Hafslund Eco AS Norway, Utilities

SCOPE BBB+ STABLE

Corporate profile

Hafslund Eco is a Norwegian utility that is wholly owned by the City of Oslo, Norway. Although the company's corporate history is very long dated, the group structure changed significantly in 2019 in the swap of assets transaction 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 20TWh. It also has a JV ownership 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 owns 42.8%).

Key metrics

			Scope estimates	
Scope credit ratios	2019	2020	2021E	2022E
EBITDA/interest cover	6.6x	3.8x	10.2x	7.9x
Scope-adjusted debt (SaD)/EBITDA, incl. div from Eidsiva)	4.1x	9.1x	2.9x	4.0x
Scope-adjusted funds from operations/SaD	8%	-2%	30%	8%
Free operating cash flow/SaD	32%	-8%	26%	4%

Rating rationale

Scope Ratings has assigned a BBB+/Stable issuer rating on Hafslund Eco AS along with a BBB+ senior unsecured debt rating and a S-2 short-term rating.

The issuer rating reflects Hafslund'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 the City of Oslo to provide support, assessed in accordance with our Government Related Entities Methodology.

With regard to Hafslund Eco's business risk profile, we 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. Further, its 50% ownership in Eidsiva Energi gives a predictable cash dividend stream, driven by the company Elvia (operating in a monopolistic power distribution market). We also recognise Hafslund Eco's low asset concentration risk, with more than 80 power stations in the southern part of Norway. Limiting factors for Hafslund Eco's business risk profile include the electricity price exposure for its unhedged production output, the volatile nature of power generation industry, coupled with a somewhat complex organisational structure with further probable M&A transactional risks.

When assessing the financial risk profile in Hafslund Eco, we note the volatility in selected credit metrics the last two to three years, due to market conditions and a relatively large exposure to the volatility in power prices. Although the fiscal year 2020 showed negative operating cash flow and weak financial credit ratios, we expect 2021 to move back to more normalised levels, given the significantly improved market prices achieved this year. When we include the subordinated loans in the Scope-adjusted leverage calculation, leverage is expected to stay in the 3x-4x range in the medium term.

Ratings & Outlook

Corporate issuer rating	BBB+/ Stable
Short-term rating	S-2
Senior unsecured rating	BBB+

Lead analyst

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Related Methodologies

European Utility Methodology

Corporate Rating Methodology

Government Related Entities Methodology

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Given the company's prudent financial policy and manageable capex program the next few years, we expect Hafslund Eco to report positive free operating cash flow in the short-to-medium term, while discretionary cash flow is expected to break even over time. Most of the committed capex is related to maintenance investments of several power generation assets, but also some upgrade and improvement of water reservoirs and dams.

Although there is some underlying potential transactional risk in the company based on its history and its clear ambition to further participate in structural transactions to grow its businesses, we believe this risk is well handled by a professional organisation. We also note that its New Energy segment is seen as a vehicle for early value creation, and not large investment plans, i.e. indicating to us that Hafslund Eco is likely to reduce shareholding interests if/when growth investments become too large. In terms of liquidity, we deem it adequate, and note that it has more than sufficient cash and back-up credit facilities, to handle its well distributed debt maturity schedule.

Outlook and rating-change drivers

The Stable Outlook reflects our expectation that Hafslund Eco will continue to be a cost efficient and profitable hydro power generation company, with a majority ownership share in Hafslund Eco Vannkraft and a significant ownership share in Eidsiva. It further assumes that the company will generate positive FOCF over time and maintain its prudent financial policy, including manageable capex plans and reasonable dividend pay-outs. It also assumes the City of Oslo will continue to be a long-term owner with both the capacity and willingness to support the company if needed.

A positive action could be warranted if excess free cash flow is used to service debt repayment, resulting in a sustainable improvement in credit metrics, e.g. exemplified by Scope-adjusted debt/EBITDA of around 2x on a sustained basis. It could also occur in the longer term if we see an increasing contribution from more stable infrastructure business for instance, which could lead to lower volatility and an improved business risk profile

A negative rating action could be triggered by lower achieved wholesale prices for electricity creating a weaker financial risk profile, exemplified by a Scope-adjusted debt/EBITDA of above 4x on a sustained basis. Further, the loss of Government Related Entity status, due to change of ownership, could trigger a downgrade.

Rating drivers

Positive rating drivers	Negative rating drivers
• Norway's 2nd largest power producer, and leading position in the Nordics as a profitable and low-cost hydro power generator (positive ESG factor) and with high water reservoir capacity • Long-term, supportive, and committed municipality owner, justifying an uplift from the standalone rating • Recurring dividend inflow from its 50% ownership in Norway's largest electricity grid company (Elvia) via Eidsiva, which operates in a regulated monopolistic distribution regime	• Relatively large exposure to the volatility in power prices for its unhedged power production output • Negative cash flow and weak financial credit ratios when market prices are low, as recently exemplified with FY 2020 numbers • 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

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Excess free cash flow used to service debt, resulting in a sustainable improvement in credit metrics, e.g. exemplified by Scope-adjusted debt/EBITDA of around 2x • Increasing contribution from the more stable infrastructure business for instance, which could lead to lower volatility or an improved business risk profile	• Weaker financial risk profile, exemplified by a Scope-adjusted debt/EBITDA of above 4x on a sustained basis • Loss of Government Related Entity status due to change of ownership

Financial overview

			Scope estimates	
Scope credit ratios	**2019**	**2020**	**2021E**	**2022E**
EBITDA/interest cover	6.6x	3.8x	10.2x	7.9x
SaD/Scope adjusted EBITDA (including dividend from Eidsiva)	4.1x	9.1x	2.9x	4.0x
Scope-adjusted debt (SaD), excl. subordinated shareholder loan /EBITDA	2.7x	6.6x	2.0x	2.8x
Scope-adjusted funds from operations/SaD	8%	-2%	30%	8%
Free operating cash flow/SaD	32%	-8%	26%	4%
Scope-adjusted EBITDA in NOK m	**2019**	**2020**	**2021E**	**2022E**
EBITDA	4,083	1,624	5,073	3,766
Dividend received from Eidsiva	-	525	400	400
Scope-adjusted EBITDA	4,083	2,149	5,473	4,166
Scope-adjusted funds from operations in NOK m	**2019**	**2020**	**2021E**	**2022E**
EBITDA	4,083	1,624	5,073	3,766
less: (net) cash interest as per cash flow statement	-620	-568	-538	-527
less: cash tax paid as per cash flow statement	-2,122	-2,047	-123	-2,293
Other items (including dividend from Eidsiva)	-65	641	375	375
Scope-adjusted funds from operations	1,276	-350	4,787	1,320
Scope-adjusted debt in NOK m	**2019**	**2020**	**2021E**	**2022E**
Reported gross financial debt	13,206	15,063	14,373	14,353
Subordinated shareholder loan	5,764	5,364	5,264	5,264
less: cash and cash equivalents	-2,444	-1,008	-3,559	-2,913
add: cash not accessible	242	57	50	50
add: other	0	0	0	0
Scope-adjusted debt	16,768	19,476	16,128	16,754

Business risk profile

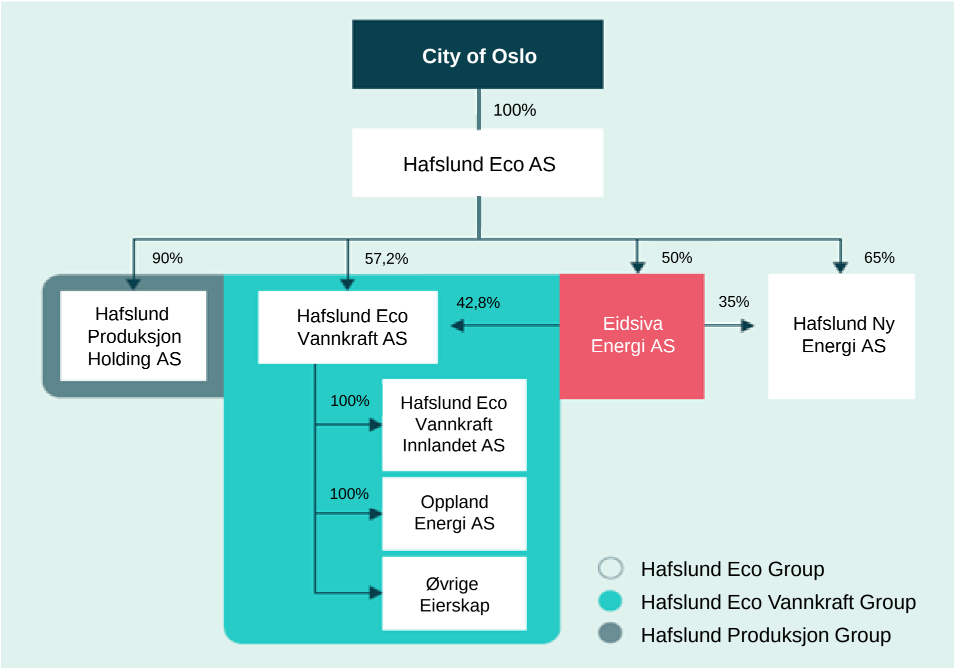
Industry risk profile

Hafslund Eco is mainly exposed to the pure power generation industry risk, which we consider to be highly cyclical and has medium entry barriers (details to be found here).

Still, knowing that they have a 50% interest in the electricity grid company Elvia (via Eidsiva Energi) that is generating a stable predictable dividend is to a certain degree incorporated in the competitive positioning evaluation and thus the overall BRP rating assessment.

As part of the transaction with Eidsiva Energi in 2019, the hydropower businesses were organised in Hafslund Eco, while the grid businesses were placed in Eidsiva Energi. The implemented structural change should enable Hafslund Eco to maintain a strong position in an evolving sector and also provide opportunities in its "New Energy" segment. The latter business segment has limited effects on our current rating assessment.

Figure 1: Simplified organisational structure



Source: Company

2nd largest power generator in Norway

With own production of about 18TWh, Hafslund Eco is considered a large power generator in Norway (2nd largest with an 13% share of total production). In the Nordics, it is considered large in terms of hydro power generation, but smaller in the larger European power generation context. Still, we highlight that size is not overly important when assessing the market position and credit quality of a power utility. We consider Hafslund Eco's market position as strong in its home markets, driven by high capacity utilisation and the favourable position of hydro power assets in the front of the merit order system and the low-cost profile. Further, we indirectly also note its 50% ownership in Elvia (via Eidsiva Energi) that operates under a monopolistic regulated regime and is the largest regional grid distribution company in Norway.

Hafslund Eco has both flexible (reservoir-based) and intermittent (run-of-river) hydropower production. Large storage capacity and high installed capacity provide the Norwegian hydropower system with significant flexibility in the European context. For Hafslund Eco specifically, we note positively that it has a relatively high share of hydro reservoir capacity, at around 45% of its annual production.

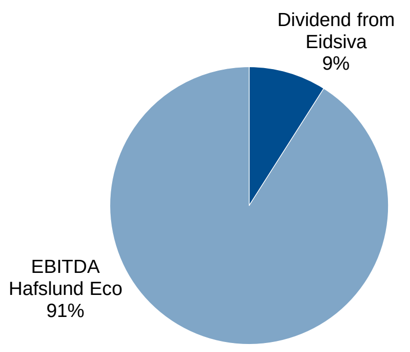
Adequate asset concentration risk, but more limited geographical diversification

We regard Hafslund Eco's geographical diversification as somewhat limited compared to the larger European power producers, but more than acceptable vs more local utility peers. The company is largely concentrated in south-eastern Norway, and while its power could virtually be sold wherever within the Nord Pool market, we are also aware of the price differentiation that could occur regionally.

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. Hafslund Eco's exposure to its largest hydro power plant makes up approximately 12% of the group's annual production, while the three largest make up approximately 30%. While an adequate level of asset concentration risk contributes positively to the overall diversification analysis, geographical and segmentation factors weigh more negatively.

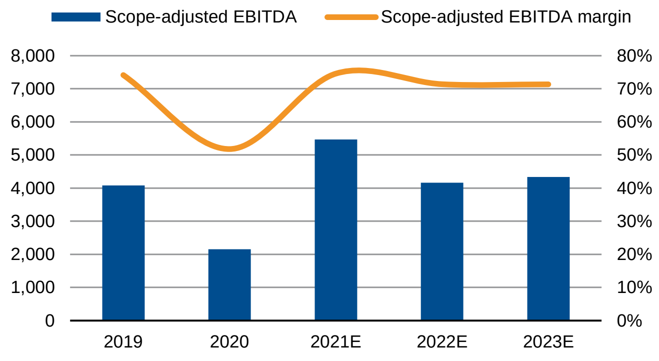
Hafslund Eco is actively seeking out collaboration and strategic alliances, as demonstrated by its offshore wind power project, the 'Ladeklar' (ready-to-charge) business or the NorthConnect project. Although these initiatives could increase diversification over time, we believe it is more likely that Hafslund Eco reduces its stakes to realise value, rather than establishing meaningful profitable diversification from these projects in the near future.

Figure 2: Breakdown of normalised Scope-adjusted EBITDA



Source: Company, Scope

Figure 3: EBITDA (NOK m, LHS) & margin development



Source: Company, Scope

Strong and volatile operating profitability

Hafslund Eco's profitability margins are very high due to its dominant hydropower production share and its 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 in the Nordic region, but the group still managed to report a margin above 50%. Although, this indicates some volatility from the normalised 70% margin we apply for this company, its profitability exceeds relevant peers, and is a positive driver for the overall competitive positioning. Although we are not incorporating the 50% Eidsiva share when calculating EBITDA margins, we take its dividend into account when we assess the volatility of the Scope-adjusted profitability.

The company's dynamic framework for hedging includes both shorter financial derivative contracts, and longer bilateral industrial contracts and PPAs. The latter contract structures have increased focus, exemplified by the recent long-term power agreements with Norsk Hydro to reduce risk relating to future cash flows from its power production segment. The overall hedging level will vary based on the Group's power price market outlook and anticipated risk-bearing capacity. in the shorter term, it could be up to half of the anticipated produced volume but is currently lower. The group is also engaged in trading activities, which are intended to generate a positive long-term return and provide analytical input for the group but are insignificant in terms of overall volume at risk.

Financial risk profile

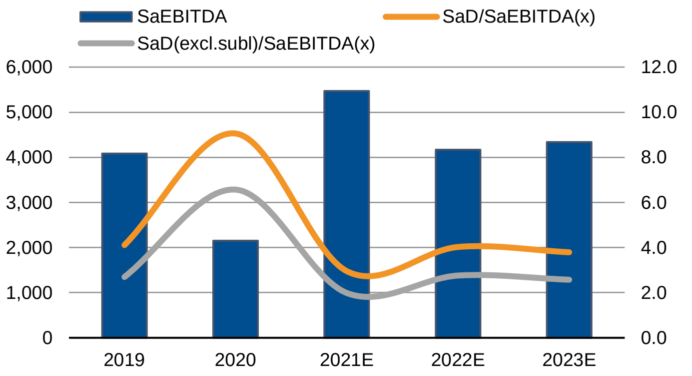
Although Hafslund Eco has a long corporate history, the group changed materially in Q3 2019 in connection with the asset swap transaction with Eidsiva Energi. Thus, our financial assessments put less weight on historical data and more weight on the forecast.

Adjustments and subordinated loans

In terms of adjustment and 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, we however, include the recurring dividend from Eidsiva in our credit metrics.

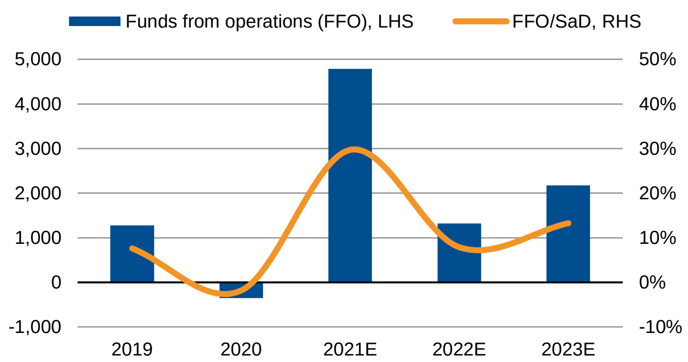
The company also has three subordinated loans (from the City of Oslo, Oslo Energi Holding which is 100% owned by the City of Oslo and Eidsiva Energi), which are included in Scope-adjusted debt (NOK 5.3bn[1] in total). However, given their characteristics of always having longer tenor than senior unsecured debt outstanding, no instalments, and incurrence tests before interest is paid (in the event of reported loss), we see these loans as somewhat quasi equity and thus show the leverage metrics with and without subordinated debt, to improve transparency about the leverage.

Figure 4: EBITDA NOKm (LHS) and leverage x (RHS)



Source: Company, Scope

Figure 5: FFO in NOK m, and FFO/SaD (%)



Source: Company, Scope

Return to more normalised leverage and interest cover ratios in 2021

The financial risk profile in Hafslund Eco has experienced some volatility in selected credit metrics the last two years, due to market conditions and a relatively large exposure to the volatility in power prices. Although last year showed negative operating cash flow and weak financial credit ratios, we expect 2021 metrics to move back into more normalised levels, given the significantly improved market prices achieved this year. The interest cover has been below 7x in the recent past, but is expected to stay above this threshold going forward. When we include the subordinated loans in the Scope-adjusted leverage calculation, leverage is expected to stay in the 3x-4x range in the medium term, while excluding the subordinated loans, the ratio will be more in the 2x-3x area. In terms of triggering our rating action levels, we see this ratio level being approximately in the midpoint between the two calculation methods.

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

- Strong recovery in revenue in 2021, due to higher achieved power prices, but also above normal production level.
  - For 2022 and beyond, we use forward market prices as guidance and normalised annual production output of 18TWh.
- Lower taxes paid in 2021, due to the low result in 2020, while 2022 is assumed to be back at more normalised and higher tax levels again.

[1] In a planned transaction where Hafslund Eco intends to merge Hafslund Eco AS with Oslo Energi Holding AS (OEH) in H2 2021, it will the reduce subordinated loans outstanding by NOK 0.1bn, i.e. the subordinated loan of NOK 1.1 bn from OEH will be replaced by a subordinated loan of NOK 1.0 bn from the City of Oslo.

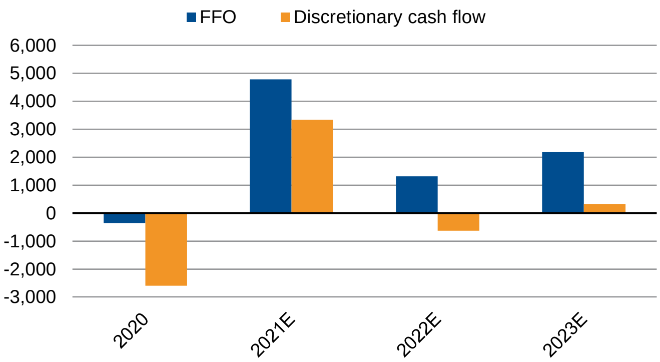
Expectation of positive FOCF over time

The volatility in cash flow is evident for this company, due to its high exposure towards power production and fluctuating market prices. In addition, we have the tax regime, which could make any particular year even more volatile. Thus, we judge the cash flow generation over time. Although we acknowledge that exceptional years like 2020 could occur, giving negative operating cash flow, we expect Hafslund Eco to report positive free cash flow over time. This is helped by its low-cost hydro power production. In our forecast, we expect discretionary cash flow to be largely break-even in the medium term, in absent of any major expansionary investment plans.

Most of the capex expected the next three to five years are related to maintenance of various hydro production plants, and also upgrades and improvements of reservoirs and dams. Investments in 2020, include the completion of the power plant Nedre Otta, and Tolga and Mork which according to plan shall be completed in 2021. The last two years, the annual capex level has been around NOK 0.6bn-0.7bn, a level we also expect for the short to medium term. We have not assumed any major expansionary capex investments in the New Energy business, except for the agreed controllable expansion in the 'Ladeklar' business.

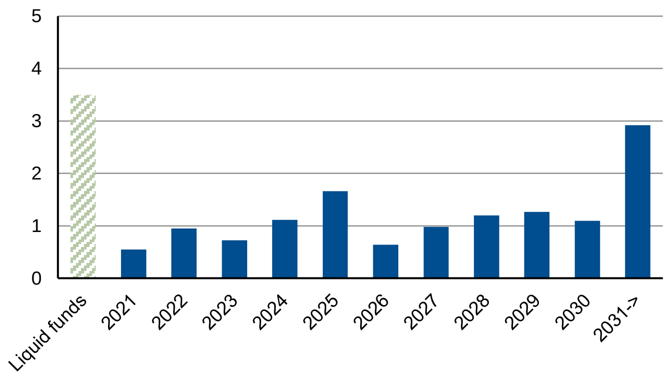
With respect to the numbers behind the discretionary cash flow expectations, we assume annual dividends paid to Hafslund Eco to be around NOK 400m p.a., while the dividend payout from Hafslund Eco to its owner will average around 70% of profit after tax.

Figure 6: FOCF and discretionary cash flow, in NOK m



Source: Company, Scope

Figure 7: Liquid funds & debt maturity as of Jun2021 (NOK m)



Source: Company, Scope

Adequate liquidity and well distributed maturity schedule

At YE 2020, the company had NOK 1bn in cash and NOK 2.5bn in long term undrawn credit lines, which was well above the short-term debt maturity at that time (NOK 1.8bn). The company also has NOK 400m in overdraft facilities and EUR 50m in an additional operating liquidity facility. Since year end, the company has established a green framework for financing and raised a 5-year NOK 500m green bond in March 2021 which has improved the liquidity further. Going forward, the debt maturity schedule is averaging around NOK 1bn p.a. the next few years, indicating a relatively evenly distributed debt profile as seen in figure 7.

Supplementary rating drivers

Prudent financial policy

We make no adjustment for financial policy, but notes that the company actively monitors quantitative and qualitative factors that affect the Group's creditworthiness in order to have high flexibility and maintain a high credit rating. The Group aims to achieve cash flows that ensure competitive returns for the owner through dividends without disadvantaging the Group's creditors. The latter was evident during 2020, when the Board awaited more clarity on the negative results effect before deciding on the final 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 (GRE) methodology 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 municipality ownership, but without 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 a having stable taxable income and thus among the better municipalities to have the capacity to support[2].

Governance and structure

We see the structure and setup of Hafslund Eco as a relatively complex one, following the transaction with Eidsiva Energi on 30 September 2019. The so-called 'look through approach' which has been set up for accounting purposes, is being used and approved to avoid double accounting, which seems fair and good to us. Capital in the group is moved through a combination of dividends and loans to subsidiaries. We also acknowledge its well-integrated ESG framework and ambitions, including publications of green financing reports.

Long-term and short-term debt ratings

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

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.

[2] *although lower than the Norwegian State directly, which we clearly assess as very high.*

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