Arva AS
Norway, Utilities

SCOPE BBB+ STABLE

Key metrics

			Scope estimates	
Scope credit ratios	**2020**	**2021**	**2022E**	**2023E**
Scope-adjusted EBITDA/interest cover	6.1x	13.3x	9.1x	4.1x
Scope-adjusted debt/EBITDA	10.1x	6.3x	4.8x	6.3x
Scope-adjusted FFO/debt	9.7%	15.3%	15.7%	12.5%
Scope-adjusted FOCF/debt	neg.	neg.	neg.	neg.

Rating rationale

Arva's rating reflects a very strong business risk profile and a weaker financial risk profile. The business risk profile is supported by the company's sole exposure to fully regulated power distribution. Arva holds a monopolistic position within its service territory in Northern Norway, under a stable and supportive regulatory framework allowing for timely pass-through of an increased cost base. Merger synergies are anticipated to positively impact profitability and efficiency measures, with EBITDA margins of 45%-55% expected.

The financial risk profile is negatively impacted by Arva's relatively high leverage and negative free operating cash flow. Scope-adjusted debt/EBITDA is expected to average around 6.0x in the short- to medium term, due to major investment plans and continued dividend ambitions. Negative discretionary cash flows will necessitate more external financing that will increase interest costs, leading to an expectation that Scope-adjusted EBITDA/net interest will likely decline towards the 4x-5x range in 2023-24.

Arva's issuer rating reflects a standalone credit assessment of BBB and a one-notch uplift for GRE status. The uplift is driven by the anticipated capacity and willingness of the company's indirect municipality owners to provide 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 grid operations. The Outlook further reflects an expectation that Scope-adjusted debt/EBITDA will stay around 6x going forward, and that free operating cash flow will be negative due to high capex. We also assume the company will remain indirectly majority-owned by Norwegian municipalities.

A positive rating action could be warranted if Arva's leverage, as measured by Scope-adjusted debt/EBITDA, falls towards 5x 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. This could be triggered by higher debt-financed growth than anticipated or an adverse operational development, leading to reduced profitability and cash flows without any lower capital expenditure or dividends. 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
29 Mar 2023	Initial rating	BBB+/Stable

Ratings & Outlook

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

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Related Methodologies

General Corporate Rating Methodology; July 2022

European Utilities Rating Methodology; March 2023

Government Related Entities Methodology; May 2022

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Rating and rating-change drivers

Positive rating drivers	Negative rating drivers
• Monopolistic power distribution company with stable and predictable cash flows and above average profitability • Operating in a supportive and well-established regulatory framework in Norway with tariffs based on cost-plus mechanisms • Committed long-term owners who indirectly through municipalities have capacity and willingness to provide support if needed	• High financial leverage and debt financing requirements to carry out planned grid investments • Relatively high investment requirements indicate negative free operating cash flow in the medium term • Continued dividend ambitions that will likely need to be funded with debt • Limited geographical outreach with network only serving municipalities in Northern Norway

Positive rating-change drivers	Negative rating-change drivers
• Scope-adjusted debt/EBITDA around 5x on a sustained basis	• Scope-adjusted debt/EBITDA ratio well above 6.5x on a sustained basis and interest cover below 4.0x • Reduced indirect municipality ownership to below 50% and the loss of GRE status

Corporate profile

Arva AS is a Norwegian utility company operating solely in regulated power distribution with regional and local grid networks. The company is the sixth largest regional grid company in Norway and its service territory covers 19 municipalities in the Nordland and Troms counties in Northern Norway. Arva owns and operates 15,000 km of power lines and serves more than 120,000 customers. The company was established in December 2020 through a merger of Troms Kraft Nett and Nordlandsnett – the grid networks of Troms Kraft AS and Bodø Energi AS. Post-merger, Troms Kraft and Bodø Energi own 60% and 36% of Arva, respectively, while Dragefossen AS owns 4%. We classify Arva as a government related entity.

Financial overview

			Scope estimates		
Scope credit ratios	**2020[1]**	**2021**	**2022E**	**2023E**	**2024E**
Scope-adjusted EBITDA/interest cover	6.1x	13.3x	9.1x	4.1x	4.0x
Scope-adjusted debt/EBITDA	10.1x	6.3x	4.8x	6.3x	6.5x
Scope-adjusted FFO/debt	9.7%	15.3%	15.7%	12.5%	11.9%
Scope-adjusted FOCF/debt	-6.9%	-10.1%	-6.3%	-13.4%	-10.3%
Scope-adjusted EBITDA in NOK m					
EBITDA	264	487	614	653	735
Other items[2]	-	-	96	-	-
Scope-adjusted EBITDA	**264**	**487**	**710**	**653**	**735**
Funds from operations in NOK m					
Scope-adjusted EBITDA	264	487	710	653	735
less: (net) cash interest paid	-43	-37	-78	-158	-184
less: cash tax paid per cash flow statement	0	0	0	0	0
Other items[3]	37	19	-96	19	19
Funds from operations (FFO)	**258**	**469**	**536**	**515**	**570**
Free operating cash flow in NOK m					
Funds from operations	258	469	536	515	570
Change in working capital	-70	-74	48	-19	-15
less: capital expenditure (net)	-370	-705	-800	-1,050	-1,050
Other items	-	-	-	-	-
Free operating cash flow (FOCF)	**-183**	**-310**	**-216**	**-555**	**-495**
Net cash interest paid in NOK m					
Interest received	-2	-2	-1	-1	-1
Interest paid	45	38	79	159	186
Other items	-	-	-	-	-
Net cash interest paid	**43**	**37**	**78**	**158**	**185**
Scope-adjusted debt in NOK m					
Reported gross financial debt	2,620	3,099	3,400	4,150	4,800
less: subordinated (hybrid) debt	-	-	-	-	-
less: cash and cash equivalents	-2	-60	-21	-61	-48
add: non-accessible cash	-	-	-	-	-
add: pension adjustment	51	37	40	40	40
Other items	-	-	-	-	-
Scope-adjusted debt (SaD)	**2,668**	**3,076**	**3,419**	**4,129**	**4,793**

[1] Arva was established in late 2020, and 2021 is the first year with a full set of annual figures for the combined company.
[2] NVE-RME granted the company a harmonisation income of NOK 96m in December 2022 in relation to the merger completed in 2020.
[3] We assume the NOK 96m of recognised harmonisation income will be collected from customers over five years starting in 2023.

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Environmental, social and governance (ESG) profile[4]

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)	Grey leaf
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)	Grey leaf
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)	Grey leaf
Physical risks (e.g. business/asset vulnerability, diversification)		Regulatory and reputational risks		Stakeholder management (shareholder payouts and respect for creditor interests)	Grey leaf

Legend

Green leaf (ESG factor: credit positive)
Red leaf (ESG factor: credit negative)
Grey leaf (ESG factor: credit neutral)

High ESG focus and transparency with separate sustainability reporting

Arva has clear sustainability ambitions, with operations focused on 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 sizeable 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 shows 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 are deemed to have a substantial impact on the overall assessment of credit risk.

[4] 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+

Industry risk profile: AA

Based on Arva's sole exposure to fully regulated power distribution, we assess its industry risk as low (AA according to our utilities methodology).

Stable and supportive regulatory framework that ensures timely cost coverage

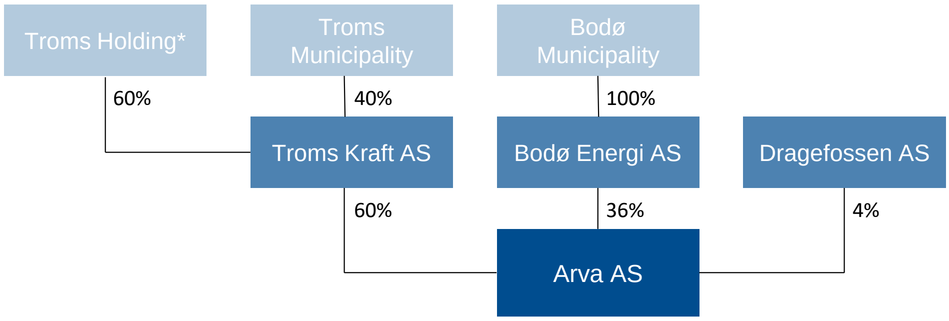
Norway's power distribution market is highly fragmented, with around 120 regional and local grid operators nationwide. However, in terms of market share, the 10 largest operators serve two -thirds of the customer base of approximately three million (based on connection points). Distribution grid operators (DSOs) naturally hold a national or regional monopoly regardless of their size, resulting in a lower importance of size for their market position. We deem Norway's tariff setting and regulatory framework for DSOs to be well established and reliable. Tariffs are reviewed regularly and based on a two-year backward-orientated approach, ensuring timely pass-through of an increased cost base. Within the framework, operators are also granted a defined return on invested capital.

Monopoly position – sixth largest DSO in Norway

Arva holds a natural monopoly over power distribution within its service territory in the Nordland and Troms regions in Northern Norway. The company became the sixth largest DSO in Norway through the merger of Troms Kraft Nett and Nordlandsnett, and it serves more than 120,000 private, commercial, and industrial customers. In addition to having a monopoly, Arva's market position is further strengthened by our view of Norway's robust economy, plus a stable service territory.

Given its monopolistic position, Arva's lack of product and geographical diversification is considered less important for the rating. While overall diversification is the weakest part of the business risk profile, the company still has a large exposure to residential customers, although in absolute terms the number is small compared to larger international peers.

Figure 1: Organisational structure



*Troms Holding is owned by Troms and Finnmark County municipality (65%) and other municipalities (35%)

Sources: Arva, Scope

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

Arva's profitability is directly dependent on the regulatory conditions set by NVE-RME and its cost efficiency compared to Norwegian peers. The cost efficiency score is calculated by the regulator and is based on benchmark analysis with other Norwegian DSOs, and is used on part of the cost base when calculating the revenue cap – creating incentives for operators to be cost-efficient. Typically, DSOs with above average efficiency scores will earn higher returns on invested capital (than the defined regulatory benchmark return) and show better underlying profitability margins, while less efficient DSOs will see lower returns. In its first full reporting year as a combined company, Arva received an efficiency score (i.e. DEA score) of 98%. Going forward, more streamlined post-merger operations are expected to benefit Arva's efficiency score.

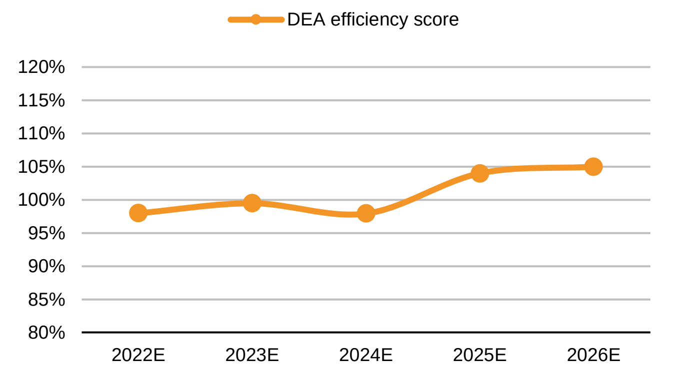
Synergies and streamlining of operations to benefit efficiency and profit margins

Since Arva was established in late 2020, historical profitability data is limited and only available separately for Troms Kraft Nett and Nordlandsnett. Arva has identified synergies from the merger totalling between NOK 40-50m that can be realised during 2022-24. The largest effects are expected in 2023 and 2024. We expect cost reductions for the company in procurement, communication, and IT systems, amongst others. In addition, planning and execution of investments is likely to benefit from a larger organisation. In addition to the synergies mentioned above, there is a pension accounting effect that will be positive for the regulatory efficiency score from 2024, and we expect Arva to be well positioned to achieve an above average score with time.

Above average profitability with expected EBITDA margins of 45%-55%

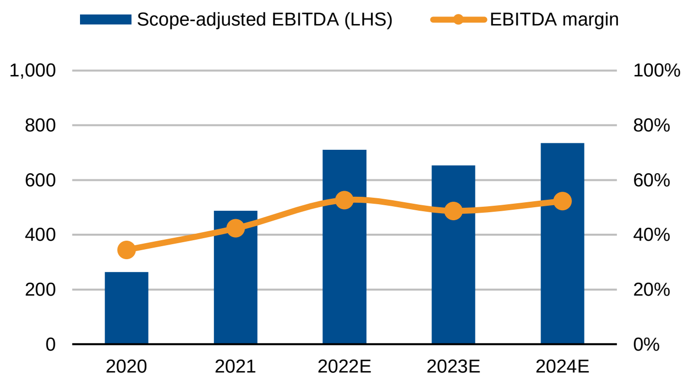
Including our view of improved cost efficiency and the realisation of synergies, we expect Arva to achieve EBITDA margins of 45%-55% over the next few years. This is above average within our peer group of Norwegian and European DSOs, and the company's profitability is therefore deemed to be strong. It should be noted that EBITDA margins for DSOs are affected by transmission costs that can vary due to volatile power prices, but these are result and cash flow neutral over time for Norwegian DSOs. Arva operates in the NO4 zone where power prices are low, and the company has therefore not seen the same acceleration of transmission costs as peers in Southern Norway (but note that these have been capped through 2023 by a temporary maximum tariff of 35 øre/kWh introduced by Statnett for all pricing zones back in 2H22).

Figure 2: Efficiency score development



Sources: Arva (estimates)

Figure 3: Scope-adjusted EBITDA (NOK m) and margin (%)



Sources: Scope (estimates)

Financial risk profile: BB-

Limited historical data as a combined entity

As pointed to earlier, Arva was established in late 2020, so historical data is limited with 2021 as the first full operational year. As a result, our financial assessment relies mostly on forecasts. Note that we have assumed a tax benefit of approximately NOK 160m at year-end 2022, which is why there are no paid taxes in our 2022-24 estimates.

Higher revenues and EBITDA levels expected going forward

With respect to EBITDA, we deem operating profitability to be stable and expect the company to achieve revenues relatively in line with its income cap, including potential running adjustments for movements in transmission costs. Based on factors such as higher reference rates used by NVE-RME and anticipated growth in Arva's regulatory asset base, we expect revenues and EBITDA levels to increase going forward. In 2022-24, Scope-adjusted EBITDA is forecasted to average approximately NOK 700m, while operating cash flows are expected to stay above NOK 500m.

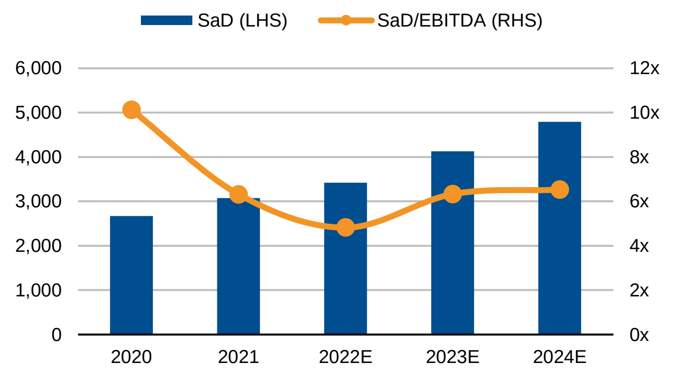
Investment plans will result in negative FOCF

Nonetheless, we expect free operating cash flow to be highly impacted by the company's sizeable 10-year investment programme, which totals approximately NOK 8.5bn. The programme includes new projects, but also maintenance and upgrades of the existing grid, including construction of power lines, voltage upgrades and green power enhancements. We understand that the programme is somewhat front-loaded, and that peak investment levels are expected already in 2023-24. However, investment levels are anticipated to still be high after this, and combined with continued dividend ambitions, this will likely result in negative FOCF and discretionary cash flows for the foreseeable future.

Leverage to average around 6x in 2022-24

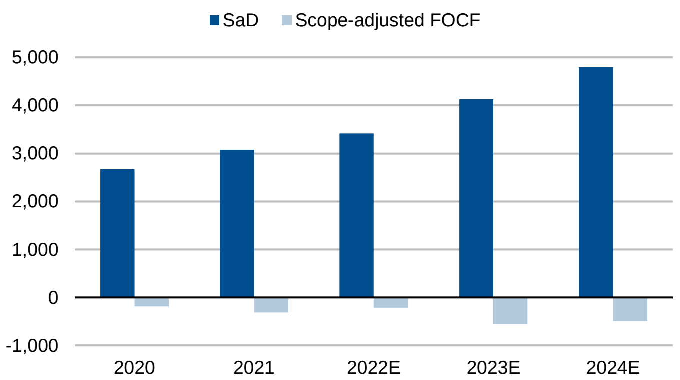
Scope-adjusted debt is expected to increase towards NOK 4.8bn by the end of 2024, and paired with our estimates for EBITDA, the Scope-adjusted debt/EBITDA ratio is anticipated to average around 6x in the short- to medium term. The ratio may see some upward pressure initially based on our assumption of peak investment levels in 2023-24.

Figure 4: SaD (NOK m) and SaD/EBITDA



Sources: Scope (estimates)

Figure 5: Scope-adjusted debt and SaFOCF, NOKm



Sources: Scope (estimates)

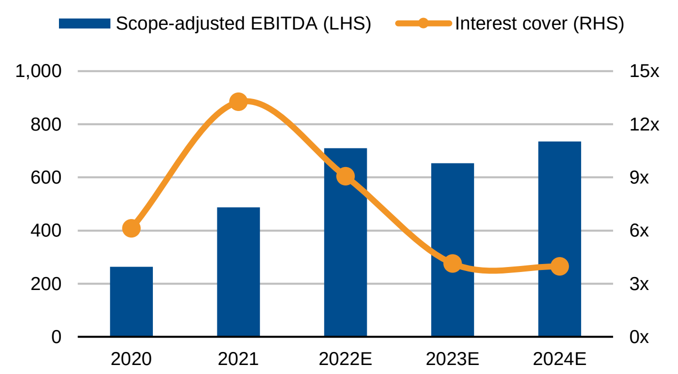
Independently funded from parent

The company is independently funded from its parent following the merger. At year-end 2022, Arva had NOK 3.4bn of interest-bearing debt, consisting of two tranches of a syndicated loan facility with maturities in mid-2024 and mid-2025, respectively, and a loan from Nordic Investment Bank maturing in 2028. Scope-adjusted debt also adds a small portion of unfunded pension liabilities.

High external financing is required

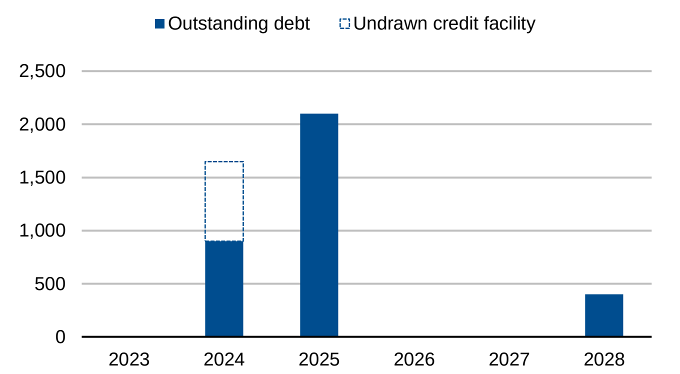
Negative discretionary cash flow will necessitate additional external financing in upcoming years, and combined with recent rises in interest rates, Arva's debt protection, as measured by Scope-adjusted EBITDA/net interest, is expected to decline towards the 4-5x range, which is still a comfortable level.

Figure 6: SaEBITDA (NOKm) and Interest cover (x)



Sources: Scope (estimates)

Figure 7: Debt maturity profile at year-end 2022, NOKm



Sources: Scope

New debt and refinancing to ensure balanced maturity profile

The company established a new credit facility of NOK 750m in late 2022. This is currently undrawn and matures in July 2024, together with a NOK 900m facility within the same bank syndicate. We expect new debt to come from a combination of bank financing and bonds, and that maturities will be spread out in line with targets presented in the financial policy, leading to good diversification of funding sources.

Adequate liquidity

Liquidity is adequate based on no upcoming debt maturities before mid-2024, and Arva's good access to bank and bond financing. Our estimate for short-term debt used in the 2024 liquidity calculation assumes the new facility of NOK 750m entered into in 2022 will be fully drawn, but a refinancing may also be completed prior to this. Based on its strong investment grade credit profile and existing bank relationships, Arva should be well positioned with good flexibility ahead of upcoming refinancing processes.

Balance in NOK m	2021	2022E	2023E	2024E
Unrestricted cash (t-1)	2	60	21	61
Open committed credit lines (t-1)	320	320	750	0
Free operating cash flow (t)	-310	-216	-555	-496
Short-term debt (t-1)	36	18	0	1,650
Coverage	**34%**	**>200%**	**n/a**	**neg.**

Supplementary rating drivers: +1 notch for parent support

Financial policy is accounted for in the financial risk profile assessment

We have made no adjustment for financial policy, which we assess as sound. The financial policy was established last year and outlines some key principles, including that net debt/EBITDA should remain below 7x and that the equity ratio should remain above 25%. It also includes principles for debt maturities and hedging of interest rate exposure, and a goal of having an investment grade rating. Although Arva is a subsidiary of Troms Kraft AS, it is fully responsible for its own financing, and thus the financial policy is independent from 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 (GRE) 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 in case 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. This warrants a one-notch uplift, and the rationale is in line with that of other Scope-rated Norwegian utility peers. The one-notch uplift on the BBB standalone credit assessment results in an issuer rating of BBB+.

Long-term and short-term debt ratings

Senior unsecured debt rating: BBB+

The rating on Arva's senior unsecured debt is assigned at BBB+, which is 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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