Electric-Corporate
Spain/Portugal
Special Report

# Iberian Energy and Utilities — Outlook 2010


### Analysts

Erwin Van Lumich, CFA
+34 93 323 8403
erwin.vanlumich@fitchratings.com

Sabrina Ran
+44 (0) 207 070 5817
sabrina.ran@fitchratings.com

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

Josef Pospisil
+44 207 682 7339
josef.pospisil@fitchratings.com


### Related Research

- *Spain Economic Update (July 2009)*
- *Portugal Full Credit Report (September 2009)*
- *Endesa, S.A. (May 2009)*
- *Energias de Portugal, S.A. (February 2009)*
- *Iberdrola, S.A. (June 2009)*
- *Gas Natural SDG, S.A. (June 2009)*
- *Enagas S.A. (September 2009)*
- *Red Electrica Corporation S.A. (December 2008)*
- *Repsol YPF (November 2009)*

## Overview: Slow Recovery at Best in 2010, Outlook Stable

Fitch Ratings anticipates that Iberian energy & utility ratings will remain largely unchanged in 2010; with the possible exception of those entities unable to contain leverage in a weak demand and pricing environment, and entities that engage in debt-funded M&A activity. M&A is unlikely to be a significant feature of the main rated players, most of which are in a phase of adjusting their business and financial profiles to transactions that were completed in 2009 and before.

While there may be some scope for demand recovery, any improvement is expected to be moderate, below the European average, and starting from a low base. Overcapacity in electricity generation, an excess of gas availability, and low electricity and gas spot market pricing will remain prevalent, putting further pressure on thermal load factors and dark and spark spreads.

While margin pressure can continue to be partially offset by hedging techniques, forward selling, and lower commodity prices, the weak environment will nevertheless have a negative effect on sector earnings. The importance of the electricity “pool” is expected to further decline in 2010, with most sales at the tariff of last resort or under forward contracts, resulting in relatively strong earnings visibility for most utilities.

Some relief may also be derived from announced efficiency and divestment programmes and from entities revisiting their capex programmes, although near-term flexibility is limited given the long build-times for new generation plants and network assets.

### Fitch Ratings’ Iberian Energy & Utility Sector Coverage

| Issuer | Long-Term IDR | Outlook | Senior Unsecured | Primary Analyst |
|---|---|---|---|---|
| Enagas S.A. | A+ | Stable | AA- | Erwin van Lumich |
| Endesa, S.A. | A- | Stable | A | Francesca Fraulo |
| EDP - Energias de Portugal, S.A. | A- | Stable | A[a] | Sabrina Ran |
| Gas Natural SDG, S.A. | A- | Negative | A[b] | Josef Pospisil |
| Iberdrola, S.A. | A- | Stable | A[c] | Sabrina Ran |
| Red Electrica Corporacion, S.A. | A+ | Stable | AA- | Sabrina Ran |
| Repsol YPF | BBB+ | Stable | BBB+ [d] | Jeffrey Woodruff |

[a] Issued by EDP, S.A. and its wholly-owned subsidiary - EDP Finance B.V.
[b] Issued by Gas Natural SDG, S.A. and its wholly-owned subsidiaries – Gas Natural Finance B.V., and Gas Natural Capital Markets
[c] Issued by Iberdrola, S.A. and its wholly-owned subsidiary – Iberdrola Finanzas, S.A.U.
[d] Issued by two of Repsol YPF’s wholly-owned financial subsidiaries - Repsol International Finance and Repsol International Capital Ltd.
Source: Fitch

## Forecasts

Fitch derives its own independent forecasts as part of the rating process. This process, and the aggregate results of the agency’s forecasts, are discussed in *“Forecasting EMEA Corporates’ Recovery: The Slow Haul Back”*, soon to be released on www. fitchratings.com.

The credit profiles of most of the integrated utilities in Iberia are at their weakest point as a result of acquisitions (a large portion of which were into renewable businesses) and the implementation of major geographical diversification over the past two years. However, with generally well-maintained liquidity and well-spread debt maturity profiles, the utilities are well placed to weather the downturn, while maintaining solid investment-grade ratings.

Rebuilding financial strength remains a priority for the integrated utilities in the region. This leads Fitch to believe that there will be very few, if any, large-scale M&A transactions instigated by the Iberian utilities in the next two years. Most companies in the region lack the headroom to undertake debt-funded M&A activity at their current rating levels, and it does not form a part of their short- to medium-term strategies. Instead, companies have shown a commitment to enhance their financial profiles through stricter internal cost-controls, capex scalebacks, asset disposals, divestments of non-core equity stakes, and successful capital increases. Nevertheless, ratings could still be under pressure if such efforts are unsuccessful in the near-term, especially against a background of ongoing weak demand and pricing.

Electricity and gas transmission companies Red Electrica Corporación and Enagas will continue to generate negative free cash flow in 2010 and beyond as a result of the implementation of their substantial capex programmes. However, the impact of these investments on key leverage ratios is expected by Fitch to be moderate, as remuneration from new assets will also boost their earnings and operating cash flows. Potential debt-funded acquisitions by these companies of the remaining portions of the network that they do not already own could nevertheless put pressure on their ratios, and hence on their ratings.

### Iberian Energy and Utility Sector – Summary of Forecasts

| | 2009 | 2009 vs. 2008 (%) | 2010 | 2010 vs. 2009 (%) | 2011 | 2011 vs. 2010 (%) |
|---|---|---|---|---|---|---|
| **Integrated utilities[a]** | | | | | | |
| Revenue (EURm) | 76,557 | 5 | 77,545 | 1 | 80,798 | 4 |
| EBITDA (EURm) | 21,116 | 15 | 21,369 | 1 | 22,264 | 4 |
| Median EBITDA margin (%) | 26 | | 26 | | 25 | |
| Funds from operations (FFO) (EURm) | 13,934 | 2 | 14,375 | 3 | 14,750 | 3 |
| Free cash flow (FCF) (EURm) | -5,003 | n.a. | 913 | n.a. | -1,215 | n.a. |
| Median FFO adjusted leverage[c,e] (x) | 4.5 | | 4.3 | | 4.3 | |
| Median adjusted net debt/EBITDAR[e] (x) | 4.0 | | 3.8 | | 3.5 | |
| Median FFO interest cover[b] (x) | 3.9 | | 4.1 | | 4.3 | |
| | | | | | | |
| **Regulated utilities[b]** | | | | | | |
| Revenue (EURm) | 2,142 | 9 | 2,325 | 9 | 2,524 | 9 |
| EBITDA (EURm) | 1,541 | 9 | 1,690 | 10 | 1,846 | 9 |
| Median EBITDA margin (%) | 72 | | 73 | | 74 | |
| Funds from operations (FFO) (EURm) | 1,110 | 27 | 1,223 | 10 | 1,338 | 9 |
| Free cash flow (FCF) (EURm) | -828 | -6 | -762 | 8 | -722 | 5 |
| Median FFO adjusted leverage[c] (x) | 4.6 | | 4.6 | | 4.7 | |
| Median adjusted net debt/EBITDAR (x) | 4.0 | | 4.1 | | 4.2 | |
| Median FFO interest cover[d] (x) | 5.2 | | 5.2 | | 4.6 | |

[a] Integrated utilities include Endesa, S.A., Iberdrola, S.A., Energias de Portugal, S.A., and Gas Natural SDG, S.A.,
[b] Regulated utilities include Red Electrica Corporacion, S.A. and Enagas, S.A.
[c] Gross adjusted debt/FFO + interest + rents
[d] FFO + interest/interest
[e] Excluding tariff deficits
Source: Fitch

In 2010, Fitch expects utilities to generate additional earnings from new projects due to enter commercial operations. This notably applies to Red Electrica and Enagas, which are remunerated based on their assets, and are therefore not exposed to volume risk. Despite some flexibility in most companies' capex programmes, companies are still broadly committed to their longer-term project pipelines. Among other things, these contain substantial network and renewable investments (mainly wind and hydro), with the aim of securing future supplies and market share, and benefiting from longer-term growth opportunities. To meet these capex needs, companies have already undertaken a series of financing initiatives during 2009, and were able to raise substantial amounts at competitive rates.

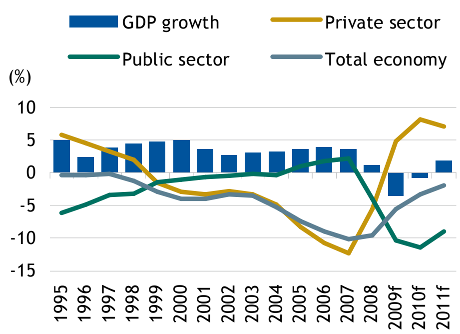
## A Challenging Operating Environment

The macroeconomic picture for Spain and Portugal is expected to remain bleak in 2010. The chart *Economic Adjustment in Spain*, which is taken from Fitch's "*Spain Economic Update*", 17 July 2009, highlights the effects of the unwinding of economic imbalances which had built up during the boom period. Unemployment should continue to rise — from an already-high level of close to 19% — and Fitch expects the government to be the only net borrower for 2009 and beyond, channelling private sector savings back into the economy.

Fitch expects a 3.6% decline in GDP in 2009, and underperformance versus the Eurozone in 2010 and 2011. Despite this, Spain's sovereign rating was affirmed at 'AAA' in August 2009; supported by a relatively good starting point in public finances, a robust response to the downturn by the authorities, and a resilient banking sector.

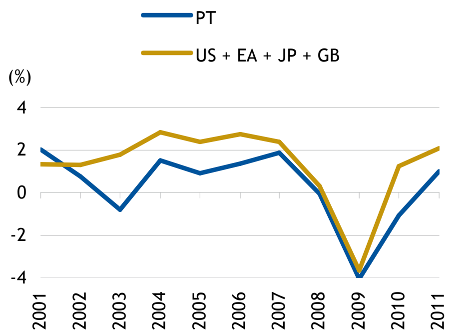
Portugal's growth has been poor since 2000, driven by low productivity compared with the other EU15 economies. Fitch's "*Portugal Credit Analysis*", from 10 September 2009, forecasts a 4.1% decline in GDP for 2009, and a slower recovery than in other Eurozone countries in 2010 and 2011. Unemployment is expected to reach 10% by 2011, from 4% in 2000. Fitch has affirmed Portugal's sovereign rating at 'AA', but the Outlook was revised to Negative from Stable in September 2009.

**Economic Adjustment in Spain**
Financial balances (% GDP) and GDP growth




Source: INE, datastream, Fitch forecasts

**Portugal's Lost Decade**
GDP growth



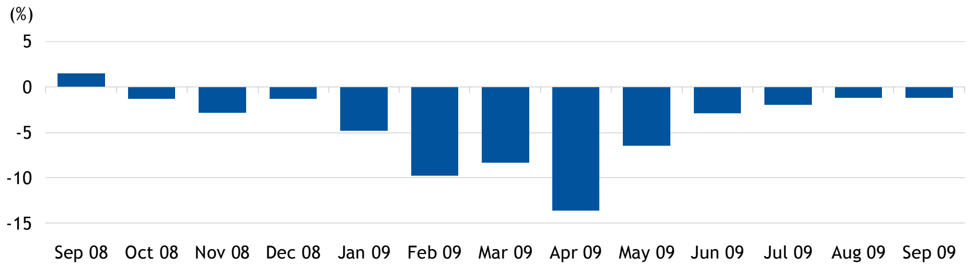

Source: Fitch global economic outlook

Against this weak macroeconomic background, the agency expects only gradual improvements in electricity and gas demand over the subdued levels of 2009. Indeed, it is likely to take well beyond 2010 for electricity and gas demand to recover to its historical highs. Fitch does believe, however, that the worst in terms of electricity and gas demand appears to be behind us now, with Spanish electricity demand having bottomed out in April 2009 and gas demand in February 2009 — as per the charts *Spanish Electricity Demand Trend* and *Spanish Gas Demand Trend*, respectively.

Spanish electricity and gas demand was down by 5% and 12% yoy, respectively (until September 2009); while the downward trend was less pronounced in Portugal, which saw electricity demand down 1.6% in the same period — up 3% for low-voltage residential customers, and down 6% for normal-voltage (industrial) customers.

### Spanish Electricity Demand Trend

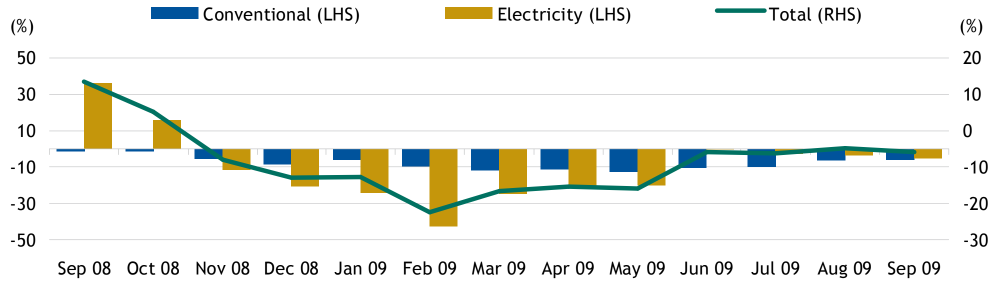
GWh




Source: Red Eléctrica, S.A.

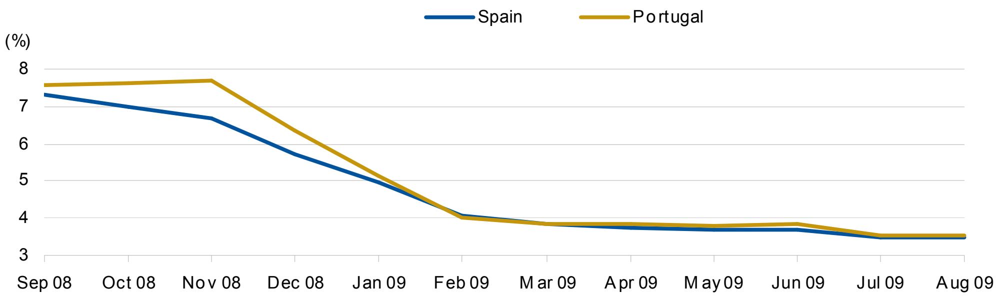
### Spanish Gas Demand Trend

GWh




Source: Enagas

### Iberian Spot Price Trend




Source: OMEL

As shown by the chart *Spanish Gas Demand Trend*, the decline in gas demand was far more pronounced in the electricity sector than in the conventional residential and industrial segments. This highlights the weak utilisation rates of combined cycle generation plants (CCGTs), which are situated towards the end of the merit order, reflecting relatively high unit costs in a weak demand and pricing environment. Against an expectation of limited electricity demand growth and slow industrial recovery, gas demand growth is therefore anticipated by Fitch to be subdued in 2010.

Pricing is also expected to remain weak, following a sharp drop in Spain and Portugal in 2009. Convergence between spot prices in Spain and Portugal continued in 2009, and this trend is also set to be a feature in 2010 as market integration takes further shape. Given companies' general strategy to sell forward a large portion of their electricity output, the impact of low spot prices on 2009 earnings was relatively moderate. However, 2010 earnings will reflect lower yoy forward prices. In this environment, Fitch expects dark and spark spreads to remain very low, especially as 2010 is also likely to see higher nuclear output following outages in 2008 — and potentially higher hydro output, following a drier-than-average 2009.

Companies' take-or-pay obligations under gas-sourcing contracts are expected to mitigate some of the pressure on electricity prices, as utilities only benefit to a very limited extent from cheap gas spot prices. The latter is further exacerbated by reduced optionality for gas sales — as arbitraging opportunities in international markets will remain limited due to transportation constraints and oversupply, negatively impacting prospects for entities with a midstream presence, such as Gas Natural.

Fitch anticipates that entities with a diversified generation mix across different technologies — and ideally with a bias towards low-cost generation capacity (hydro, renewables, nuclear) such as EDP and Iberdrola — will continue to be better placed than entities with a bias towards coal- and gas-fired plants, such as Gas Natural. Importantly, in view of an expectation by Fitch of low CO2 emission allowance values in 2010, coal plants are likely to continue to be more competitive than CCGTs in the Iberian peninsula.

Consequently, CCGT utilisation rates are likely to remain sub-optimal in the coming year, though will continue to be run due to associated take-or-pay gas contracts. Fitch nevertheless expects that thermal technologies will continue to set the price most of the time, despite additional renewable capacity coming on stream that may potentially result in an even more generous reserve margin.

Fitch also anticipates that Spain will be affected by gas oversupply, especially with the expected commissioning of the 8 billion cubic metres (bcm) Medgaz pipeline linking Algeria with Spain. While the agency understands that the launch of the pipeline has been somewhat delayed, and that volumes will be subject to a ramp-up phase, it is hard to imagine strong returns for the additional volume that will be pumped into the market. Fitch does note, though, that liquefied natural gas (LNG) contracts with Algeria — estimated at some 5bcm — are likely be reduced, partially offsetting the effect of Medgaz.

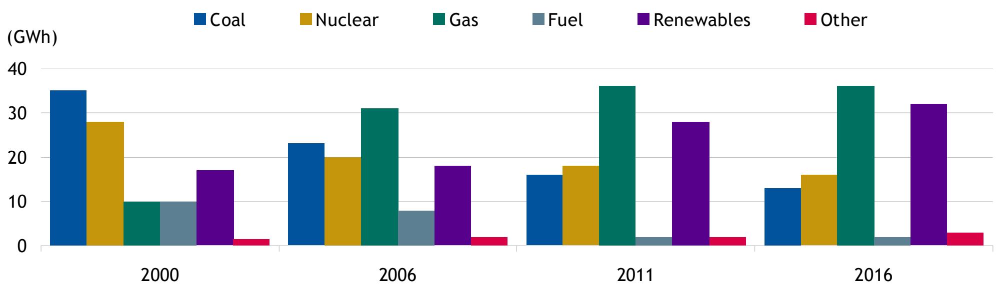
While Spain may in the longer-term develop into a key European gas hub, additional infrastructure (also between countries via interconnections) is required for it to be able to develop this strategy. The current gas export capacity from Spain into France is only 0.2bcm. The interconnection is planned to be expanded to 3bcm in 2013 and 5bcm in 2015. Meanwhile, gas oversupply is likely to be a feature of the market, also in view of Spain's 35bcm of available LNG re-gasification capacity.

## Adjusting to the New Reality

Fitch anticipates that the Spanish government will adjust its longer-term electricity and gas demand growth assumptions to the new realities in 2010. While residential demand remains relatively robust, this is not the case for industrial demand. Initial assumptions formed an important input into the EUR19.4bn infrastructure plan for 2008-2016, of which EUR9.2bn is allocated to the electricity sector and the remainder to the gas sector.

Fitch would view a downward adjustment to the infrastructure plan — to be mainly carried out by electricity transmission group Red Electrica and gas transmission company Enagas — as a positive development, as it would reduce pressure on these and other companies' capital structures and cash flow profiles.

In view of the new demand dynamics, Fitch also anticipates some changes to the rollout speed of generation capacity. While the trend will still be very much towards more CCGT and renewable capacity — compensating for a reduction in nuclear, and coal-fired capacity — the current environment does not appear to justify the construction of additional CCGT plants, except for those players that have a clear gas-sourcing cost advantage.




## Regulatory Development

The regulatory agenda in Iberia has generally been positive for the sector over the past two years. This was mainly evident from the introduction of the Decree Law 165/2008 in Portugal, and the Royal Decree 6/2009 in Spain (see below). Fitch views the implementation of these decrees in both countries as having a positive impact on utility companies' cash flow and liquidity profiles.

### Spain

The Royal Decree 6/2009 was published in May 2009. A number of measures were introduced by the law to help reduce some of the regulatory uncertainty to which the sector has been exposed in the past decade. Fitch feels the most significant was related to a gradual abolition of the tariff deficit by 2013. The tariff deficit is the result of cost assumptions applied by the regulator for the calculation of electricity tariffs being below actual costs. The law allows utilities that have funded a portion of the historical deficit to offload the related balance sheet obligation to a structured fund, which will issue debt that is backed by a state guarantee. The fund will include collection rights already accrued and not yet transferred to third parties up to EUR10bn (at end-2008), and those related to deficits likely to be generated from 2009-2012.

Fitch will actively monitor the timing of the upcoming tariff deficit transactions and any development that contributes towards further evidence of true sector liberalisation. Despite the state guarantee being embedded in the new law — and, consequently, the increased likelihood that companies will be able to offload the tariff deficit burden — Fitch remains cautious regarding the speed of implementation of the new law, and hence the timing of any resultant cash-flows. Further delays could still limit companies' ability to strengthen their credit profiles in the meantime. At end-9M09, Endesa reported liabilities related to the tariff deficit of EUR6.2bn, followed by Iberdrola (EUR3.3bn), Gas Natural (EUR941m) and EDP (EUR445m)

Another positive development of the new law is that it abolishes, effective from July 2009, the claw-back mechanism related to costs for freely-obtained CO2 permits, which was introduced in Royal Decree 11/2007. The sector-wide cash flow effect of the claw-back is estimated at below EUR1bn per annum, but it will nevertheless support earnings in 2010.

The law also introduced a "social bonus" to be funded by generators from July 2009 until end-2012, to cover the difference between the tariff of last resort and a reference tariff for vulnerable customers. It is expected to apply to around 7 million customers on low incomes and with contracted capacity of less than 3kilowatts (kw). Fitch notes that the negative impact of this measure on utilities' cash flows is likely to be limited, as the timeframe for its application is relatively short. Fitch estimates that on a sector-wide basis, the "social tariff" may require a similar cash outflow to the cancelled CO2 claw-back, thereby roughly offsetting each other.

In addition, the law established the obligation for companies to assume liabilities from nuclear waste. Fitch views that this too will have a limited impact on utilities' financial ratios, due to relatively small related costs that will be incurred as a portion of utilities' overall liabilities.

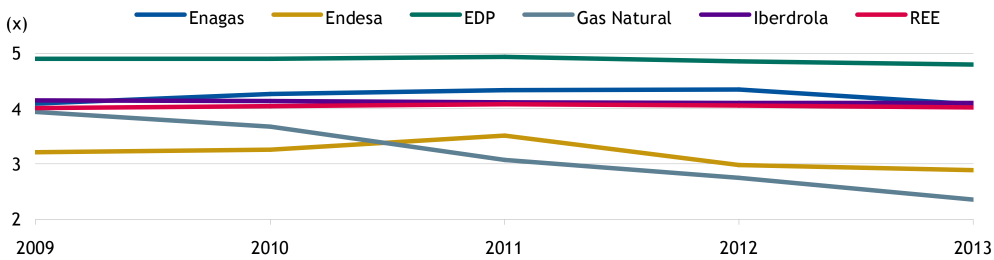
### Portugal

The Portuguese Electricity Regulator (ERSE) introduced Decree Law 165/2008 to eliminate the tariff deficit impact. According to the law, the historical deficit (2007-2009, amounting to EUR1.7bn) should be recovered with interest in 15 years from 1 January 2010 through tariffs applicable to all consumers in the Portuguese electricity system. The law also recognises utilities' right to transfer the right to recover the tariff deficit to a third party on a non-recourse basis. EDP successfully arranged for the securitisation of the tariff deficit in 2009, providing it with an upfront cash inflow of EUR1.2bn.

For the regulatory period 2009-2011, the regulator allows a 4.9% average annual electricity tariff increase in Portugal. When setting parameters for electricity tariffs, ERSE had assumed a 3.3% average increase in consumption and an electricity purchase price of EUR70.8/MWh. Both assumptions are currently (December 2009) well above market expectations for 2010. Consequently, Fitch expects the accumulated tariff deficit to decline during the current regulatory period.

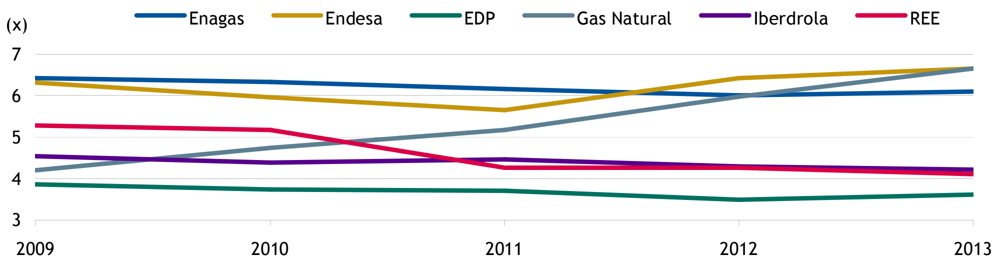
## Appendix

**Iberia Utilities - Gross Leverage Forecast**
2009-2013



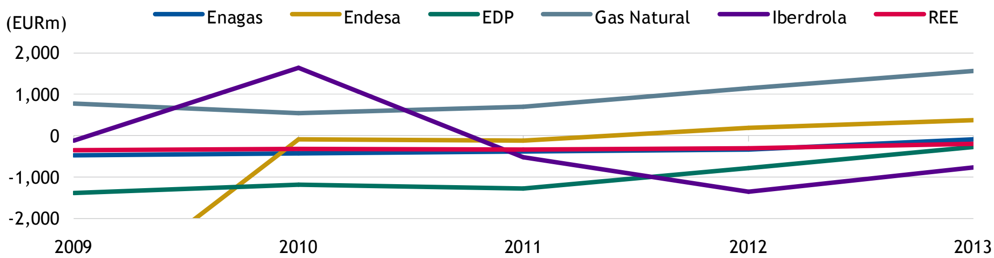

Source: Fitch

**Iberia Utilities - Interest Coverage Forecast**
2009-2013




Source: Fitch

**Iberia Utilities - Free Cash Flow Forecast**
2009-2013




Source: Fitch