Credit Opinion: Electricity Supply Board (ESB)

Global Credit Research - 04 Mar 2016

Dublin, Ireland

Ratings

Category	Moody's Rating
Outlook	Stable
Issuer Rating	Baa1
Senior Unsecured MTN -Dom Curr	(P)Baa1
ST Issuer Rating -Dom Curr	P-2
ESB Finance Limited (ESB Finance)	
Outlook	Stable
Bkd Senior Unsecured	Baa1

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Key Indicators

[1]**Electricity Supply Board (ESB)**

	31/12/2014	31/12/2013	31/12/2012	31/12/2011
FFO Interest Coverage	4.4x	4.6x	4.4x	4.4x
Net Debt / Fixed Assets	52.4%	51.6%	52.7%	52.3%
FFO / Net Debt	16.7%	20.0%	16.3%	15.7%
RCF / Net Debt	11.7%	17.2%	15.0%	14.3%

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. Source: Moody's Financial Metrics

Note: For definitions of Moody's most common ratio terms please see the accompanying User's Guide.

Opinion

Rating Drivers

High proportion of earnings from price-regulated networks businesses supported by a consistent and transparent regulatory framework

Material earnings contribution from higher-risk generation and supply businesses but company is well-placed to cope with low power price environment and changing market dynamics

Financial profile in 2015 estimated to be broadly in line with 2014 before recovering over 2016-17

Prudent financial policy means leverage will remain moderate despite significant capital expenditure programme

Corporate Profile

Electricity Supply Board (ESB) is the former incumbent vertically integrated electric utility in the Republic of Ireland (RoI, Baa1 stable), which holds leading market positions in power generation and electricity supply, as well as being the monopoly owner of electricity distribution and transmission networks across RoI and Northern Ireland.

The group's regulated businesses contribute the majority of the group's earnings. Across RoI and Northern Ireland, ESB's network assets (which include over 6,600km of transmission lines and 160,000km of distribution network) had a combined regulatory asset base (RAB) of approximately EUR9.0 billion as at the end of December 2014.

In addition, the group had a market share of 43% across the Irish Single Electricity Market (SEM) during 2014 and served 1.5 million electricity and gas customers across Ireland, which equated to a 37% market share.

ESB is majority owned (95%) by the Government of Ireland through the Minister for Public Expenditure Reform (85%) and the Minister for Communications, Energy and Natural Resources (10%). The remaining 5% stake is held by an employee share ownership trust.

SUMMARY RATING RATIONALE

ESB's Baa1 ratings reflect (1) the significant proportion of the company's earnings generated through its regulated transmission and distribution operations in the Republic of Ireland and Northern Ireland; (2) the low business risk profile of these businesses generating stable returns under well-established and transparent regulatory frameworks; and (3) the company's strong liquidity and access to a diversified range of funding sources.

However, the ratings also more negatively reflect (1) the relatively higher business risk profile of ESB's generation and supply business; (2) the challenges associated with a large capital investment programme; and (3) an increased level of uncertainty in the generation business resulting from the ongoing re-design of the Irish electricity market (the I-SEM reforms), which is due to be implemented by the end of 2017.

Despite an increased debt burden following the 2010 acquisition of Northern Ireland Electricity (NIE, not rated) and a difficult macroeconomic environment in recent years, ESB has effectively managed the challenges associated with maintaining cash flow, key financial metrics and liquidity. Over the past three years, net debt to fixed assets has averaged just over 52% while funds from operations (FFO) to net debt has averaged just over 17%.

ESB's Baa1 issuer rating is at the same level as the Irish government bond rating and does not incorporate any uplift for potential support from its government shareholders.

DETAILED RATING CONSIDERATIONS

HIGH PROPORTION OF EARNINGS FROM PRICE-REGULATED NETWORKS BUSINESS SUPPORTED BY A CONSISTENT AND TRANSPARENT REGULATORY FRAMEWORK

Approximately 55% of earnings before depreciation and amortisation (EBITDA) in the six months to June 2015 was derived from the group's price-regulated transmission and distribution assets. Regulated revenues, cost allowances and operational incentives are subject to five-year-price controls imposed by regulators in RoI (Commission for Energy Regulation, CER) and in Northern Ireland (Utility Regulator, UR).

The current five year regulatory period, PR4, started in January 2016 following the final determinations published by the CER in December 2015 for both the distribution and transmission businesses. The final determinations support our view of a consistent and predictable regulatory framework, with no material changes to the regulatory principles implemented in previous price controls, and limited evolutionary reforms of the kind introduced for recent energy networks price controls in Great Britain.

Overall, we view the settlement as more challenging, but manageable. Positively, all capital expenditure (capex) and operating expenditure (opex) spent by ESB during the previous period, PR3, was allowed on the basis that it was necessary and efficient. With respect to PR4, overall allowed revenues of EUR 5.3 billion (real, 2014) are in line with ESB's submission. As expected, given the current lower interest rate environment, the allowed WACC of 4.95% (pre-tax, real) is lower than PR3's 5.95% (revised to 5.2% for 2014/15). In addition, the CER has set opex and capex allowances for PR4 that will require ESB to cut costs; however these targets are achievable in our view, and there remains some potential upside from incentive mechanisms. CER is still to make a decision on certain outstanding items, although these seem unlikely materially to affect ESB over the next 2-3 years, including: (1) recovery of pension costs associated with a 2010 staff agreement (which are currently not covered by the tariffs, and for which ESB is to make a case in Q1 2016); (2) a bonus and penalty scheme in relation to certain qualitative targets; and (3) whether a EUR500 million investment programme for the roll-out of smart meters should be implemented.

The capex allowance provides for a significant investment programme, which in part reflects an element of `catch-up' following the underspend in PR3. The final determinations' projections for the regulated asset base (RAB) imply a growth over the five year period of 12% to EUR6.0 billion (real, 2014)_on the distribution side, and of 32% to EUR2.8 billion (real, 2014) on the transmission side. Growth on the transmission side reflects the need to accommodate new wind farms, many of which are to be commissioned by 2017 in order to benefit from the REFIT tariff scheme.

ESB's Northern Ireland business (NIE), has good visibility about future cash flows until 2017 following the publication in April 2014 by the UK Competition and Markets Authority of its Final Determination in relation to the 2012-2017 period. A decision by the UR to adopt in future a methodology more similar to that used by the Office of Electricity and Gas Markets (Ofgem) in Great Britain would reduce regulatory risk and hence would be a credit positive.The regulator's consultation published in September 2015 suggests that it is likely to adopt a balanced approach.

MATERIAL EARNINGS CONTRIBUTION FROM HIGHER-RISK GENERATION AND SUPPLY BUSINESSES BUT ESB IS WELL-PLACED TO COPE WITH LOW POWER PRICE ENVIRONMENT AND CHANGING MARKET DYNAMICS

The majority of group earnings not derived from regulated network businesses are from ESB's power generation business (ESB Generation and Wholesale Markets), which we consider to be well diversified in respect of the SEM.

In the SEM, ESB has a power generation portfolio with a diverse fuel mix, which protects its earnings against shifts in commodity price dynamics which have in recent years resulted in higher running hours for coal-fired generation at the expense of plant fired by natural gas. The strong earnings contribution from its hydro, coal and peat assets have helped the portfolio to generate a stable source of earnings.

Power prices in SEM have declined by more than 20% since mid-2015, reflecting a decline in commodity prices, including gas and CO2 prices which dropped 15.3% and 33.4% respectively over the same period. Current prices of around EUR40/MWh are well below our estimates published in June 2015 of EUR53-58/MWh. However, we estimate that ESB's hedging policy, and its diversified portfolio will help limit the negative impact on profitability.

The capacity payment mechanism also helps stabilise the group's generation earnings even as load factors for some of ESB's older gas-fired power plants decline as they have been pushed out of merit. However, the level of potential remuneration under this mechanism is likely to fall from the end of 2017 as part of the re-design of the Irish electricity market (the I-SEM reforms), which is currently being designed in order for Ireland to achieve "market coupling" with Great Britain, part of EU Target Model, which envisages ever greater interconnection of national energy markets within the EU.

Based on the high-level design announced in September 2014, the aim of the I-SEM reforms will be to put in place new market frameworks which reduce overall system costs and reallocate those costs (principally between standby "capacity" and more active "flexibility") to reflect the changing shape of the market. As the former incumbent and with by far the largest market share, ESB could be vulnerable in the face of any attempts to increase competition. However, we expect that the very complexity of the reforms could benefit larger players. These will include, inter alia, the creation of new physical power markets; a self-balancing requirement and new forms of financial hedging.

FINANCIAL PROFILE IN 2015 ESTIMATED TO BE BROADLY IN LINE WITH 2014 BEFORE RECOVERING OVER 2016-17

ESB's financial profile deteriorated in 2014, with funds from operations (FFO) to net debt declining to 16.7%. from 20% in 2013 - mainly because of the impact of lower power prices, reduced availability at the Moneypoint coal plant in 2014 and certain one-offs.

We estimate leverage ratios to be broadly in line in 2015 before recovering somewhat over 2016-17. Underlying EBITDA increased to EUR 690 million during the first half of 2015, up from EUR 665 million in the earlier period. We estimate that EBITDA will have increased slightly for 2015 overall, thanks mainly to improved availability across the generation fleet, the non-recurrence of 2014's storm related costs, which should counteract the negative effect on Networks' earnings of the lower PR3 interim WACC review. However, improved operating performance is likely to have been offset by rising debt levels as the company continues its investment programme.

The construction of the new 880 megawatt combined cycle gas-fired plant at Carrington, near Manchester is due to be fully commissioned around mid-2016 at which point the impact of the project on group credit metrics should turn positive as it starts to generate earnings (we estimate around EUR50-60 million EBITDA per annum) and repay associated debt.

PRUDENT FINANCIAL POLICY MEANS LEVERAGE WILL REMAIN MODERATE DESPITE SIGNIFICANT CAPITAL EXPENDITURE PROGRAMME

In January 2015, ESB completed the payment of EUR421 million of special dividends to its shareholders, which it agreed in 2013 to fund through the sale of non-core assets. The final tranche was partially funded by a drawdown of ESB's credit facilities rather than, as originally envisaged, through the sale of the peat-fired generation assets at West Offaly and Lough Ree.

We expect the Irish government to act in a flexible manner and to support ESB in its explicit aim to strengthen its positioning within the current Baa1 rating category. To this end, we expect the company to remain moderately levered (with net debt to fixed assets below 60%) for the foreseeable future despite what we consider to be a material capital investment programme agreed with the CER as part of the RoI networks price control. The company will need regular access to capital markets to fund what we expect to be around EUR1 billion capital outlay per annum.

Liquidity Profile

We consider ESB to have a sound liquidity position. As at 30 June 2015, the company reported approximately EUR234 million of cash and cash equivalents and EUR1.6 billion of undrawn committed facilities, including a EUR1.44 billion revolving credit facility extended to 2020 in January 2015, with an option for a further two year extension to 2022.

We estimate that if ESB will have sufficient liquidity through cash, committed facilities and more than EUR1.4 billion of retained cash flow to fund approximately EUR1.9 billion of capital expenditure and EUR500 million of debt amortisations and maturities across 2015-2016 if it did not have access to capital markets or other sources of funding not already committed.

Following the issuance of a EUR500 million bond in May 2015 and the refinancing of bonds maturing in 2017, the next maturity concentration is in 2019.

Rating Outlook

The stable outlook reflects our expectation that ESB will maintain credit metrics in line with our guidance for the Baa1 rating level, which includes funds from operations (FFO) interest cover of above 3.5x and FFO to net debt of at least the mid-teens.

What Could Change the Rating - Up

Upward rating pressure could materialise if (1) no material negative consequences arise from the review of the SEM market design and/or ESB demonstrates its ability to reduce downside risks resulting from the changing dynamics in the generation market; and (2) ESB's credit metrics improve such that FFO interest cover and FFO / net debt are expected to be persistently above 4.5x and 20%, respectively.

What Could Change the Rating - Down

Downward rating pressure could arise from (1) downward movement in the Government of Ireland's rating by more than one notch; (2) a material debt-funded acquisition or capital investment that eroded ESB's financial flexibility; (3) material unfavourable changes in the regulatory framework in Ireland; (4) an increase in the proportion of non-regulated activities within ESB's business mix; (5) a deterioration in the group's credit metrics such that they were expected to remain persistently below the guidance.

Other Considerations

RATING LOWER THAN GRID-IMPLIED RATING REFLECTS RISKS NOT EXPLICITLY FACTORED INTO RATING GRID

Our rating assessment of ESB is based on our methodology for Regulated Electric & Gas Networks, published in November 2014.

Whilst the methodology grid maps ESB to an A2 based on three years of historic metrics and an A3 based on our forward view of financial metrics, the assigned rating of Baa1 is lower. This is because the grid does not specifically take into account the additional risk compared to peers rated under the methodology posed by the material contribution to group earnings from unregulated businesses, such as power generation and electricity supply.

GOVERNMENT-RELATED ISSUER METHODOLOGY CONSIDERATIONS

As a result of the fact that ESB is 95%-owned by the Irish government, we also consider ESB's rating according to our methodology for Government-Related Issuers, published in October 2014. In view of this and the critical importance of ESB's assets to the Irish state, we consider there to be a clear linkage between the credit profile of the company and that of the Irish government. In recent years, ESB's regulated network earnings justified a rating one notch higher than that of the Irish government however, such a differential is not appropriate at the current Baa1 rating level given the baseline credit assessment of baa1. A downgrade of ESB's ratings would be unlikely in the event of a one notch downgrade in the rating of the Irish government. Similarly, a one notch upgrade in the rating of the Irish government is unlikely to result in an upgrade of ESB's ratings.

Rating Factors

Electricity Supply Board (ESB)

Regulated Electric and Gas Networks Industry Grid [1][2]	**Current FY 31/12/2014**		[3]**Moody's 12-18 Month Forward ViewAs of 26/02/2016**	
Factor 1 : Regulatory Environment and Asset	**Measure**	**Score**	**Measure**	**Score**

Ownership Model (40%)				
a) Stability and Predictability of Regulatory Regime		Aa		Aa
b) Asset Ownership Model		Aa		Aa
c) Cost and Investment Recovery (Ability and Timeliness)		A		A
d) Revenue Risk		Aa		Aa
Factor 2 : Scale and Complexity of Capital Program (10%)				
a) Scale and Complexity of Capital Program		Baa		Baa
Factor 3 : Financial Policy (10%)				
a) Financial Policy		Baa		Baa
Factor 4 : Leverage and Coverage (40%)				
a) FFO Interest Coverage (3 Year Avg)	4.4x	A	3.8x - 4.2x	A
b) Net Debt / Fixed Assets (3 Year Avg)	52.2%	A	56% - 58%	A
c) FFO / Net Debt (3 Year Avg)	17.6%	Baa	15% - 17%	Baa
d) RCF / Net Debt (3 Year Avg)	14.6%	A	10% - 14%	Baa
Rating:				
a) Indicated Rating from Grid Factors 1-4		A2		A3
a) Indicated Rating from Grid Factors 1-4		0		0
a) Indicated Rating from Grid		A2		A3
b) Actual Baseline Credit Assessment		baa1		baa1

Government-Related Issuer	**Factor**	**Factor**
a) Baseline Credit Assessment	baa1	baa1
b) Government Local Currency Rating	Baa1	Baa1
c) Default Dependence	High	High
d) Support	Moderate	Moderate
e) Final Rating Outcome	Baa1	Baa1

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. [2] As of 31/12/2014; Source: Moody's Financial Metrics [3] This represents Moody's forward view; not the view of the issuer; and unless noted in the text, does not incorporate significant acquisitions and divestitures

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