ACRA

Principles of Assessing Industry Factors in the Rating Analysis of Non-financial Corporations

Regulated Network Companies (Electricity/Gas)

This document is part of the Methodology for Assigning Credit Ratings to Non-financial Corporations under the International Scale (hereinafter, the Methodology) and describes the specifics in conducting rating analyses of the operational and financial profiles of regulated network companies (electricity/gas).

The document provides lists of indicators used, factor weights, assessment score boundaries for quantitative factors, and the principles of assessing qualitative factors for companies in the industry.

1 Industry Companies

The assessment approaches described in this document are applicable to companies whose core business is the transmission and/or distribution of electric energy or transportation of gas using gas distribution networks (and is regulated by the legislation). The companies in the industry mostly provide services to non-retail customers and are monopolists in the territories where their networks are located. The tariffs for the services provided, whether regulated at the national or regional level, are reviewed on a regular basis according to legislation.

Electric energy is transmitted using high voltage grids, and gas is transported via high pressure pipelines. Supplying electric energy and gas to end consumers is the responsibility of distribution companies, which are not analyzed under this Methodology.

The main assets of companies in the industry are transmission networks. ACRA notes that a part of transmission networks can be used to transmit electric energy or transport gas to end consumers, but companies that operate the networks do not engage in billing or metering.

2 Rating Factor Structure

Creditworthiness analyses of rated entities in the industry are based on assessing seven indicator blocks, which are combined into two profiles and have their own weights totaling 100%. The weights presented in Table 1 are base weights, i.e., they may change depending on the assessment scores derived for factor blocks (see Subsection 4.1.3 of the Methodology for a description of the floating weights concept).

Table 1. Scorecard for the sector of regulated network companies (electricity/gas)

Profile	Factors	Factor weighting	Sub-factors
Operational profile	Business profile	40%	Market position and asset ownership model
			Regulatory regime and distribution risks
			Tariff policy
	Financial policy and corporate governance	10%	Financial policy
			Corporate governance
Financial profile	Size	15%	Net fixed assets (USD bln)
			Qualitative assessment of the investment program
	Leverage	15%	Total debt to funds from operations (FFO) before interest payments

			Net debt to net fixed assets
			Qualitative leverage assessment
	Coverage	10%	FFO before interest payments to interest payments
	Liquidity	5%	Liquidity ratio
			Qualitative liquidity assessment
	Cash flow	5%	Free cash flow (FCF) margin
			Qualitative assessment of FCF stability

Source: ACRA

3 Operational Profile

The following describes the basic factors in the rating analysis of the operational profile, the degree of their influence when determining the credit rating of a non-financial corporation, and assessment specifics.

To assess operational profile qualitative indicators for rated entities in the industry, ACRA uses a set of characteristics specific to the industry that translate into a qualitative assessment category. Operational profile indicator weights are shown in Table 6.

3.1. Business Profile

The business profile assessment is part of the creditworthiness analysis and takes into account market position and scheme of the asset ownership model, as well as the stability and predictability of the regulatory regime and tariffing principles (regarding timely changes in tariffs and setting them at a level sufficient to cover operating costs and make the required capital investments). The industry exhibits high regulatory risks, dependence on the implemented tariff policy, and the risk of nonpayment on the part of customers whose payment discipline primarily depends on the level of economic development of the region of presence. The business profile is assessed taking into account the following subfactors subject to qualitative assessment.

3.1.1. Market position and asset ownership model

Market position is determined by a company’s share both in the market as a whole and in its individual segments. A dominant market position may be held by companies that either own infrastructure or are monopolists (in the case of operating leases on assets or managing assets under concession agreement).

Market position also depends on asset ownership model. For example, in contrast to companies that fully own and control transmission networks, companies leasing them or managing them under concession agreements may face the risk of contract termination. In addition, companies that operate assets under short-term lease agreements are at a higher risk of contract termination.

The qualitative assessment category for the market position and asset ownership model is determined according to Table 2.

Table 2. Qualitative assessment of the market position and asset ownership scheme

Assessment category	Main features
I	National monopolist; wholly owned assets, duration of ownership is not limited
II	Regional monopolist that owns assets or manages them under long-term concession agreements, or a player with a well-diversified portfolio of assets in operating leases with a high share (over 80%) of renewable contracts for network operations
III	Regional player managing assets under a long-term concession agreement (moderate risk of termination) or a player with a diversified portfolio of assets held under operating leases with a significant share (over 70%) of renewable contracts for network operations
IV	Regional player with a significant portion of operating lease assets; limited asset diversification; renewal of contracts for network operations unlikely
V	In breach of the terms of a concession agreement; license for network operations is likely to be revoked or high risk of asset expropriation

Source: ACRA

3.1.2. Regulatory regime and distribution risks

Under this subfactor, ACRA assesses the regulatory regime in jurisdictions where a company operates. The main factors determining the assessment category for the regulatory regime are transparency and predictability of regulation, the presence or absence of a long history of predictable regulation, the level of development of political and legal institutions, and the independence of regulatory authorities from political agendas. In addition, ACRA assesses judicial system risks in the context of resolving commercial disputes.

The main distribution risks of network companies come from nonpayment of electricity transmission or gas transportation services. An assessment of distribution risks connected to nonpayment of services provided is based on the amount of data on overdue accounts receivable for one year.

The qualitative assessment category for the regulatory regime and distribution risks indicator is determined according to Table 3.

Table 3. Qualitative assessment of the regulatory regime and distribution risks

Assessment category	Main features
I	Independent and efficient regulatory regime exhibiting high predictability (no legislative changes worsening the position of the companies in the industry for more than five years); likelihood of changes very low Low risk of nonpayment, overdue receivables do not exceed 2% of annual revenue
II	Regulatory regime generally independent and efficient or newly introduced, but based on good and efficient regulation rules; low probability of changes Moderately low risk of nonpayment, overdue receivables account for 2−5% of annual revenue
III	Developed regulation, although past cases exist of violation of, or deviation from, established rules; tariff regulation can be affected by noneconomic factors (decisions may be politically motivated), with this trend expected to continue in the future Moderate risk of nonpayment, overdue receivables account for 5−10% of annual revenue
IV	Regulatory regime difficult to predict, no proven track record of its use; tariff regulation prone to frequent changes and affected by noneconomic factors (decisions may be politically motivated), with this trend expected to continue in the future High risk of nonpayment, overdue receivables account for 10−20% of annual revenue
V	Regulatory regime unpredictable or absent; tariff regulation affected by noneconomic factors (many decisions depend on the political situation in the country, which has a very negative impact on companies in the industry) Very high risk of nonpayment, overdue receivables exceed 20% of annual revenue

Source: ACRA

3.1.3. Tariff policy

Under this subfactor, ACRA assesses the impact of the implemented tariff policy on operating and financial performance. In particular, ACRA assesses whether the established tariff rate covers current operating costs and generates sufficient funds for capital investment, including its peak values. The predominant mode of tariff-setting in many jurisdictions is defined as "cost-plus," which guarantees the high predictability of a company's performance. However, given that regulatory regimes in various countries are different, the size and payback period of costs incurred can be interpreted in different ways. Companies that are not subject to restrictions in setting tariff levels required to cover both current expenses and future capital and financial investments will be assigned a high score for this subfactor. However, the companies for which a tariff is established that covers in a timely manner both current expenses and investments, but for which the way of calculating expenses is subject to stringent regulatory checks, will be assigned a medium assessment score for this subfactor. Companies for which the established tariff implies delay in recovery of the expenses incurred or an inadequate rate of return on investments will be assigned a low assessment score for this subfactor.

The qualitative assessment category for tariff policy is determined according to Table 4.

Table 4. Qualitative assessment of tariff policy

Assessment category	Main features
I	Established tariffs allow for timely recovery of incurred operating costs (including network losses) and ensure an acceptable rate of return on investments made; calculation of costs not subject to rigid scrutiny by the regulator; pay backs for peak investment values possible
II	Established tariffs allow for timely pay back on incurred operating costs (network losses may be compensated only partially); return on investments prescribed and regulated by supervisory authorities; payback period for peak investment costs can take longer; size of current costs subject to rigorous assessment of effectiveness
III	Established tariffs do not allow for complete coverage of costs incurred (network losses compensated partially); investment expenses not adequately reflected in the tariff, which does not allow for full recovery especially in terms of peak values; losses from tariff regulation have a negative effect on the financial and investment attractiveness of the business
IV	Established tariffs do not cover costs incurred or provide sufficient return on capital investment, even in the amount of depreciation charges
V	Established tariffs only partially cover incurred cash costs

Source: ACRA

3.2. Financial Policy and Corporate Governance

To assess financial policy and corporate governance, ACRA uses a common set of characteristics that translate into a qualitative assessment category for all industries (for a general description of the concept of corporate governance qualitative assessment, see Section 5 of the Methodology). The assessment of financial policy and corporate governance is carried out according to Table 6.

4 Financial Profile

The following describes the basic factors in the rating analysis of the financial profile, the degree of their influence when determining the credit rating of a non-financial corporations, and assessment specifics.

To assess qualitative indicators in the financial profile of rated entities in the industry, ACRA uses a common set of characteristics that translate into a qualitative assessment category for all economy sectors (for a general description of qualitative assessment of financial profile indicators, see Section 6 of the Methodology).

Quantitative indicators in the financial profile are assessed in points on the basis of being part of a particular range and qualitative indicators, on the basis of qualitative assessment categories according to Table 7.

4.1. Size

To assess business scale, ACRA uses the size of net fixed assets and a qualitative assessment of the investment program. This indicator is important in assessing the creditworthiness of a rated entity, its operating sustainability and competitiveness, and the quality of core assets. Most companies in the industry need to make capital investments on a regular basis to maintain system stability, replace outdated and inefficient equipment, and implement advanced technologies. Companies often enter periods of large-scale investment programs exposed to the risks of technical and managerial implementation.

Qualitative assessment of the investment program is made in in accordance with Table 5.

Table 5. Qualitative assessment of the investment program

Assessment category	Main features
I	Limited need for capital investments (total annual capex is no more than 6–7% of total fixed assets), indicating high quality of assets that only need enough investment to maintain operability
II	Moderate need for capital investment (total annual capex no more than 15% of total fixed assets); technically simple program (involving replacement of equipment)
III	Substantial investment program (total annual capex up to 25% of the total fixed assets), technically complex and involving a number of small projects or one large project; amount of investment raises financial risks
IV	Very substantial investment program (total annual capex less than 33% of the total fixed assets), very technically complex; significant financial risks
V	Very large investment program (total annual capex more than 35% of the total fixed assets), very technically complex, including one or several large projects that could undermine financial stability

Source: ACRA

4.2. Leverage

The leverage assessment is a key factor in analyzing the financial sustainability of companies in the industry, given its cyclicity. To assess leverage, ACRA uses the ratio of total debt to FFO before interest payments and the ratio of net debt to net fixed assets. Qualitative characteristics are also used to assess leverage.

4.3. Coverage

To assess coverage, ACRA uses an indicator calculated as the ratio of FFO before interest payments to interest payments.

4.4. Liquidity

To assess liquidity, ACRA uses the short-term liquidity ratio and qualitative characteristics.

4.5. Cash Flow

To assess cash flow, ACRA uses FCF margin indicator, as well as the qualitative assessment of FCF stability.

The ability to fund the investment program with operating cash flow is important to companies in the industry, given the fact that in order to ensure a stable market position and smooth network operations (as determined by current and historical levels of capital expenditures), companies need to invest in repairing and upgrading existing fixed assets. Dividend payouts made by a company are analyzed separately. Amid high capital costs, high dividend payouts can exert significant pressure on FCF.

Table 6. Operational profile factors

Factors	Sub-factors	Sub-factor weighting	Sub-factor score				
			5	4	3	2	1
Business profile	Market position and asset ownership model	25%	V	IV	III	II	I
	Regulatory regime and distribution risks	35%	V	IV	III	II	I
	Tariff policy	40%	V	IV	III	II	I
Financial policy and corporate governance	Financial policy	50%	V	IV	III	II	I
	Corporate governance	50%	V	IV	III	II	I

Source: ACRA

Table 7. Financial profile factors

Factors	Sub-factors	Sub-factor weighting	Sub-factor score				
			5	4	3	2	1
Size	Net fixed assets (USD bln)	50%	(−∞; 1)	[1; 3)	[3; 10)	[10; 30)	[30; ∞)
	Qualitative assessment of the investment program	50%	V	IV	III	II	I
Leverage	Total debt to FFO before interest payments	50%	(8; ∞)	(6; 8]	(4; 6]	(2; 4]	[0; 2]
	Net debt to net fixed assets	30%	(0.6; ∞)	(0.5; 0.6]	(0.4; 0.5]	(0.3; 0.4]	[0; 0.3]
	Qualitative leverage assessment	20%	V	IV	III	II	I
Coverage	FFO before interest payments to interest payments	100%	(−∞; 1)	[1; 3)	[3; 6)	[6; 10)	[10; ∞)
Liquidity	Liquidity ratio	50%	(−∞; 0.8)	[0.8; 1)	[1; 1.25)	[1.25; 1.5)	[1.5; ∞)
	Qualitative liquidity assessment	50%	V	IV	III	II	I
Cash flow	FCF margin	50%	(−∞; −10%)	[−10%; 0%)	[0%; 5%)	[5%; 10%)	[10%; ∞)
	Qualitative assessment of FCF stability	50%	V	IV	III	II	I

Source: ACRA

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