FITCH AFFIRMS ELECTRICITY SUPPLY BOARD AT 'BBB+'; OUTLOOK STABLE

Fitch Ratings-London-14 August 2017: Fitch Ratings has affirmed Ireland-based Electricity Supply Board's (ESB) Long-Term Issuer Default Rating (IDR) at 'BBB+'. At the same time it has affirmed ESB's senior unsecured rating at 'A-'. The Outlook on the IDR is Stable. A full list of rating actions for ESB and its subsidiaries is provided at the end of this commentary.

The ratings and Stable Outlook reflect ESB's strong business profile with the majority of its EBITDA being derived from regulated electricity networks (63% in 2016). In addition, around 50% of the company's generation gross margin benefits from the support of SEM's capacity payments, support for its wind margins under REFIT/ROC regimes and its peat plant's margin, which has a fixed return under a public service obligation contract up to 2019. We expect some increase in business risk due to the introduction of the integrated single electricity market (I-SEM) in May 2018.

The affirmation is also based on Fitch's expectations that ESB's overall credit metrics will remain within current rating guidelines over the forecast period to 2021, with comfortable liquidity and reliable access to capital markets. It also takes into account the outcome of the final determination for the price control for ESB's subsidiary, Northern Ireland Electricity Networks Limited (NIE Networks; BBB+/Stable) starting in October 2017 (RP6) (see " Fitch Affirms Northern Ireland Electricity Networks at 'BBB+'; Outlook Stable", at www.fitchratings.com).

KEY RATING DRIVERS

Adequate Financial Profile: Fitch forecasts average FFO adjusted net leverage at 4.4x from 2017 to 2021, compared with our guideline of 4.5x for negative rating action. We also forecast average FFO fixed charge coverage at 4.7x which is above the agency's guideline of 3.7x, and calculated net debt-to-RAB is strong at around 52% for the forecast period.

The limited leverage headroom is driven by the ambitious capex programme mainly focused in Networks and renewables and the lower earnings from the generation business, including the end of both the Public Service Obligation (PSO) for its peat plants and a favourable gas contract for one of its power plants in 2019. The company also has the obligation to make last payments due to non-recurring pension costs payments associated with a 2010 ESB staff pension agreement.

Regulated Earnings Support Ratings: ESB's ratings are supported by a high proportion of regulated network earnings from electricity transmission and distribution in Republic of Ireland (RoI) and Northern Ireland compared with most integrated utilities in EMEA (63% of EBITDA in 2016) with high regulatory visibility (PR4 runs up to December 2021 and RP6 up to March 2024). Future earnings growth is largely driven by Networks investment, despite lower expectations for inflation and delays to capital expenditure related to the transmission networks in the RoI, and a challenging RP6 starting in October 2017 in Northern Ireland.

In addition, around 50% of the company's generation gross margin benefits from the support of SEM's capacity payments, support for its wind margins under REFIT/ROC regimes and its peat plant's margin, which has a fixed return under a public service oblication contract up to 2019.

Business Risk Could Increase: Fitch considers that ESB's business risk could increase following the introduction of the I-SEM in May 2018. The current regulated capacity payments are to be replaced with competitive reliability auctions, increasing uncertainty over long-term cash-flow generation for ESB's plants. The reduction in capacity revenue may be partially or fully offset by additional ancillary services income. The specific features of some of ESB's plants and their good overall position in the merit order will help it to compete in the new untested market design. The first capacity auctions will be held in December 2017 providing more visibility on the cash-flow impact.

Lower SMP affects Generation: Fitch expects lower system marginal prices (SMP) and electricity spreads for the generation segment, resulting in reduced revenues. ESB has a diversified generation portfolio by fuel source and plant merit order. We believe that this diversification helps ESB to optimise its plants operation to maximise returns during peak periods.

Renewables Support Generation: ESB's market share in the generation business to continue decreasing over the forecast period from 47% in 2016 (49% in 2015) mainly due to increasing amounts of new renewable capacity coming into operation, in our view. This is expected to be partly offset by the full contribution to earnings from the Carrington CCGT plant in the UK from 2017 and around 800 MW of new capacity installed through 2021, largely wind and solar in Ireland.

In addition, the regulatory support for two of ESB's peat plants is due to expire in 2019, but we see this being offset by a potential modification of the peat plants to be co-fired with peat and biomass, with regulatory support eligibility currently being discussed.

Stable Electricity Supply: For the supply business, we expect competitive pressures to persist in the medium term, but forecast a slow recovery of supply's contribution over the remainder of the forecast period. The limited growth is based on our expectations of modest electricity output growth, retention of higher-margin customers by ESB and the take-off of new product offerings and areas of coverage (Northern Ireland).

Adequate Regulatory/Operational Performance: For the first year of the price control period from 1 January 2016 to 31 December 2020 (PR4) in RoI, the company has made good progress on both the capital and maintenance programmes. During 2016, management has developed a framework for monitoring performance and it is implementing new efficiency initiatives and new processes. In our view PR4 is more challenging than the prior price control but we expect the company to be able to deliver the required regulatory outputs within the regulatory allowances of capex and opex, in spite of the efficiency challenge included in the final determination.

DERIVATION SUMMARY

ESB's business profile is well supported by around 63% of regulated networks earnings, one of the highest shares among integrated utilities in Europe, and under the supportive, mature and transparent regulatory frameworks in the UK and RoI. We see ESB's business profile as similar to rated peers including Iberdrola S.A. (BBB+/Stable) who also benefits from significant geographical diversification, SSE plc (BBB+/Stable) and stronger than Energias de Portugal, S.A. (EDP, BBB-/Stable), given its materially lower exposure to regulated networks.
In addition, ESB has as a large proportion of quasi-regulated earnings (ie. generation capacity payments, PSO income from peat plants and renewables generation) that it is also the case for the other peers although more biased towards renewables incentives. Financially, ESB has similar leverage compared with Iberdrola and SSE and lower than EDP.
Parent/Subsidiary linkage is applicable and the ratings are based on ESB's standalone credit profile.

KEY ASSUMPTIONS

Fitch's key assumptions within our rating case for the issuer include:
- EBITDA for ESB's network business in RoI in line with the delivery of the PR4 revenue determination, except for lower income from incentives assumptions;
- RP6 regulatory framework in Northern Ireland from October 2017, which reflects lower EBITDA contribution from NIE Networks than historically and our assumption of limited opex overspent (subject to the 50:50 cost sharing mechanism) and reliability incentive;

- reduced EBITDA for generation business due to lower energy gross margins assumptions (SMP and spark spread) and reduced SEM's capacity payments from 2018;
- we factor in ancillary services at 2016 levels;

- capex plans of around EUR1 billion per annum on average;
- remaining ESB's non-recurring pension cost payments associated with a 2010 staff agreement in 2017 and 2018;
- average negative free cash flow (FCF) of around EUR160 million per annum in the forecast period;
- cash interest adjusted for the paydown provisions related to the restructuring of the index-linked swaps;
- dividend policy of 40% payout, increasing from 38% in 2016 in line with the agreed dividend policy;
- funding access to be retained at an increased cost (up 100bp compared with company's expectations for new debt raised by ESB);
- EUR/GBP of 0.86 on average (2017-2021).

RATING SENSITIVITIES

Future Developments That May, Individually or Collectively, Lead to Positive Rating Action
-Stronger-than-expected performance leading to improved metrics with FFO adjusted net leverage around 4.0x, FFO fixed charge coverage above 4.2x and gearing below 55% on a sustained basis
Future Developments That May, Individually or Collectively, Lead to Negative Rating Action
- Business under-performance with increase in debt leading to an FFO adjusted net leverage well above 4.5x, FFO fixed charge coverage below 3.7x and gearing above 60% on a sustained basis

- Structural changes in the generation or supply markets, in particular, changes currently being contemplated for the I-SEM could lead to a redefinition of leverage guidelines for the rating.

LIQUIDITY

As of 31 December 2016 ESB had EUR1.5 billion of undrawn committed credit facilities (EUR1.44 billion syndicated revolving credit facility and EUR0.07 billion EIB capex facility) and EUR332 million of non-restricted cash and cash equivalents. Short-term debt maturities totalled EUR0.489 billion. Fitch expects ESB to report negative FCF in 2017-2021. However, liquidity is sufficient to cover scheduled debt maturities, capex, operating requirements and dividends for over 24 months.

FULL LIST OF RATING ACTIONS

Electricity Supply Board
-Long-Term IDR affirmed at 'BBB+'; Stable Outlook;
-Short-Term IDR affirmed at 'F2'
-Senior unsecured rating affirmed at 'A-' reflecting generic sector recovery uplift

ESB Finance Designated Activity Company

-Senior unsecured guaranteed notes including EMTN programme affirmed at 'A-' reflecting generic sector recovery uplift

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Summary of Financial Statement Adjustments
--EBITDA is net of customer contributions release
--Capex is net of customer contributions
--Readily available cash is net of part of the outside centralised pools balance (EUR32 million).
--Cash interest includes the RPI swaps adjustment (interest payments on RPI swaps plus 50% of annual inflation accretion)
--Cash interest income is adjusted for 50% of annual inflation accretion from RPI Swaps
--Forecast FFO-based credit ratios are adjusted by ESB's exceptional pension deficit payments for 2017 to 2018 as we view them as non-recurring. Cash outflow related to these payments are included below FFO

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Additional information is available on www.fitchratings.com. For regulatory purposes in various jurisdictions, the supervisory analyst named above is deemed to be the primary analyst for this issuer; the principal analyst is deemed to be the secondary.

Applicable Criteria
Corporate Rating Criteria (pub. 07 Aug 2017)
https://www.fitchratings.com/site/re/901296
Parent and Subsidiary Rating Linkage (pub. 31 Aug 2016)
https://www.fitchratings.com/site/re/886557