Research Update:

# Electricity Supply Board Affirmed At 'A-/A-2' On Pandemic Resilience And Regulatory Visibility; Outlook Stable

**July 7, 2021**

## Rating Action Overview

- Ireland-based Electricity Supply Board (ESB) has shown business strength, underpinned by its relative resilience through the COVID-19 pandemic in 2020.
- We consider the Irish regulator's Price Review 5 (PR5) determination for ESB's Irish regulated network activities as supportive, and it is well aligned to benefit from the country's climate ambitions.
- Following higher visibility on the company's stable cash generation, by determination of Ireland's regulatory period 2021-2025, we reassessed liquidity to strong from adequate.
- We affirmed our 'A-' long-term and 'A-2' issuer credit ratings on ESB.
- The stable outlook reflects that, despite sizable capital expenditure (capex) required for the transformation of its generation portfolio, ESB should maintain funds from operations (FFO) to debt, as adjusted by S&P Global Ratings, above 17%, based on its stable regulated network contribution and improved generation profitability.

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## Rating Action Rationale

**In our view, state-owned utility ESB has proven relatively resilient to the effects of the COVID-19 pandemic.** This is because ESB is providing an essential service to its markets and over two-thirds of its activity is regulated. Lower demand on its regulated activities should only delay regulated earnings, although the company anticipated lower 2020 volumes in its tariffs. Slowing economic conditions in 2020 ultimately depressed electricity demand to a limited extend (only 1% year on year). Therefore, higher collections in 2020 will be compensated by lower collections in 2022. Pandemic-related bad debt provisions in ESB's customer solutions segments was only about €15 million last year (limited realized as of now), and its generation business benefits from limited wholesale commodity price exposure, with hedging in place. Furthermore, the company implemented contingency plans to manage pandemic disruptions, and we expect it to maintain credit metrics at a level consistent with the current rating over the next three years.

**The PR5 determination for ESB's regulated transmission and distribution activities in Ireland (about 60% of EBITDA) confirms lower remuneration for transmission activities.** Ireland's Commission for Regulation of Utilities (CRU) set the pre-tax, real weighted average cost of capital (WACC) for the 2021-2025 regulatory period to 3.80% from 4.95% (PR4), lifting regulatory reset risk for the coming five-year period. The lower assessment is mainly a reflection of lower interest in capital markets. Notwithstanding this, we note that the WACC is still among the highest compared to European regulatory frameworks. We positively view the increased gross capex allowance to €4.4 billion under PR5--from €2.7 billion (PR4)--to account for accelerated smart meter roll-out and renewable expansion. Furthermore, we understand the CRU will allow capex flexibility depending on the speed of electrification in other sectors (namely heating and transport). For financing purposes, we expect the dividend policy to remain flexible and the state supportive.

**ESB's strong investment program, which focuses on networks and renewables, should strengthen its long-term position by aligning the company's direction with the energy transition.** The company plans to invest €1.5 billion-€1.6 billion (gross capex) annually between 2021 and 2025 with more than 70% in business risk supportive network activities. The company intends to allocate most of the remainder to renewable generation expansion, targeting 3.5 gigawatts (GW) by 2030 from about 1 GW currently.

**We assess ESB's group credit profile (GCP) at 'bbb+', based on the consolidated cash flow and debt at the ESB level..** We view NIE Networks (NIE) as a core group entity because its activities are aligned with the group's strategic focus on regulated networks. Even though we assess NIE's stand-alone credit profile (SACP) at 'a-', we do not think that regulatory or other protections are sufficient to insulate its credit quality from that of its parent. Accordingly, we rate NIE at the level of the GCP.

**We consider ESB a government-related entity (GRE).** Our 'A-' long-term issuer credit rating incorporates one notch of uplift above the SACP. This reflects our view that there is a moderately high likelihood that Ireland would provide timely and sufficient extraordinary support to ESB in the event of financial distress. We base our view of a moderately high likelihood of extraordinary government support on our assessment of ESB's:

- Important role as the monopoly owner of the national electricity transmission grid and the owner and operator of the electricity distribution network. The group has a leading position in the Irish energy market; and
- Strong link with the Irish government, based on our view that the government will remain a majority shareholder and has no plans to privatize or divest a minority stake. ESB is 96% state-owned; the remainder is held through an employee share-ownership plan. Although ESB has an independent management team that makes autonomous business decisions, the government has a strong influence on the group's strategy and business plan.

## Outlook

The stable outlook on ESB mirrors that on Ireland. We expect ESB to maintain S&P Global Ratings-adjusted FFO to debt above 17%, based on its regulated network's stable contribution, and despite the sizable capex required for the transformation of its generation portfolio.

### Downside scenario

We could lower the rating on ESB if we take a similar action on Ireland. If earnings are more volatile or if the group's profitability weakens, we could revise down ESB's SACP. This could stem from lower returns from the regulated network businesses--reflecting underperformance against regulatory allowances--or weaker performance in the unregulated business.

The SACP could also come under pressure if the group's debt increases without a simultaneous increase in FFO. This could be caused by an unexpected increase in capex, a debt-financed acquisition, or higher-than-anticipated dividend payouts. At the current sovereign rating level, if we revised down the SACP by one notch, we would also lower the rating on ESB by one notch under our GRE methodology.

### Upside scenario

We cap our ratings on ESB at the sovereign rating because the Irish government owns 96% of ESB, and a significant proportion of the group's earnings are regulated in, and originate from, Ireland. If we raise the rating on Ireland by one notch, the rating on ESB would not change, all else being equal.

We are unlikely to revise ESB's SACP upward over our three-year rating horizon, mainly based on the group's forecast metrics, which are affected by its sizable and partly debt-financed capex program.

## Company Description

ESB was established in 1927 and is 96% owned by the government of Ireland. During 2020, it achieved an adjusted EBITDA of roughly €1.35 billion. ESB is an integrated utility predominantly operating in Ireland and Northern Ireland. It has a leading market position across the island. ESB's activities span power generation, the transmission and distribution of electricity, and power supply.

ESB is the monopoly owner of the transmission and distribution grids in Ireland and Northern Ireland and has a 29% share in the integrated single electricity generation market across the whole island.

NIE is a wholly owned subsidiary of ESB. It is the only electricity transmission asset owner and the electricity distribution network owner and operator in Northern Ireland.

In 2020, ESB had a 34% share of the Irish electricity supply market, while within gas supply, ESB had a market share of 15% and supplied electricity and gas to about 1.5 million customers.

## Our Base-Case Scenario

### Assumptions

Our base-case assumptions for 2021-2023 are:

- Real GDP growth for Ireland of 4.0% in 2021 and 2022, and 3.0% in 2023.
- Reduction in WACC for PR5 to 3.80% from 4.95% under PR4.

- Continued regulatory visibility and high predictability of earnings from ESB's Ireland-based network operations, as well as its subsidiary, NIE.
- Annual net capex of about €1.4 billion on average over 2021-2023, with over two-thirds invested in regulated networks.
- Dividend payouts of about 30% of net income in 2021 and beyond.

## Key metrics

| | 2019a | 2020a | 2021e | 2022e | 2023e |
|---|---|---|---|---|---|
| EBITDA (bil. €) | 1.37 | 1.35 | 1.3-1.4 | 1.3-1.4 | 1.45-1.55 |
| Debt (bil. €) | 6 | 5.8 | 6.0-6.2 | 6.4-6.6 | 6.7-6.9 |
| Dividends (mil. €) | 43 | 50 | 150-170 | 100-120 | 125-145 |
| Capex (Bil. €) | 0.95 | 0.88 | 1.1-1.3 | 1.1-1.3 | 1.1-1.3 |
| FFO/debt (%) | 18.7 | 18.7 | >18 | ~17 | >17 |
| Debt/EBITDA (x) | 4.4 | 4.3 | 4.3-4.4 | 4.8-4.9 | 4.4-4.6 |

a--Actual. e--Estimate.

## Liquidity

We now assess ESB's liquidity position as strong, reflecting our view that its liquidity resources will exceed its funding needs 2.0x in the 24 months started March 31, 2021. The group's ongoing and proactive liquidity and debt management; solid relationships with banks; and ample, proven access to capital markets, further support our assessment. Even though our liquidity sources over uses test suggests a higher liquidity assessment, we understand ESB is not committed to maintaining a higher liquidity score for now.

Principal liquidity sources include:

- Available cash balance of about €355 million;
- An undrawn committed credit facility of about €1.4 billion maturing in February 2025; and
- Annual cash FFO of about €1.2 billion.

Principal liquidity uses include:

- Annual capex of about €1.1 billion–€1.3 billion;
- Dividends of about €160 million in the next 12 months;
- Debt maturities of about €220 million over the next 24 months; and
- Working capital outflows of €35 million, also over the next 24 months.

## Issue Ratings - Subordination Risk Analysis

### Capital structure

ESB's group capital debt structure totaled €5.2 billion at Dec. 31, 2020, mostly unsecured. The majority of ESB's debt is raised via ESB Finance DAC (financing vehicle), apart from NIE debt (currently €832 of million bonds), which is raised by NIE Finance. As a result, structural subordination is fairly limited, at about 16% under our calculations.

### Analytical conclusions

ESB's debt is rated 'A-', the same level as the long-term issuer credit rating, because no significant elements of subordination risk are present in the capital structure.

## Ratings Score Snapshot

### Issuer Credit Rating: A-/Stable/A-2

**Business risk: Strong**

- Country risk: Low
- Industry risk: Low
- Competitive position: Strong

**Financial risk: Significant**

- Cash flow/leverage: Significant (medial volatility table)

**Anchor: bbb**

**Modifiers**

- Diversification/portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Strong (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Positive (+1 notch)

**Stand-alone credit profile: bbb+**

- Likelihood of government support: Moderately high (+1 notch from SACP)

## Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Guarantee Criteria, Oct. 21, 2016
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | Industrials: Key Credit Factors For The Unregulated Power And Gas Industry, March 28, 2014
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- Criteria | Corporates | Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010

## Ratings List

| **Ratings Affirmed** | |
|---|---|
| **Electricity Supply Board** | |
| Issuer Credit Rating | A-/Stable/A-2 |
| **ESB Finance DAC** | |
| Senior Unsecured | A- |

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