

Benelux, France, Italy, Iberia | Energy Transition Shapes Credit Quality

This article is an update from our previous report published in January 2023 and is part of a series covering Southern Europe, Benelux, the U.K., and Germany.

Jan. 8, 2024

Key Takeaways

- We expect rated regulated power businesses to maintain their focus on strengthening networks and connecting increasing renewable capacity to the grid.
- We anticipate credit metrics for power grid operators will weaken, owing to high, mostly debt-funded investment, despite generally supportive regulations, and that uncertainty will persist for gas grid operators as they transition to renewable gases, which is why we expect gradually more supportive policies to strengthen metrics.
- High power prices continue to drive credit performance of unregulated activities, with more selectivity on profitable renewable deployment, and affordability concerns should remain a risk in the region, although we do not forecast heavy fiscal or negative regulatory intervention from 2024.
- The sector has fairly solid balance sheets added to asset sale flexibility, despite higher capital spending and energy price volatility, although credit metrics and cash flows of power grid operators in the region will remain pressured in 2024, especially for power grid operators, given the high investment cycle and their relatively aggressive financial policies.

How will the energy transition shape the credit profile of utilities in Southern Europe and Benelux?

Power grids' leverage increases amid stepped-up investments, pressuring financial profiles despite regulatory support. Electricity networks' credit quality will be under increased pressure given that investments related to the energy transition are set to accelerate. Most power transmission system operators in the region have published 10-year development plans that anticipate extra capital expenditure (capex) because the energy transition demands additional network capacity and flexibility, with increased renewable capacity connection.

Based on recent strategic updates, we see capex for power grids in the region rising by 50%-150% over 2023-2025, mostly to accelerate the energy transition, but also to strengthen the grid and its resilience. Capex increases also incorporate heavy sector-specific inflation. In Belgium, Elia Transmission Belgium (ETB), 100%-owned domestic subsidiary of Elia Group, committed to a material capex acceleration up to €1.4 billion per year over 2023-2026. The Netherlands will face another equally large plan with Tennet's dedicated capex for its domestic market, which represents about 30% of the group's total €5 billion annual investments, while the remainder of its capex will be used for developing its German grid. We will monitor the execution of the

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extensive and relatively inflexible capex plans that could pressure operating capabilities of grid operators.

Positively, the remuneration of these investments is increasingly reflecting inflation and higher interest rates. That's the case in Belgium, where the regulator is proposing to significantly raise the expected regulatory return to about 7.2% (versus 6% for the current regulatory period) under its cost-plus model. These higher earnings prospects were key in our December affirmation of our 'BBB+' rating on ETB, despite the material cash flow pressure arising from capex. That's also the case in Italy, where the regulator has announced an increase of weighted average cost of capital (WACC) of 80 basis points for 2024 for electricity networks (5.8% for transmission and 6.0% for distribution). This is because the regulation, which we consider very supportive, foresees a yearly review of the allowed WACC to reflect changes in the risk-free rate, inflation, and country risk premium. By contrast, in Spain, remuneration lags, reflecting inflation and work-in-progress capex, creating some profitability pressure on capex and leading some operators to reduce the pace of investments until they gain more clarity over regulatory conditions in the 2026-2031 regulatory period, as evidenced by plans announced by Red Electrica, Iberdrola, and Endesa.

Supportive regulatory frameworks in the region provide cash flow resiliency and allow for inflation pass-through, although at different timing, except in Spain, where we see inflation receding in 2024 but remaining higher than in the past 10-year average. We expect consumer price inflation of 3.2% on average across Iberia and Benelux, and of 2.5% on average in France and Italy. In this context, we expect regulated tariffs indexed to inflation to protect network operators' profitability in Benelux, France, Italy, and Portugal. However, this is not the case for Spanish operators. In Spain inflation is not fully updated automatically in tariffs and depends on regulatory decisions for the subsequent regulatory period.

Gas grids' deleveraging broadly relies on financial policy due to limited growth and uncertainty in hydrogen (H2) deployment. Gas grids in the region remain exposed to long-term stranded-asset risk due to a gradual but predictable long-term decline in gas demand. Specifically, for Spain, we have reflected this in our revision of the business risk profiles for gas distribution system operators to strong from excellent, and this comes with tighter minimum credit metrics expectations compared with other regions for the same rating level. This reflects the less supportive regulation, under which Spanish gas distributors profits are somewhat exposed to volumes, as evidenced in 2022 and 2023 earnings fluctuation, because demand fell (except gas for power) by about 10%-15%, driven by high gas prices and mild temperatures in the 2022-2023 winter.

Across Western Europe we expect regulation to reflect a gradual decline in demand, both from residential and industrial customers, a drop we expect to accelerate over the next decade. Incentives for green gas investments will be key for the next regulatory period. As such, we view that deleveraging will be critical for gas grid operators to maintain current ratings, given limited growth prospects and the intensification of the energy transition.

For Italy's gas networks, we expect that, despite almost flat demand, the slower decarbonization path and favorable regulation, will support financial performance, even if we view the concessions renewal process as lengthy. Snam's new storage and liquified natural gas projects announced in early 2023 will extend the lifetime of its transmission grids while the Adriatic pipeline could be a platform for building an H2 backbone linking to potential future supply from North Africa (South H2 corridor).

We see Dutch gas grid networks facing relatively resilient demand until 2030, and industrial demand likely being boosted by H2. The Netherlands is also one of the most advanced European countries, along with Germany, in terms of transitioning to green gases. Gasunie will start the development of the grid for about €1.5 billion until 2030, half of which will be paid by state

subsidies. Overall in Europe, uncertainties on the ramping up of a H2 economy at scale are combined with lack of foreseeable regulation for H2 infrastructures before the next decade. Regulation is a crucial precondition to de-risk investments in such infrastructure for grid operators, and investment returns key to preserve their long-term relevant role.

Unregulated power generation will benefit from sustained high commodity prices as windfall taxes phase out. The current high price environment should continue to support earnings for fixed-cost power generators, to the degree they are exposed to merchant activities or have rolled over hedges at 2022 and 2023 levels. We believe this will be the case in 2024 even if prices have receded from 2022 peaks because of the removal of price caps and the windfall tax, which was originally set up to address the difference between the market price and a market participants' marginal cost of production in relation to exceptionally elevated power prices. In terms of regional difference, Italy sets the upper bounds of prices and Spain the lower bounds, due to still high thermal dependency for Italy and relatively high renewable penetration for Spain.

Pricing and operational environment by technology

- **Renewables (solar and wind)** – Combined solar and wind capacity are expected to grow by 61 gigawatts (GW) by end-2025 or by more than 15% per year in the region, weighted largely on Solar (80% total new capacities) and on Spain (40% total new capacities). We forecast continued captured price pressure on Spanish solar generators due to increasing penetration and on further erosion in captured prices (against the base load compared with wind technology). This risk of price cannibalization for the Spanish market could be mitigated if demand picks up and potentially by increased cross-border flows into France.
- **Hydro** – Hydro generation relies, particularly for run-of-river capacity and on weather-dependent hydrology, and its earnings are merchant exposed. In 2023, hydro conditions were supportive of Italian, Spanish, and French generation, with volumes increasing 25%-35% (from an exceptionally low 2022). In our view, hydro stock risk has narrowed sharply versus a year ago with storage levels mostly converging on five-year average levels.
- **Nuclear** – We expect French nuclear power recovery to continue in 2024 thanks to persistent higher availability. French nuclear output ramped up significantly in 2023 (we expect about 319 terawatt hours [TWh], up 40 TWh or 14%) thanks to gradual return to operation of units previously idled on the back of prolonged work on stress corrosion issues; we expect EDF's production to expand each year during 2024-2026, including the Flamanville-3 commissioning. Availability improvement and sustained power prices will benefit nuclear power producer EDF (we now forecast adjusted EBITDA of more than €23 billion in 2023 versus the negative €13 billion in 2022 caused by significant production shortfalls and regulatory headwinds).
- **Thermal** – We expect margins will decline for thermal generation, especially in Iberia, due to the combination of further renewable capacity expansion and energy efficiency efforts gradually reducing load factors. This trend could be less pronounced depending on hydro conditions and the evolution of power demand. Capacity market mechanisms could sustain earnings. The Spanish government has taken steps to establish continuity in 2024 for its 26 GW fleet of combined cycle gas turbines as regulated back-up to its growing renewable capacity, anticipating gradual nuclear retirements from late 2027.

We expect power generators to be more selective on renewable deployment and potentially moderate the pace of capex growth. This is notably because cost inflation, increased financing costs, and tighter supply chains (notably offshore) are reducing the profitability of new renewable

power generation projects. The strain on operating margins may incentivize generators to focus on higher returns on investment to adequately reflect risks and to ultimately moderate the pace of renewable deployment. We also believe large integrated groups will prioritize investments on frameworks with the most favorable investment conditions, such as Western Europe and the U.S. (albeit remaining more cautious on offshore), whereas in Latin America investments of Enel, Iberdrola, and EDP are becoming somewhat less material.

Main risks to our base case

- **Affordability** – While affordability pressure is easing compared with the 2022 peak, as evidenced by reduced government intervention, it remains a key risk in the region. Most of the 2022 regulatory and fiscal measures introduced in Southern Europe to mitigate higher energy bills in the region ended in 2023: that's the case for most windfall taxes (except in Spain where it was reconducted for another year although at different tax conditions), clawback mechanisms on renewable generation, and the reduction or full withdrawal of system costs that impacted Spanish and Italian retailers more strongly. We thus expect merchant power generators and retail utilities to fully benefit from market pricing in 2024.
- **Slower greening of generation portfolio or disrupted acceleration** – Beyond supply chains, site-permitting and grid access represent a risk to the pace and cost of the renewable buildup, notably for wind. The situation varies, relative to permitting, with much higher administrative lengthiness observed in Italy, and France despite the government pushing for faster approvals. The process in the Netherlands is more streamlined, evidenced by substantial pick-up of solar renewable capacity over the past five years (22 GW installed to date), confirming the densely populated country as a global leader in solar capacity installed per capita. Bottlenecks in grid connection, more prominent in Italy, should be gradually addressed by the stepped-up investments in power grids. We think an acceleration of renewable capacity installations would be positive for the companies' credit quality, so long as the projects benefit from profitable contracting, as this will allow to them to accelerate the greening of their generation portfolios. The effect on their financial risk profiles is less clear as lower returns stemming from higher funding costs may weigh on balance sheets.

Despite higher capex and energy market uncertainties, the sector has generally fairly robust balance sheets, asset sale flexibility, and access to capital.

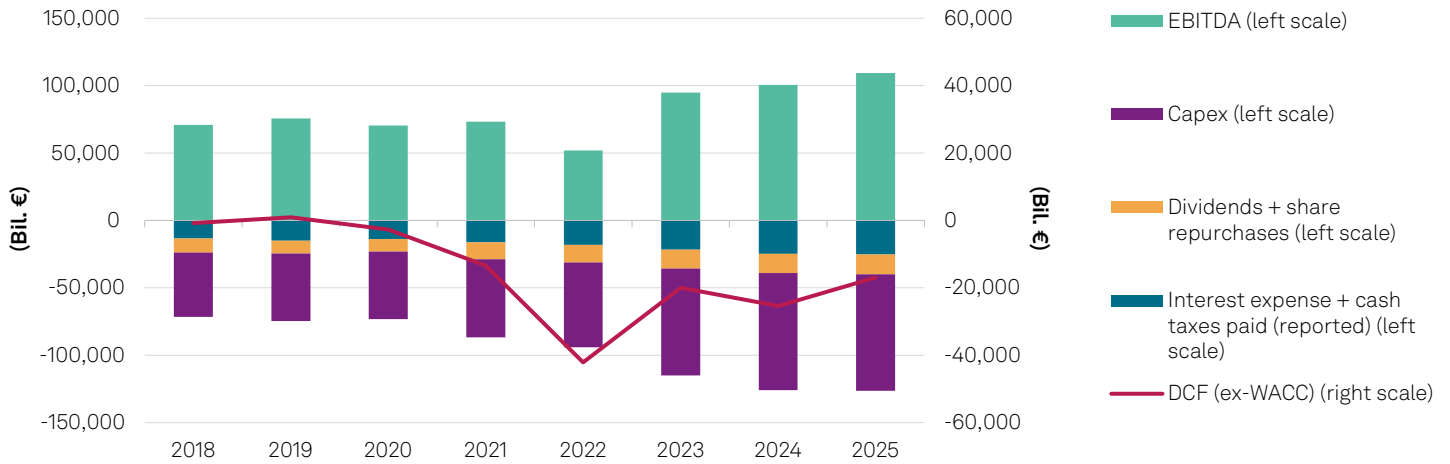
Overall, growth should enable utilities in the region to keep their credit metrics within our bands for the current ratings, to the extent their financial policies are supportive. Beyond earnings, utilities can sustain their balance sheets through asset disposals, hybrid capital, or issuance of common equity (particularly government-related power networks). We do not factor debt-funded acquisitions into our ratings, with the termination of the PNM Resources takeover by Iberdrola's Avangrid subsidiary, and we do not see undisciplined capital allocation as the main risk.

Heavy capex to accompany the energy transition will continue pressuring discretionary cash flow into negative territory, especially for electric utilities. On average across our rated universe of regulated and unregulated companies for the region, we anticipate for 2024 that companies will increase investments in most jurisdictions, led by grid operators, partially reflecting higher development costs.

At the same time, we forecast that shareholder remuneration will increase gradually in line with earnings growth in the region, particularly from earnings linked to profitable power generation, based on the maintenance of stable dividend payout or of dividend floors that we view as aggressive per se.

Top 15 Western European utilities | 2021-2025 capex and dividends drag DCF

Aggregate numbers mask broader spectrum of capex and shareholder distributions



Capex--Capital expenditure. DCF--Discretionary cash flow. WACC--Weighted average cost of capital. Source: S&P Global Ratings.

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- [Elia Group, Eurogrid Lowered To 'BBB' On Capex Acceleration; Elia Transmission Belgium 'BBB+' Affirmed; Outlooks Stable](#), Dec. 8, 2023
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- [Utilities Handbook 2023: Western Europe Regulated Power](#), Oct. 18, 2023
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- [Terna SpA](#), June 20, 2023
- [Snam SpA](#), June 1, 2023
- [Selling Its German TSO Could Improve TenneT's Credit Quality, Depending On The Size And Use Of Proceeds](#), April 13, 2023