Preliminary ratings considerations for a new BNE peaking plant

22 June 2015

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Introduction

- The analysis presented below has been provided by RBS at Viridian's request in connection with Viridian's response to the Regulator on the 2015 Best New Entrant ('BNE') peaking plant cost consultation
- The analysis comprises the following
  - Illustrative calculation of BNE credit rating ratios, based primarily on the assumptions supplied by Viridian
  - Illustrative positioning of the BNE peaking plant on the Moody's unregulated power companies methodology 'grid' based on information available and RBS and Viridian's assumptions, noting that the grid is only one of a number of factors in the overall rating analysis and that no views have been sought from Moody's on the analysis, and as such the analysis in no way represents a final rating indication
  - Illustrative application of the S&P rating methodology to the BNE peaking plant on the same basis; no views have been sought from S&P on the analysis
  - RBS summary observations on the analysis

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BNE implied income statement and key rating ratios

- Based upon Viridian's calculation of the implied income statement for a new peaking plant and certain additional assumptions set out below, we have undertaken a preliminary assessment of the new peaking plant's implied financial leverage and coverage metrics, including the use of Moody's methodology for unregulated utilities and power companies dated 31 October 2014

Viridian's BNE consultation assumptions *

	Unit	Value
Plant capacity	MW	195.7
BNE capacity payment	€/kw	65.5
Inframarginal rent	€/kw	6.1
Ancillary service income	€/kw	4.6
Operating costs	€m	(5.2)
Capital cost	€m	(126.9)
Gearing	%	60%
Implied debt requirement	€m	76.2

Additional calculation assumptions **

	Unit	Value
Assumed depreciation period	years	20
Cost of debt (NI mid-point)	%	1.5%
Assumed tax rate	%	20.0%
Assumed dividend payout rate	% net income	100%

Implied financials

		Unit	Value
	Capacity payments	€m	12.8
	Inframarginal rent	€m	1.2
	Ancillary service income	€m	0.9
	Total revenue	**€m**	**14.9**
	Operating costs	€m	(5.2)
(a)	**EBITDA**	**€m**	**9.7**
	Depreciation	€m	(6.3)
	EBIT	**€m**	**3.4**
(b)	Interest	€m	(1.1)
	PBT	**€m**	**2.2**
(c)	Tax	€m	(0.4)
	Net income	**€m**	**1.8**
(d)	Dividend payment	€m	(1.8)

Key rating ratio inputs

	Unit	Value
CFO Pre-W/C ((a) + (b) + (c))	€m	8.1
Total Debt	€m	76.2
RCF ((a) + (b) + (c) + (d))	€m	6.3

Key rating ratio calculations

(CFO Pre-W/C + Interest)/Interest (a.k.a. FFO / cash interest)	8.1x
(CFO Pre-W/C)/Total Debt (a.k.a. FFO / Debt)	10.7%
RCF/Total debt	8.3%
Debt / EBITDA	7.8x

Source: * Viridian, based on BNE consultation inputs; CEPA / Ramboll "Costs of a best new entrant peaking plant for the calendar year 2016" paper.
** Additional RBS assumptions, based on CEPA / Ramboll "Costs of a best new entrant peaking plant for the calendar year 2016" paper.

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1. Moody's unregulated power companies methodology factor grid – BNE positioning considerations

- Moody's rating factors grid is a tool 'that can be used to approximate credit profiles within the unregulated utilities and unregulated power sector in most cases. The grid provides summarised guidance for the factors that are generally most important in assigning ratings to companies in these industries. However, the grid does not include every rating consideration. The weights shown for each factor in the grid represent an approximation of their importance for rating decisions but actual importance may vary substantially… the grid-indicated rating is not expected to match the actual rating of each company.'*
- On the pages below we indicatively position the stand-alone hypothetical BNE plant on the Moody's rating factors grid for the unregulated power companies

Note: (*) Moody's "Unregulated Utilities and Unregulated Power Companies" methodology, dated 31 October 2014; p.1.

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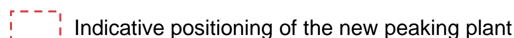
1. Moody's unregulated power companies methodology factor grid

Illustrative application to the BNE assumptions

"Investment grade" ← | → "Sub-investment grade"

Factor	Weight	Aaa	Aa	A	Baa	Ba	B	Caa
1: Scale	**10%**							
Scale (USDbn)	10%	Total assets ≥USD100	Total assets USD50-100	Total assets USD25-50 OR Total assets >USD10 and entrenched position in substantial national/regional market	Total assets USD10-25 OR Total assets USD5-10 and entrenched position in substantial national/regional market	Total assets USD5-10 OR Total assets USD2.5-5 and entrenched position in substantial national/regional market	Total assets USD2.5-5 OR Total assetsUSD1-2.5 and entrenched position in local market	Total assets <USD2.5
2: Business profile	**35%**							
Market diversification	5%	Expected to maintain material operations in 5 or more separate well developed geographic or market regions	Expected to maintain material operations in 3 or more separate well developed geographic or market regions with no one market accounting for 50% or more of EBITDA	Expected to maintain material operations in 3 or more separate well developed geographic or market regions but >50% of EBITDA comes from a single market	Expected to maintain material operations in more than one geographic or market regions with no one market accounting for >75% of EBITDA	Expected to operate predominantly in a single well developed geographic region	Expected to operate in multiple geographic regions but power markets are undeveloped or emerging	Expected to operate in a single undeveloped or emerging power market
Hedging and integration impact on cash flow predictability	10%	Forward hedges or other contractual/market arrangements provide a high degree of visibility on substantially all expected cash flow for the next 10-years OR Large, high quality captive downstream customer base in non-competitive market eliminates exposure to commodity risk over the long-term	Forward hedges or other contractual/market arrangements provide good visibility on 75% or more of expected cash flow for the next 7-years OR good visibility on >50% expected cash flow for the next 5-year, if underpinned by sizeable high quality customer base	Forward hedges or other contractual/market arrangements provide good visibility on 50% or more of expected cash flow for the next 5-years OR good visibility on >50% expected cash flow for the next 3-year, if underpinned by sizeable high quality customer base	Forward hedges or other contractual/market arrangements provide good visibility on 50% or more of expected cash flow for the next 3-years OR good visibility on >30% expected cash flow for the next 2-year, if underpinned by sizeable high quality customer base	Forward hedges or other contractual/market arrangements provide good visibility on 30% or more of expected cash flow for at least the next 2-years OR good visibility on >30% expected cash flow for at least the next year, if underpinned by sizeable high quality customer base	Minimal reliable cash flow visibility OR Limited ability to hedge OR Portfolio of contracts/hedges very short term OR Substantial short generation position versus customer base	No reliable cash flow visibility OR Hedging strategy is ineffective OR Most assets in underdeveloped markets characterized by little transparency, poor liquidity and limited potential to hedge


Indicative positioning of the new peaking plant

Note: The underlying Moody's grid is replicated from Moody's "Unregulated Utilities and Unregulated Power Companies" methodology, dated 31 October 2014, pp-31-36.

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1. Moody's unregulated power companies methodology factor grid (cont'd)

Illustrative application to the BNE assumptions

"Investment grade" ← | → "Sub-investment grade"

Factor	Weight	Aaa	Aa	A	Baa	Ba	B	Caa
2: Business profile	**35%**							
Market framework and Positioning	15%	Assets operate as a monopoly with unquestioned statutory government protection of competitive position AND Absence of fuel concentration risks	All assets operate in well designed, stable markets and company enjoys a dominant market position that provides it with a degree of pricing power AND Location, quality and cost competitiveness of assets are among the top decile and provide commanding market position with limited threat AND Absence of meaningful fuel concentration risk (e.g. no more than 50% of generation from single fuel type)	All assets operate in liquid, well designed competitive markets with supportive frameworks AND Location, quality and cost competitiveness of assets are within the top quartile and provide a clear competitive advantage or provide for contractual pass-through of costs AND Absence of meaningful fuel concentration risk (e.g. no more than 50% of generation from single fuel type)	Majority of assets operate in a liquid, well-designed competitive markets but whose frameworks may be undergoing some change AND Location, quality and cost competitiveness of assets are above average and provide some advantage or a solid market position AND Absence of meaningful fuel concentration risk (e.g. no more than 50% of generation from single fuel type)	Some assets operate in competitive market that exhibit design weaknesses or are undergoing more substantial change OR Asset quality, cost profile and market position is average. Assets may have some exposure to environmental issues OR Presence of fuel concentration risk (e.g. more than 50% of generation from single fuel type)	Majority of assets operate in competitive markets that are oversupplied, poorly designed or new and untested or have a high risk of adverse political interference OR Asset quality, cost profile and market position are below average and assets may have significant exposure to environmental issues OR Presence of meaningful fuel concentration risk (e.g. 90% or more of generation from single fuel type)	Assets operate in markets that are persistently oversupplied, undeveloped or exhibit characteristics that are unfavorable to generators OR Assets are of questionable quality or at significant risk of shut-down due to economic and/or environmental considerations
Capital requirements and operational performance	5%	Extremely modest levels of capex needed for maintenance, environmental related expenditures or expansion of asset base, reflecting a modern, highly developed asset base (e.g., total annual future capex typically 3% or less of net PP&E)	Minimal levels of capex needed for maintenance, environmental related expenditures or expansion of asset base, reflecting a modern, well developed asset base (e.g., total annual future capex typically 5% or less of net PP&E)	Modest levels of capex needed for maintenance, environmental related expenditures or expansion of asset base, reflecting a modern, well developed asset base (e.g., total annual future capex typically 8% or less of net PP&E). Expenditures generally straightforward consisting of replacement plus a number of development projects with limited execution risk	Manageable levels of capex needed for maintenance, environmental related expenditures or expansion of asset base (e.g., total annual future capex is typically 12% or less of net PP&E). Operational performance of the fleet is typically average relative to competitors	Large capex program needed for maintenance, environmental related expenditures or expansion of asset base (e.g., total annual future capex is typically 15% or less net PP&E) OR Capex program is challenging in scope and complexity and carries a degree of execution risk OR Operational performance is somewhat below average relative to competitors	Significant capex program needed for maintenance, environmental related expenditures or expansion of asset base (e.g., total annual future capex is typically 20% or less of net PP&E) OR Capex program is challenging in scope and complexity and carries a high degree of execution risk OR Operational performance is decidedly below average relative to competitors	Significant capex program needed for maintenance, environmental related expenditures or expansion of asset base (e.g., total annual future capex is typically 20% or more of net PP&E) OR Capex program is challenging in scope and complexity and carries a very high degree of execution risk OR Severe operational challenges

Indicative positioning of the new peaking plant

Note: The underlying Moody's grid is replicated from Moody's "Unregulated Utilities and Unregulated Power Companies" methodology, dated 31 October 2014; pp-31-36.

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1. Moody's unregulated power companies methodology factor grid (cont'd)

Illustrative application to the BNE assumptions

"Investment grade" | "Sub-investment grade"

Factor	Weight	Aaa	Aa	A	Baa	Ba	B	Caa
3: Financial policy	**15%**							
Financial policy	15%	Long track record and expected maintenance of extremely conservative financial policy; very stable metrics; low debt levels for the industry; AND Public commitment to the highest credit quality over the long-term	Long track record and expected maintenance of a conservative financial policy; stable metrics; lower than average debt levels for the industry; AND Public commitment to a very high credit quality over the long-term	Extended track record and expected maintenance of a conservative financial policy; moderate debt leverage and a balance between shareholders and creditors; Not likely to increase shareholder distributions and/or make acquisitions which could lead to a weaker credit profile Solid commitment to high credit quality	Track record and expected maintenance of a conservative financial policy; an average level of debt for the industry and a balance between shareholders and creditors; Some risk that shareholder distributions and/or acquisitions could lead to a weaker credit profile; Solid commitment to targeted metrics	Track record or expectation of maintenance of a financial policy that is likely to favor shareholders over creditors; higher than average but not excessive, level of leverage; Owners are likely to focus on extracting distributions and/or acquisitions but not at the expense of financial stability	Track record of aggressive financial policies or expected to have a financial policy that favours shareholders through high levels of leverage with only a modest cushion for creditors; OR High financial risk resulting from shareholder distributions or acquisitions	Expected to have a financial policy unfavorable to creditors with a track record of or expected policy of maintaining excessively high debt leverage; OR Elevated risk of debt restructuring
4: Leverage and coverage	**40%**							
3-year average								
(CFO Pre-W/C + Interest)/Interest	10%	≥18x	13x-18x	8x-13x	4.2x-8x	2.8x-4.2x	1x-2.8x	<1x
(CFO Pre-W/C)/ Net Debt	20%	≥90%	60%-90%	35%-60%	20%-35%	12%-20%	5%-12%	<5%
RCF/Net debt	10%	≥60%	45%-60%	25%-45%	15%-25%	8%-15%	3%-8%	<3%

Note: Leverage metrics for unregulated utilities are calculated on a 'net debt' basis (defined as total debt minus unrestricted cash) while those for unregulated power companies are calculated on a total debt basis. The different treatment is driven by characteristics for each business sector.

Indicative positioning of the new peaking plant

Illustratively, the outcome of the grid as above is Ba2.

In order to reach 'Baa' outcome for the 'Leverage and coverage' factor on the grid, all else being equal, gearing ratio of below 35% is likely to be required. However, we note that achieving this improvement in financial metrics would not automatically imply an overall "investment-grade" grid outcome as it is also driven by a number of non-financial factors.

Moody's rating grid is only one factor in the rating analysis and not a reflection of any potential final rating by a Moody's committee.

Note: The underlying Moody's grid is replicated from Moody's "Unregulated Utilities and Unregulated Power Companies" methodology, dated 31 October 2014; pp-31-36.

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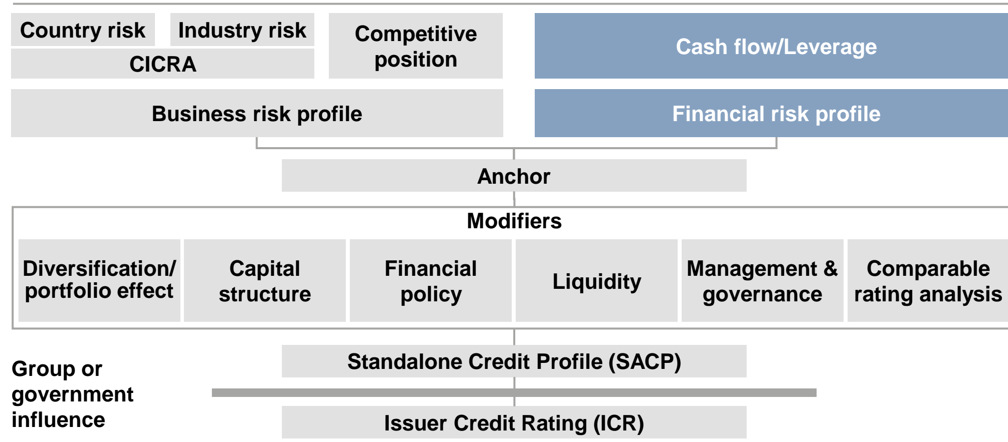
2. S&P – Financial risk profile (FRP)

Cash flow/leverage illustrative analysis shows 'highly leverage' FRP outcome

Corporate criteria framework – Financial risk profile



Summary

- The combination of the financial risk profile and the business risk profile determines the **anchor** rating
- We use the key ratios calculated from the preliminary analysis to derive an indicative financial risk profile for the hypothetical BNE plant
  - **Two core ratios (FFO/Debt and Debt/EBITDA)** determine the preliminary profile; core ratios are supplemented by others depending on the credit
- Three sets of benchmark metrics applied based on the entity's CICRA

A. **Standard volatility – generally applies to unregulated generators (CICRA of 2 or worse/entities with a CICRA of 1 or 2 and a competitive position of 5 or 6)**

B. Medial volatility – could apply to integrated utilities with at least 30% regulated network cash flows (CICRA of 1 or 2 and under circumstances described in the respective sector's KCF criteria)

C. Low volatility – generally applies to fully regulated utilities (CICRA is 1 (unless otherwise specified in sector's KCF))

A Cash flow/leverage analysis – Standard volatility

	Core ratios		Supplemental coverage ratios		Supplemental payback ratios		
Financial risk profile	**FFO/Debt (%)**	**Debt/ EBITDA (x)**	**FFO/cash interest (x)**	**EBITDA/ interest (x)**	**CFO/Debt (%)**	**FOCF/Debt (%)**	**DCF/Debt (%)**
Minimal	60 +	< 1.5	> 13.0	> 15.0	> 50	40+	25+
Modest	45 – 60	1.5 – 2	9 – 13	10 – 15	35 – 50	25 – 40	15 – 25
Intermediate	30 – 45	2 – 3	6 – 9	6 – 10	25 – 35	15 – 25	10 – 15
Significant	20 – 30	3 – 4	4 – 6	3 – 6	15 – 25	10 – 15	5 – 10
Aggressive	12 – 20	4 – 5	2 – 4	2 – 3	10 – 15	5 – 10	2 – 5
Highly leveraged	< 12	> 5	< 2.0	< 2.0	< 10	< 5	< 2

B Cash flow/leverage analysis – Medial volatility

	Core ratios		Supplemental coverage ratios		Supplemental payback ratios		
Financial risk profile	**FFO/Debt (%)**	**Debt/ EBITDA (x)**	**FFO/cash interest (x)**	**EBITDA/ interest (x)**	**CFO/Debt (%)**	**FOCF/Debt (%)**	**DCF/Debt (%)**
Minimal	50+	< 1.75	10.5+	14+	40+	30+	18+
Modest	35 – 50	1.75 – 2.5	7.5 – 10.5	9 – 14	27.5 – 40	17.5 – 30	11 – 18
Intermediate	23 – 35	2.5 – 3.5	5 – 7.5	5 – 9	18.5 – 27.5	9.5 – 17.5	6.5 – 11
Significant	13 – 23	3.5 – 4.5	3 – 5	2.75 – 5	10.5 – 18.5	5 – 9.5	2.5 – 6.5
Aggressive	9 – 13	4.5 – 5.5	1.75 – 3	1.75 – 2.75	7 – 10.5	0 – 5	(11) – 2.5
Highly leveraged	< 9	> 5.5	< 1.75	< 1.75	< 7	< 0	< (11)

C Cash flow/leverage analysis – Low volatility

	Core ratios		Supplemental coverage ratios		Supplemental payback ratios		
Financial risk profile	**FFO/Debt (%)**	**Debt/ EBITDA (x)**	**FFO/cash interest (x)**	**EBITDA/ interest (x)**	**CFO/Debt (%)**	**FOCF/Debt (%)**	**DCF/Debt (%)**
Minimal	35+	< 2	> 8	> 13	> 30	20+	11+
Modest	23 – 35	2 – 3	5 – 8	7 – 13	20 – 30	10 – 20	7 – 11
Intermediate	13 – 23	3 – 4	3 – 5	4 – 7	12 – 20	4 – 10	3 – 7
Significant	9 – 13	4 – 5	2 – 3	2.5 – 4	8 – 12	0 – 4	0 – 3
Aggressive	6 – 9	5 – 6	1.5 – 2	1.5 – 2.5	5 – 8	(10) – 0	(20) – 0
Highly leveraged	< 6	> 6	< 1.5	< 1.5	< 5	< (10)	< (20)

Source: 'Criteria | Corporates | General: Corporate Methodology' (Nov 2013) p.29 – 37

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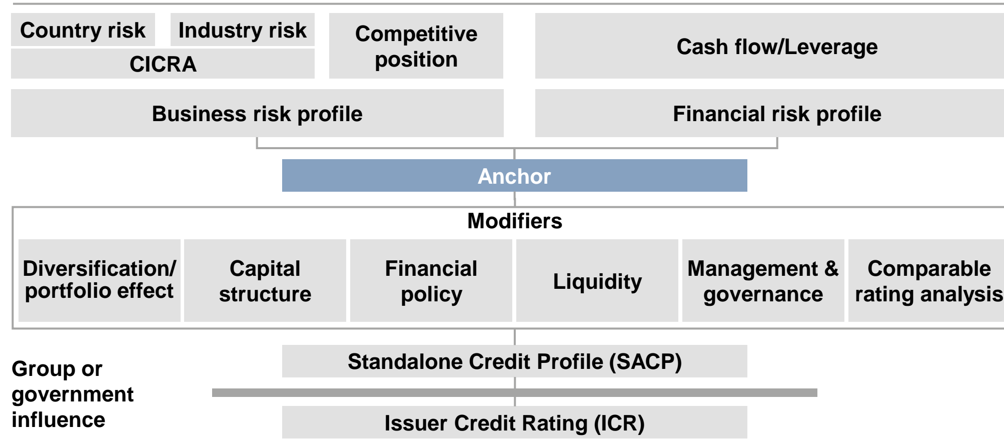
2. S&P – Combining the business and financial risk profiles to determine the 'Anchor'

Corporate criteria framework – Anchor



Summary

- The combination of the financial risk profile (p.9) and the business risk profile (BRP) determines the **anchor** rating (see table on the right)
- Major integrated utility sector companies would typically have a 'Strong' BRP, whilst fully regulated entities (e.g., the UK water companies) would have 'Excellent' BRP largely due to regulated cash flows
- This outcome is highly unlikely for a stand-alone power generator; however, even allowing for a 'Satisfactory' business risk, the hypothetical BNE plant is unlikely to achieve investment grade under the indicative assumptions on p.4 based on the illustrative application of the S&P matrix

Combining the business and financial risk profiles to determine the anchor

	Financial risk profile					
Business risk profile	Minimal	Modest	Intermediate	Significant	Aggressive	**Highly leveraged**
Excellent	aaa/aa+	aa	a+/a	a-	bbb	bbb-/bb+
Strong	aa/aa-	a+/a	a-/bbb+	bbb	bb+	bb
Satisfactory	a/a-	bbb+	bbb/bbb-	bbb-/bb+	bb	**b+**
Fair	bbb/bbb-	bbb-	bb+	bb	bb-	**b**
Weak	bb+	bb+	bb	bb-	b+	b/b-
Vulnerable	bb-	bb-	bb-/b+	b+	b	b-

For two anchor outcomes: anchor is based on comparative strength of business risk profile

For two anchor outcomes: anchor is based on comparative strength of financial risk profile

Utilities sector comparison	EDF	E.ON	SSE	Drax
Business Risk Profile	Excellent	Strong	Strong	Fair
Financial Risk Profile	Significant	Significant	Intermediate	Intermediate
Anchor	a-	bbb	a-	bb+
Modifiers	-	+1[1]	-	-1[2]
Standalone Credit Profile	a-	bbb+	a-	bb
Government support	Yes (+2)	No	No	No
Issuer Credit Rating	**A+**	**BBB+**	**A-**	**BB**

Source: 'Criteria | Corporates | General: Corporate Methodology' (Nov 2013) p.8; S&P research.
Notes: (1) E.ON is uplifted for comp. ratings analysis, reflecting reflect E.ON's future enhanced visibility on cash flows and substantial insulation from merchant risk; (2) Drax affected by comp. ratings analysis due to ongoing execution risks of the biomass conversion project.

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Summary observations

- Without the scale, geographical diversification and substantial EBITDA contribution from regulated networks, a generation and supply utility operating solely in the Island of Ireland market is unlikely, in our view, to be rated 'investment grade' with the gearing levels/capital structure proposed by CEPA/the Regulatory Authorities
  - Utilities referred to in the CEPA / Ramboll "Costs of a best new entrant peaking plant for the calendar year 2016" paper (p.53) and rated "investment grade" in EMEA benefit from scale, diversification and regulated network cash flow advantages which largely drive their investment grade rating. None of these characteristics would benefit the credit profile of the assumed benchmark greenfield plant
  - All of the referenced integrated utilities maintain gearing significantly below 60%; their ratings are based on the actual leverage rather than an 'optimised' capital structure as referred to in the paper
- As such, the capital structure and rating assumptions put forward in the CEPA paper would appropriately remunerate a hypothetical integrated utility group rather than the assumed benchmark greenfield plant's risk profile at the asset level
  - When making an investment decision, an integrated utility investor would themselves likely consider the risk profile of the stand-alone project – rather than the group's risk profile – to determine an appropriate return/remuneration on their capital

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