

European energy: liquidity crisis eases

Utilities still face tough market conditions, requiring emphatic government response



Europe's power utilities can put the summer's liquidity crunch behind them as pressures ease in energy markets, but, with prices still high, government support is crucial to avert a market collapse – while the companies face other financial challenges.

The immediate source of respite for the sector is the combination of factors narrowing the gap between market and power prices hedged via exchange-traded futures that had widened dangerously when Russia's use of its energy exports in its war against Ukraine sent European gas and electricity prices soaring even higher this year.

The wider that this gap is and the more volatile the underlying commodity price, the more cash utilities are obliged to set aside as collateral (initial and variation margin) because of the size of the swing in the value of the hedging contract. This explains the liquidity squeeze they faced as Russia's suspension of some supplies of gas to Europe sent prices for electricity and gas to more than 10 times the levels of last year when many utilities had hedged much of their output.

From Russia, with trouble ...

... but price cap talk, rising gas stocks, government action calm markets

We expect the liquidity squeeze to diminish, if governments finalise agreement on a cap on energy prices, providing general state guarantees or (temporarily) relaxing the requirements for the provision of cash collateral for hedged positions.

Success in replenishing European gas stocks despite the lack of Russian gas, fears of recession, and setbacks in Russia's war effort have also helped bring market prices more in line with hedged prices. The risk of another spike in gas and electricity prices is much reduced even if prices are sure to remain volatile.

In addition, the roll-off of hedging contracts for which utilities had to provide massive extra collateral is now leading to the release of working capital, freeing up cash for utilities to take out less onerous new hedges, build up cash reserves and/or pay down debt that was raised for working capital funding.

If some utilities remain under intense financial pressure, the cause is Russian state-controlled gas utility Gazprom OAO's refusal to honour long-term gas supply contracts. The lack of Russian gas has forced these utilities, most notably Germany's Uniper AG which the government is preparing to nationalise, to buy alternative supplies of gas at elevated spot-market prices, well above those at which they had contracted to sell gas to industry. The result is unsustainable operating losses.

We are confident that government support, in the case of the most troubled utilities, will prevent bankruptcies of systemically important utilities such as Uniper and the market contagion that would lead to. Other utilities less reliant on Russian gas have ample liquidity or access to bank credit lines or guarantees from sovereigns or sub-sovereigns.

Other financial pressure points emerge

While we see a limited risk of the collapse of utility with systemic importance, and diminished risk of another spike in power prices, other financial pressures are building for the European sector in general over and above the collateral issue, with potential long-term consequences for investment.

In particular, the much higher energy prices put news stress on working capital, with risk from higher defaults on receivables and delays in receivables collection.

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Rising interest rates significant for capital-intensive sector

Rising interest rates are increasing debt-servicing costs in the capital-intensive sector. Uncertainty over future taxation as governments consider windfall levies risks deterring or delaying management from committing to the investment projects that Europe needs to improve the functioning and security of the energy market – new clean generating capacity, more storage, more interconnectors – and to meet environmental goals.

Margining exposure has peaked

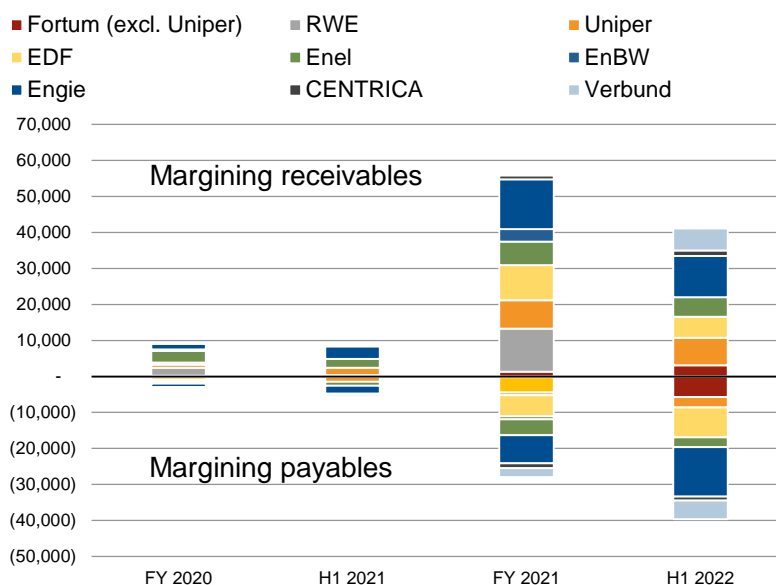
Understanding the European utilities' liquidity crisis

Available data¹ on margining receivables and payables which are not netted on the balance sheets of major European utilities shows very clearly the increased margining exposure they have faced this year and last compared with previous years (see **Figure 1** and more details in **Figure 2**).

The situation remains challenging, given elevated and volatile underlying electricity and gas prices in Q3 2022.

However, absolute exposures of provided and received margining deposits differ widely among utilities as the comparison between Fortum Oyj (Uniper's largest single shareholder before nationalisation), Uniper itself, Eléctricité de France SA, Italy's Enel SpA and France's Engie SA shows.

Figure 1: Bi-annual margining exposures of major European utilities in EURm



Margining receivables/deposits made = positive
Margining payables/deposits received = negative

Source: Company reports, Scope

Expectations of EU-wide price cap

The EU continues to discuss bloc-wide intervention to cap the price of electricity and imported gas and other measures. The European Commission is expected to deliver a package of unprecedented and robust measures soon, largely anticipated by President Ursula von der Leyen during her State of the Union speech on 14 September 2022.

Individual governments have taken action to provide temporary “umbrellas” in several forms: bridge financing, guarantees, credit lines.

For example, the Nordic, the UK and the German governments are setting up robust support schemes, while deepening commitments in Germany (Uniper) and Austria (Wien

¹ Detailed information on margining exposure is still scarce in the regular reporting of utilities as the topic of significantly increased margin calls for sold and bought energy volumes has just evolved as a major topic since H2 2021. Often the exposure is included within the other or financial receivables and payables or combined with derivate assets and liabilities. In other cases, detailed information is available in the full year reporting, but not in quarterly reports.

Energie) to bail out troubled utilities have demonstrated how governments are committed to a 'whatever it takes' approach. Switzerland (Axpo AG) and Finland (Fortum) have extended significant credit facilities (see **page 5** for more detail.)

Different picture for different utilities

The margining profile strongly differs across major European energy utilities.

As most utility incumbents operate with a double position – as a seller and a purchaser of energy – the net exposure of net cash collateral provided/received depends on the amount of hedged energy purchases and sales and whether the differential between market prices and contracted prices on individual contracts is positive or negative.

Hedging strategies vary across European sector

Figure 2: Margining exposure for European utilities (in EUR m)

		FY 2020	H1 2021	FY 2021	H1 2022
CENTRICA	Margining assets	63	94	1,057	1,488
	Margining liabilities	(79)	(117)	(1,377)	(1,148)
EDF	Margining assets	600	n/a	9,800	5,900
	Margining liabilities	(200)	n/a	(5,800)	(8,300)
EnBW	Margining assets	433	n/a	3,475	n/a
	Margining liabilities	(360)	n/a	(4,358)	n/a
Enel	Margining assets	3,223	2,465	6,485	5,397
	Margining liabilities	(370)	(1,078)	(918)	(2,762)
Engie	Margining assets	1,585	3,504	13,856	11,471
	Margining liabilities	(982)	(2,156)	(7,835)	(13,695)
Fortum (excl. Uniper)	Margining assets	234	401	1,297	3,129
	Margining liabilities	(138)	(156)	(202)	(5,754)
Uniper	Margining assets	898	2,019	7,866	7,590
	Margining liabilities	(193)	(1,357)	(783)	(2,833)
RWE	Margining assets	2,154	n/a	11,997	n/a
	Margining liabilities	(716)	n/a	(4,239)	n/a
Verbund	Margining assets	29	127	504	1,118
	Margining liabilities	(129)	(577)	(2,426)	(5,123)

Sources: company reports, Scope Ratings

EDF, Engie have favourable net margining positions

Most utilities in our sample deposited significant net cash in collateral, but some such as EDF and Engie had higher margining liabilities than margining receivables. In other words, they had more cash deposited at the clearing houses for bought energy volumes than they had to deposit for their own trades in which they are the sellers.

Credit quality: need to distinguish between liquidity, solvency challenges

We see the European sector facing a temporary liquidity crunch which would only threaten credit quality if government and creditor support for the sector were to disappear which is unlikely given the economically indispensable role that utilities play.

Parallels with the banking sector at the time of the global financial crisis are weak at best as there are no questions hanging over the quality of the assets on the utilities' balance sheets, in contrast with US and European banks in 2007 and 2008. The utilities face short-term pain related to cash outflows which will likely be more than offset by cash inflows when the hedge contracts are settled.

Government support for sector is a given

Near-term working capital pressures to ease

First, provision of short-term liquidity – through extended or new credit facilities by either parent companies or governments/government-related financial institutions or guarantees – demonstrates the willingness of governments and parent companies to bridge short-term gaps in utilities' working capital.

Liquidity conditions set to improve

This bridge financing is to be refinanced once the contracts settle and once the impact of widening margin calls is reduced by other measures underway. If the providers of short-term funding keep their commitments, utilities will not run out of cash. The potential provision of state guarantees will also improve the utilities' cash cushions.

Secondly, the chances that the spreads between market prices and contracted prices will continue to widen – triggering margin calls for the deposit of additional cash collateral – are decreasing as governments step in nationally and at the EU level to stabilise energy markets.

The volatility in prices of the past few months should also subside, leading to lower initial margins and related margin calls. Should the market prices hold steady and move more in line with hedged prices, margining positions will be released.

Moreover, many positions for which utilities have built up margining deposits over the last 12 months will be settled in the next few months, thereby releasing more cash that can be used as collateral for other positions or the repayment of increased credit facilities.

Utilities are also increasingly shifting to other forms of hedging, such as bilateral OTC contracts that avoid the similar margining required on exchanges, or reducing their hedging activities overall.

Utilities face residual liquidity, financing constraints

Europe's utilities are not entirely out of the woods.

With less financing headroom than last year, the utilities have limited capacity for taking out additional hedges should governments fail to cap market prices and decrease price volatility.

Taking out new hedging positions may depend on liquidity released from settled contracts or from extended credit facilities and guarantees, unless the utilities opt instead for OTC hedging described above.

Available cash that is channelled into energy trading curtails the funds available for executing strategically important investment projects which may in turn lead to an investment backlog.

The additional external funding comes with interest payments as the capital raised for the provision of margining deposits are interest-bearing.

However, the situation is less severe than headlines suggest considering the current short-term liquidity drain is easing and there is still significant liquidity available from the companies' cash buffers and undrawn volumes from credit facilities (see **Figure 3**).

Figure 3: Bi-annual liquidity position (cash + undrawn volume from credit facilities) of major European utilities in EUR m

	Dec-20	Jun-21	Dec-21	Jun-22
CENTRICA	6,259	8,066	9,519	8,174
EDF	17,380	16,685	22,958	19,393
EnBW	4,257	6,797	10,068	12,103
ENEL	24,465	14,721	24,118	20,006
ENGIE	22,651	20,885	20,889	23,264
Fortum (excl. Uniper)	5,319	4,607	5,073	4,740
RWE	9,774	12,043	10,825	12,615
Uniper	2,089	2,196	6,419	5,525
Verbund	599	524	1,233	2,205

Sources: company reports, Scope Ratings

Utilities still have cashflow upside

The likely cashflow upside from closed hedges on power production from inframarginal generation capacities over the next few quarters will clearly help energy generators to swiftly repay the drawn-down debt.

The companies are set to generate taxable income from the higher profit margins that can be earned from the settled hedges (see section on hedged volumes and prices).

Government support takes shape for European sector

Governments already in action, while awaiting EU intervention

European policy makers are looking at several possible options to restore order to Europe's energy markets and minimise the economic damage elevated prices threaten to do to utilities and energy-intensive industry, from emerging credit lines, guarantees and bridge finance to market intervention in the form of price caps or margining limits.

As the EU thrashes out a bloc-wide approach, many national governments have taken matters into their own hands.

- Finland is to set up a loan and guarantee scheme of up to EUR 10bn to companies engaged in electricity production. Fortum received EUR 2.35bn of bridge financings.
- Sweden has proposed state credit guarantees for electricity producers trading in the market for electricity derivatives (around EUR 23bn).
- Denmark is planning to provide up to EUR 13.5bn of loan guarantees to utilities.
- The UK is setting up an Energy Markets Finance Scheme to provide GBP 40bn (EUR 46bn) in short-term liquidity to wholesale energy producers, while Centrica is currently negotiating additional credit lines from banks.
- Austria has bailed out biggest utility Wien Energie with a EUR 2.0bn loan.
- Switzerland granted a CHF 4.0bn credit line to its main player Axpo.
- Germany, while working on a EUR 67bn loan guarantees package to assist energy companies, has provided financial support for Uniper in terms of committed debt and equity (up to EUR 21bn since the beginning of 2022), with additional funds on the way (EUR 8bn capital injection to take over Fortum's stake leading to a nationalisation of the company).

European Commission promises wide-ranging measures

EC President von der Leyen's State of the Union speech demonstrated that Brussels is willing to match its efforts in supporting business's recovery from the pandemic in dealing with the energy crisis.

Discussions with market regulators are currently in place for possible amendments to EMIR requirements for collateral, along with provisions aimed at stemming intra-day price volatility. The state aid framework will be amended to allow member states to provide guarantees to the utilities sector.

Proposals such as price cap on Russian gas and electricity market reform including decoupling gas prices from the oil market, if effectively implemented, could reduce future pressure on energy prices, consequently resulting in a progressive reduction in margining requirements. As regards the announced introduction of a windfall tax on inframarginal generators (renewables, nuclear and lignite), potential funds raised from this measure, estimated in more than EUR 140bn by the European Commission, would instead be redistributed to households and corporates in difficulty to pay bills.

Public actions enough to overcome short-term squeeze

We are reassured by the measures undertaken and planned at the national and regional level which should shield the utilities from Russia's weaponization of its gas exports.

Hedging is in interest of energy providers and customers

Hedging – two sides of the story

Utilities usually hedge a large portion of their anticipated energy sales volumes well in advance for good reasons: they lock in the prices which provides visibility on future operating cash flow (see **page 7** for snapshot of how margining works in Europe’s energy markets).

We emphasise that usually the goal of such hedging is not speculation. Energy generators/traders want to have certainty about sales volumes. Likewise, customers, who buy through bilateral agreements or on the exchanges, want to secure energy volumes with some price transparency.

Gaining visibility on future operating cash flow

Data on hedged electricity volumes of those major European utilities (see **Figures 4 & 5**) which disclose them show achieved average prices in June 2022. On average, most have contracted more than 80% of their generation volumes for the rest of 2022, more than 50% for 2023 and more than 30% for 2024.

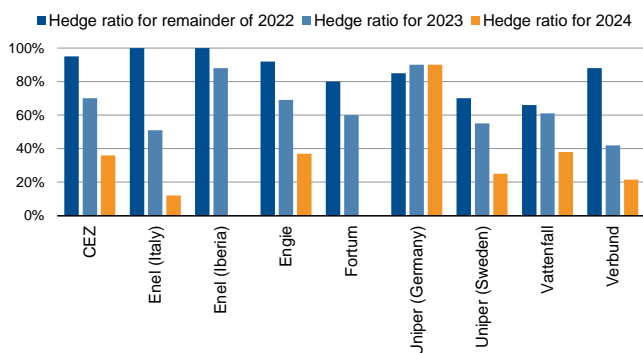
Apart from hedged contracts in the Nordics – taken out by Vattenfall, Fortum, Uniper (Sweden) – hedged prices are significantly higher than those of recent years.

Utilities such as Austria’s Verbund, Czechia’s CEZ, Italy’s Enel or France’s Engie have secured average prices at record levels for 2023 and 2024, with extreme case of more than EUR 100/MWh.

Higher EBITDA margin to be earned once hedged are settled

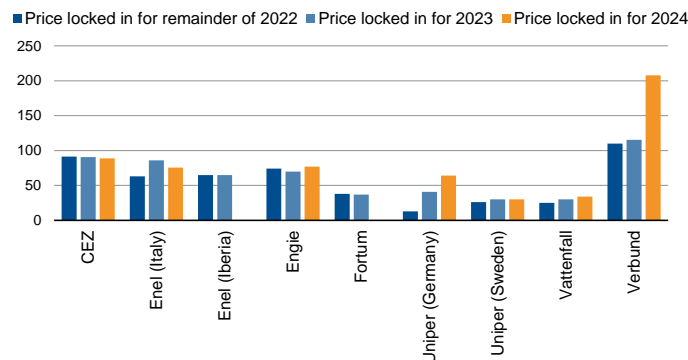
Once the contracts are settled at the determined price levels, the margin earned for generation volumes from inframarginal generation capacities more than offsets the extra interest needed to be paid on the external funding needed for margining.

Figure 4: Hedge ratios for electricity volumes sold, June 2022



Sources: companies’ investor presentations for H1 2022, Scope

Figure 5: Locked in average prices for contracted electricity hedges, June 2022 (EUR/MWh)



Sources: companies’ investor presentations for H1 2022, Scope

Margin deposits in European energy markets: how they work

- The margining deposit is a mechanism usually applied in the financial markets and defined as the demand made to an investor to deposit additional funds when the securities in its account fall below a minimum value (i.e. 'maintenance margin').
- While we are used to hear about margin calls in relation to the "financial world" of banks and capital markets, it should be noted that also utilities operating in the markets as traders are affected by such mechanism.
- Indeed, the European Market Infrastructure Regulation (EMIR), which aims to increase transparency in derivative markets and lower systemic counterparty risk, is also applied to the futures markets where utilities trade energy (and some OTC transactions), such as electricity and gas.
- EMIR envisages clearing obligation and risk mitigation techniques, such as a minimum margin to be provided into an account (i.e. exchange's clearing house) by the trader, to lower the counterparty risk deriving from potential defaults or contract breaches.
- Therefore, since many utilities (especially generators) operate in the markets (selling and buying power in advance for hedging purposes), they need to comply with the regulations.
- Even in this context a margin call is the request to deposit additional funds when the cash collateral in the account drop below the minimum margin required, due to a swing in the value of the underlying asset (affecting the initial which could be driven by increased price volatility of the underlying commodity and the variation margin which is driven by the gap between the fixed and market price).
- Amid high volatility and elevated market prices that are well above hedged prices, margin calls can be triggered continuously (even on an intraday basis), resulting in increasing margin requirements to preserve the 'maintenance level' of the safety account.
- It should be noted that, given the simultaneous double position usually taken by traders (buy-side and sell-side), temporary positive effects may occur, for instance when margining payables exceed margining receivables.
- Margining can affect utilities differently, based on net open positions (assets vs liabilities) in the market, which may indicate liquidity stress (if increasing collateral is requested) or a financial benefit (when deposits are returned after trade settlement).



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