



European Utilities Rating Methodology

Corporate Ratings

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1. Introduction

Scope Ratings' updated methodology for rating European utilities supplements our [Corporate Rating Methodology](#), published on 6 July 2021. It can also be applied selectively to non-European issuers where appropriate.

The methodology remains unchanged. The updated methodology does not add new rating drivers to the existing methodology and does not lead to any change to existing ratings.

Scope defines utilities as companies that collect the majority of their total revenues and cash flows through the generation, storage, transmission and/or distribution of electricity, heat and/or gas from facilities it owns and/or operates. Scope's sector methodology covers regulated and non-regulated energy utilities, applying a combined approach, however, addressing individual segment-specific characteristics. Some utilities are partially exposed to other infrastructure segments, such as waste and water, local or regional public transport, public pools and telecommunication services. 'Pure plays' in these subsectors are not covered by Scope's methodology, nor are pure energy traders/retailers. Furthermore, Scope does not apply this methodology to alternative energy utilities such as independent power producers and project developers, which are covered by a separate methodology (> [Click here to download](#)). Ultimately, the methodology does not cover infrastructure asset or fund managers that focus purely on managing energy infrastructure assets through special purpose vehicles (SPVs) or funds.

Our Corporate Rating Methodology lays down the key principles and criteria which we apply when assigning ratings to corporate issuers and their debt instruments.

2. The European utilities industry

Business models in the European utilities industry vary greatly, in terms of size, operational exposure to regulated and non-regulated utility segments, horizontal diversification and vertical integration. The European utilities industry is highly fragmented and ranges from large pan-European incumbents displaying a high degree of vertical integration and covering multiple utility infrastructure segments, such as exploration, power generation, storage, transmission, distribution, to small, regional or local utilities, which show limited integration and control few infrastructure assets. The degree of fragmentation depends strongly on a country's level of decentralisation: more centralised energy markets including France, Norway, Finland, Italy and Spain are dominated by few power generators and distributors; more decentralised markets such as Germany, Austria and Switzerland show a high degree of fragmentation with many regional or local utilities controlled by municipalities (i.e. German 'Stadtwerke') or regional sub-sovereign authorities.

Given its public importance, certain utility segments are strictly regulated at sovereign or sub-sovereign level. Such regulations apply to either tariff regulation (e.g. in energy transmission, distribution, renewable energy generation) or to operations and safety requirements. While tariff regulation provides particular visibility and transparency in cash flows, utilities may face risks of intervention, as well as unforeseen regulatory changes.

Utilities typically offer essential products and services that cannot be substituted easily. However, the exposure to general economic cycles depends heavily on the business model and degree of integration. The resilience of different utility segments to the overall economic cycle varies greatly. Activities, such as energy transmission and distribution, show strong defensive and non-cyclical qualities due to their monopolistic structures and inelastic demand patterns in residential segments. By contrast, activities, such as commodity exploration and conventional power generation, may be highly exposed to severe cyclical risks. This is amplified by price risks, depending on regulations and the position of power generation plants in the merit order system. Moreover, these infrastructure segments also suffer greater construction and operational risk, such as costs that may either not be recovered through price rates, or recovered but with material delays. Downstream activities such as energy supply may also display cyclical features, particularly when strongly exposed to industrial customers, in light of the industry inherent volatility of commodity prices and potentially significant churn rates.

The utilities industry is further characterised as highly capital intensive. Construction, acquisition and maintenance of utilities' infrastructure – power plants, gas networks or electricity grids – demands significant investment. Despite raising high entry barriers and reducing competition, the high level of capital investment is coupled with higher leverage and longer amortisation profiles than for the average industrial company. However, the relatively high leverage is frequently backed by comparatively stable asset values.

Utilities' operating cash flows (OCF) and free operating cash flows (FOCF) and their volatility differ widely in the industry, depending on the business model and position in the industry's value chain. Utilities in the transmission and distribution benefit from

monopolistic structures and enjoy comparatively stable profitability and predictable cash flows, thanks to regulated tariffs, as well as high virtual exposure to residential customers and controllable cost structures. In contrast, utilities whose cash flows are highly exposed to unregulated upstream activities are subject to more volatile and less-predictable cash flows, particularly if they are derived from power generation assets at the end of the merit order system. Moreover, different capital needs regarding volume and timing strongly impact FOCF generation. While expansion and maintenance capex of grid and network operators can be spread over a wider time horizon and FOCFs tend to show smoother patterns, FOCFs of power generators usually show stronger capex concentration in some years and thus higher volatility.

Given the public importance of infrastructure services, many utilities receive government support with sovereigns or sub-sovereigns as the main shareholder. Such government support is normally provided through capital support, tariff setting by regulatory authorities or laws, or most importantly the possibility of a bail-out through the provision of guarantor liability. This form of government support may materially reduce default risk compared to other industries and therefore makes a significant difference between a stand-alone credit rating and a final issuer rating for utilities.

Parameters which qualify a utility for an investment grade rating are: strong cash flow protection with low substitution risk through stable regulation and strong market position across different service territories; a well-diversified asset and customer base anchored strongly in non-cyclical business segments; solid profitability patterns with low volatility; highly predictable cash flows; and sound financial metrics. Strong government support from a financially strong sovereign or sub-sovereign reduces the likelihood of a utility's corporate default and can improve a utility's credit rating to the higher investment grade categories.

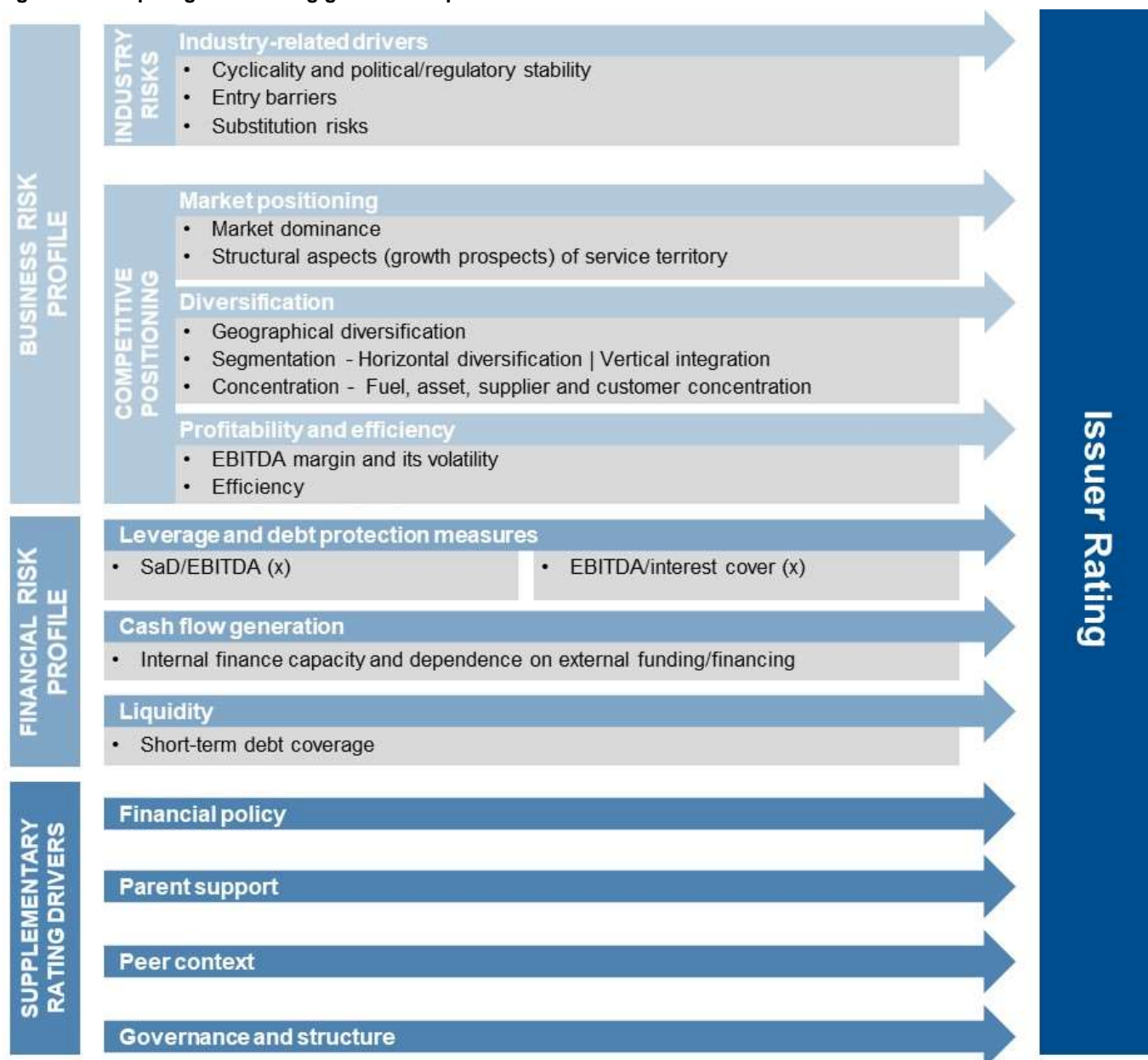
In contrast, high merchant and substitution risks due to challenging or unstable regulations or government interference, a comparatively small and less diversified asset portfolio that is vulnerable to event risks, and a strong cyclical exposure in power generation, exploration or supply can be indicators for a sub-investment grade rating. Other indicators of a utility's credit quality in the sub-investment grade bracket are high exposure to loss-making infrastructure segments, such as public baths or public transport that require continuous financial support or cross-subsidising from other activities. Such business risks may be coupled with less predictable and volatile cash flows in conjunction with weaker financial measures that also indicate a sub-investment grade rating.

Ratings of utilities can reach up to higher investment grade categories, driven mostly by the degree of business protection, which may stem from a supportive and stable regulatory environment or a monopolistic market position, a very well-diversified geographic footprint or a strong link to potential government support in case of a bail-out.

3. Rating drivers

Scope's Corporate Rating Methodology applies to European utilities as outlined in Figure 1 below. The business risk and financial risk indicators are non-exhaustive and may not apply fully to all utilities. The importance of these rating drivers varies according to the company's business model.

Figure 1 – Scope's general rating grid on European utilities



Scope's rating analysis in this sector covers factors common to all industries, such as, management and financial policy, liquidity, corporate structure, governance and country risks. More detail can be found in Scope's Corporate Rating Methodology (updated in February 2020). Scope notes that rating drivers are not mutually exclusive and collectively exhaustive and may overlap. Issuer-specific rating factors may be added to Scope's rating approach.

3.1 Business risk profile

Scope adopts a forward-looking approach when analysing a utility's business risk profile. It takes in account the utility's market and sector dynamics, and business drivers. The business risk profile is divided into an industry-related section and a company-specific part.

3.1.1 Industry-related drivers

Scope assesses industry fundamentals of European utilities by examining the following industry drivers:

- Cyclicity and political/regulatory stability;
- Entry barriers; and
- Substitution risks.

Cyclicity

To minimise the need for rating changes due to cyclical volatility, Scope aims to include the impact of the economic cycle in its rating wherever possible. While the utilities industry is often associated with defensive and non-cyclical features compared to industries with inelastic demand patterns, these vary widely depending on the individual business model. Scope incorporates exposure to economic trends that affect downside volatility of cash flows, as well as the cessation of certain business activities, such as closure of power plants or exploration sites. Downside volatility can arise from either volume risks stemming from high exposure to industrial customers, or volume and pricing risks through commodity exploration or power generation activities. Moreover, a high proportion of residential and commercial customers can help utilities weather economic downturns and exhibit more stable operating performance. Utilities with greater exposure to industrial customers, which are more likely to seek economic alternatives, are more vulnerable to economic cyclicity.

In Scope's view, utilities with a high proportion of unregulated activities such as exploration/production and power generation capacities at the end of the merit order system show highly cyclical features unless relying on a high proportion of forward-selling. In contrast, operators of electricity grids, gas or water networks, as well as fully regulated power plants display low cyclical characteristics with low substitution risks for offered services with comparatively stable price developments. The cyclical exposure of utilities which sell own-generated or third-party electricity and gas volumes to end-customers depends strongly on the customer structure and energy sourcing. Utilities with a high exposure to industrial customers or with energy sourcing from auctioning carry medium risks, while utilities with a large residential customer base or energy sourcing based on medium- or long-term contracts are considered to have low cyclical risk exposure.

Political/regulatory stability

In contrast to other industrial sectors, the public interest in utilities' services makes them more likely to be the target of regulatory action. The regulatory framework and exposure to political intervention is important when assessing a utility's credit risk. Tariffs and cost regulation may impact utilities' cash generation directly, while energy, environmental and tax policies affect it indirectly. Moreover, government intervention may affect issues relevant to the rating such as the power generation mix, changes in the procedure of tariff setting, new safety requirements or the approach to the timing of cost recovery. An unstable and less predictable institutional framework stemming from regulatory and political intervention may increase the probability that utilities will experience financial stress.

Regulations may impact a utility's business model positively on the revenue side by creating high entry barriers (electricity grids/gas and heat networks) and through price stability (renewable energy regulations). But regulations or political intervention can also impose heavy burdens on a utility's credit quality, particularly when regulations are unstable and do not provide a timely cost recovery, are very challenging regarding cost or operating efficiency, or impose high investment requirements (maintenance of grids and power plants). In analysing a utility's credit quality, Scope assesses how a country's regulatory framework may impact and support stability and predictability of its cash flow generation. Issuers with strong credit quality operate in markets characterised by a supportive institutional framework that creates stable and protective regulations, as well as environments with minimal political interference. Issuers at the lower end of the ratings scale often operate in unstable or challenging regulatory environments prone to drastic changes that prevent timely cost recovery, or compromise efficiency.

Entry barriers

While the capital-intensive nature of operated infrastructure assets and the high degree of sector regulation imposes high entry barriers in the industry, the extent of business protection from existing or new competitors depends strongly on the operated asset classes and services provided. Highly regulated utilities such as transmission and distribution grid/network operators are seen by Scope as well shielded from competition, thanks to high entry barriers stemming from an existing non-substitutable infrastructure and protection of service territories through long-term concessions. Scope assesses entry barriers in the area of power generation to be medium. Despite the high capital intensity and long construction periods of new power generation capacities, competition from new power generation capacities can be stiff, particularly from independent power producers, which operate renewable energy capacities. This competition is partly mitigated by competitive marginal power generation costs from partly or fully amortised power plants, as well as by uncertainties about future regulation (i.e. particularly conventional power plants). On the unregulated downstream side of the utilities business (power supply), entry barriers are generally low, and depend on the competitiveness of grid charges in a particular service territory, and a new entrant's ability to purchase attractively priced energy volumes on the market.

Substitution risks

As with entry barriers from potential new competitors, the degree of substitution risks from existing competitors depends strongly on a utility's service area. Monopolistic structures for operators of gas networks and electricity grids makes substitution risk non-existent. The same applies to operators of regulated renewable energy power plants, which enjoy guaranteed take-off of generated power at fixed feed-in tariffs. The extent of substitution risks for operators of non-regulated power generation assets depends strongly on the power plants' position in a power market's merit order system. Operators of unregulated power plant capacities with comparatively low marginal power generation costs (i.e. hydro, nuclear power plants at the front of the merit order system) face lower substitution risks, while operators of power plants with higher marginal power generation costs at the end of the merit order (i.e. gas, hard coal, lignite, oil) may face higher substitution risks. Utility-specific features such as a high proportion of hedging or long-term contracts from power purchase agreements with customers can strongly mitigate such substitution risks.

For regulated grid/network operators with comparatively low cyclicity, high entry barriers and low substitution risks, Scope assigns industry risks of AA. The same applies to operators of fully regulated power generation assets. Operators of non-regulated power generation assets would be assigned an industry risk of BB. Large-scale hydro power plants would generally be assessed as non-regulated generation capacities. The usually credit-positive exposure to power generation from hydro power plants is generally reflected in a utilities market position and profitability as a result of hydro assets' position within a market's merit order. Utilities with strong downstream exposure in energy trading facing medium/low cyclicity, low entry barriers and high substitution risks display an industry risk equivalent of BB/BBB depending on their exposure to either industrial or residential customers. The final risk assessment for such downstream utilities depends on the degree of hedging and the individual customer structure, which are determining factors for the utility's exposure to substitution risks.

Figure 2 – Scope's industry risk assessment for different utility segments

Cyclicity \ Entry barriers	Entry barriers		
	Low	Medium	High
High	CCC/B	B/BB	BB/BBB
Medium	B/BB	BB/BBB	BBB/A
Low	BB/BBB	BBB/A	AA/AAA

Annotations:

- Non-regulated power generation: points to the B/BB cell (High Cyclicity, Medium Entry barriers).
- Trading activities: points to the BB/BBB cell (Low Cyclicity, Low Entry barriers).
- Network/grid operators and regulated power generation: points to the AA/AAA cell (Low Cyclicity, High Entry barriers).

As European utilities tend to be highly integrated with upstream, midstream and downstream activities, Scope judges a utility's industry risks by the proportional EBITDA contribution of such activities. Utilities with an overall low exposure to cyclicity and low substitution risks display higher cash flow stability and better control on cost coverage. Utilities which are protected largely by a reliable regulatory framework or offer non-substitutable or less cyclical services, such as operation of energy grids and networks with a high proportion of hedged gas and electricity volumes, or a strong footprint with residential customers in their service territory, offer greater visibility and stability of cash flows. This is in contrast to utilities highly exposed to merchant risks in areas such as energy trading, exploration of energy commodities, and certain unregulated power generation activities.

3.1.2 Competitive positioning

Market positioning

Scope's analysis of a utility's competitive position focuses on drivers of cash flow stability determined by factors such as the degree of a utility's market dominance and competitiveness in its service territory as well as the utility's growth prospects in its service territory. Due to the low-risk nature and high dominance in a respective service territory – particularly regulated utilities – a utility's size is not considered an indicator for credit quality.

Market dominance

Though strength and dominance on the market is generally related to a company's size, Scope notes that a utility's sheer size does not determine credit strength due to monopolistic structures in a service territory. These monopolistic structures are characterised by high physical entry barriers where a utility's asset base is located (grids/networks, heat generation capacities), regulatory or political protection, or by cost competitiveness of an incumbent's power generation mix.

Structural aspects (growth prospects) of service territory

While the size of the service territory is not a rating driver, Scope considers economic and demographic growth prospects to be crucial for the credit quality of utilities which cover a limited service territory (local and regional utilities). Utilities servicing regions which display great economic prosperity with a wide range of commercial and industrial customers as well as growing or stable demographics show lower risks of cash flow erosion. By contrast, local or regional utilities which cover service territories with weak economic development and a shrinking population face higher risks for cash flow volatility and structural cash flow deterioration.

Figure 3 – Market positioning by rating category

	A and above	BBB	BB	B and below
Market dominance	Monopoly or quasi-monopoly structures		Strong competition from existing and new market participants	
Structural aspects (growth prospects) of service territory	Very strong exposure to residential customers	Well-diversified base of residential, commercial and industrial customers	Customer mix biased towards commercial and industrial customers	Strong exposure to industrial customers without major hedging activities
	Economically growing service territory with many industrial and commercial customers and growing demographics	Economically stable service territory and stable demographic developments	Economically modest service territory and slightly declining demographic developments	Economically weak service territory with few commercial and industrial customers and continuously shrinking demographic developments

Diversification

Diversifying business operations helps to mitigate the risk of a single business segment disproportionately impacting a company's cash flow and credit quality. A utility's diversification determines its ability to offset cash flow volatility arising from economic cycles and industry dynamics, regulatory changes, and commodity price fluctuations. This is particularly important as utilities are exposed to multiple segments with different levels of cyclical exposure and substitution risks. As a general rule, concentration risk diminishes when segments are balanced across different business operations, geographic regions and service territories, regulatory regimes, fuel sources, suppliers and customers. Segment diversification reduces a utility's risk of experiencing sudden or rapid deterioration in its overall creditworthiness because of adverse developments in any part of its operations.

Geographical diversification

Spreading activities across various geographical regions and jurisdictions generally lessens the impact from external shocks such as regulatory changes, economic downturns or adverse weather conditions. A balanced exposure across different service territories with low price correlations can mitigate cash flow volatility from unfavourable market developments, while enhancing credit quality. Scope's views this as a positive rating driver. On the other hand, operations in a single geographical market may negatively affect a utility's credit quality, particularly if a service territory is economically weak, i.e. burdened by unfavourable demographic developments or a low-diversified customer base.

Segmentation – horizontal diversification | vertical integration

Scope considers solid segmentation across different energy infrastructure segments to be a positive rating driver.

Horizontal diversification

This type of segmentation relates to a utility's horizontal diversification, such as: electricity generation; transmission and distribution to gas supply; other infrastructure activities, such as transportation, water, public baths, waste disposal or recycling. A portfolio balanced across different business segments with different cyclical patterns – such as less cyclical energy transmission/distribution or water supply, and more cyclical (conventional) energy generation – reduces the incremental effects of business disruptions or temporary negative operating cash flows in one or more business segments. Scope's assessment takes into account whether a utility's core businesses can sustainably balance out, cover or subsidise other segments with highly volatile cash flows such as exploration/production or conventional energy generation or which are chronically loss-making, like local pools or public transport.

Vertical diversification

Scope sees the degree of vertical integration in a utility as an important rating driver. While strong vertical integration with high exposure to upstream activities, such as exploration/production and power generation may enhance a utility's profitability and footprint under benign economic conditions, it is also linked to extended business risks. Such business risks include stronger cash flow volatility, higher capex requirements, an increased asset concentration and ultimately severe losses if market fundamentals are weak. As a result, a utility's vertical integration is evaluated in light of future market fundamentals.

Concentration – Fuel, asset, supplier and customer concentration

A utility's concentration can be a key aspect for determining its creditworthiness, particularly if in case of detrimental events such as continuously adverse weather conditions, operating disruptions or detrimental regulatory interventions. Concentration risks may refer to a concentration of fuel types or assets in a utility's power generation portfolio (fuel type and/or load coverage, such as base-, mid- and peak-load power) or counterparties in the supplier or customer base. A high concentration in any of these factors may lead to operational and financial distress, for example when macroeconomic conditions make power generation in the existing power generation portfolio not economically viable or the cancellation of major suppliers or sales contracts burden operations and cash flow generation. Hence, the less vulnerable a utility's cash flow generation, the less concentration risks it may face.

Figure 4 – Diversification by rating category

		A and above	BBB	BB	B and below
Segmentation	Geographical diversification	Strong geographical diversification across pan-European energy markets with little price correlation	Geographical diversification across different regional energy markets with little price correlation	Geographical diversification across different regional energy markets with significant price correlation	No geographical diversification across different energy markets with little price correlation
	Horizontal diversification	Strong business segmentation across a well-balanced mix of cyclical and non-cyclical activities with little or no exposure to chronically loss-making or very volatile utility segments	Moderate business segmentation across different utilities segments with little exposure to chronically loss-making or very volatile utility segments	Modest business segmentation across different utilities segments with significant exposure to chronically loss-making or very volatile utility segments	High exposure to chronically loss-making business segments
	Vertical integration	Reasonable vertical integration with sizeable retail customer base		No vertical integration with concentration on higher-risk non-regulated activities	
Concentration risks	Supplier and customer concentration	Strongly diversified supplier and customer base	Modest dependence on single suppliers or customers	Moderate dependence on single suppliers or customers	High dependence on single suppliers or customers
	Asset concentration	Very low dependency on specific fuel types or single assets	Modest dependency on specific fuel types or single power plants	Moderate concentration risks relating to specific fuel types and power generation assets	High concentration risks relating to specific fuel types and power generation assets

Profitability and efficiency

Profitability

Profitability is a key indicator for a company's market position as well as its technological competitiveness and efficiency. Profitability and efficiency is indicated by both the level and volatility of a utility's margins. Profitability can vary strongly depending on core business activities. Hence, Scope's analysis compares a utility's profitability to those of its direct peer group. Such a peer group strongly depends on the sub-sector of a utility being exposed more to upstream activities, such as power generation and grid businesses, or downstream activities, such as power supply and energy services.

Scope regards highly predictable and sustainable margins from regulated or quasi-regulated utility segments, such as regulated power generation with fixed tariff structures (feed-in tariffs or long-term power purchase agreements) or regulated transmission and distribution activities as credit-positive. While unregulated generation may improve a utility's margin profile, which is typically credit-positive, it may also increase volatility of cash flows. Depending on the market environment, it may also lead to severe losses that remaining business activities would then need to cover.

When measuring profitability, Scope considers a utility's EBITDA margin as the best proxy; its level and volatility depends largely on business activities, that is, upstream versus downstream utility segment exposures.

For utilities with a high exposure to upstream activities, the quality and attractiveness of the exploration and power generation portfolio mainly ensures long-term profitability. Given the high business risks and the higher indebtedness of such infrastructure assets, profitability tends to be high under sound economic conditions, but may fluctuate strongly and even be negative when market conditions are weak. Power generators that have favourable energy mixes in the merit order system and low marginal costs of production (such as hydro and other renewables or nuclear) provide solid use of power plant capacities and solid profitability of above 30%, even in economic downturns. By contrast, utilities which are heavily exposed to price and volume risks from gas/oil exploration activities or thermal power plant capacities, display more volatile profitability patterns. Grid operators usually achieve high and predictable margins.

Utilities which are more exposed to downstream activities tend to show low supply or trading margins averaging 0-25%. However, lower margins in downstream activities can be widely controlled and are thus more predictable and recurring/sustainable from a credit perspective.

Efficiency

Given the strong correlation between profitability and operating efficiency, Scope considers not only efficiency factors such as the level and volatility of load factors for a utility's power generation assets, the economic age and technological status of power generation and transmission/distribution assets, but also a regulated utility's cost position against the industry benchmark. Highly volatile or below-industry average efficiency metrics are seen as critical for utilities' credit quality as they might point to structural operating problems, less predictable future cash flow patterns or deteriorating free operating cash flows, burdened by high capex requirements.

Figure 5 – Profitability and efficiency by rating category

		A and above	BBB	BB	B and below
EBITDA margin	High upstream exposure	> 40%	25 to 40%	10 to 25%	< 10%
	High downstream exposure	> 18%	12 to 18%	8 to 12%	< 8%
Volatility of group margin		Very stable profitability patterns	Stable profitability patterns	Volatile and non-controllable profitability patterns	Strongly volatile and non-controllable profitability patterns
Efficiency		Highly cost-competitive power generation portfolio which provide stable load factors		Power generation assets which are less cost efficient and which may display strongly fluctuating load factors	
		Above-average economic age of power plant portfolio or transmission/distribution assets		Below-average economic age of power plant portfolio or transmission/distribution assets	
		Above-average efficiency (e.g. load factors, grid losses, efficiency benchmarks)		Below-average efficiency (e.g. load factors, grid losses, efficiency benchmarks)	
		Tariff system which allows timely pass-through of increased cost base		Significant time lags in the utility's cost recovery from increased cost base	

3.2 Financial risk profile

In calculating key credit metrics, Scope uses items from a company's cash flow statement in order to highlight its cash-oriented approach to calculating debt protection metrics.

3.2.1 Leverage and debt protection measures

While historical financial performance is important and provides an indication of a corporate's financial position, Scope's ratings emphasise a company's expected future financial performance. Scope's assessments of leverage and debt protection measures take the following into account:

- Leverage
 - Scope-adjusted debt (SaD)/EBITDA (x)

- Debt protection
 - EBITDA/interest cover (x)

For the definitions of such metrics and their inputs pls refer to Scope's Corporate Rating Methodology.

Utilities typically have greater leverage and longer debt maturities than the average industrial company, due to the long-term nature of infrastructure assets combined with more predictable cash flows. It also benefits from supportive regulations, a monopoly-like structure in respective service territories, and, in many cases, a guarantors' liability from a government body which allows for higher leverage. The higher indebtedness is usually covered by higher levels of relatively stable asset values and backed by solid debt protection measures.

Scope adjusts financial information when the impact on credit metrics is considered material. Scope's analysis typically adjusts the debt of a utility by various factors, including off-balance sheet debt from the leasing of long-term assets (if not reflected by IFRS 16), debt-like provisions such as unfunded pension provisions and unfunded asset retirement provisions for decommissioning power plants or site remediation¹. We do not adjust our Scope-adjusted debt for a discounted exposure to long-term purchase commitments, i.e. power purchase agreements for off-takers of renewable energy contracts as we do not see a major difference to shorter-term power purchase commitment through hedges closed with power generators directly or contracted through power exchanges. Obligations can vary noticeably depending on each country's legislation and regulations, and the technologies and industrial practices used in each company.

¹ Provisions made for asset retirement obligations reflect commitments for the disposal, dismantling or decommissioning of assets during their operation and/or at the end of their lifetime in sectors such as power generation, mining or commodity exploration. Scope highlights that the characteristics of asset retirement obligations are different to conventional debt regarding timing, measurement of the estimated obligation including potential asset-salvage values, tax effects or funding mechanisms among others. Particularly, the payment schedule may often extend over a very long time horizon, with obligations arising more than 20 years after the cessation of assets. As with pension provisions, Scope-adjusted debt would consider the unfunded part of such obligations. Dedicated retirement fund assets are likely to cover required payments in times of economic distress. Scope's debt adjustments for asset retirement obligations aim at capturing the nature of the expected payments on an individual basis which Scope deems appropriate for the corresponding assets/activities (i.e. power plants, exploration sites, waste disposal). When assessing the debt burden from asset retirement obligations, Scope takes into account the likely funding requirement for the next 25 years only. The reasoning behind this approach is twofold: On the one hand, Scope views potential funding needs for very-long-term obligations as not overly representative of the creditworthiness of a corporate and of the full coverage of interest-bearing debt instruments, which are likely to mature in less than 25 years. On the other hand, Scope points to the strong impact of current discount rates on very-long-term provisions. As such discount rates may fluctuate strongly over a long time horizon, a full approach on the theoretical funding requirements may be misleading.

In analysing key credit metrics, Scope differentiates between unregulated or regulated activities.

Figure 6 – Credit metrics by rating category²

	A and above	BBB	BB	B and below
SaD/EBITDA (x)				
Unregulated	< 2.25	2.25 to 3.50	3.50 to 4.75	> 4.75
Regulated	< 2.75	2.75 to 4.00	4.00 to 5.25	> 5.25
EBITDA/interest cover (x)				
Unregulated	> 7.50	5.50 to 7.50	3.75 to 5.50	< 3.75
Regulated	> 7.00	5.00 to 7.00	3.25 to 5.00	< 3.25

Scope deliberately does not base the assessment of a regulated grid/network operator's leverage on a RAB (regulatory asset base) related metric. We prefer a leverage based on audited financials over any metric that could be impacted by different approaches on how to calculate RAB, timing of asset inclusion, deviations between regulatory frameworks or the age of the regulated asset base.

3.2.2 Cash flow generation

Utilities tend to be highly capital intensive. High investment is required to continuously expand, maintain or decommission infrastructure assets to sustain operating efficiency or adapt to changing market conditions. In particular, thermal power-plant capacities, transmission grids and exploration sites require high upfront capex, which may result in negative FOCF because lead times for these investments tend to span a few years. As a result, such investment activities are covered either by the utility's internal operating cash flows or require new debt and/or equity or asset rotation through the disposal of selected assets. Scope qualitatively assesses the utility's capex coverage through its internal and external financing ability.

While an investment-grade-rated company is expected to fully cover its capex internally, a non-investment grade company is more likely to depend on external funding over a longer period. Scope also takes into account a utility's standing in the capital market and diversification of financing instruments.

Figure 7 – Free operating cash flow generation by rating category

	A and above	BBB	BB	B and below
Capex coverage and free operating cash flow generation	High internal financing capacity with structurally neutral-to-positive free operating cash flow across the investment cycle		Strong dependence on external financing across the investment cycle	

For the definition of FOCF pls refer to Scope's Corporate Rating Methodology.

3.2.3 Liquidity

There is no sector-specific assessment of a utility's liquidity. Liquidity is addressed in Scope's Corporate Rating Methodology.

² For the rating of European utilities, Scope does not explicitly use FFO-related credit metrics such as FFO/interest cover or FFO/Scope-adjusted debt. Scope is fully aware of the cash flow impact under different tax regimes (e.g. corporate taxes or specific technology-specific taxes) which could lead to strong deviations on FFO-based credit metrics for utilities in different jurisdictions. We indirectly reflect lower taxes through the cash flow impact on a company's Scope-adjusted debt and within the peer group context of European utilities.

3.3 Supplementary rating drivers

3.3.1 Financial policy

Our ratings capture a utility's management 'risk appetite' for discretionary spending decisions like acquisitions, dividends and share buybacks and the extent to which these are funded with debt; also capturing management's ratings commitment, both credit-positive and negative. For family-owned companies, we believe management commitment in case of short-term deviations from its stated financial policy as a consequence of debt-funded acquisitions is usually stronger than for non-owner managed companies. We aim to reflect this in our financial policy assessment based on the companies' track record and level of commitment.

3.3.2 Parent support

We recognise that a utility's likelihood of corporate default may be affected by structural issues linked to its shareholder structure or the public importance of such companies. Many utilities are controlled by sovereign, sub-sovereign shareholders or other utilities. If required, parent companies may have to provide direct funding or recapitalisation because of a contingent liability, such as a guarantor liability. A sovereign or sub-sovereign could bail out a utility even if no stake exists, as they may perceive sufficiently high social or political risks arising from distressed utilities. This may be because of its position as a major local or regional employer, or because of sufficiently high public interest that the provision of public services continues.

When assessing the credit quality of a utility that may benefit from government support, we incorporate the sovereign's or sub-sovereign's capacity and willingness to bail out a utility in financial distress, as laid out in [Scope's rating methodology for Government Related Entities](#).

The impact on a potential rating uplift depends strongly on our assessment of the likelihood of such a bail-out action, which reflects a sovereign's or sub-sovereign's willingness to cover liquidity gaps of a utility. Such willingness might be characterised by contractual obligations such as guarantees or comfort letters. Moreover, the assessment on the willingness of a government body to subsidise a utility in need reflects our view on the strategic importance of a controlling share in the utility.

The more likely that sufficient and timely government intervention takes place, the higher the impact on the rating. Utilities that hardly benefit from such potential support will be rated with the utility's standalone credit rating. Utilities which may benefit from the extraordinary support of a sovereign or sub-sovereign could be rated up to three notches higher than the standalone rating (bottom-up approach). The incorporation of a three-notch uplift will only occur in rare cases where we deem the controlling entity's capacity and willingness to be strong.

3.3.3 Peer context

Our ratings reflect additional considerations in a peer group context, which aim at ensuring consistency across the rating spectrum, with both credit-positive and negative implications.

3.3.4 Governance and structure

In its rating analysis, Scope assesses the corporate's management and management track record (as described in the Corporate Rating Methodology). A solid track record is considered a positive factor for the rating and provides Scope with confidence in the company's forecasts.

Although a corporate governance structure does not drive up a utility's rating, it is an important factor in determining Scope's credit ratings. Adequate corporate governance forms the minimum standard for a rating, but weak corporate governance can drive down a rating.

3.4 Additional methodology factors - ESG

For further details on how we incorporate ESG in our analysis, rating Outlooks for corporate debt ratings, short-term ratings, recovery analysis and individual instrument ratings or rating categories, please see our Rating Methodology Corporate Ratings from in sections 3.1.3 and 6.

During the corporate rating process, we implicitly capture environmental, social and governance (ESG) factors that have a material credit impact. We conduct an explicit corporate governance assessment during the corporate rating process. Our rating analysis remains focused on credit quality and credit assessment drivers. We only consider an ESG factor relevant to our credit rating process if it has a ubiquitously discernible and material impact on the rated entity's cash flow profile and, by extension, its overall credit quality.

Contrary to ESG ratings which are based on quantitative scores for different rating dimensions, credit-relevant ESG drivers can directly or indirectly all the rating elements which make up our assessment of an issuer's business risk profile, financial risk profile and supplementary rating drivers. Identified ESG rating factors reflect an opinion in a relative context (factors are ordinal rather than cardinal).

4. Corporate issuer rating

The final corporate issuer rating is based on a combination of the business and financial risk analyses on the one hand, and the potential effects of supplementary rating drivers on the other. The rating committee decides on the relative importance of each rating driver. In general, business risk and financial risk profiles are weighted equally for BB/BBB rated companies. The analysis of investment grade companies (rated BBB- and above) focuses more on the business risk profile. B (and below) ratings are assigned with a stronger focus on the financial risk profile. The weighting between the business risk and financial risk profiles may be adjusted for specific business models and markets.

5. Additional methodology factors

For further details on our rating Outlooks for corporate debt ratings, short-term ratings, recovery analysis and individual instrument ratings or rating categories, please refer to our Corporate Rating Methodology.



European Utilities Rating Methodology

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