Research Update:

Ellevio AB Outlook Revised To Stable From Negative On Improving Regulatory Environment; Issue Ratings Affirmed

July 12, 2021

Rating Action Overview

- The regulatory environment for Swedish distribution system operators (DSOs) is changing after the regulator set the weighted-average cost of capital (WACC) at 2.16% two years ago, with a recent court ruling and the possibility to roll over under-recovered funds being positive factors.
- With the possibility to roll over from previous periods, and an established WACC of at least 2.35%, we expect Ellevio's funds from operations (FFO) to debt at 6%-8% and debt to EBITDA below 10x for its senior debt over 2021-2022.
- We therefore revised our outlook on the company's debt to stable from negative and affirmed our 'BBB' issue rating on the class A debt and our 'BB+' issue rating on the class B debt.
- The stable outlook reflects the stabilizing situation regarding the Swedish regulatory framework, although we recognize the final court outcome is pending; and our expectation that Ellevio's credit ratios would be maintained above 6%.

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Rating Action Rationale

The Swedish regulatory framework has improved for DSOs, although the situation is evolving. In May this year, the Swedish parliament passed legislation allowing DSOs to carry forward under-recovered amounts for investments from regulatory periods 1 (2012-2015) and 2 (2016-2019) to the current one (2020-2023) and the following period under certain conditions. In our view, this signals a broad understanding for increased investments, triggered by the increasing pace of the energy transition. For Ellevio, this meant about Swedish krona (SEK) 2 billion of increased allowed revenue not fully used from earlier periods. The reason behind the unused amounts is because of court proceedings from regulatory period 1 and 2, where DSOs appealed the announced WACC. In both cases, courts ruled in favor of DSOs, increasing the WACC to 6.5% from 5.2% in period 1 and to 5.85% from 4.53% in period 2. The regulator appealed the court decision regarding regulatory period 3, but in February this year, courts ruled in favor of the

DSOs. (For more information, see "Swedish Electricity DSOs Remain In Limbo As The Regulator Appeals Court Decision On Their Remuneration," published March 18, 2021, on RatingsDirect.) We believe it's likely that the appeal's ruling will not be released until a ruling from a similar case with the EU Commission against Germany in the EU Court of Justice, which we expect before the end of the year. We continue to assess the Swedish regulatory framework as very supportive because we view positively that the legal process effectively shields the framework from being a politicized regulatory process and proves that DSOs can challenge decisions in court, but also a favorable environment for cost coverage and investments. We expect Ellevio to increase its investment in the current regulatory period to about SEK13.6 billion, compared with SEK10.9 billion in the previous period.

We expect WACC of no lower than 2.35%; a higher rate would likely result in Ellevio increasing shareholder remuneration, implying little change in the financial position. On Feb. 26, 2021, courts ruled that the Swedish Energy Market Inspectorate did not adhere to the framework and laws when lowering the WACC to 2.35% over 2020-2023, and requested the regulator recalibrate the WACC parameters. Given this uncertainty, when forecasting for Swedish DSOs in 2021, we will continue to assume a WACC of 2.35%, which we understand is the regulator's guidance. We view this as the lowest possible scenario, given that the outcome from the court proceedings cannot result in a lower WACC. Also, any WACC increase would apply for the full regulatory period (2020-2023). Also, a catch-up mechanism in the system would allow Ellevio to be compensated for the full period, which we view positively. The collection could take place over more than one regulatory period. Using the same method as that in the previous regulatory period, the WACC would be calculated at about 5% according to our estimates. Even if the WACC rises from 2.35%, we believe that it would increase Ellevio earnings and cash flow; we also expect that the company would start paying interest on its shareholder loans. An increased WACC would therefore likely not lead to any meaningful improvement on credit ratios. We expect FFO to debt above 6%-8% and debt to EBITDA below 10x for the senior debt, and about 6% and below 12x, respectively, for its total debt.

Structural features in the senior secured debt continue to support the rating. Ellevio is the borrower under a ring-fencing structure, with two classes of debt--senior class A debt and subordinated class B debt. Under our methodology, we look at:

- The senior debt ratios only to determine the class A debt rating, which is one notch above the senior credit quality (stand-alone credit profile [SACP]) of 'bbb-'; and
- The consolidated debt ratios only to determine the class B (total debt) rating, which is two notches below the class A debt or at the same level as the 'bb+' consolidated SACP, whichever is lower.

The senior debt's SACP benefits one notch uplift due to various structural features designed to increase cash flow certainty for debtholders. These include restricted payment conditions and a covenanted liquidity structure that should, in our opinion, enabling Ellevio to manage temporary cash flow shocks. The debtholders benefit from the following features, which include:

- Two levels of financial covenants (trigger events and events of default) and an automatic 12-month standstill period after an event of default; and
- A liquidity facility available if the group enters a standstill and that is sufficient to cover finance charges for at least 12 months. The liquidity facility was undrawn as of June 30, 2021.

Outlook

The stable outlook reflects our expectation that the company's EBITDA and FFO will continue increasing, driven by our expectation that the WACC will not be below 2.35% for the current regulatory period. The outlook also reflects that Ellevio will continue to adjust shareholder remuneration to protect the rating if needed, for example not paying interest on its shareholder loans if the WACC remains at 2.35%. On the other hand, we also expect that the company would pay shareholder remuneration if WACC increases from 2.35%. We expect FFO to debt above 8% and debt to EBITDA below 10x throughout that period for the senior debt and debt to EBITDA below 12x for all (including subordinated) debt, which we consider commensurate with the 'BBB' issue rating for senior debt and the 'BB-' issue rating for subordinated debt.

Downside scenario

We could lower the ratings if Ellevio was unable to exercise flexibility in its financial policy, for example, by increasing shareholder remuneration or lowering capital expenditure (capex), and this resulted in FFO to debt below 6% or debt to EBITDA above 10x for the senior debt, which would most likely be triggered by shareholder renumeration. We could lower the subordinated debt rating if we lower the senior debt rating or if debt to EBITDA rises above 12x at the consolidated level, including subordinated debt.

Upside scenario

We believe that a positive rating action is unlikely. We believe that even if the WACC would increase significantly because of a favorable court ruling, so Ellevio would increase its shareholder remuneration and maintain FFO to debt that is commensurate with a 'bbb-' SACP. We could, however, consider an upgrade if the company were to commit to a deleveraging plan, resulting in FFO to debt sustainably above 8% and debt to EBITDA below 9x for senior debt. We view this as unlikely over the outlook horizon, given the business plan.

Company Description

Together with Vattenfall and E.ON, Ellevio is one of the three largest electricity DSOs in Sweden. Its market share, in terms of customers, is about 18%. It has about 966,000 customers and operates in four Swedish regional areas, with the majority of its customers in the Stockholm area. It has in total 78,500 kilometers of power lines, and distributed 26 terawatt-hours in 2020. As well as delivering electricity, Ellevio is responsible for maintaining and developing its network.

The Government and Energy Markets Inspectorate regulates all of Ellevio's operations, primarily through the Swedish Electricity Act, and by different ordinances. In 2020, the company reported sales of almost SEK7.0 billion and EBITDA of SEK3.6 billion (€360 million equivalent).

Ellevio is owned by Omers Infrastructure Holdings (formerly Borealis Infrastructure Management; with a 50% share); two of the Swedish states' buffer funds within the national pension system, AP3 (20%) and AP1 (12.5%); and Folksam (17.5%), which acquired Ellevio from Fortum Oyj for about SEK61 billion in June 2015.

Our Base-Case Scenario

Assumptions

- WACC of at least 2.35%, resulting in flat-to-2% higher revenue annually.
- RAB to increase to about SEK43 billion by year-end 2023 from about SEK37 billion at end of 2020.
- EBITDA margins of 54%-57% for the current regulatory period.
- DSOs carrying forward any under-recovered funds from previous periods, which for Ellevio means about SEK2 billion.
- Capex of about SEK3.5 billion to SEK3.8 billion in 2021 and 2022. We then expect capex to decline toward SEK2.8 billion-SEK3.0 billion in 2023.
- Subordinated debt not exceeding 10% of total debt.
- No shareholder remuneration in 2021, but shareholder remuneration could resume in 2022 if WACC is higher than 2.35%.

Key metrics

Ellevio AB--Key Metrics

	--Fiscal year ended Dec. 31--				
(Mil. SEK)	2019	2020	2021e	2022f	2023f
EBITDA	3,986	3,740	3,600-3,800	3,800-4,000	3,800-4,200
FFO	2,756	2,637	2,600-2,800	2,700-2,900	2,700-3,100
Class A--FFO to debt (%)	7.6	7.4	7.0-8.0	7.0-8.0	7.0-8.0
Class A--Debt to EBITDA (x)	9.1	9.5	9.5-9.9	9.5-9.9	9.5-9.9
Total debt--FFO to debt (%)	7	6.6	6.0-7.0	6.0-7.0	6.0-7.0
Total debt--Debt to EBITDA (x)	9.8	10.6	10.0-11.0	10.0-11.0	10.0-11.0

*All figures adjusted by S&P Global Ratings. a--Actual. e--Estimate. f--Forecast. RAB--Regulatory asset base. FFO--Funds from operations. SEK--Swedish krona.

Liquidity

We view Ellevio's liquidity as strong and expect this to continue. We believe that available liquidity sources should exceed forecast near-term cash outflows by about 1.8x. In our assessment of liquidity, we also factor in qualitative factors such as the company's sound relationships with banks, satisfactory standing in credit markets, and likely ability to absorb high-impact, low-probability events with limited refinancing. We assume that Ellevio will maintain adequate headroom under its financial covenants.

Principal liquidity sources as of June 30, 2021, include:

- Forecast FFO of about SEK2.6 billion
- Access to committed credit lines of about SEK7.5 billion.

Principal liquidity uses for the same period include:

- Capex of about SEK3.6 billion over the next 12 months.
- Debt repayment of SEK300 million in that time.
- Shareholder remuneration of about SEK1.5 billion in the coming 12 months.

Covenants

The credit facility contains covenants for lock-up of 10.75x; and for default, stipulating debt to EBITDA of 12.00x and interest coverage of 1.7x and 1.2x for senior debt. It also contains lock-up and default covenants for total debt, with debt to EBITDA at 11.9x and 13.0x, respectively. Ellevio complies with the debt-maturity limitations in the documentation and has met all of its financial covenants before.

Issue Ratings - Subordination Risk Analysis

Capital structure

Ellevio is the operating company in the Ellevio group, which comprises four holding companies. The ultimate owners are international investor OMERS Infrastructure; two Swedish national pension funds (AP3 and AP1); and Swedish mutual insurance company Folksam. Following debt refinancing, Ellevio and its immediate holding company, Ellevio Holding 4 AB, have formed a ring-fenced financing structure, with Ellevio as the borrower.

Analytical conclusions

Ellevio issues two types of debt: senior (class A) and subordinated (class B). We analyze the group in two steps because we assess the subordinated debt as having a greater risk of default than the senior debt. This is because the subordinated debt would be paid after the senior debt, and has no claim on the security until the senior debt is paid, and its default could not cause the senior debt to default.

- We rate the class A debt 'BBB' based on credit metrics excluding the subordinated debt, and including one notch of uplift for various structural features, in particular the additional protection from the deferral of the subordinated debt interest and principal if the financing group had insufficient cash to make the payments due.
- We rate the class B debt 'BB+' based on credit metrics including for senior and subordinated debt.

We rate Ellevio's senior secured debt one notch higher than the SACP because of structural features designed to increase cash flow certainty for the debtholders. These features include:

- Restrictions on mergers, acquisitions, and asset disposals; and a share pledge over the assets and shares of the operating and holding company (to the extent allowed by legislation). Security over fixed assets, such as real property and business mortgages are, however, not material in relation to secured debt;

- Dividend- and debt-restricted payment conditions and a covenanted liquidity structure that should, in our opinion, allow Ellevio's financing group to manage temporary cash flow shocks;
- An automatic 12-month standstill period after an event of default, during which time creditors can take control of Ellevio and either aim for operational recovery or sell the shares in the operating and immediate holding company.
- Prudent management of foreign exchange, refinancing, and counterparty risks.

Ratings Score Snapshot

Class A Issue Rating: BBB/Stable

Business risk: Excellent

- Country risk: Very low
- Industry risk: Very low
- Competitive position: Strong

Financial risk: Aggressive

- Cash flow/leverage: Aggressive (low volatility table)

Anchor: bbb

Modifiers

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

Stand-alone credit profile: bbb-

- Structural enhanced debt: +1 notch

Class B Issue Rating: BB+/Stable

Business risk: Excellent

- Country risk: Very low
- Industry risk: Very low
- Competitive position: Strong

Financial risk: Highly leveraged

- Cash flow/leverage: Highly leveraged (low volatility table)

Anchor: bbb-

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
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- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory
- Comparable rating analysis: Negative (-1 notch)

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | Utilities: Rating Structurally Enhanced Debt Issued By Regulated Utilities And Transportation Infrastructure Businesses, Feb. 24, 2016
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | General: The Treatment Of Non-Common Equity Financing In Nonfinancial Corporate Entities, April 29, 2014
- Criteria | Corporates | Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, 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

Related Research

- Swedish Electricity DSOs Remain In Limbo As The Regulator Appeals Court Decision On Their Remuneration, March 18, 2021
- Credit FAQ: Are Regulatory Framework Changes Threatening The Credit Quality Of Swedish DSOs?, Aug. 21, 2019

Ratings List

Ratings Affirmed: Outlook Action	To	From
Ellevio AB		
Senior Secured	BBB/Stable	BBB/Negative
Subordinated	BB+/Stable	BB+/Negative