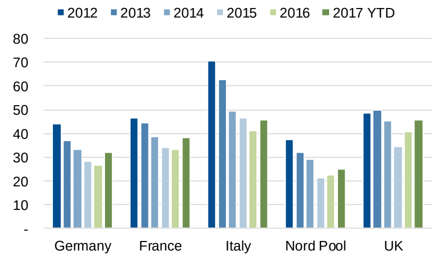
European Utilities
Commodity Rebound – Past the Trough

In view of the recent rebound in electricity wholesale prices across various European power markets, Scope believes that unregulated power generators are likely to have emerged from the trough for power generation margins. The Q3 reporting season indicates for major utilities that hedging volumes and locked-in forward prices are likely to trigger improved cash flow patterns beyond 2017. Particularly power generators in the German/Austrian and Nord Pool markets, whose power prices have been squeezed most over the past few years, will benefit from this revival. Moreover, Scope notes that most utilities have 'done their homework' and restructured their power generation portfolios towards more robust cash flow generation from cleaner energy sources or selling under capacity market schemes. Consequently, Scope believes that most European power generators should have left the cash flow trough behind and average leverage is expected to stabilise at below 3.0x in the mid-term.

Power prices on the rebound

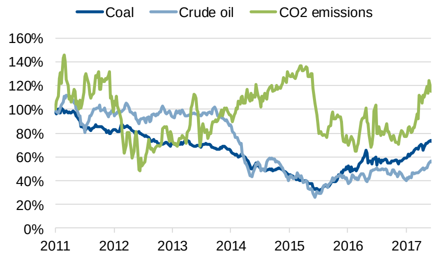
Scope estimates that those European utilities which did not hedge a significant portion of their 2018 outright production in 2016/17 will significantly benefit from the rebound in power prices, as illustrated in Figures 1 and 2. This applies to most of the utilities with a high proportion of hydro and nuclear power such as Statkraft, Fortum and Verbund which will pocket windfall profits on their comparatively cheap power plants. Improvements in cash flow profiles for the power generation division will follow for those utilities which have tended to hedge large volumes for late 2018/19 (i.e. EnBW, Uniper, RWE), thereby mirroring the recent uptrend in wholesale prices.

Figure 1: Average one-year forward baseload prices (EUR/MWh)



Source: Bloomberg, Scope

Figure 2: Price rebound for major input commodities (Dec 2011=100%)



Source: Bloomberg, Scope

We believe that the rebound of electricity prices will not be short-lived. Average power prices in major European markets will tend to increase in the medium to long term given underlying sector developments such as: i) the upcoming nuclear phase-out in Germany in 2021/22 (around 15% of current annual power generation) and a further reduction in lignite capacities; ii) the assumed mothballing of nuclear capacities in Belgium and France; iii) the slowdown in capacity expansion for subsidised renewables; and iv) the potential effects of reform to the European Emissions Trading Scheme (ETS).

Outlook

Scope believes that credit quality for unregulated power generators, particularly those utilities which operate in more volatile markets such as Germany and Scandinavia, should have stabilised on a sustainable basis as we do not anticipate that margins in power generation will be squeezed strongly over the next few years. The commodity rebound is likely to become visible in most utilities' EBITDA performance in 2018/19. As a consequence, we believe that average leverage ratios (Scope-adjusted debt/EBITDA including adjustments for pensions, margining, asset retirement obligations and leases) should remain below 3.0x, commensurate with a BBB financial risk profile.

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Bloomberg: SCOP

Different hedging strategies to protect cash flow

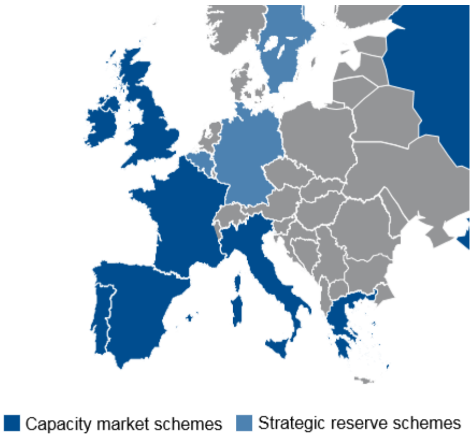
Hedging price and volume risks

Scope observes the implementation of different hedging strategies across the European utilities sectors.

- Substantial forward hedging of outright generation volumes over multiple periods with electricity wholesalers/retailers;
- Bilateral capacity hedging or power purchase agreements (PPAs) with industrials;
- Capacity hedging under strategic reserve (i.e. winter reserves) or capacity market schemes (see Figure 3).

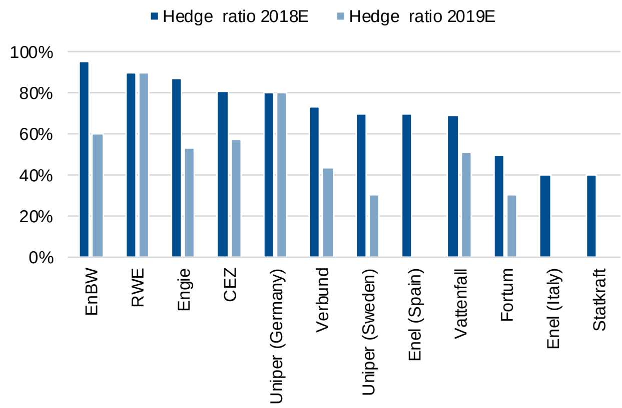
Substantial hedging of volumes will provide downside protection in bearish commodity markets; hence, comparatively low hedging may offer a stronger cash flow upside in bullish electricity markets. Moreover, remuneration through capacity schemes may prevent plant operators from suffering heavy losses. Consequently, Scope acknowledges the advantages of these risk protection mechanisms as they reduce year-on-year cash flow volatility and provide better visibility on the creditworthiness of a utility.

Figure 3: Capacity market schemes across Europe



Source: Uniper, Scope

Figure 4: Hedge ratios* as per Sep 2017 for outright generation



* midpoints if ranges are given

Source: Q3 2017 reports, Scope

Conventional power generators naturally hedge most

The estimation of the direction in which wholesale power prices will move and resulting adaptation of hedging policies will remain a major credit risk driver. Each European utility will come to its own conclusions regarding potential price developments, which may imply divergent hedging strategies. Scope notes that those power generators which run a large fleet of conventional power plants, such as EnBW, RWE, Engie, CEZ or Uniper (Germany), tend to hedge most of their outright production volumes, with one-year hedging volumes of above 80% (Figure 4). By contrast, those utilities whose power generation fleets have attained a favourable position within the merit order system (hydro, nuclear), such as Fortum or Statkraft, can largely refrain from selling large quantities forward.

Nordic utilities with lower hedging volumes will benefit in 2018 …

… while German/Austrian utilities engaging in greater hedging activities will follow in 2019

While it is likely that the latter group of utilities will already benefit from the uptrend of power prices in 2018, the former's cash flows will still, to some extent, be burdened by the lower hedged power prices from 2016 and H1 2017 before gradually climbing in 2019, thereby mirroring the recent growth in wholesale prices. In general, Scope acknowledges the tendency towards substantial hedging activity, particularly in the most volatile power markets such as the Nord Pool area (with one-year baseload prices ranging from EUR 51/MWh to EUR 21/MWh from 2010-2017) and Germany/Austria (one-year baseload prices ranging from EUR 52/MWh to EUR 26/MWh from 2010-2017).

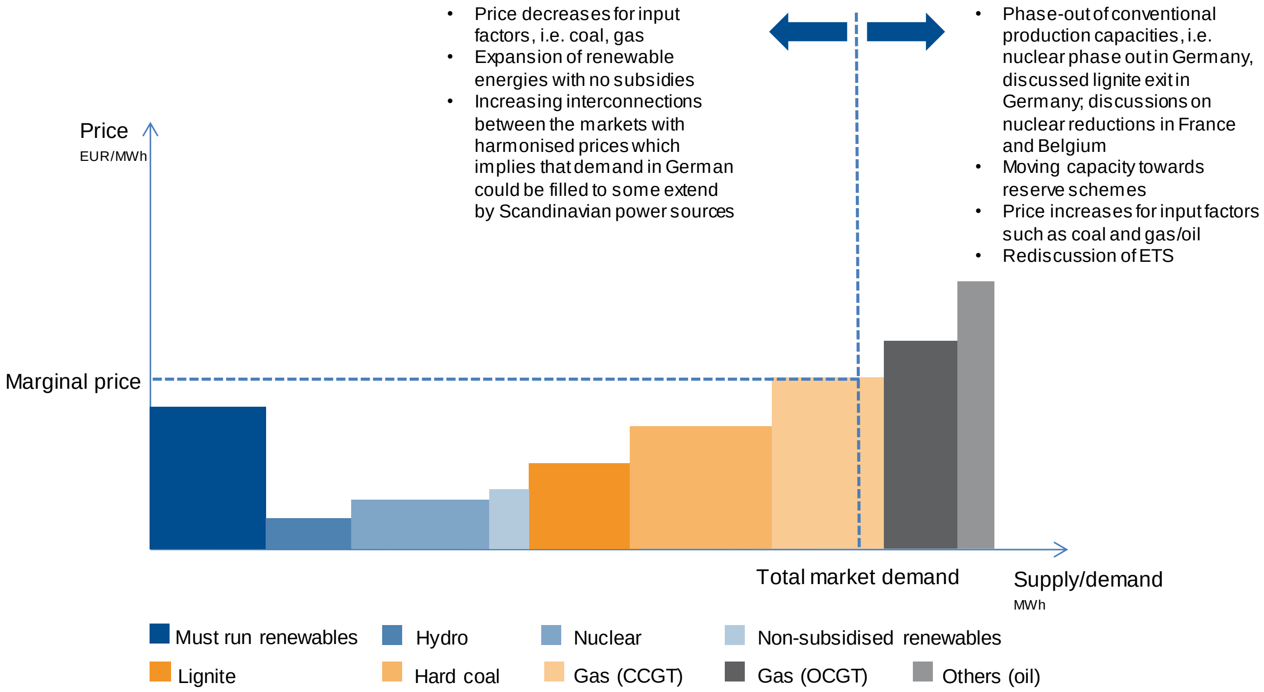
Upward trend in wholesale prices should be sustainable

Long-term shift in merit order to the right

Scope believes that the structural changes in wholesale power prices across European electricity markets should be sustainable. This is based on Scope's perception that factors shifting the marginal price within a market's merit order system to the right should outweigh those factors which would lead to a lower marginal price (see illustration in Figure 5). This change is primarily driven by:

- The phase-out or mothballing of a significant portion of conventional power generation capacity, i.e. nuclear power in Germany, Belgium and France, which needs to be substituted with other sources;
- Reduced disruption of the merit order system through subsidised 'must run renewables' with prioritised feed-in;
- Reallocation of CO_2 certificates leading to a price volume above the current EUR 7.3/ton.

Figure 5: Movements of power prices in a simplified merit order system



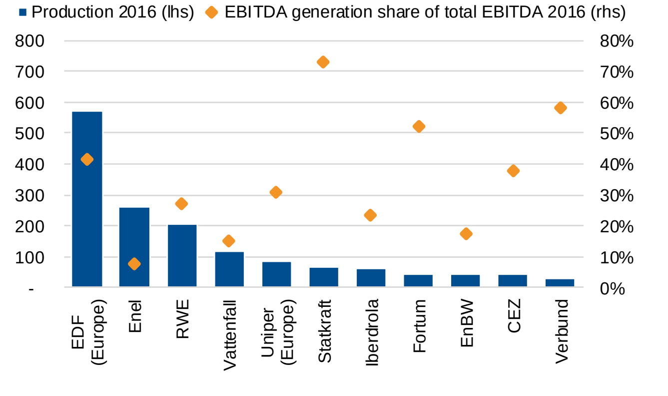
Source: Scope presentation

Smaller utilities to benefit most

Large power generators have the strongest cash flow upside/downside, but smaller utilities will see a greater impact on overall earnings

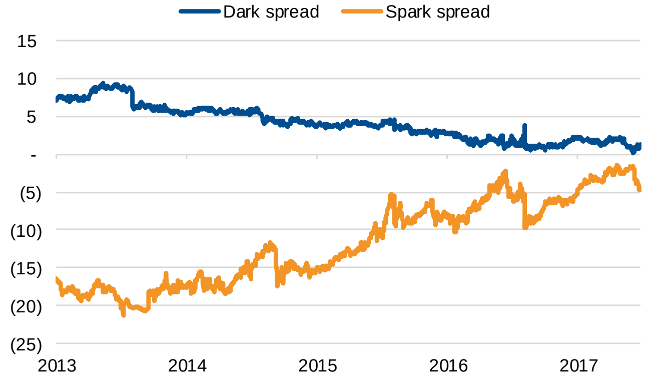
While a price increase of EUR 1/MWh does not appear huge, it could considerably improve total cash flow profiles due to windfall profits (+1 EUR/MWh multiplied by outright [unhedged] production). Europe's largest power generators EDF, Engie, Enel, RWE, Vattenfall and Uniper naturally have the greatest earnings upside from improving power prices. However, the impact on overall cash flow generation – measured by EBITDA – is greatest for the smaller utilities such as Statkraft, Fortum, Verbund, which generate more than 50% of total EBITDA from unregulated power production (see Figure 6). Moreover, losses from gas-fired power plants can be reduced substantially as can be seen in the movement of CSS (clean spark spreads) in the German market (Figure 7).

Figure 6: Power generation volumes (TWh) and EBITDA impact from power generation on group EBITDA



Source: Company reports, Scope

Figure 7: Development of dark and spark spreads (EUR/MWh) (Germany 1y ahead base)



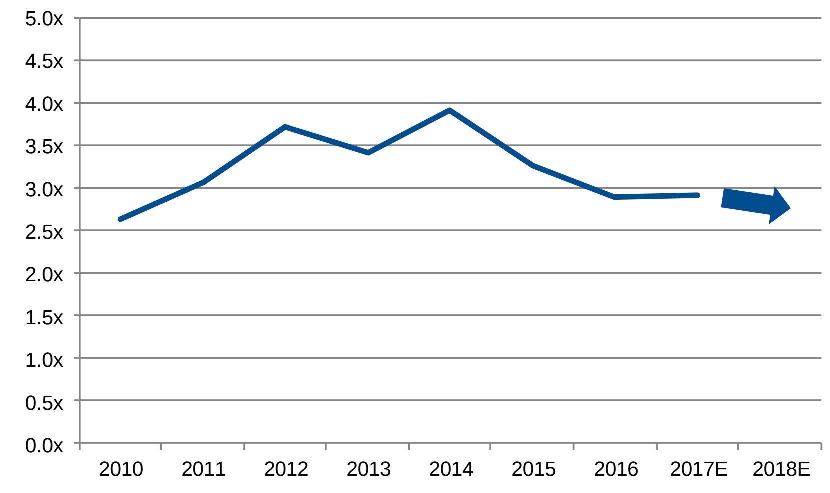
Source: Bloomberg, Scope

Conclusion

Average leverage should remain below 3.0x

Scope believes that pressure on credit quality for unregulated power generators, particularly those utilities which operate in more volatile markets such as Germany and Scandinavia, should have faded on a sustainable basis as we do not anticipate that margins in power generation will be squeezed strongly over the next few years. The commodity rebound is likely to become visible in most utilities' EBITDA performance in 2018/19. As a consequence, we believe that average leverage ratios (Scope-adjusted debt/EBITDA including adjustments for pensions, margining, asset retirement obligations and leases) should remain below 3.0x, commensurate with a BBB financial risk profile.

Figure 8: Leverage development of European utilities with significant portion from unregulated power generation



Source: 30 European utilities with significant generation capacities, Scope

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