# Hafslund Eco AS
# Norway, Utilities

POSITIVE
BBB+

## Key metrics

| | | | Scope estimates | |
|---|---|---|---|---|
| **Scope credit ratios** | **2020** | **2021** | **2022E** | **2023E** |
| Scope-adjusted EBITDA (SaEBITDA)/interest cover | 3.8x | 16.7x | 21.8x | 15.0x |
| Scope-adjusted debt (SaD)/SaEBITDA | 9.1x | 1.2x | 0.7x | 1.2x |
| Funds from operations/SaD | -2% | 78% | 93% | 17% |
| Free operating cash flow/SaD | -8% | 68% | 85% | 9% |

## Rating rationale

The issuer rating reflects Hafslund Eco's standalone credit quality of BBB and a one-notch uplift based on our assessment of parent support. The uplift is driven by the anticipated capacity and willingness of Hafslund Eco's parent, the City of Oslo, to provide support if needed.

With regard to Hafslund Eco's business risk profile, we continue to note positively that the company has a leading position in the power generation market in Norway and the Nordic area with its low-cost hydro production. Hafslund Eco's sizeable reservoir capacity (about 50% of annual production) provides its power generation segment with more flexibility, which is advantageous when operating in a market that has volatile prices. The volatile nature of power generation coupled with a somewhat complex organisational structure with further probable M&A transactional risks is limiting the rating. Still, positively, its 50% ownership in Eidsiva Energi gives a predictable cash dividend stream, driven by the contribution of subsidiary Elvia (operating in a monopolistic power distribution market).

When assessing the financial risk profile, we note Hafslund Eco's currently conservative credit metrics, but also the volatility in some credit metrics due to recent market pricing conditions and its exposure to the volatility in power prices. Given the company's prudent financial policy and manageable capex programme in the next few years, we expect positive free operating cash flow and strong credit metrics.

## Outlook and rating-change drivers

The Positive Outlook reflects our expectation that Hafslund Eco can sustain a more conservative financial risk profile given the prospect of continued higher-than-normal achievable power prices, thus generating sufficient positive free operating cash flow over time.

A positive action could be warranted if excess free cash flow is used to repay debt, resulting in a sustainable improvement in credit metrics exemplified by a Scope-adjusted debt/EBITDA sustained below 2x.

A negative rating action (back to a Stable Outlook) could be triggered by lower achieved wholesale prices, higher capex or structural transactions that weaken the financial risk profile, exemplified by Scope-adjusted debt/EBITDA staying in the 2x-4x range.

## Rating history

| Date | Rating action/Monitoring | Issuer rating & Outlook |
|---|---|---|
| 9 July 2021 | New | BBB+/Stable |

### Ratings & Outlook

| | |
|---|---|
| Issuer | BBB+/Positive |
| Short-term debt | S-2 |
| Senior unsecured debt | BBB+ |

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### Related Methodologies

Corporate Rating Methodology; July 2021

Rating Methodology: Government Related Entities Methodology, May 2022

European Utility Methodology, March 2022

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Bloomberg: RESP SCOP

| Positive rating drivers | Negative rating drivers |
|---|---|
| • Norway's second largest power producer, and leading position in the Nordics as a profitable and low-cost hydro power generator (positive ESG factor) with high water reservoir capacity<br>• Long-term, supportive and committed municipality owner, justifying an uplift from the standalone rating<br>• Recurring dividend inflow from its 50% indirect ownership in Norway's largest electricity grid company, Elvia, which operates in a regulated monopolistic distribution regime | • Relatively large exposure to the volatility in power prices for unhedged power production output<br>• Negative cash flow and weak financial credit ratios when market prices are low, as recently exemplified with FY 2020 numbers<br>• Somewhat complex organisational structure with potential new transactional risks, due to its clear ambition to further participate in structural transactions to grow its different businesses |

| Positive rating-change drivers | Negative rating-change drivers |
|---|---|
| • Excess free cash flow used to repay debt and the maintenance of its financial policies, resulting in a sustainable improvement in credit metrics exemplified by Scope-adjusted debt/EBITDA of below 2x<br>• Increasing contribution from the more stable infrastructure business, which could lead to lower volatility or an improved business risk profile | • Lower achieved wholesale prices, higher capex or structural transactions that weaken the financial risk profile, exemplified by Scope-adjusted debt/EBITDA staying in the 2x-4x range would result in Stable outlook again.<br>• Loss of status as a government related entity due to change of ownership |

## Corporate profile

Hafslund Eco is a Norwegian utility that is wholly owned by the City of Oslo, a Norwegian municipality. Although the company's corporate history is very long, the group structure changed significantly in 2019 with the swap of assets with Eidsiva Energi. Today, the company is Norway's second largest power producer, with operating responsibility for an annual hydro power production of more than 21TWh. It also has a joint venture in grid operations (Elvia) through its 50% stake in Eidsiva Energi (BBB+/Stable) and has a 49% interest in Fredrikstad Energi AS. Its main hydropower assets are placed in Hafslund Eco Vannkraft (of which Eidsiva Energi owns 43.5%). From Q2 2022, it also became the majority owner (60%) of Hafslund Oslo Celsio (HOC, previously called Fortum Oslo Varme), with Infranode and HitecVision each owning 20%.

## Financial overview

| | | | Scope estimates | |
|---|---|---|---|---|
| **Scope credit ratios** | **2020** | **2021** | **2022E** | **2023E** |
| SaEBITDA/interest cover | 3.8x | 16.7x | 21.8x | 15.0x |
| SaD/SaEBITDA | 9.1x | 1.2x | 0.7x | 1.2x |
| SaD (excl. shareholder loans)/SaEBITDA | 6.6x | 0.7x | 0.2x | 0.5x |
| Funds from operations/SaD | -2% | 78% | 93% | 17% |
| Free operating cash flow/SaD | -8% | 68% | 85% | 9% |
| **Scope-adjusted EBITDA in NOK m** | | | | |
| EBITDA | 1,624 | 9,611 | 15,307 | 11,323 |
| Dividend received from Eidsiva | 525 | 513 | 500 | 500 |
| **Scope-adjusted EBITDA** | **2,149** | **10,124** | **15,807** | **11,823** |
| **Scope-adjusted funds from operations in NOK m** | | | | |
| Scope adjusted EBITDA | 2,149 | 10,124 | 15,807 | 11,823 |
| less: (net) cash interest paid | -568 | -605 | -723 | -788 |
| less: cash tax paid as per cash flow statement | -2,047 | -273 | -5,291 | -8,658 |
| Other items | 116 | 264 | - | - |
| **Funds from operations** | **-350** | **9,510** | **9,792** | **2,378** |
| **Free operating cash flow in NOK m** | | | | |
| Funds from operations | -350 | 9,510 | 9,792 | 2,378 |
| Working capital change | -555 | -650 | -*[1] | 0 |
| Non-operating cash flow adjustments | 4 | 0 | -* | 0 |
| less: capital expenditure (net) | -622 | -590 | -800 | -1,100 |
| **Free operating cash flow** | **-1,523** | **8,270** | **8,992** | **1,278** |
| **Scope-adjusted debt in NOK m** | | | | |
| Reported gross financial debt | 15,063 | 13,591 | 15,273 | 13,373 |
| Subordinated shareholder loans | 5,364 | 5,264 | 7,338 | 7,338 |
| less: cash and cash equivalents | -1,008 | -6,988 | -12,428 | -7,188 |
| add: cash not accessible | 57 | 364 | 364 | 182 |
| **Scope-adjusted debt** | **19,476** | **12,231** | **10,547** | **13,705** |

[1] *& *: Based on the consolidation of HOC in 2022, there will be some adjustment effects, which are not included/disclosed here*

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## Environmental, social and governance (ESG) profile[2]

| Environment | | Social | | Governance | |
|---|---|---|---|---|---|
| Resource management (e.g. raw materials consumption, carbon emissions, fuel efficiency) | Green leaf | Labour management | | Management and supervision (supervisory boards and key person risk) | Grey leaf |
| Efficiencies (e.g. in production) | | Health and safety (e.g. staff and customers) | | Clarity and transparency (clarity, quality and timeliness of financial disclosures, ability to communicate) | Grey leaf |
| Product innovation (e.g. transition costs, substitution of products and services, green buildings, clean technology, renewables) | | Clients and supply chain (geographical/product diversification) | | Corporate structure (complexity) | Grey leaf |
| Physical risks (e.g. business/asset vulnerability, diversification) | | Regulatory and reputational risks | | Stakeholder management (shareholder payouts and respect for creditor interests) | Grey leaf |

**Legend**

Green leaf (ESG factor: credit positive)
Red leaf (ESG factor: credit negative)
Grey leaf (ESG factor: credit neutral)

### Well-integrated ESG framework

Hafslund Eco supports the UN's Sustainability Goals, and the group's activities have a direct impact on several of these goals. As a producer of hydroelectric power, the group focuses on the UN Sustainability Goals where it can have the greatest impact. The group updated its materiality analysis on sustainability in 2021. This analysis focuses on factors deemed material for Hafslund Eco's organisation and the group's stakeholders. The analysis highlights both risks and opportunities, and identifies sustainability themes which is material for the group attaining its strategic objectives.

We acknowledge Hafslund Eco's well-integrated ESG framework and ambitions, including publications of green financing reports. The company has received an ESG Second Party Opinion from Cicero, attaining a 'Dark Green Rating'. The company has issued green bonds, with proceeds used exclusively for low-carbon solutions and climate change adaption. All projects take into account environmental concerns, social impacts, landowners and potential local resistance. The Green Finance Report will be published annually as long as there are green finance instruments outstanding or until full allocation.

[2] The ESG profile only evaluates the extent to which ESG factors are credit-relevant. Our evaluations are not mutually exclusive or collectively exhaustive as these factors overlap and evolve. We only consider an ESG factor relevant to our credit rating process if it has a ubiquitously discernible and material impact on the rated entity's cash flow profile and, by extension, its overall credit quality.

## Business risk profile: BBB+

**Second largest power generator in Norway**

We consider Hafslund Eco's market position as strong in its home markets, driven by high capacity utilisation, the position of its hydro power assets at the front of the merit order system, and the low-cost profile. Further, we note its 50% indirect ownership in Elvia (via Eidsiva Energi), which operates under a monopolistic regulated regime and is the largest regional grid distribution company in Norway.

Hafslund Eco has both flexible (60% reservoir-based) and intermittent (40% run-of-river) hydropower production. Large storage capacity and high installed capacity provide the Norwegian hydropower system with significant flexibility in the European context.

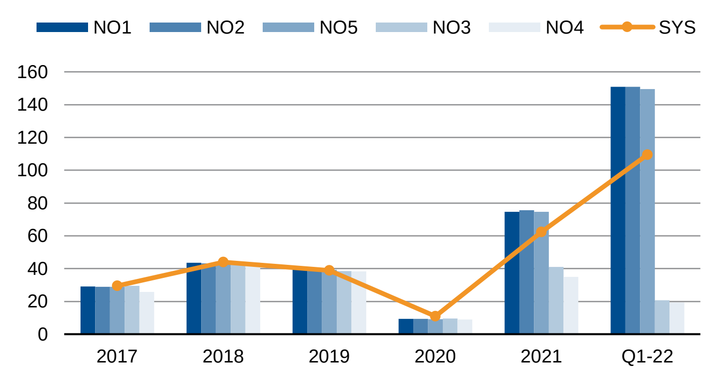
**Adequate asset concentration risk, but more limited geographical diversification**

We regard Hafslund Eco's geographical diversification as somewhat limited compared to that of the larger European power producers, but more than acceptable compared to that of more locally focused utility peers. The company is largely concentrated in south-eastern Norway. While Hafslund Eco could sell its power virtually anywhere in the Nord Pool market, price differences among the Norwegian regions are high, and Hafslund Eco's area is more beneficial that price areas in the north.

With 80 power plants, we regard Hafslund Eco's diversification within its power generation portfolio to be fairly good, as we note limited concentration risk. While an adequate level of asset concentration risk contributes positively to the overall diversification analysis, geographical and segmentation factors weigh more negatively.

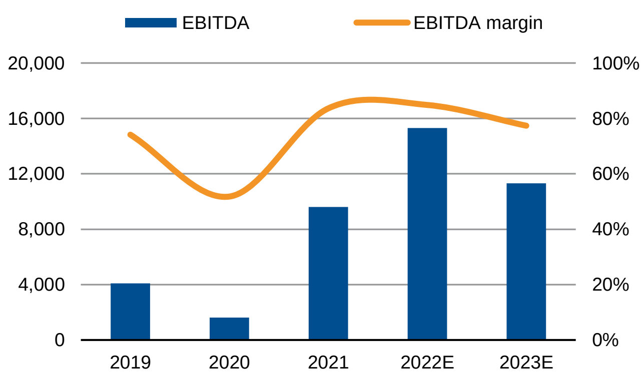
Hafslund Eco is seeking out collaborations and strategic alliances, as recently demonstrated this year when Hafslund Eco became the majority owner of HOC. The transaction will increase Hafslund Eco's energy production by almost 2 TWh annually and secure ownership of important infrastructure in the Oslo region. Other projects that could add diversification over time include an offshore wind power project and the 'Elaway' (ready-to-charge) business for instance. However, for those other projects, Hafslund Eco could also likely reduce its ownership stakes in the future to realise value.

**Figure 1: Nordic system power price and various Norwegian regions (EUR/MWh)**




Sources: Nord Pool, Scope

**Figure 2: EBITDA (NOK m, LHS) & margin development**




Sources: Company, Scope estimates

**Strong operating profitability with some volatility**

Profitability margins are very high due to Hafslund Eco's dominant hydropower production share and efficient operations. As a result, we pay attention to the fluctuating factors stemming from electricity generation volumes and achievable prices when assessing the profitability volatility of the group. In 2020, the EBITDA margin was negatively affected by the historically low power prices, while in 2021 and YTD 2022 it was the opposite. Although, this indicates high volatility from the normalised 70% margin we apply for this company, its profitability exceeds that of relevant peers and is a positive driver for the overall competitive positioning.

The company's dynamic framework for hedging includes both shorter financial derivative contracts and longer bilateral industrial contracts and power purchase agreements. The latter longer contract structures have increased focus.

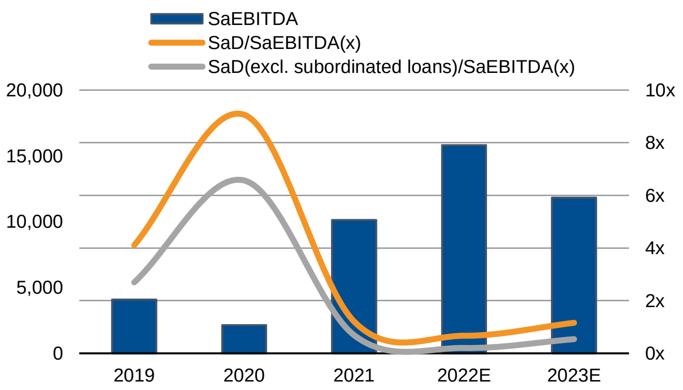
## Financial risk profile: BBB

**Adjustments and shareholder loans**

In terms of adjustments and the calculation of credit metrics, we note that the company's 50% ownership in Eidsiva Energi is accounted for as an equity investment in the group's IFRS accounts. In our Scope-adjusted EBITDA, however, we include the recurring dividend from Eidsiva Energi.

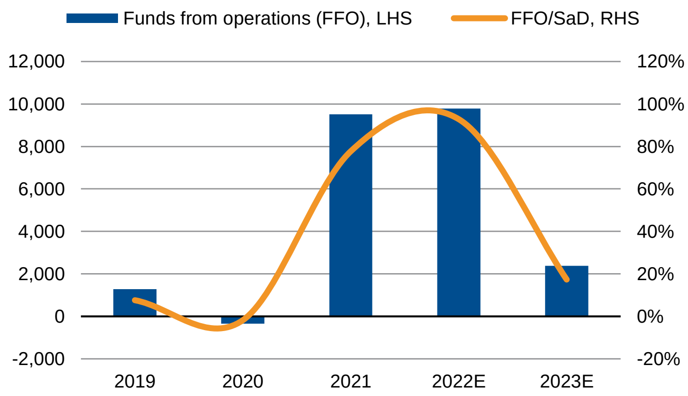
After the HOC transaction, the company has four subordinated loans (from the City of Oslo and Eidsiva Energi), which are included in Scope-adjusted debt (NOK 7.3bn in total). However, given the loans' characteristics of always having a longer tenor than senior unsecured debt outstanding, no instalments, and incurrence tests before interest is paid (in the event of reported loss), we see them as quasi equity and thus show leverage metrics with and without subordinated shareholder debt to improve transparency on leverage. As the loans from Infranode and HitecVision to HOC (NOK 1.6bn in total) are not subordinated, we treat these as more standard loans, i.e. and without any quasi equity characteristics, and not shown on a separate line on page 3.

**Figure 3: SaEBITDA NOK m (LHS) and leverage x (RHS)**




Sources: Company, Scope estimates

**Figure 4: Funds from operations in NOK m and relative to Scope-adjusted debt (%)**




Sources: Company, Scope estimates

**Improved leverage ratios from 2021, at sustainably more conservative levels than in the past**

Some credit metrics has been somewhat volatile in the last three years due to market conditions and a relatively large exposure to the volatility in power prices. Including the subordinated shareholder loans, Scope-adjusted leverage is expected to stay below 2x in the medium term; excluding the shareholder loans results in the ratio staying below 1x. In terms of rating action triggers, we see this ratio level as roughly the midpoint between the two calculation methods.

The main drivers behind our forecast and credit ratios expectations are:

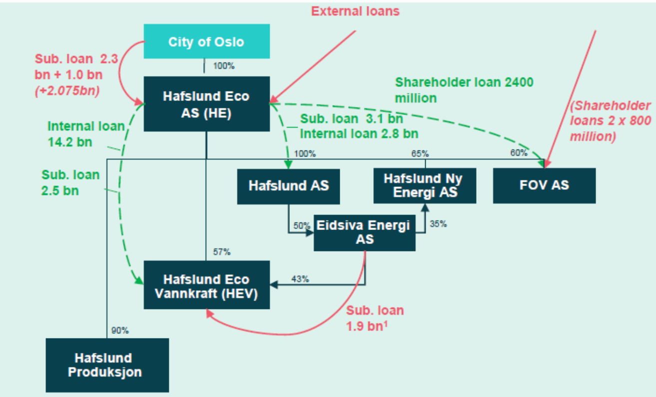
- Assume record high power prices achieved in 2022, but lower-than-normal production output. For 2023 and beyond, forward market prices used as guidance (somewhere between the Nordic system price and the NO1 forward price) and normalised annual production output.
- Including the HOC transaction as of H1 2022

**Expectation of positive free operating cash flow over time**

The volatility in cash flow is evident due to the high exposure to power production and the fluctuating market prices. In addition, we have the tax regime, which could make any particular year even more volatile. Thus, we judge cash flow generation over time.

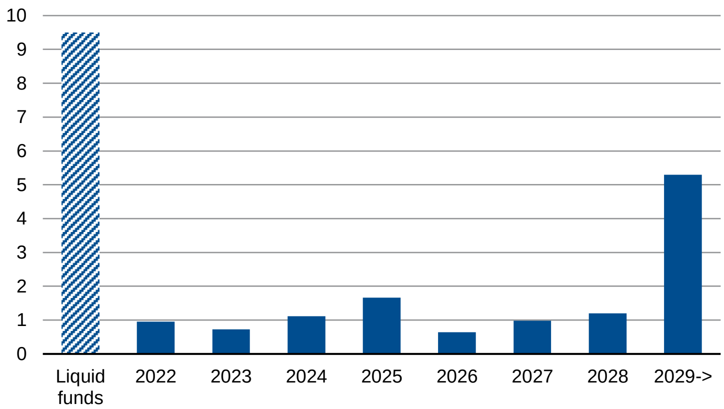
Most of the capex expected in the next three to five years are related to the maintenance of various hydro production plants as well as upgrades and improvements of reservoirs and dams. In the last two years, annual capex has been around NOK 0.6bn, which we expect to increase in the short to medium term due to the inclusion of HOC. We have not assumed any major expansionary investments but acknowledge some potential for such projects in the coming years. This is based on ambitions stated in the announcement of the HOC transaction, amongst other about the carbon capture project at Klementsrud in Oslo, which is aimed to reduce Oslo's CO2 emissions.

**Figure 5: Organisational and debt structure overview**




Source: Company

**Figure 6: Liquid funds & debt maturity profile YE2021 (NOKm)**




Source: Company

### Adequate liquidity and well-distributed maturity schedule

At YE 2021, the company had NOK 7bn in cash and NOK 2.5bn in long-term undrawn credit lines, which together is well above the short-term debt maturity at that time (NOK 1bn). The company also has NOK 400m in overdraft facilities and an additional EUR 50m operating liquidity facility. In the next few years, the debt maturity schedule will average around NOK 1bn yearly, indicating a relatively even debt profile, as seen in Figure 6. The FOV transaction has changed the picture a bit, but very strong liquidity will remain likely.

## Supplementary rating drivers: +1 notch for GRE

**Prudent financial policy**

We make no adjustment for financial policy but note that the company actively monitors quantitative and qualitative factors that affect creditworthiness to maintain high flexibility and a strong credit rating. The group aims for cash flows that ensure competitive returns for the owner through dividends but without disadvantaging the group's creditors. The latter was evident during 2020, when the board of directors waited for more clarity on the negative results' effect before finalising the dividend pay-out.

**Government related entity with one-notch uplift**

Hafslund Eco is 100% owned by the Norwegian municipality, the City of Oslo. We have used our government related entities methodology and continue to assign a one-notch uplift to Hafslund Eco's standalone credit rating. The one-notch uplift for ownership is in line with other Scope-rated Norwegian utilities with majority or full municipal ownership that lack explicit guarantees.

Based on the methodology framework, we assess both the overall capacity and likelihood of the owner to provide support, which includes an evaluation of strategic importance, ease of substitution and default implications. Compared to other municipalities or county municipality owners in Norway, we see the capital of Norway as having stable taxable income and is thus among the better municipalities that have the capacity to support[3].

**Governance and structure**

We see the structure and setup of Hafslund Eco as relatively complex, following the transaction with Eidsiva Energi on 30 September 2019 and the latest HOC transaction. The 'look-through approach' set up for accounting purposes is being used and has been approved to avoid double-counting, an approach we consider appropriate. Capital in the group is moved through a combination of dividends and loans to subsidiaries.

## Long-term and short-term debt ratings

**Short term rating of S-2 and BBB+ senior unsecured rating**

The BBB+ senior unsecured debt rating is in line with the issuer rating, based on the company's standard bond documentation, which includes a pari passu clause and a negative pledge. Senior unsecured bonds are issued by Hafslund Eco AS.

The S-2 short-term rating reflects the good short-term debt coverage, as well as good access to both bank loan and debt capital markets.

[3] Although lower than the Norwegian State directly, which we clearly assess as very high.

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