15 May 2024 Corporates

Arva AS
Kingdom of Norway, Utilities

STABLE
BBB+

Key metrics

			Scope estimates	
Scope credit ratios	**2022**	**2023**	**2024E**	**2025E**
Scope-adjusted EBITDA/interest cover	6.1x	5.0x	3.4x	3.7x
Scope-adjusted debt/EBITDA	6.8x	5.1x	5.2x	5.9x
Scope-adjusted funds from operations/debt	10%	15%	14%	11%
Scope-adjusted free operating cash flow/debt	1%	-5%	-11%	-14%

Rating rationale

Arva's rating remains supported by low business risks given the sole exposure to regulated power distribution. The company holds a monopoly position within its service territory in the Nordland and Troms regions in northern Norway, under a reliable regulatory framework that allows for a timely cost coverage. The financial risk profile is moderate, which is the main rating constraint, reflecting our view that high capex and continued dividend payments will increase leverage (Scope-adjusted debt/EBITDA) to around 6.0x over the next years.

Arva's rating is derived from a standalone credit assessment of BBB and a one-notch uplift based on its government-related entity (GRE) status. The uplift is driven by the anticipated capacity and willingness of the company's indirect municipal owners to provide financial support if needed.

Outlook and rating-change drivers

The Stable Outlook reflects our view that Arva will continue to generate solid operating cash flows from its monopolistic and fully regulated power grid operations. It further reflects our forecast that negative free operating cash flow due to high capital expenditure plans will result in Scope-adjusted debt/EBITDA of around 6.0x. Lastly, the Outlook assumes continued indirect majority-ownership by Norwegian municipalities.

A positive rating action could be warranted if Scope-adjusted debt/EBITDA fell to around 5.0x on a sustained basis, resulting in an improved financial risk profile.

A negative rating action could be motivated by an increase in Scope-adjusted debt/EBITDA to well above 6.5x and interest cover falling below 4.0x, both on a sustained basis. Alternatively, a reduction in indirect municipal ownership to below 50% and the loss of GRE status could also trigger a downgrade.

Rating history

Date	Rating action/monitoring review	Issuer rating & Outlook
5 April 2024	Affirmation	BBB+/Stable
29 Mar 2023	New	BBB+/Stable

Ratings & Outlook

Issuer	BBB+/Stable
Short-term debt	S-2
Senior unsecured debt	BBB+

Analysts

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Related Methodologies

General Corporate Rating Methodology; October 2023

European Utilities Rating Methodology; March 2023

Government Related Entities Rating Methodology; July 2023

Related Research

Europe's grid operators brace for capex surge; Rising regulated tariffs on enlarged RAB and countermeasures provide longer-term relief, July 2023

Nordic utilities: north-south price gap benefits southern generators; TSOs also gain, Nov 2022

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Bloomberg: RESP SCOP

Rating and rating-change drivers

Positive rating drivers	Negative rating drivers
• Regional monopoly in fully regulated power distribution • Transparent and reliable regulatory scheme that ensures timely pass-through of costs with tariffs based on a cost-plus mechanism • Major part of investment plan earmarked for enabling of energy transition (ESG factor) • Above-average profitability among European peers as measured by EBITDA margin • Acceptable interest cover of around 4.0x expected in the medium to long term, supporting the financial risk profile • Good access to external financing to ensure timely coverage of refinancing and planned investment • GRE status: long-term indirect municipal owners with capacity and willingness to provide financial support if needed	• Moderate financial risk profile with leverage (Scope-adjusted debt/EBITDA) expected to increase to a sustained level of around 6.0x • Relatively large 10-year capex programme of NOK 8bn-9bn expected to result in negative free operating cash flow for a prolonged period • Continued dividend ambitions that will likely need to be funded with debt • Limited geographical outreach with all operations in northern Norway, although not a huge concern given adequate customer diversification and monopolistic market position

Positive rating-change drivers	Negative rating-change drivers
• Leverage (Scope-adjusted debt/EBITDA) of around 5.0x	• Leverage (Scope-adjusted debt/EBITDA) of well above 6.5x and interest cover below 4.0x, both on a sustained basis • Loss of GRE status (remote) through reduced indirect municipal ownership to below 50%

Corporate profile

Arva is a Norwegian power grid operator which owns and operates the power distribution system within a service territory of 19 municipalities in the Nordland and Troms counties. It serves more than 120,000 customers as measured by connection points, making it the largest power grid operator in northern Norway and the sixth largest domestically. The company was established in December 2020 by a merger between the power distribution activities of Troms Kraft and Bodø Energi, which after the transaction own 60% and 36% of Arva, respectively. The remaining 4% is owned by Dragefossen AS.

We define Arva as a GRE in accordance with our Government Related Entities Rating Methodology. This is based on the indirect public majority municipal ownership and the essential public services provided by the company as the sole power grid operator within its service territory.

Financial overview

				Scope estimates		
Scope credit ratios	**2021**	**2022**	**2023**	**2024E**	**2025E**	**2026E**
Scope-adjusted EBITDA/interest cover	11.4x	6.1x	5.0x	3.4x	3.7x	3.9x
Scope-adjusted debt/EBITDA	6.8x	6.8x	5.1x	5.2x	5.9x	6.1x
Scope-adjusted funds from operations/debt	15%	10%	15%	14%	11%	11%
Scope-adjusted free operating cash flow/debt	-10%	1%	-5%	-11%	-14%	-11%
Scope-adjusted EBITDA in NOK m						
EBITDA	487	714	722	727	783	892
Other items	(34)	(255)	(42)	54	54	54
Scope-adjusted EBITDA	**453**	**459**	**679**	**781**	**837**	**946**
Funds from operations in NOK m						
Scope-adjusted EBITDA	453	459	679	781	837	946
less: (net) cash interest paid	(37)	(73)	(134)	(228)	(226)	(240)
less: cash tax paid per cash flow statement	-	-	-	-	(63)	(70)
Other items	53	(63)	(35)	-	-	-
Funds from operations (FFO)	**469**	**324**	**510**	**553**	**548**	**636**
Free operating cash flow in NOK m						
FFO	469	324	510	553	548	636
Change in working capital	(74)	155	19	6	2	3
less: capital expenditure (net)	(705)	(434)	(714)	(1,000)	(1,250)	(1,250)
Free operating cash flow (FOCF)	**(310)**	**45**	**(185)**	**(441)**	**(700)**	**(611)**
Net cash interest paid in NOK m						
Net cash interest per cash flow statement	40	75	136	230	228	242
Change in other items	-	-	-	-	-	-
Net cash interest paid	**40**	**75**	**136**	**230**	**228**	**242**
Scope-adjusted debt in NOK m						
Reported gross financial debt	3,099	3,402	3,632	4,300	5,100	5,850
less: subordinated (hybrid) debt	-	-	-	-	-	-
less: available cash and cash equivalents	(60)	(302)	(191)	(238)	(173)	(130)
add: pension adjustment	37	21	8	8	8	8
Scope-adjusted debt (SaD)	**3,076**	**3,121**	**3,449**	**4,070**	**4,935**	**5,728**

Table of Content

Environmental, social and governance (ESG) profile[1]

Environment	Social	Governance
Resource management (e.g. raw materials consumption, carbon emissions, fuel efficiency)	Labour management	Management and supervision (supervisory boards and key person risk)
Efficiencies (e.g. in production)	Health and safety (e.g. staff and customers)	Clarity and transparency (clarity, quality and timeliness of financial disclosures, ability to communicate)
Product innovation (e.g. transition costs, substitution of products and services, green buildings, clean technology, renewables)	Clients and supply chain (geographical/product diversification)	Corporate structure (complexity)
Physical risks (e.g. business/asset vulnerability, diversification)	Regulatory and reputational risks	Stakeholder management (shareholder payouts and respect for creditor interests)

Legend

Green leaf (ESG factor: credit positive)

Red leaf (ESG factor: credit negative)

Grey leaf (ESG factor: credit neutral)

ESG focus and transparency with separate sustainability reporting

Arva has clear sustainability ambitions, with operations focused on the distribution of clean energy to customers in its service areas. Most generation supplying electricity to the company's service territory comes from hydropower and wind assets, and a power grid is crucial to efficiently utilise this energy. The company has a sustainable ESG strategy in place for 2022-24 with three main pillars: i) network capacity; ii) efficiency; and iii) quality. These three pillars focus on direct impact stakeholders. Further, the company's 10-year investment programme of about NOK 8.5bn includes projects to facilitate new green technologies and electrification and is required to ensure continued energy security for the population. Arva achieves high transparency in ESG and has implemented separate reporting on sustainability, including on Scope 1, Scope 2 and Scope 3 emissions.

The Norwegian utility sector is subject to clear regulatory and reputational risks via a concession system. However, the regulatory environment is considered very stable and predictable, which helps to mitigate these risks.

Overall, we see no company-specific ESG factors at this stage which would have a substantial impact on the overall assessment of credit risk.

[1] These evaluations are not mutually exclusive or exhaustive as ESG factors may overlap and evolve over time. We only consider ESG factors that are credit-relevant, i.e. those that have a discernible, material impact on the rated entity's cash flow and, by extension, its credit quality.

Business risk profile: A+

Strong business risk profile

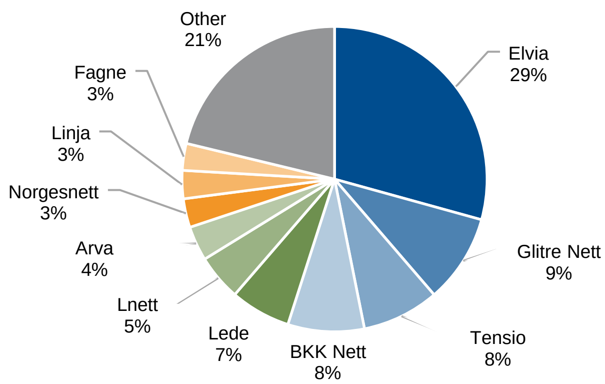
Arva's credit quality remains driven by its monopoly position in power distribution within its service area in the Nordland and Troms counties in northern Norway. This ensures predictable cash flow given Norway's transparent regulation, underpinning the company's low business risks.

Monopoly position - sixth largest DSO in Norway

The 10 largest Norwegian power grid operators serve about two-thirds of the total customer base of 3.3 million connection points. Operators of the power distribution system (DSOs) in Norway hold a natural monopoly and size is therefore less important for their market positioning. Arva became the sixth largest DSO in Norway through the merger of Troms Kraft Nett and Nordlandsnett in late 2020, and it serves more than 120,000 private, commercial, and industrial customers.

Given its monopolistic market position, we consider Arva's lack of product and geographical diversification less important for the rating. However, overall diversification remains the weakest element of its business risk profile.

Figure 1: Largest Norwegian DSOs for electricity by connection points*, '000s



*Note that Tensio reflects two independent grid operators, Tensio TS and Tensio TN.

Sources: NVE-RME, Scope

Stable service territory

We consider Arva's service territory to be stable, reflecting relatively flat population growth and Norway's robust economy (rated AAA/Stable by Scope). Demand for Arva's services is expected to increase, driven by electrification and the establishment of power intensive industry. This is also backed by the company's investment programme, which incorporates more than a doubling of grid capacity by 2030.

Timely pass-through of an increased cost base

Arva's financial performance is directly dependent on the regulatory framework set by NVE-RME and its cost efficiency compared to Norwegian peers. The cost-plus framework for DSOs is considered transparent and robust, with tariffs being reviewed regularly and based on a two-year backward-orientated approach. This ensures a timely pass-through of an increased cost base and operators are also granted a defined return on invested capital.

Part of the cost recovery for DSOs in Norway is subject to incentives for cost efficiency

The regulatory framework incentivises cost efficiency, with the income cap taking into account 30% of an operator's actual costs while the remaining 70% is based on a cost norm. DSOs delivering above-average efficiency scores will earn higher returns on their invested capital than the defined regulatory benchmark return, and show better underlying profitability margins. Less efficient DSOs will see lower returns.

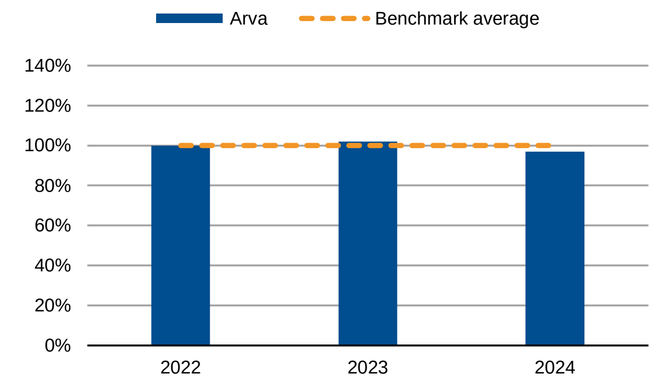
Average regulatory cost-efficiency

The company's regulatory efficiency in 2022 and 2023 was 100% and 102%, respectively, indicating cost efficiency close to an average Norwegian power grid operator. The company aims to achieve 105% by 2027, likely requiring the successful realisation of synergies from the merger back in 2020 and the continued streamlining of operations.

EBITDA margin of around 50% expected in the next years

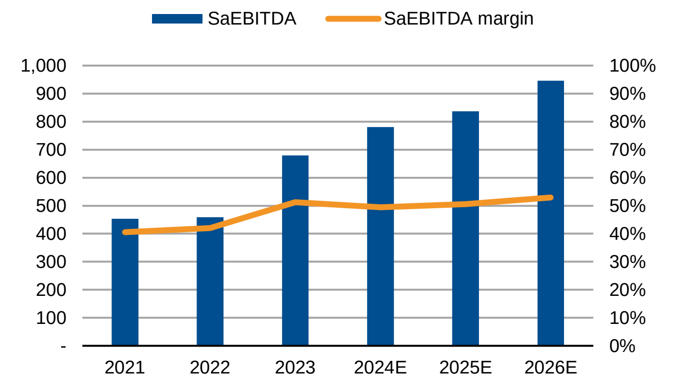
Arva's EBITDA margin recovered from 42% in 2022 to 51%in 2023. This was supported by a reduced revenue deficit last year, which ended at NOK 42m, versus NOK 164m in 2022. In the next few years, we expect Arva to achieve an EBITDA margin of around 50%, which is above average within our peer group of Norwegian and European DSOs. The volatility of the EBITDA margin and cash flow of DSOs in Norway is affected by transmission costs, which are dependent on volatile power prices. However, this exposure is result and cash flow neutral over time.

Figure 2: Arva's regulatory efficiency score versus benchmark average



Sources: Arva, Scope

Figure 3: Scope-adjusted EBITDA (NOK m, LHS) and EBITDA margin (RHS)



Sources: Arva, Scope (estimates)

Financial risk profile: BB-

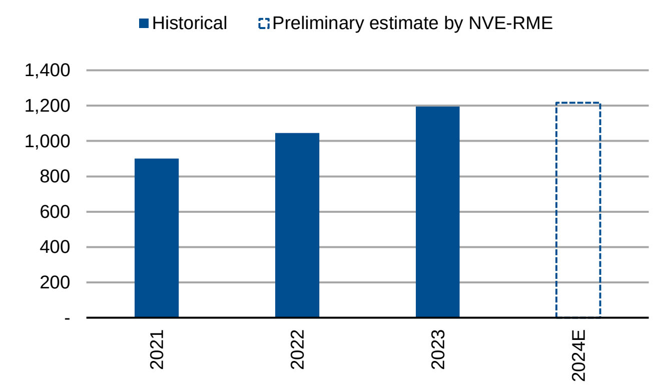
EBITDA adjusted for annual revenue surplus/deficit

The company reports under Norwegian accounting principles (NGAAP). Scope-adjusted EBITDA is therefore adjusted to consider the incurred annual revenue surplus/deficit, making it more reflective of actual cash flow. Still, we note this is just a periodisation effect, as DSOs in Norway are required to take their revenue balance towards zero over time. At YE 2023, Arva had a revenue deficit of NOK 213m.

Higher interest rates and inflation increase income cap

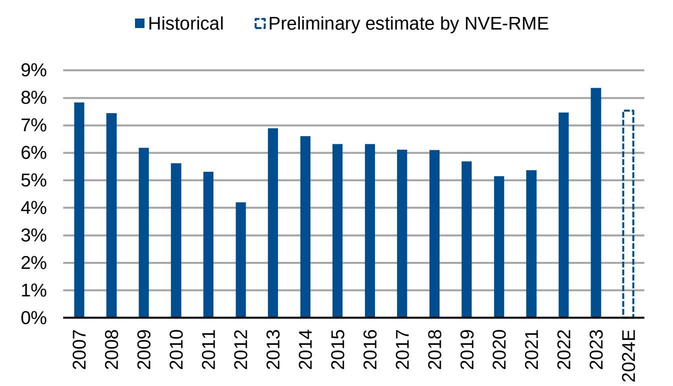
In 2023-2024, Arva's income cap has increased to around NOK 1.2bn from about NOK 1bn in 2022, supported by higher interest rates and inflation.

Figure 4: Arva's income cap, NOK m



Sources: NVE-RME, Scope

Figure 5: Regulatory benchmark return



Sources: NVE-RME, Scope

Leverage expected to stabilise at around 6.0x over the coming years

Arva's financial risk profile of BB- is constrained by high leverage. We expect Scope-adjusted debt/EBITDA to weaken to around 6.0x over the next years, which is still below the company's own target of net debt/EBITDA of 7.0x. We do not consider the high Scope-adjusted debt/EBITDA of 6.8x recorded in 2022 to be overly important, as this was largely due to a revenue deficit of NOK 164m, with the ratio already improving to 5.1x in 2023.

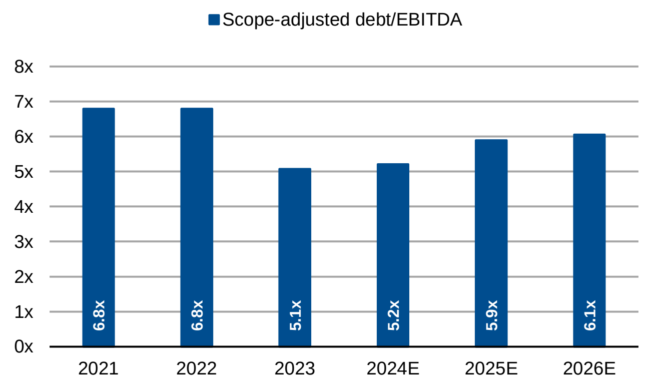
10-year investment programme of around NOK 8.5bn

We expect free operating cash flow to stay negative for a prolonged period based on the company's 10-year investment programme of about NOK 8.5bn. The capex plan includes new projects, but also maintenance and upgrades of the existing grid, including power lines, voltage upgrades and green power enhancements. In combination with continued dividend payments, this is expected to require additional external financing in the coming years. However, over time, the capex will feed into an increasing regulatory asset base and a larger cost base, supporting a sustained growth in EBITDA and operating cash flow, eventually helping to stabilise credit metrics.

Moderate interest cover

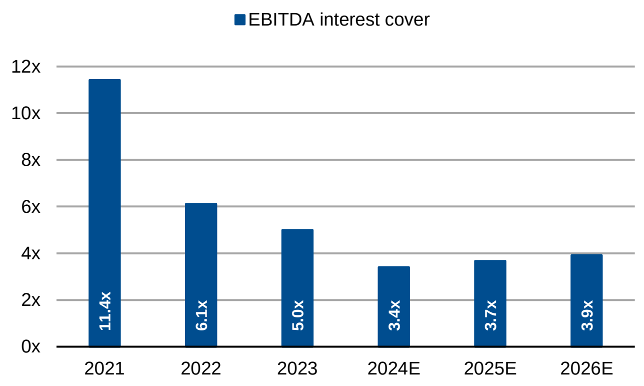
Higher interest rates and debt expansion is expected to pressure Scope-adjusted EBITDA interest cover in the near term. We forecast that this ratio will decline from 5.0x in 2023 to 3.4x in 2024, before gradually improving to around 4.0x in 2025-2026.

Figure 6: Leverage



Sources: Arva, Scope (estimates)

Figure 7: Interest cover



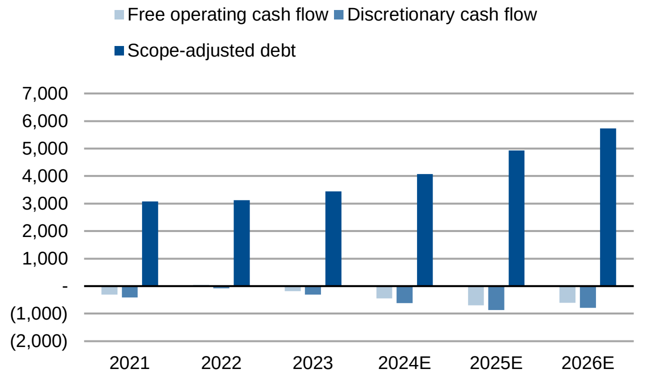
Sources: Arva, Scope (estimates)

Adequate liquidity supported by good access to external funding

Liquidity remains adequate. Debt maturities in 2024 were refinanced via new debt raised in Q1 2024, comprising a NOK 500m loan signed with the Nordic Investment Bank and the issuance of two bonds totaling NOK 600m. We also expect that the company will extend its NOK 750m undrawn committed credit facility, which matures in June 2024. Liquidity ratios are expected to remain pressured by negative free operating cash flow and upcoming debt maturities of NOK 700m in 2025 and NOK 1,400m in 2026. However, we believe Arva can raise new debt as needed thanks to its good access to external funding.

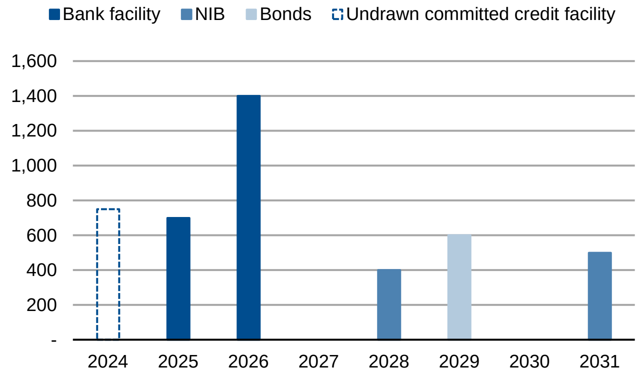
Balance in NOK m	2023	2024E	2025E
Unrestricted cash (t-1)	302	191	238
Open committed credit lines (t-1)	750	550	750
Free operating cash flow	(185)	(441)	(700)
Short-term debt (t-1)	2	1,132	700
Coverage	**>200%**	**26%**	**41%**

Figure 8: Cash flow and Scope-adjusted debt, NOK m



Sources: Arva, Scope (estimates)

Figure 9: Maturity profile as of April 2024, NOK m



Sources: Arva, Scope

Supplementary rating drivers: +/- 0 notches

Financial policy accounted for in financial risk profile assessment

We have made no adjustment for financial policy. Arva's financial policy was established in 2022 and outlines some key principles, including maintaining net debt/EBITDA below 7x and the equity ratio above 25%. It also includes principles for debt maturities and the hedging of interest rate exposure as well as the goal of an investment grade rating. Although Arva is a subsidiary of Troms Kraft AS, it is fully responsible for its own financing, making its financial policy independent of the parent.

One-notch uplift for indirect majority municipal ownership

With respect to parent support from the indirect municipal owners, including the Troms and Bodø municipalities, we assign a one-notch uplift from the standalone credit assessment based on our government related entity methodology, using a bottom-up approach. We have accounted for the ownership of all municipality shareholders as that of a single shareholder due to Arva's strategic importance for the Troms and Nordland regions. The indirect ownership and common interest between municipalities allow us to assess the willingness to provide support should Arva need it. Although this indirect municipality ownership is slightly more complex than direct ownership, we deem it highly likely that the municipality owners would be able and willing to support Arva, despite the lack of explicit terms or guarantees.

Long-term and short-term debt ratings

Senior unsecured debt: BBB+

Senior unsecured debt is rated BBB+, in line with the issuer rating.

Short-term debt rating: S-2

The S-2 short-term debt rating is based on the underlying BBB+/Stable issuer rating and is supported by adequate liquidity, good banking relationships, and adequate access to diverse funding sources.

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