S&P Global
Ratings

Industry Top Trends 2020

Utilities – EMEA Regulated

Negative outlook in the face of strict regulations

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What's changed?

The sector outlook has turned negative. The main drivers are harsher regulatory resets on the back of lower cost of capital, sovereign pressure, and expansionist strategies. We believe credit quality may deteriorate as a consequence.

ESG matters more. Energy transition remains an impetus for investments in the sector. But there are now more considerations arising from regulators: excellent service quality is a prerequisite while affordability is the new mantra.

Lower interest rates, higher leverage? Cheap and abundant capital has pushed financial leverage up to boost returns. And regulators are concerned.

What to look for in the sector in 2020?

Investments continue to peak. Investments in the sector continue to increase well above historical averages as a result of the need to improve the reliability of an aging asset base, and to integrate new infrastructure for renewables generation.

Adapting to stricter regulations. Substantial cuts in remuneration combined with regulators' demands for greater service quality may lead us to review the supportiveness of some regulations. And ultimately ratings.

Political pressure beyond regulation. With the rise of populism across Europe, affordability of public services is high on the political agenda. This, combined with nationalization or re-municipalization risk, further pressures utilities.

What are the key medium-term credit drivers?

There's more differentiation among networks. Gas infrastructure assets are more at risk from energy transition policies and geopolitics. We also see electricity distribution networks becoming key enablers of energy transition.

Operating efficiency will increasingly influence ratings. Utilities face zero-tolerance on service quality, increasing complexity of operations, and tighter cost controls. Penalties emerge if they fail, operating performance is key.

Ratings trends and outlook

Utilities – EMEA Regulated

Chart 1

Ratings distribution

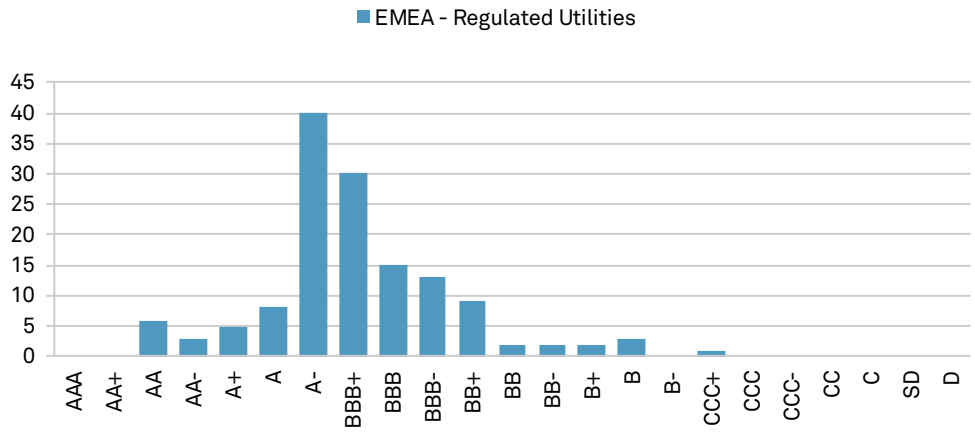


Chart 2

Ratings outlooks

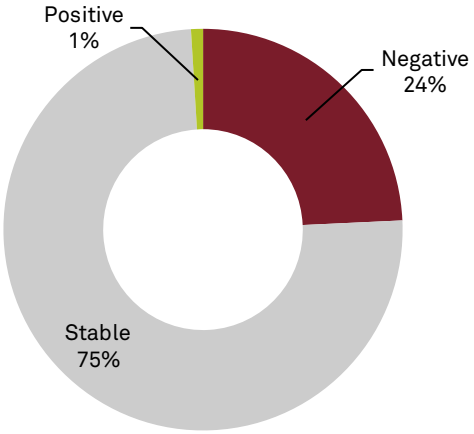
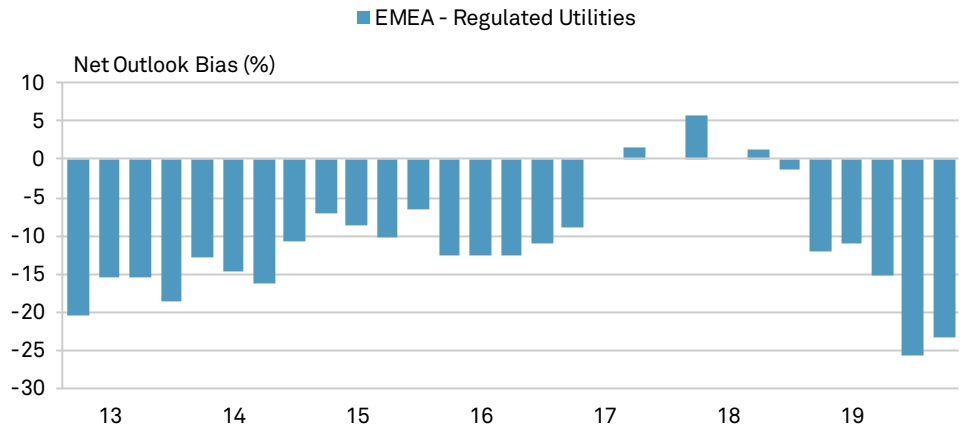


Chart 3

Ratings outlook net bias



Source: S&P Global Ratings. Ratings data measured at quarter end. Data for Q4 2019 is end October, 2019

Industry credit metrics

Utilities – EMEA Regulated

Chart 4

Debt / EBITDA (median, adjusted)

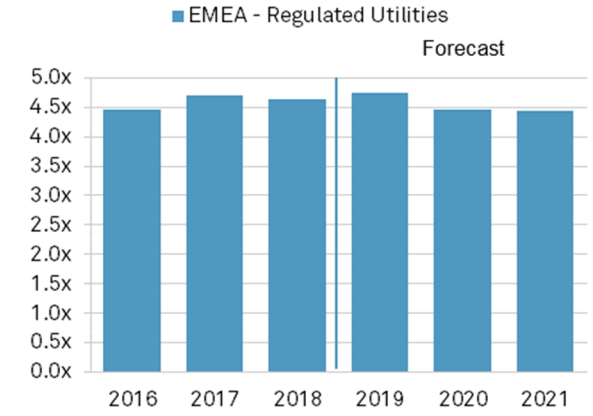


Chart 5

FFO / Debt (median, adjusted)

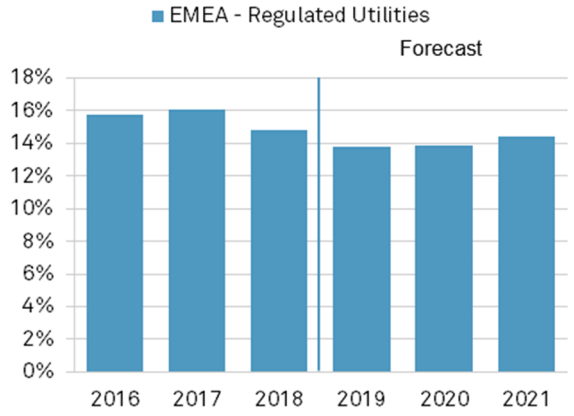


Chart 6

Cash flow and primary uses

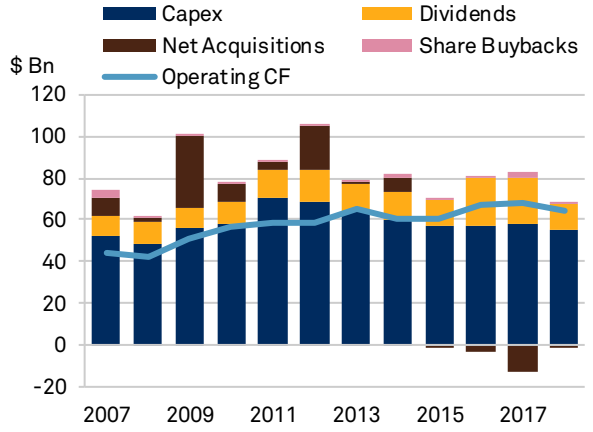
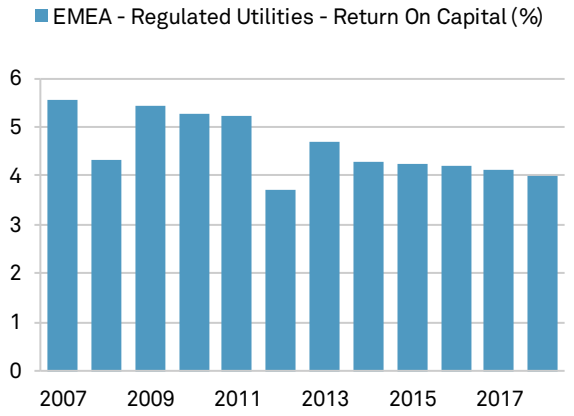


Chart 7

Return on capital employed



Source: S&P Global Ratings, S&P Global Market Intelligence. All figures are converted into U.S. Dollars using historic exchange rates. Forecasts are converted at the last financial year-end spot rate. FFO--Funds from operations.

Industry Outlook

Key assumptions

1. Macro-environment remains favorable

Cheap and abundant capital, low but positive economic growth, and voluntary environmental policies all point to favorable trends for the sector, and have clearly benefited past financial performance. The energy transition is accelerating investments to networks, which are notably achievable thanks to favorable financing conditions.

2. Stricter regulatory reviews, beyond remuneration cuts

The drawback of cheap capital is that regulators reflect this in upcoming tariff reviews – and will eventually even try to catch up on past gains. This leads to severe cuts to remuneration and ultimately jeopardizes rating stability. What's more, regulators have also introduced more penalties related to operating performance, ESG indicators, and service quality, while control on costs is tightening. The challenge for utilities is to reconcile tighter remuneration with significant investment requirements.

3. Political risk, again and again

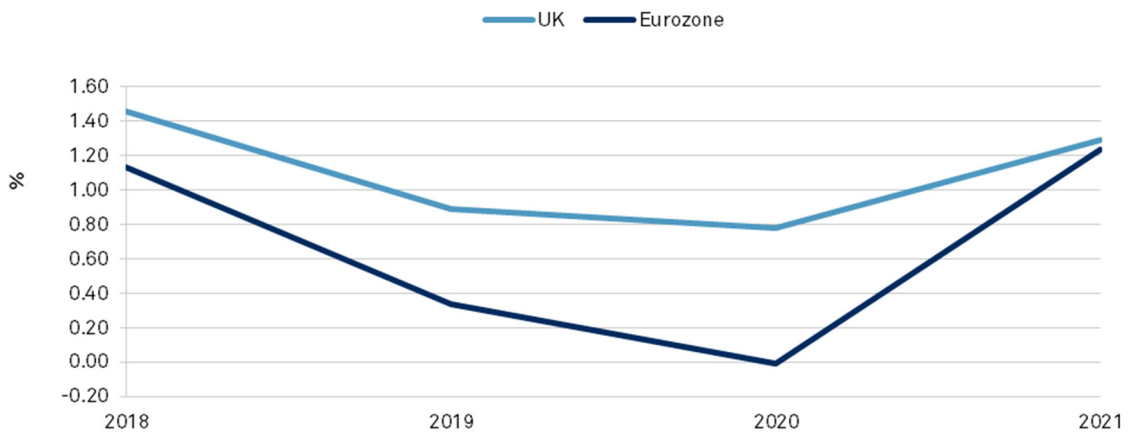
Given their crucial role in society, utilities have always been a target for politicians. With mounting populism across Europe, such scrutiny is not abating. Given the substantial cost of energy transition, affordability is a major theme, again pressuring remuneration. Any service quality issue places heavy financial pressure on operators, including their license to operate. The specter of nationalization and/or remunicipalization of networks is never far away.

The macroeconomic environment remains broadly favorable

Quantitative easing from the ECB has favored the utilities sector in recent years and we expect issuers to continue benefiting from the low cost of debt in 2020 (see chart 8). Cheap funding is key to delivering the considerable investments to be made in the sector over the coming three years.

Chart 8

Long Rate (10Y Avg)

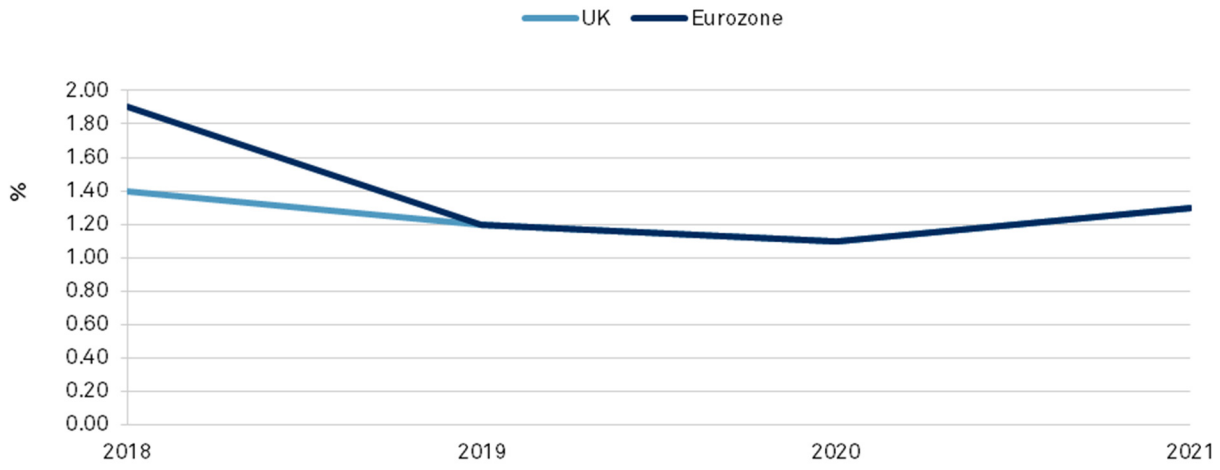


Source: S&P Global Ratings

Low but sustained economic growth (see chart 9) in Europe provides additional support to the sector, while inflation remains well under control.

Chart 9

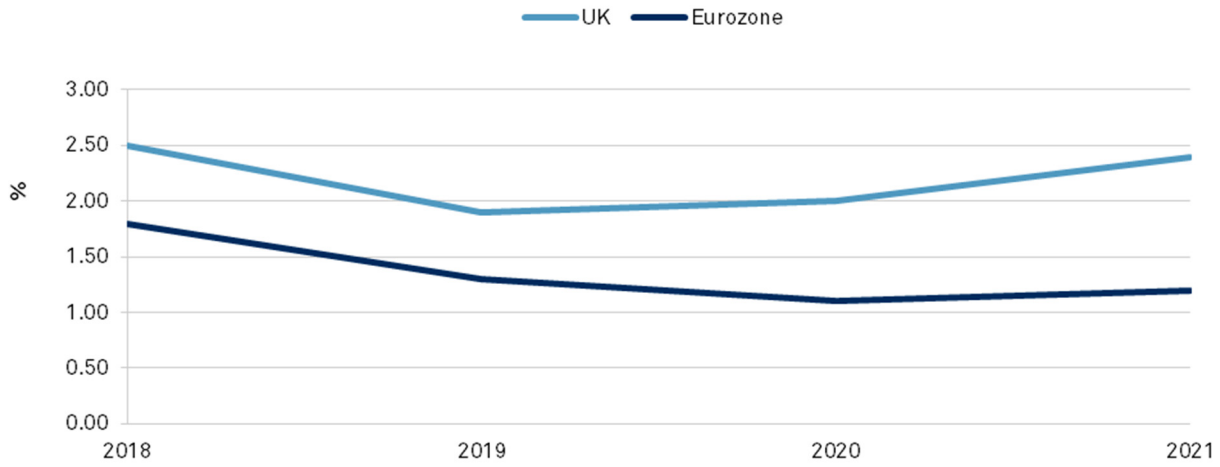
GDP Growth (Real YOY%)



Source: S&P Global Ratings

Chart 10

CPI Growth (Avg YOY%)



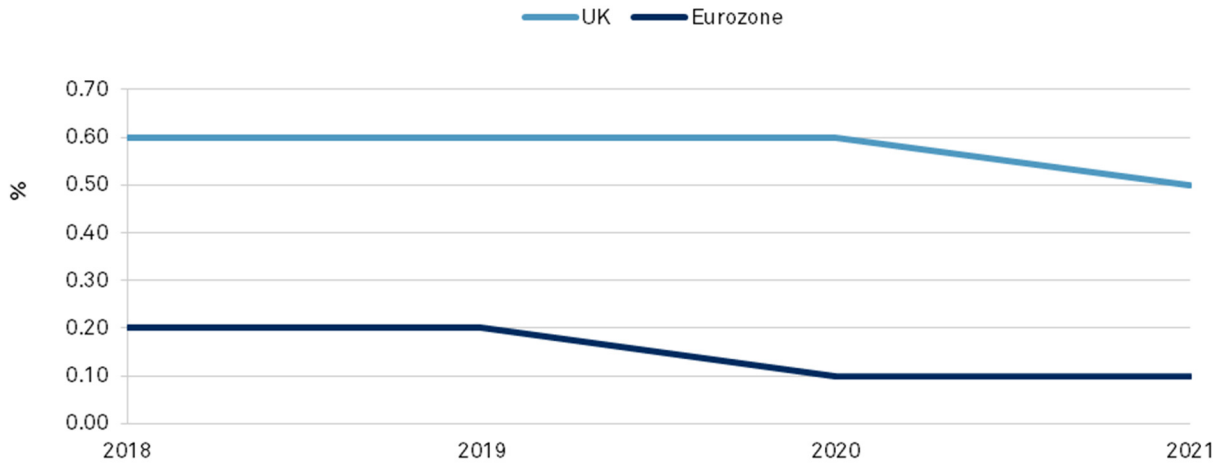
Source: S&P Global Ratings

We do not see Brexit being a major hurdle for U.K. utilities and we also believe that the sector remains largely immune to ongoing global trade wars, primarily owing to its inherent local activity. Major macroeconomic threats will scarcely affect sector performance, in our view.

More important is the continuous (and increasing) political focus on energy transition and environmental considerations. This plays a role at the European level, where the authorities have set ambitious targets that will require substantial investments in infrastructure over the coming decade. It's also a national matter: governments have their own plans to fight climate change and utilities have a key role to play.

Chart 11

Population Growth



Source: S&P Global Ratings

Some of our ratings on utilities are facing negative sovereign rating pressure, for example in Italy. This is because we view domestic utilities as closely linked to their local economies and we rarely disconnect their credit performance with that of the sovereign.

More stringent regulatory reviews, beyond remuneration cuts

Regulations have tightened for forthcoming regulatory periods. We have historically considered that European regulated utilities benefit from broadly supportive and stable frameworks that enhance their credit quality and ratings. During 2019, we have seen unexpected regulatory developments. Specifically, material remuneration tightening, risk of non-recoverability of certain costs, and asymmetrical incentive schemes for the forthcoming regulatory periods in several markets, could undermine the supportiveness of certain regulations in our view. We constantly reassess our view of European jurisdictions, based on new developments, and will continue to do so as final methodology frameworks and remuneration levels are publicly known.

Affordability and service quality are a growing focus. Regulators are proposing new regulations with an increasing focus on ESG factors, affordability, and a willingness to reflect the lower cost of capital in a low interest environment. This puts additional pressure on utilities, including greater costs and investments to meet more stringent requirements – eventually entailing cash flows. Overall we believe improvements in operating efficiency will become even more critical for cash flow performance and ultimately ratings. We believe we may therefore see more rating distinction among networks, depending on their ability to meet these more stringent requirements.

Ratings on U.K. utilities are under pressure. With regulatory reviews, Brexit, and political scrutiny over tariffs and service quality, U.K. water and energy utilities face several threats to credit quality (see "U.K. Utilities Are Feeling the Heat," published June 14, 2019, on RatingsDirect).

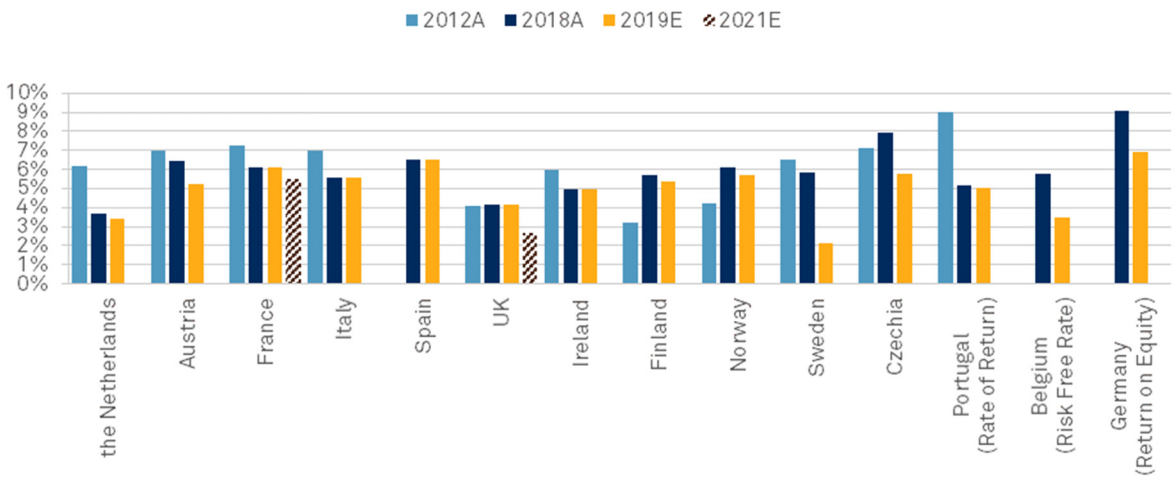
Spain announced remuneration cuts to electricity networks and uncertainty remains for the upcoming regulatory review of thegas sector. At the end of October, the Spanish regulator published its final determination on electricity networks, leading notably to a remuneration cut to 5.6% from 6.5%, broadly in line with propositions published earlier this year. While this will negatively affect the earnings of electricity network operators, we already factor this into our current ratings. The proposed reform on gas, however, remains uncertain and may have a more negative impact on our rated entities (see

"Various Rating Actions Taken On Spanish Gas DSOs And TSOs Following Regulatory Proposal," published July 25, 2019, on RatingsDirect).

Upcoming regulation in Sweden reveals ongoing tensions. Swedish electricity DSOs also face severe cuts in remuneration and potentially weakened ability to recover costs in the 2020-2023 regulatory period. This is mainly due to a planned decrease in weighted average cost of capital (see "Are Regulatory Framework Changes Threatening The Credit Quality Of Swedish DSOs?" published Aug. 21, 2019 on RatingsDirect). The regulator published in late October its tariff determination, although details were not communicated and we understand that most operators will appeal the decision in court.

Chart 12

Pre-tax Regulatory WACC Evolution



Source: S&P Global Ratings

Political risk, again and again

While regulators across the continent are generally insulated from political intervention, they remain subject to political pressure to reduce prices for consumers, but also improve service quality and environmental standards.

ESG risk factors have been high on the political agenda. This has attracted significant media coverage in 2019. Several utility companies have come under public pressure and been criticized by the public and politicians for mishandling these risks--for making excessive profits, lacking transparency, mistreating vulnerable customers, underinvesting in aging assets, and failing to protect the environment. As a result, utility companies are now subject to more stringent regulatory requirements, including for leakage reduction (water), lower service interruption (power), and better customer service generally. In parallel, ESG risk factors play an important role in investment decisions made by market participants

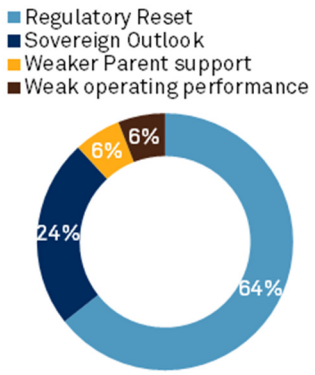
Talk of renationalization of utilities is adding uncertainty. Opposition parties--for example the Labour Party in the U.K. and the Five Star Movement in Italy--are proposing to bring key utilities back into public ownership. This has raised significant concerns among private investors. Such a scenario is not our base case at this point. Nevertheless, if utility companies did move into public ownership, we would consider rating them as government-related entities (GREs). Our general analytical approach to GREs is to consider their credit quality as falling between the inclusive bounds formed by the GRE's stand-alone credit profile (SACP) and the sovereign rating. Any uplift from the SACP depends on our opinion of the likelihood of sufficient and timely extraordinary government support of the GRE in meeting its financial obligations, which we derive from

our assessment of the GRE's role for and link with the government. Currently, there are significant uncertainties about the effect on the sovereign ratings, how utilities would be managed after a renationalization, whether it would affect their regulatory framework and whether a renationalization policy would render the sector less attractive to investors and ultimately hinder their ability to access capital markets to finance their capex.

Beyond talk of nationalization, we also see remunicipalization moves in district heating and local energy distribution networks. This means municipalities take back control of assets and operations at license renewal. While still too limited to call it a regional trend, we see this as an additional risk for the sector--again triggered by affordability, service quality, and environmental considerations.

Chart 13

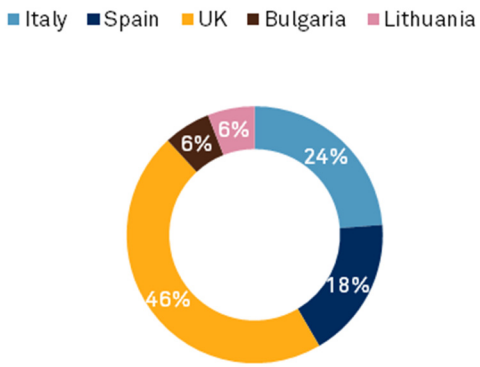
Negative Outlook Split by Rationale



Source: S&P Global Ratings

Chart 14

Negative Outlook Split by Country



Source: S&P Global Ratings

Key risks and opportunities

1. Investment pipeline set to peak over the next three years

We see investments jumping from 2019 onward. This is first and foremost propelled by energy transition and the need to connect and manage huge new renewable power generation projects. Continuous network improvements, to maximize reliability, resilience, and safety, will also increase investment momentum. Uninterrupted service for power is more crucial than ever, while water leakages run counter to more stringent environmental targets. Utilities are no longer able to defer such investments. On top of this, there could be M&A risk.

2. Low cost of debt has pushed leverage up, weakening rating stability

For some time we have seen utilities' financial outperformance being largely driven by financial engineering. In other words, more debt. This was helped by very low interest rates, which ultimately did not penalize cash flow metrics. Over the past two years, we have placed more focus on debt to EBITDA, in our analysis, to reflect this trend. And it is fair to say that stretched balance sheets have weakened the ability of certain utilities to cope with tariff cuts. This has increased pressure on ratings. Ultimately, financial policies will play a key role in rating transitions for the sector.

3. More differentiation across network types

Another key development is more differentiation between networks. On one hand, we believe that gas infrastructure is now less favorably positioned within energy transition, as reflected by the European Commission taxonomy. What's more, mounting geopolitical tensions may further undermine the long-term viability of some gas routes in Eastern and Central Europe. On the other hand, we see electricity DSOs having a greater role to play in decentralized energy and energy management – to the extent they are sufficiently equipped to face these industry challenges.

The investment pipeline will peak over the next three years

We see investments in rated electricity networks rising to accompany energy transition and adapt to climate change. This includes:

- Connecting more renewables to the network and building substations for offshore wind farms.
- Building new transmission lines from remote, less dense areas, to high consumption zones.
- Upgrading networks to improve reliability and to manage the increasing intermittency of power sources.
- Improving network resilience (for example, shifting from overhead powerlines to underground cables).

For non-power networks, large investment programs refer notably to continuous network improvements to ensure a high degree of reliability, resilience, and safety.

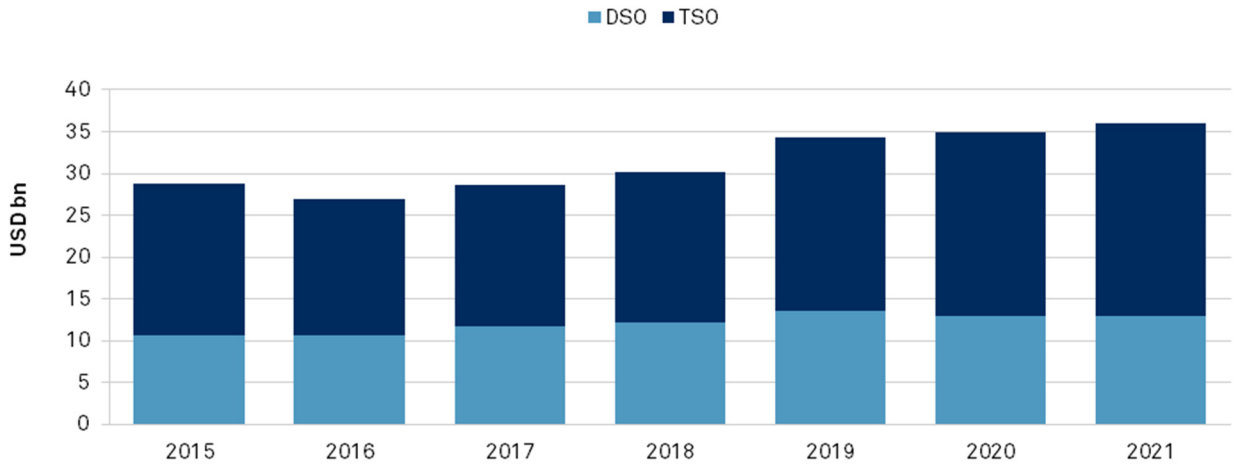
We believe these additional investments support future earnings growth and expansion of the regulated asset base, which we view positively. At the same time, given the size of the proposed investment pipeline and affordability constraints set by regulators, we believe this pace of investment will pressure balance sheets and ultimately ratings. As for oil and gas, partnering may be an option when investment requirements become too weighty.

We also see risks related to the execution of the investment pipeline. Notably, we see potential constraints around the granting of building permits for the construction of the required substations. Permits will require local and federal coordination around planning and connection prioritizations, given the likely bottlenecks related to significant increases in demand for connections.

Besides the heavy investment program, we also believe M&A risk remains high. This is because some network operators see a benefit in reducing exposure to a single regulator or country. Apart from earnings diversification, there is also an attractive cost of debt. This has led utilities, especially in Southern Europe, to engage in acquisitions abroad (for example, Enagas acquired U.S. midstream company Talgrass) or in industries such as telecoms. While diversification has its benefits, moving away from supportive regulated activities generally weakens a utility's business profile.

Chart 15

Investment Split by Network type



Source: S&P Global Ratings

Low cost of debt has increased leverage, undermining ratings stability

With abundant market liquidity and five-year bond yields approaching zero-coupon for 'BBB' rated entities, the temptation to increase financial leverage at utilities is high. Interestingly, cash flow metrics move only gradually when debt increases, especially when older more-expensive debt is refinanced (and increased) at current market rates. This has happened in recent years, when the outperformance of some utilities mostly stemmed from more-indebted balance sheets rather than operating excellence.

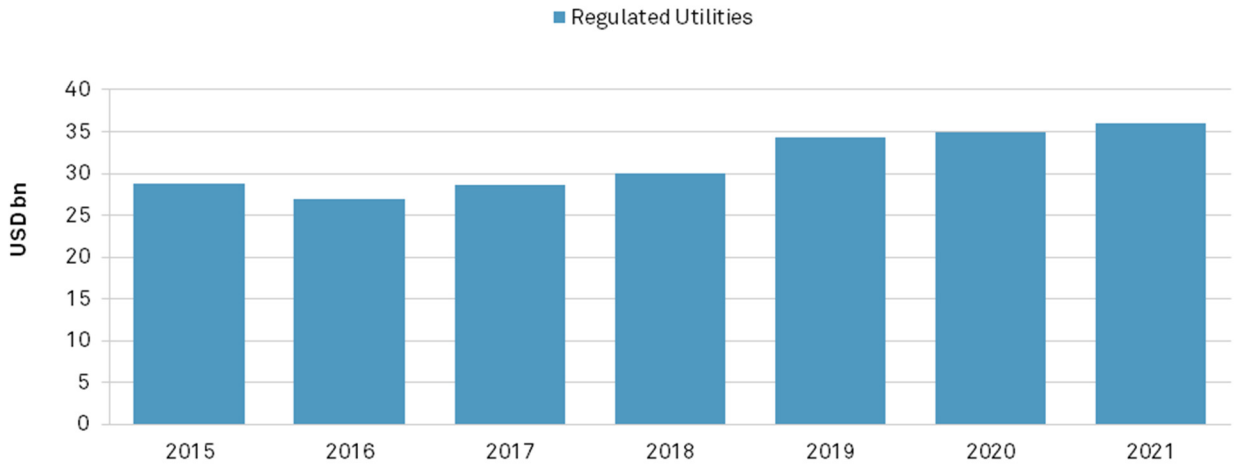
The sector's average leverage has therefore increased, exacerbated further by recent changes of ownership of networks, which were sold at very high multiples and typically financed by maximizing debt levels cheaply. So while the sector remains well entrenched in investment grade, we see rating headroom being significantly reduced at a time when regulated tariffs may be cut. This absence of financial buffers largely explains our current negative outlooks.

As the cost of debt is so low, our benchmark ratio for the sector (FFO to debt) may not fully reflect the additional stretch to balance sheets. Over the past two years, we have therefore put more emphasis on other credit metrics, notably debt to EBITDA. Between 2016 and 2021, we see this leverage ratio increasing to 5.1x, from 4.5x, for the sector. While this is largely embedded in our current ratings, it reflects generally higher debt tolerance and increasing pressure on regulated tariffs.

Interestingly, we have seen rising scrutiny from regulators on utilities' balance sheet structures. The U.K. has always been at the forefront in this, with licenses to operate linked to investment grade ratings to ensure access to capital for the sector. Other markets have followed. In particular, Spain introduced a series of benchmark ratios to surveil credit quality.

Chart 16

Investment Evolution for Regulated Utilities



Source: S&P Global Ratings

More differentiation across network types

We are starting to see increasing differentiation across network types in the context of energy transition.

Gas networks may come under increasing pressure. Gas pipelines currently benefit from supportive regulatory frameworks or long-term ship-or-pay contracts. Ultimately, however, uncertainty about the future role of gas in the European fuel mix poses the risk of gas infrastructure becoming stranded assets over time. Concerns about gas supply diversification, transit, and geopolitical risk have resulted in excess infrastructure (including import pipelines, interconnectors, and LNG terminals), even when adjusted for seasonal demand peaks. Geopolitical risk is particularly salient for assets in the Ukrainian corridor, even more so after Denmark issued an environmental permit for Nord Stream 2. In addition, unlike electricity distribution and transportation, gas production and pipelines do not fit into the European Union's taxonomy for meeting climate-related goals. This taxonomy aims to enable capital markets to identify and respond to investment opportunities that contribute to environmental policy objectives (see "The EU Green Taxonomy: What's In A Name?," published on Sept 11, 2019). We believe this could already start pressuring regulatory returns and investments in gas, more so than for electricity. Hydrogen or biogas could help reposition gas infrastructure in the long term given their more environmentally friendly footprint. But the technology is not yet there, notably to bring down costs. For hydrogen, electrolysis alone is still an energy-intensive process and, technically, existing natural gas pipelines can typically accept no more than 10%-20% hydrogen. As such, we do not think these future promising developments will fully offset the risks in the coming decade. While this is not yet reflected in regulatory frameworks and in our ratings, we believe this is a rising risk for the sector.

Electricity DSOs will play a more significant role. With increasingly diversified and localized energy production from wind and solar, electricity distribution companies are playing a greater role in energy transition. They must manage an increasing number of

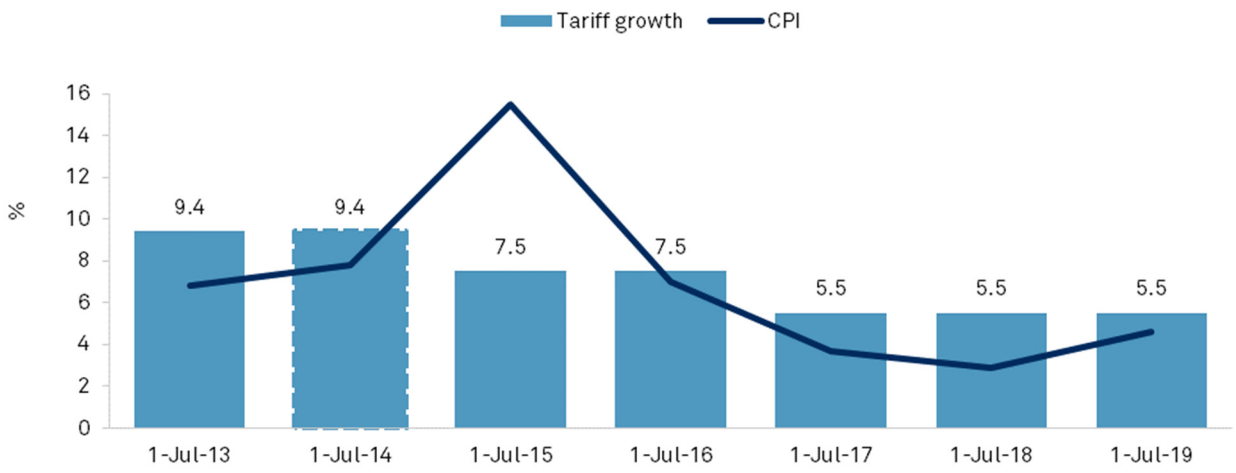
connections of energy sources and be in a position to manage much more complex flows of energy in territories--from local and dispersed production sites to self-consumption. As such, they also have the crucial role (in most markets) of deploying smart meters. We believe the upscaling of IT capabilities and R&D efforts may increasingly differentiate the operating performance and positioning of network operators and eventually push for more consolidation to reach synergies. We view positively the EON-Innogy transaction in this context.

The Situation in Russia

We expect Russia's regulated electricity companies' credit metrics to be on a positive trajectory in 2019-2020. Although Russian tariff regulation remains politicized and frequently changing, we expect electricity transmission and distribution tariffs to increase at least broadly in line with inflation, and we expect the start of the new regulatory period for the country's TSO Federal Grid in mid-2020 to bring no major surprises.

Chart 17

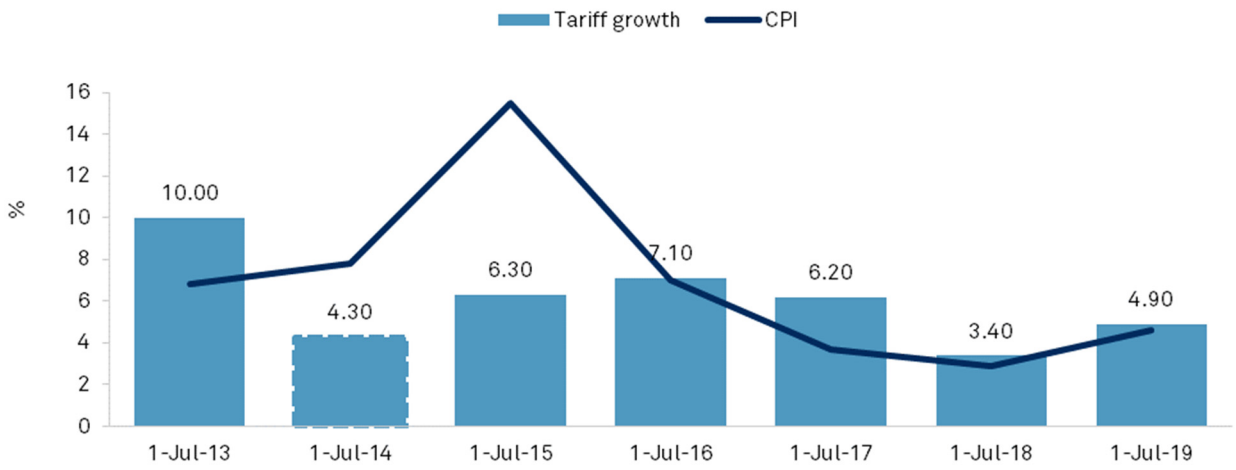
TSO tariff growth and CPI for 2013-2019



Source: S&P Global Ratings

Chart 18

DSO tariff growth and CPI for 2013-2019



Source: S&P Global Ratings

We believe that the program for the digital transformation of electricity transmission and distribution, which was approved by the government and board of state-owned power company Rosseti in late 2018, is unlikely to materially increase capital spending. This is because Russian utility companies aim to replace traditional projects with new economically efficient digital solutions. Companies will benefit further if the government approves network capacity payments, longer regulatory periods, and higher connection fees to support returns on digitalization spending. Although the government's focus on national infrastructure projects implies large capital spending on electrification and raises the risk of stranded assets (unfinished construction is not part of regulated asset base), we expect companies to continue offsetting regulatory uncertainties via flexibility in maintenance capital spending. A potential increase in dividends (Rosseti plans to adopt a new dividend policy by the end of 2019) and acquisitions remain a risk given that they are not necessarily covered by tariffs, but should be manageable in light of the pending proceeds for the sale of non-core asset, InterRAO stake, due by end-2019.

Related Research

- The Energy Transition: Nuclear Dead And Alive, Nov 11. 2019
- The Energy Transition: Different Nuclear Energy Policies, Diverging Global Credit Trends, Nov 11, 2019
- Renewable Energy Matures With Blossoming Complexity: Top 10 Issues, Nov 8. 2019
- The Energy Transition: What It Means For European Power Prices And Producers, Nov 7. 2019
- Spain's Stricter Utility Regulations Are In Line With Our Expectations, Nov 6. 2019
- Are Regulatory Framework Changes Threatening The Credit Quality Of Swedish DSOs? Aug 21, 2019.
- Credit FAQ: U.K. Utilities Are Feeling The Heat, June 14. 2019
- Issuer Ranking: European Utilities, Strongest To Weakest, May 30. 2019
- ESG Industry Report Card: Power Generation, May 13. 2019
- ESG Industry Report Card: Regulated Utilities Networks, May 13. 2019
- The Italian Renewable Power Market: Up For Auction, May 6. 2019
- A Trio Of "Special Situations" M&A In European Utilities And Their Rating Implications, April 18. 2019

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