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Research

Energy Co. Electricite de France Outlook Revised To Negative On Lower 2018 EBITDA Guidance; 'A-/A-2' Ratings Affirmed

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- Electricite de France (EDF) has revised downward its EBITDA guidance for 2018, and while the revision is largely due to one-offs, we now foresee uncertainty in the improvement of EDF's credit metrics.
- We note that this is partly offset by debt reduction achieved by the group earlier this year, and that recent improvement in power prices may improve the group's cash flows from 2019.
- Consequently, we are revising our outlook on EDF to negative from stable, and affirming our 'A-/A-2' ratings on the company.
- The negative outlook reflects the weaker-than-expected recovery in EBITDA next year, resulting in prolonged low headroom in credit metrics over 2017-2018, as well as our increased concern of upward trending adjusted debt over 2018-2020.

PARIS (S&P Global Ratings) Nov. 20, 2017--S&P Global Ratings today revised its outlook on French integrated energy company Electricite de France S.A. (EDF) to negative from stable. We affirmed our 'A-' long-term and 'A-2' short-term corporate credit ratings on EDF.

In addition, we revised the outlook to negative from stable on EDF's U.K. subsidiaries EDF Energy PLC and EDF Energy Customers PLC. We affirmed our 'BBB-/A-3' long- and short-term corporate credit ratings on EDF Energy PLC and our 'BBB-' long-term corporate credit rating on EDF Energy Customers PLC.

At the same time, we affirmed the 'A-' issue rating on EDF's senior unsecured facilities, the 'BB' issue rating on EDF's junior subordinated facilities (i.e., its hybrids), and the 'A-2' issue ratings on EDF's commercial paper.

The outlook revision follows EDF's downward revision of its EBITDA guidance for 2018 to €14.6 billion-€15.3 billion, from at or higher than €15.2 billion previously, that it announced last week, after an earlier revision to 2017 guidance. The key reasons behind EDF's revision are mostly one-offs and include:

- Lower-than-expected electricity consumption in France, with a 0.3% reduction in 2018 distributed volumes now expected by Enedis (the distribution subsidiary of EDF), with an estimated net effect of EBITDA of €300 million (such shortfall are however recovered in subsequent years as per the regulation);
- Less-than-expected availability of nuclear reactors in early 2018, during winter when power prices are higher, with an estimated net effect on EBITDA of about €200 million; and
- Potential unfavorable arbitrage risks related to the French regulated power price framework ARENH, among other elements.

The outlook revision also reflects increased pressure on the ratings that we see due to:

- Lower-than-expected EBITDA in 2017 and 2018, which together with other factors lead us to revise our debt forecasts up by about €2 billion over 2017-2018. This is partly offset by debt-reduction efforts launched by the company in 2016;
- Some new negative structural evolution in operations, including greater competitive pressure in France and the U.K.;
- Our medium-term concern that EDF's remedial actions (2017 capital increase, disposals, cost cutting, and scrip dividends) will not lead to lasting debt reduction, with the adjusted debt forecast trending back toward previous levels by 2019. Notably, we expect free cash flows will remain negative in and post 2018, given the substantial investment program, and despite our expectation of a more pronounced rebound in earnings in 2019, in addition to discounting impacts on the company's sizable nuclear liabilities (close to €45 billion at year-end 2016);
- The lack of concrete progress and clarity on any evolution of the market design or regulatory framework (notably the ARENH) that will support EDF's business model post 2018.

Our assessment of EDF's business risk profile as strong reflects the company's significant size as one of the largest integrated utilities in the world; its position as the dominant player in France in energy generation, distribution, and supply; and leading positions in the U.K. and Italian power generation markets. The substantial share of regulated networks in the portfolio (31%) and a portfolio of contracted renewables that still contributes a relatively small share of earnings also support the strong assessment.

Factors that constrain our assessment of EDF's business risk profile include the increasing share of revenues from unregulated activities following the partial liberalization of the French energy market. In addition, we consider in our assessment EDF's higher exposure to volatile power prices and the predominance of largely fixed-cost nuclear and hydro operations, which together account for about 80% of the group's annual output. EDF relies heavily on nuclear operations, which implies technology concentration compared with peers.

The group's financial risk profile is constrained, in our view, by relatively high leverage (with S&P Global Ratings-adjusted debt to EBITDA rising above 4.5x over 2017-2018), with significant nonfinancial liabilities from pensions and the nuclear operations, and a sizable investment plan leading to negative cash flows. Strong liquidity, underpinned with prudent liability management and solid access to capital markets, helps mitigate these weaknesses.

For more details about EDF's business and financial risk, please refer to "Full Analysis: Electricite de France S.A.", published July 4, 2017, on RatingsDirect.

EDF's half-year 2017 results showed a massive year-on-year EBITDA decline to €7 billion (-20%), notably due to the effect of lower power prices contracted for this period and the significant nuclear outages for inspections required by the French state's Nuclear Safety Authority during the winter. We anticipated this EBITDA contraction in our base case, and we believe 2017 will be a trough year for EDF. Our adjusted debt calculation as of June 30, 2017, reached about €67 billion, comprising notably €31 billion of reported net financial debt, €16 billion of pension deficit, €10 billion of asset retirement obligations, and €5 billion of hybrids.

The negative outlook on EDF reflects the company's lower-than-anticipated operating performance in 2017 and 2018, and adjusted FFO to debt staying at 15%-16% for two consecutive years.

The negative outlook also points to our concern that, after the debt reduction achieved this year, EDF's adjusted debt may trend up more meaningfully than previously assumed (back toward previous levels by 2019). This is because of continued negative free cash flow generation (after growth investments in Hinkley Point C and Linky) and asset retirement adjustments.

This is partly offset by the positive effects stemming from the timely roll-out of the plan set by EDF and the French government to lower EDF's debt, and the potential benefit in 2019 from rising power prices.

Rating downside over the next two years is possible, if we see additional deterioration of EDF's operating performance, and an unexpected renewed downturn in power prices (albeit recently improving), or if we foresee a further delay, or a reduced likelihood, in the group's financial leverage reduction by 2019.

Other risk factors stem from potential delays or cost overruns from the group's nuclear projects currently embarked by EDF; and a material and sharp deterioration of the domestic and U.K. unregulated power markets.

Separately, if we downgrade France by more than one notch, this would trigger a downgrade of EDF. Although not anticipated, if we consider that the likelihood of extraordinary support from the French government to EDF had decreased, we could also lower the ratings on EDF.

We could revise the outlook to stable if we expect to see substantial EBITDA growth in 2019, on the back of lasting higher power prices in France and Europe, new projects coming online, or potential improvements in regulatory developments (supporting EDF's nuclear base generation in the current changed market environment). We could also revise the outlook to stable if we see a higher likelihood of FFO to debt metrics improving to provide more headroom within the 15%-18% range, together with a more sustainable long-term discretionary cash flow or debt trajectory.

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