

Croatia: HEP upgraded outlook to positive

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Croatian state-owned power utility HEP was revised the outlook to positive from stable over its solid financial performance, while affirming its 'BB+' long-term issuer credit and issue ratings, Credit rating agency Standard & Poor's (S&P) said.

The statement from the agency said that The positive outlook reflects the likelihood that we upgrade HEP if the company continues to post funds from operations (FFO) to debt above 45 % and debt to EBITDA below 3x, and demonstrate prudent risk management and sufficient resilience to both the COVID-19-related economic downturn and the expected increase in purchase prices for power and gas in 2021-2022. HEP's financial performance continues to be solid amid the coronavirus pandemic, even though this is partly due to the temporary effect of lower purchase costs for imported electricity and gas.

Historically, the rating has been constrained by the view that the company's business entails an inherent degree of volatility because significant fluctuations in hydro generation (total hydro generation has been 4-8 TWh per year in the past 20 years). When hydro conditions are poor, the company compensates with its 1,060 MW of installed thermal capacity or international electricity procurement, which on a typical year represents 30-35 % of HEP's electricity sales. This exposes the utility to volatility in prices for imported power, gas, and carbon emissions. However, the company has consistently delivered on its strategic plan and demonstrated robust credit metrics, including FFO to debt above 100 % in three years with below-average hydrological conditions (2015, 2017 and our expectation for 2020; see chart). This indicates that HEP is structurally improving its risk management and the volatility we still capture in the rating is likely declining.

Until 2020, the company manages its exposure to electricity, gas, and emission allowance prices by hedging about 60 % of its volume every year. In contrast, European peers typically hedge on multiyear contracts, which provides greater cash flow stability for longer. Starting in 2021, HEP will use its access to the Intercontinental Exchange to increase the use of multiyear financial hedging strategies, and lock sales positions for multiple years. This is an important positive development in the utility's risk management policy, which should reduce earnings volatility.

S&P expects HEP to deliver a solid financial performance in 2020 despite COVID-19, while 2021 performance will depend on the post-pandemic macroeconomic recovery.

Despite expectations of 8 % GDP decline in Croatia in 2020 and 6 % decline in the country's electricity consumption, S&P expects HEP's EBITDA to remain resilient in 2020, for several reasons. Firstly, the utility generates 35-40 % less electricity than it sells, and electricity prices at domestic market adapt with a lag to international prices, leading to a positive difference between procurement costs and price of sold electricity. Also, HEP's customers are mostly residential and in 2020 will benefit from Government support measures in place due

to the pandemic (such as job preservation mechanisms), so a major increase in bad debt provisions this year is not expected.