FitchRatings

Fitch Affirms EDF at 'A-'; Stable Outlook

Fitch Ratings - Milan - 29 August 2019:

Fitch Ratings has affirmed Electricite de France's (EDF) Long-Term Issuer Default Rating (IDR) and senior unsecured rating at 'A-'.

Fitch has also affirmed subsidiary EDF Energy Nuclear Generation Limited's (EDF ENGL) Long-Term IDR at 'A-', reflecting the company's strong links with the parent. The Outlooks on the Long-Term IDRs are Stable.

The rating affirmation reflects the group's continuing strong business profile, based on a clean and profitable asset base and dominant market position in France, better than expected results in 2018 and a commitment to moderate leverage. On the other hand, it also considers a fairly rigid cost and capex structure (partially related to an ageing nuclear fleet), ongoing problems with new nuclear, a penalising market structure due to the ARENH (Acces regule a l'electricite nucleaire historique) mechanism and structurally negative free cash flows (FCF) based on Fitch's definition and forecast.

We expect EDF to achieve a moderate increase in EBITDA and funds from operations (FFO) adjusted net leverage to average 3.9x through 2022, with moderate headroom for the rating. We estimate regulated & contracted EBITDA at 40%-50% of total, some way below that of main peers. EDF's Long-Term IDR reflects the company's standalone credit profile applying Fitch's criteria for Government Related Entities.

RATING ACTIONS

ENTITY/DEBT	RATING		PRIOR
Electricite de France (EDF)	LT IDR A- ⭘ Affirmed		A- ⭘
	ST IDR F2 Affirmed		F2
senior unsecured	LT A- Affirmed		A-
subordinated	LT BBB Affirmed		BBB
EDF Energy Nuclear Generation Limited	LT IDR A- ⭘ Affirmed		A- ⭘

Key Rating Drivers

Strong Market Positions: EDF is the incumbent utilities operator in France with 83GW of nuclear and hydro capacity, matched by supply activity with market shares of around 80% of the domestic residential market and around 60% of the non-residential market. Competition in France is gradually eroding the group's market share (especially in non-residential), but EDF remains the clear leader for the foreseeable future.

The group has a regulatory asset base (RAB) of EUR51 billion in electricity distribution in France, and regulated and contracted EBITDA accounts for 40%-50% of total, helping to stabilise earnings. EDF also has a solid market position in renewables, with 9.7GW of net installed capacity worldwide (excluding hydro) and a pipeline of 34.4GW at June 2019, as well as in generation and supply in the UK and, to a lesser extent, Italy.

Current Price Mechanism in France: The ARENH, introduced in France in 2011 to protect customers and foster competition, currently represents the reference price (at 42EUR/MWh) for around 70%-75% of EDF's French electricity sales, without providing any protection in case of a market downturn (it acts as a cap but not as a floor). The remaining 25%-30% of French electricity sales is fully exposed to the market trends, mitigated by hedging transactions.

Potential Market Reform in France: The ARENH is currently under revision, potentially both in terms of price and amount of electricity, but more generally the government is working on a new market structure for existing nuclear fleet, potentially including a cap and floor corridor for prices. Even if there is no visibility on the final outcome of the reform (which will also need to be backed by the European Commission), we believe that the government's endorsement of market reform is a positive development for EDF. The reform would also be a pre-requisite for the group's reorganisation, which based on recent press reports could see EDF being split into 'EDF Blue' (which could potentially include nuclear, hydro) and 'EDF Green' (remaining activities).

Rising Nuclear Production, Uncertainties Remain: In 2018 EDF's nuclear production increased 2.4% yoy to 393TWh, after 2017 was hit by unplanned outages at some plants. EDF guides at a broadly flat production of 395TWh in 2019. However, the average age of the nuclear fleet and the high number of safety inspections expected in the coming years as part of the Grand Carenage programme reduce visibility on medium-term nuclear production. In the UK we expect a decline of nuclear production to around 51TWh in 2019 due to inspection at Hunterston B and extended unplanned outage at Dungeness B, with a rebound from 2020 to around 60TWh.

EPR Technology Delays: The business risk of new nuclear should fall as EPR technology starts to enter commercial service, specifically in China. However, at Flamanville in June 2019 the French Nuclear Safety Authority (ASN) said that EDF has to repair eight welds in the containment building before commissioning the reactor, which was expected for late 2019. EDF should update the market on the revised schedule and additional costs in this respect in the upcoming weeks. Commissioning cannot be expected before end of 2022.

Rising Costs for Hinkley Point C: Hinkley Point C (HPC), the other key nuclear project of EDF, saw an estimated construction cost increase of GBP1.5 billion (2015 real terms, around 8% of the initial cost estimate) in July 2017 and further extra costs cannot be ruled out, with the commissioning of Unit 1 expected for end-2025. Fitch's rating case is based on EUR2 billion-EUR2.5 billion of capex each year through 2022 for HPC. As renewables become more competitive, delays may further weaken the economics of nuclear.

Improving Price Environment: Given the clean asset base, EDF is firmly positioned to take advantage of the surge in CO2 prices and consequently in wholesale prices across Europe in the last 12-to-18 months. The benefits of this trend are substantially mitigated by the ARENH mechanism; however, we expect some improvement in margins to materialize, as hedges made in a worse price environment are rolled off, leading to increasing EBITDA for France generation. We also expect improved EBITDA visibility in the UK and Italy generation from the reinstatement and the introduction of the capacity market, respectively.

Rigid Capex: With increased public concern over nuclear safety, the sector's strong commitment to renewables development and investments needed for the electricity distribution network, EDF has low flexibility over capex, in our view. Management guided to total net capex of around EUR15 billion per year, which we see as a recurring value also in the medium term, as capex reduction in some items (such as the smart meters roll-out project Linky) could be offset by an increase in other developments, including renewables and HPC.

Negative FCF: Fitch's defined FCF (which does not include proceeds from disposals) has been negative in the range of EUR5.5 billion-EUR6 billion in 2017-2018 and we expect this trend to persist also during the plan period 2019-2022. Dividends cash out will remain very low, as the State has committed to scrip dividend in relation to net income of 2019-2020. In autumn 2018 EDF completed its EUR10 billion asset disposal plan for 2015-2020. New disposals targeted for 2019-2020 of EUR2 billion-EUR3 billion were partially achieved in early 2019 (mainly a minority stake in Alpiq and oil&gas activities of Edison).

Good Performance in 2018, Flat 1H19: EDF's performance in 2018 has been overall positive, with reported EBITDA increasing 11.1%, mainly due to higher margins in France generation and trading. EDF achieved its targets also for disposals and reported leverage, amongst others. Based on Fitch's definition, higher FFO (up 33% yoy) translated into a decrease of FFO adjusted net leverage to 3.5x from 4.1x in 2017. In 1H19, EBITDA was flat yoy (i.e. without considering IFRS 16 and at constant business scope), while reported net debt decreased slightly by EUR0.5 billion to EUR37.4 billion excluding the IFRS 16 impact.

Alignment of EDF UK ENGL's IDR: We believe it is appropriate to align the ratings of EDF ENGL with its 80% ultimate parent EDF, on the back of strong operational and strategic ties and moderate-to-strong legal ties between the two companies. All EDF ENGL's cash is pooled with EDF's, consistent with the latter's financial policy, and there is no external debt at EDF ENGL. Moreover, both entities are integrated in terms of management and operations. EDF ENGL is the largest subsidiary of EDF, at around 12% of the group's nuclear capacity. We believe that the possible sale by Centrica of its 20% economic interest in EDF ENGL is unlikely to affect our view of EDF ENGL's links with EDF.

No Impact from GRE: The French State has a strong ownership (83.7% stake) and control of EDF, but we deem the support track record as weak. The socio-political impact of default is moderate, as we expect the vast majority of EDF facilities to remain operational even in the event of a financial default (i.e. provision of service and employment continue) and the financial impact of a default is weak, since EDF's gross debt is equivalent to around 3% of national GDP and around 4% of government debt.

Derivation Summary

We estimate regulated & contracted EBITDA at around 50% of total, some way below that of peers Engie S.A. (A/Stable), Enel S.p.A. (A-/Stable), Iberdrola S.A. and E.ON SE (BBB+/Stable). We believe that the debt capacity of the mentioned companies is similar, since EDF compensates its lower regulated EBITDA proportion with a clean and low-cost asset base, an incumbent position in France and a good country mix exposure. As a consequence, the rating differential mainly reflects different levels of FFO adjusted net leverage, which we forecast slightly below 4.0x through 2022 for EDF, similar to Enel's. Compared with peers' EDF's financial profile is penalised by negative FCF expected across its business plan.

Key Assumptions

Fitch's Key Assumptions within our Rating Case for the Issuer

France Generation & Supply

- French nuclear output stands at around 385TWh for 2019-2022

- French hydro low at 32TWh in 2019, but recovering to around 35TWh for 2020-2022

- Market prices in France trending towards EUR48-50/MWh for 2019-2022 (for unhedged production)

- Net market purchases to continue through 2019-2022, with current forwards consistently above EUR42/MWh, assuming no reform of ARENH

France Regulated Business

- Enedis' EBITDA to follow regulated tariff increases (for example up 2.3% in August 2019); Linky to start contributing to EBITDA from 2020

- Other regulated EBITDA to grow around 2.5% per year

UK Generation &Supply

- UK nuclear output at around 60TWh in 2020-2022, recovering from the low 51TWh expected in 2019 (it was 59TWh in 2018 and above 60TWh in previous years)

- Capacity market revenues in 2020 to include also the amounts related to the period in which the capacity market has been suspended

- Supply EBITDA margins of 1% through 2022 vs. 2% in 2017-2018

Italy Electricity & Gas

- Market electricity price to converge at around EUR55/MWh in 2021-2022

Group

- Cash tax as per guidance; cost of new funding at 3%

- Allocations to dedicated assets related to nuclear provisions higher than management guidance; higher capex to include extra costs at Flamanville3

- Cash dividends assumed at 50% of prior year net income excluding non-recurring items; French State to scrip for the balance of 2018 dividends and dividends related to 2019-2020

- Asset disposals as per guidance

RATING SENSITIVITIES

Developments That May, Individually or Collectively, Lead to Positive Rating Action

- FFO adjusted net leverage below 3.5x on a sustained basis (2018: 3.5x)

- FFO fixed charge cover above 4.0x on a sustained basis (2018: 4.6x)

- Sustained reduction in negative FCF

- Market reform for nuclear in France leading to higher cash flow visibility, for example through a cap-and-floor mechanism

Developments That May, Individually or Collectively, Lead to Negative Rating Action

- FFO adjusted net leverage above 4.2x on a sustained basis

- FFO fixed charge cover below 3.5x on a sustained basis

- A substantial decline in electricity prices in France, UK and Italy

- Adverse impact on margins from market reform in France, due for example to the expansion of the ARENH mechanism at below-market conditions

Liquidity and Debt Structure

At 31 December 2018, EDF had readily available cash comprising cash and cash equivalents of EUR3.1 billion, liquid assets of EUR19 billion and committed undrawn facilities of EUR11.3 billion, of which EUR3.2 billion would mature within one year. This means that EDF can cover scheduled debt maturities (EUR11.3 billion for 2019-2020), capex and operating requirements into 2020 without resorting to additional debt issue.

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Additional information is available on www.fitchratings.com

Applicable Criteria

Corporates Notching and Recovery Ratings Criteria (pub. 23 Mar 2018)
Parent and Subsidiary Rating Linkage (pub. 16 Jul 2018)
Government-Related Entities Rating Criteria (pub. 25 Oct 2018)
Corporate Rating Criteria (pub. 19 Feb 2019)
Short-Term Ratings Criteria (pub. 02 May 2019)

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