloomberg, Scope

Increasing M&A activities imply opportunities and threats

From contraction to expansion

Scope sees an increased risk appetite of European utilities for bolt-on acquisitions (see Scope study: „European Utilities - More predators than prey as deal-making pushes asset prices higher“, Sep 2018). While 2018 will mark an interim record regarding transaction volumes in the European utilities landscape, this picture will likely persist in 2019 with the finalisation of the RWE-innogy-E.ON deal and a closure of the EDP-China Three Gorges deal.

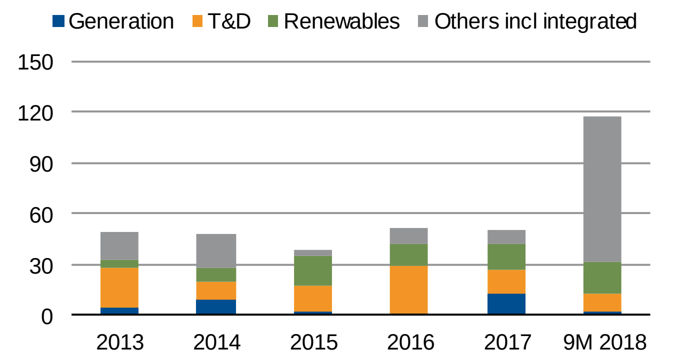
From Scope's perspective, the acceleration of M&A activities will be stimulated from different directions:

- Many utilities have more financial firepower now that asset rotations have ended after a long period in which deleveraging was also a priority;
- CFOs have better cash flow visibility thanks to rising forward power prices and higher CO2 prices, which in turn are putting the focus back on the CO2-intensity of power-generation fleets;
- Mounting competition for European energy assets from new sources, notably oil&gas majors and financial investors who often benefit from better credit conditions, may spur more deal-making as might defensive moves in the face of more unsolicited foreign bids, primarily from Chinese or Middle Eastern state-linked entities;
- The strategic focus might also return to a search for external growth through international renewable-power projects or expanding in new markets outside Europe (e.g. Enel battling over network assets in Brasil or Statkraft accelerating growth in LatAm and Asia) given the organic expansion of ancillary services does not bring the same scale and margins.

Utilities have to stay in the game

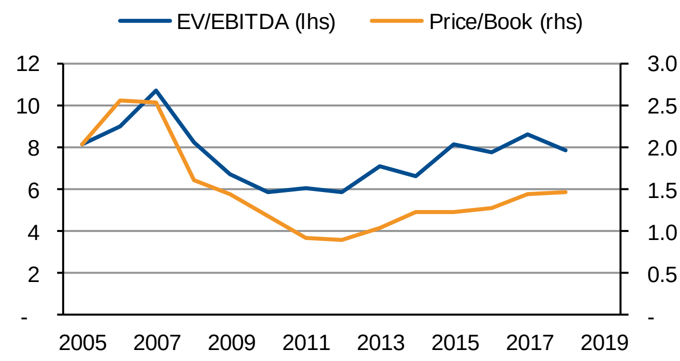
The danger is that if European utilities do not take up M&A opportunities, fearing that deals might stretch their balance sheets as valuations rise, they risk giving up market share to industry outsiders which could in turn undermine their long-term growth prospects and credit quality. A complicating factor for potential buyers and sellers is growing government sensitivity about the strategic importance of energy infrastructure in Europe.

Figure 8: Announced power transactions in Europe - Deal value and volume, by segment



Source: EY analysis based on Mergermarket data, Scope

Figure 9: EURO STOXX Utilities: Average valuation multiples



Source: Bloomberg, Scope

Elevated transaction multiples might strike back

Elevated transaction multiples might raise issues for the credit quality of corporates such as utilities if paid multiples prove to have been too high and cash flow from the acquired ventures turns out to be weaker than expected. Overpaying is not necessarily a huge problem as long as money remains cheap.

Excursus: E-mobility

Utilities but also oil&gas major keen to tap e-mobility

The accelerated shift towards e-mobility has grabbed the news headlines in Europe after diesel scandals at some auto manufacturers, driving bans for diesel cars in some German cities and protests over increased fuel tax in France. In theory, the presence on the roads of more and more electric vehicles requiring recharging will have a major impact on the region's generation, transmission and distribution of electricity. The question is when. The answer, for now and in the near future, is not much.

Utilities will be keen to benefit from a stimulus to electricity demand which could compensate for efficiency gains or losses should more industrial production move outside Europe to lower cost countries. Europe's oil & gas majors are eager to enter the electricity sector as a long-term alternative to reduced demand for gasoline and diesel. Any rapid and largescale transition of Europe's road-transport fleets to rechargeable batteries from fossil fuels could have a huge impact on the power sector.

Short-term impact on electricity demand very limited

Even so, some circumspection is necessary.

Firstly, the European power-generation market remains oversupplied despite the phaseout of some conventional generation in few markets. Any new surge in demand would also remind governments and regulators of the importance of having peak-load capacity from gas- and coal-fired plants when generation from renewables is not sufficient.

Secondly, the short-term impact on power generation appears to be limited based on rough estimates. We assume average power consumption of 15kWh per 100km for a standard car driven for 20,000km, the typical annual range, which would imply the need of 3,000kWh of electricity a year, a generous estimate as this is around the annual electricity consumption of a typical German 4-person household.

E-mobility does not compensate for targeted efficiency gains

Continuing to take Germany as a good example, considering the e-mobility transition might be relatively rapid after the diesel scandal at VW and diesel bans in some German cities, we assume that Chancellor Angela Merkel meets the targets of her possibly ambitious "National Electromobility Development Plan" of about 1m electric vehicles cruising in Germany in 2020, up from just around 25k in 2017. In that case, the vehicles would consume around 3TWh of electricity. That is just 0.5% of Germany's total annual electricity consumption of more than 600TWh. Factor in the EU's targeted power-sector efficiency gains of 1.5%, and the net impact would be minimal.

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