Electric-Corporate
Germany
Special Report

German Energy and Utilities – 2009 Outlook

Analysts

Jacek Kawalczewski, CFA
+48 22 338 62 91
jacek.kawalczewski@fitchratings.com

Francesca Fraulo
+39 02 879 087 237
francesca.fraulo@fitchratings.com

Andrew Steel
+44 20 7682 7486
andrew.steel@fitchratings.com

Related Research

- *E.ON AG (May 2008)*
- *RWE AG (March 2008)*
- *Fitch: European Utilities Face Weaker Interest Cover Ratios (December 2008)*
- *Fitch: Potential Delay In Nuclear Phase-Out Beneficial For German Utilities (July 2008)*

Overview: Challenging Time Ahead in 2009

Fitch Ratings' outlook for the German energy and utilities sector in 2009 is moderately negative: electricity and gas demand will slow down as a result of the recession that is expected to affect Germany, in line with the rest of the euro area; volatility of oil prices will persist; and domestic competitive pressure will increase. Other likely developments are consolidation among Stadtwerke (municipal utilities) and possible domestic M&A activity related to the unbundling of the German transmission grids. Fitch expects that E.ON AG (Long-Term IDR 'A+'/Negative Outlook), RWE AG ('A+'/Negative), EnBW AG, and Vattenfall Europe AG, a subsidiary of Vattenfall AB ('A+'/Negative), will retain strong positions in their respective market segments, on the back of their incumbent position in generation (60% installed capacity) and energy generated (about 75%).

Leverage

In 2008 both E.ON and RWE increased their net leverage by debt funding organic growth investments and acquisitions, as well as higher dividend payments and share buy backs. The deliberate re-leveraging strategy implemented in 2008 was designed by the utilities to restore balance sheet efficiency and to reach declared leverage targets by end-2008 for E.ON, and end-2010 for RWE.

Fitch expects pressure on ratings will increase due to higher gross debt and increased borrowing costs, especially for issues placed in H208. The balance and timing between the additional cash flows and required capex related to recently acquired assets, continues to be viewed as critical in the Agency's assessment of credit quality. Pressure on current ratings might rise because of increased leverage caused by debt founded acquisitions and implementation of the capex programme. In the medium term the consequences of the utilities' leveraging strategy, if accompanied by a severe deterioration of profit margins due to falling electricity and gas prices and consumption, might provide scope for further rating actions.

Access to the Bond Markets

The German utilities RWE, EnBW and E.ON have been among the first entities to take advantage of opportunities to issue in November 2008 in what was an intermittently open bond market. E.ON was a regular and frequent issuer over the past year, and has issued more than EUR18bn of bonds since September 2007.

Fitch expects that these utilities will continue to be well placed to take advantage of potential further capital market issuance opportunities in 2009, as their ratings and risk perceptions are supported by the sector's stable and geographically diversified cash flows and relatively non-cyclical business characteristics. As German utilities have limited near-term refinancing needs (the largest is for E.ON, EUR4.3bn due in May 2009), Fitch views positively their flexibility in deciding whether or not to access the bond market during the current challenging conditions.

Borrowing Costs and Capex Plans

In 2008, the German utilities continued to implement large investment plans, which add up to more than EUR100bn, with the largest amounts planned by E.ON (EUR63bn) and RWE (EUR33bn). Substantial progress in spending in the first nine months of 2008 was mainly driven by the finalisation of some acquisitions closed in previous periods (including Endesa and OGK-4), and cash outlays related to organic growth.

The managements of German utilities confirmed recently that they will continue to strive for full implementation of their investment plans. Fitch believes, however, that this view may be revised as utilities revisit their capex programmes in light of increased borrowing costs and slowing economic growth in a number of European markets where they are active. Fitch believes that E.ON and RWE are to a certain extent protected in the near term from significant increases in their average cost of debt due to a "portfolio effect": the utilities have large portfolios of outstanding bonds spread across different maturities, which were issued at a time when pricing was substantially lower. Fitch notes, however, that if the current pricing environment is sustained in the medium term and large portions of bonds are refinanced at a more expensive level, together with new debt for the capex programmes, then it could have a major impact on coverage ratios.

The German Electricity Transmission Grid

Although the transmission assets were split into separate legal entities, the German high-voltage transmission grid is still owned and operated by four major utilities. Under huge pressure from the European Union, two of the four, E.ON and Vattenfall, have decided to dispose of their shares.

A possible alternative to selling their stakes, which is currently under consideration, is to create a national grid holding, das Netz AG. However, complex legal and administrative issues, the potential size of the transaction and also for there to be conflicts in grid management, could make the Netz AG concept unfeasible. It remains to be seen which model will be implemented in the German market, but in light of the progress made on the Vattenfall transaction and the commitment of E.ON's management, Fitch expects that these two transactions will be completed by 2010. The assets generate stable long-term cash flows, which are attractive to certain categories of financial investors like pension funds and insurance companies.

Fitch expects that the profitability of transmission system operators (TSOs) will rise on the back of improved ROE, however the allowed revenue under the complex formula, which is binding from 2009, will be determined by a TSO's ability to eliminate inefficiencies compared to a benchmark. Additionally, revenues will be reduced by a global X-factor applied by the regulator to all grid operators (1.25% p.a. for the first five-year period), but overall growth will still occur as we expect CPI to be higher than the X factor. Additionally, there are opportunities for revenue growth through expansion capex for distribution system operators (DSOs), as the expansion factor built in the revenue formula reflects number of connections and the size of the service area. The credit profile of the TSOs will continue to be driven by more stable revenues but substantially lower profitability than the generation or supply segments. The grid operators also face significant capex programmes over the coming years, related to connection and strengthening works for onshore wind parks and new power plants.

The agency believes the credit profile of the vertically integrated utilities will only be affected by the transmission grid disposal to a limited degree. This is because the loss of this stable, regulated source of cash flow, and control over the entire value chain, is likely to be mitigated by increased profitability and avoidance of large grid investments. In Fitch's opinion, the utilisation of cash proceeds from the asset disposals will be a key factor for the future rating profiles. If the sale proceeds are solely used for the benefit of shareholders then the agency would view this negatively.

Transmission Grid (380/220kV)

	Length in 000 km
RWE AG	11.3
E.ON AG	10.6
Vattenfall	9.5
EnBW	3.7

Source: Company information

Incentive-Based Regulation

Utilities are required to adjust their business models to the new incentive-based regulation from January 2009. In Fitch's opinion the increased equity return rates embedded therein will help to stimulate capex, especially related to grid connections to offshore wind farms and new power plants. The permitted ROE for new investments has been raised to 9.29% from 7.91%, and for assets constructed prior to 2006 it was increased to 7.56% from 6.50%.

Additionally the introduction of an efficiency benchmark, set by the regulator's assessment of the most effective TSO, will mean that an operator's future profitability will depend on its ability to outperform the regulator's target. Fitch believes meeting efficiency targets could be challenging and costly for the non-benchmark entities. Given the complexity of the new system being introduced, it is at present unclear which entity is likely to set the benchmark.

Stadtwerke

Germany's municipal utilities, the Stadtwerke, were always seen as a target area for domestic expansion by major incumbent utilities. However, 2008 showed that for some players further acquisitions of Stadtwerke are no longer likely to be possible. In November 2008, Germany's Federal Court of Justice ruled that E.ON and RWE would not be allowed to acquire more stakes in municipal utilities, due to the two utilities dominance of the German power market.

Despite this court ruling, Fitch believes that Stadtwerke will still be at the centre of developments in the German energy sector in 2009. The agency notes that the budget problems of their municipal owners, their likely decline in profitability due to harsh power and gas grid regulation, and deteriorating access to external debt from the banking sector are factors likely to promote a consolidation wave and/or investment opportunities for EnBW and Vattenfall. The latter are seeking a stable, local client base, and have already declared increased interest in acquiring local utilities.

In 2009, Fitch does not expect major progress on the sale of E.ON's Stadtwerke holding company Thüga, which comprises E.ON's shares in more than 100 municipal utilities, as the size and complexity of the transaction (valuations and legal constraints) is likely to delay any finalisation of the disposal. The current political framework does not allow for further development of Thüga under the leadership of E.ON, Fitch believes, however, that there are several players in the Stadtwerke landscape strong enough to afford the acquisition alone or as consortium.

Nuclear Phase-Out

Under the Atomic Energy Act, the operating life of nuclear power plants in Germany is limited to 32 years. The law also states that four out of 17 existing operating plants with a total capacity of almost 4.0GW are to be closed by 2009.

Fitch expects that the heated discussion in 2008 on potential delays in phasing out nuclear power will continue, especially in light of the general elections scheduled for autumn 2009. The agency expects no binding decisions before 2010.

As analysed in Fitch's comment "*Potential Delay in Nuclear Phase-Out Beneficial for German Utilities*", the primary arguments for rethinking the government's nuclear policy remain costs related to CO_2 emissions, dependence on Russian natural gas, substantial replacement needs for ageing German energy generation assets and delayed realisation of several wind energy projects.

On the other hand, high oil, gas and coal prices — which were used as an additional argument for nuclear power as a reliable energy source with low production costs — have fallen substantially since mid-2008 and therefore eased the pressure on energy prices. Fitch notes that increased borrowing costs and tight access to the credit market might also emphasise the need to avoid heavy cash outlays for the replacement of lost nuclear capacity, for nuclear waste disposal and for decommissioning costs in the short term.

Fitch believes that none of the nuclear power plants originally scheduled to be closed by end-2009 will be effectively decommissioned, as the operators will use unplanned and technical outages to postpone the closure deadline beyond the elections. Therefore, Fitch assigns full credit in 2009 to the beneficial role of German utilities' nuclear portfolio with regard to their generation mix and stability of cash flows; however, the overall profitability of utilities might be affected if unplanned outages force the utilities to deliver energy from more expensive sources within their generation portfolio to satisfy the energy supply contracts.

German utilities have the potential to benefit from a nuclear "revival" across Europe in the longer term, with the opportunity to realise significant projects in the UK or in southern and Eastern Europe; however, there is likely to be stiff competition from the dominant nuclear utility in Europe - Electricite de France ('AA-'/ Rating Watch Negative) - and at this stage any impact from future new build nuclear is likely to be long-term and is not factored into the German entities ratings.

Strong Position Maintained Despite Challenges

Fitch believes the German utilities should not be affected significantly by adverse market condition in 2009 thanks to their strong business profiles. However, cash flow generation, which is diversified across several segments and different countries, is likely to experience some pressure from the economic slowdown. The utilities active hedging policies, under which a substantial portion of 2009 and 2010 energy has been sold forward at attractive prices until mid-2009, should also help to mitigate some of the negative market pressures.

The German utilities' financial profiles have the potential to be impacted by leverage and increased borrowing costs; however, Fitch anticipates that the utilities may revise their capex programmes in response to the changed economic conditions. Despite a slight reduction in the cash cushion in the first nine months of 2008, the liquidity position of the companies remains sound, and is anticipated to remain so in 2009 following the new issues successfully placed in November 2008.