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Italian Local Utilities Sector:

Amid Ongoing Consolidation, Entities Are Adopting Different Business Models, With Varying Credit Risk Implications

Summary Opinion

Moody's believes that Italian local utilities face a significant event risk as the sector restructuring and consolidation continues and companies reshape themselves to succeed in the changing environment. The rating impact – whether positive, negative or neutral – of any merger or acquisition will depend on the relative credit qualities of the entities and assets involved as well as other factors such as management quality and the business and financial strategies adopted, the type of financing used and the resulting corporate structure.

In Italy, local municipal-owned companies have traditionally always provided essential public services such as the supply of electricity, gas and water as well as wastewater services. These local utilities continue to provide these services, despite recent regulatory and legislative changes, and thus need to be viewed in the context of the developments and characteristics pertaining to the country's overall electricity, gas and water markets.

As regards Italy's electricity sector, one of the key factors to have affected and partly reshaped the industry has been the obligation on ENEL¹ to sell some of its generation companies (gencos) and distribution networks in certain major cities. These changes are still ongoing. However, ENEL and Edison remain the leading operators. In addition, the Bersani Decree and the new EU Directive have been driving liberalisation: as from 2004 all non-household customers are able to choose their electricity supplier, extending to all other customers by 2007. However, the prospects for full market liberalisation have lessened somewhat as a result of a generic shortage of electricity in the free market and a lower-than-expected level of customers being eligible to switch suppliers.

In the gas sector, a new regulatory framework, which came into effect through the so-called Letta Decree, theoretically opened up the market to full competition as from January 2003. The local municipal-owned distribution companies maintain strong positions in their home markets, largely as a consequence of the relative long-term average duration of their concession licences. Local gas utilities are also typically growing in size (by number of customers, volumes and revenues) and increasing their market shares through collaborations/alliances and friendly mergers with other gas operators with the aim of achieving larger customer bases and higher supply volumes. Nonetheless, ENI continues to hold a dominant position in both gas supply and distribution, with respective market shares of almost 70% and 25%. We expect this dominance to continue.

1. Still 50.6% owned by the Italian State, which is, however, planning to reduce its stake to 20%-25% in the near future.

ENEL is also increasing its operations through a focused strategy of acquiring small- and medium-sized local distributors and investing in the LNG business through the construction of a terminal in Brindisi and entering into additional long-term supply contracts. Edison is also increasing its weight in terms of total imports and volumes sold. Nonetheless, we also anticipate that the local utilities will continue forming alliances with each other, thus improving their competitiveness and partially increasing the weight of municipal-owned utilities in this sector.

With regard to water and wastewater services, Italy now benefits from a substantial regulatory framework on both the EU and domestic levels. The current water and sewerage system was introduced by Law no. 36 of January 1994 (the Galli Law) and entailed a clear separation between the public role of planning and control and the management of water operations. However, the sector remains very fragmented, with around 8,000 active operators still competing for the assignment of long-term local water concessions. It is reasonable to believe that a major consolidation and alliance-forming process among various water operators will materialise over the next few years.

Italy's local municipal-owned companies, which are still strongly integrated into their respective municipalities, have been undergoing structural changes as a result of local public sector reforms (Law 142/1990 and Art.35 of Law 448/2001). Top-tier local utilities have been partially privatised², mainly through IPO processes benefiting from more transparent and efficient operations and fresh cash resources. However, Moody's cautions that these entities' credit profiles could face pressure from shareholders' return on investments and the requirement to upstream sizeable dividend flows or enter into sizeable M&A transactions.

Recent regulatory developments have also been driving the ongoing consolidation process among Italian local utilities, whose credit profiles have in many cases changed significantly as a result. Some major local utilities have also undergone credit profile changes as a consequence of their debt market-funded capital investments in former ENEL 'gencos' and/or distribution networks in certain major cities. Moody's also notes that the strategy adopted by many municipal-owned companies of expanding riskier activities such as electricity generation, electricity/gas trading and wholesale supply is having the negative effect of raising their business risk – a key rating determinant.

In determining the creditworthiness of Italian local utilities, Moody's will consider various rating factors with a particular focus on (i) possible ownership support, (ii) future strategies (business model) and management quality and track record, (iii) operating and financial performance and source of liquidity, and (iv) the ongoing evolution of the regulatory framework.

Italian Local Utilities Sector: Introduction

Italy's local utilities sector comprises former municipal-owned companies that have been privatised and are still partially owned by the relevant municipality (local authority). Their key sectors of operations are electricity, gas and integrated water services, with almost all of them engaged in more than one of these areas.

Although the number of these utilities is very high, only a few of them are currently listed companies with relatively sizeable operations. Many municipal-owned companies are engaged in other less visible but still essential service sectors such as public transportation and waste management.

Given their areas of operation, Italy's local utilities need to be viewed within the context of the developments and characteristics pertaining to the country's overall electricity, gas and water markets.

Italian Electricity, Gas And Water Sectors: Overview

ELECTRICITY: MARKET OVERVIEW

Still dominated by ENEL and Edison despite regulatory restrictions introduced by Bersani Decree

Italy's electricity market has historically been, and is still, dominated by ENEL and, to a lesser extent, the Edison Group.

The so-called Bersani Decree – which came into force on 1 April 1999 and which implemented the EU Electricity Directive – introduced various regulations, including a cap on the total electricity generation capacity (or imports) of a single company or group to a maximum of 50% of total Italian production (or imports). This provision triggered a significant reshaping of the market by forcing ENEL to sell up to 15,000 MW in production capacity, represented by its generation companies or 'gencos'.

2. Only the City of Milan is in the process of reducing its control on AEM Milan below 51%.

ENEL still owns the “Terna” national transmission grid but has been now required to reduce its ownership to 20% and its voting rights to 5% by 2007 and to manage the network in agreement with the rules set by *Gestore della Rete di Trasmissione Nazionale* (GRTN), the body responsible for the safety of the system.

Figure 1: Purchasers of Former ENEL “Gencos”

Purchasers	Genco
ACEA-Electrabel, AMGA, Energia, HERA	Interpower
Edison, AEM Torino, AEM Milano, ATEL	Eurogen
ASM Brescia, Endesa	Elettrogen

Local utilities’ increased market shares in generation through partnerships have raised their business risk

Some local utilities have increased their presence in electricity generation through important partnerships with domestic and international players. We note that, although this has typically led to an increase in their intrinsic business risk, some factors such as downstream integration, partnership structures and non-recourse financing may in many cases help mitigate their higher credit profiles.

Liberalisation of electricity supply has in practice progressed more slowly than expected

Meanwhile, the Bersani Decree also initiated liberalisation of the electricity supply market, with 35% and 40% of the market being opened up in 2000 and 2002, respectively. The new EU Directive drove this process further forward, with all non-household customers being able to choose their electricity supplier as from 2004, while from 2007 the market will be fully liberalised with all customers having free choice.

At the moment, liberalised customers theoretically account for 60%-70% of the market. However, thanks to the very fragmented presence of the local utilities and the generally low client churn rate, the true free market share is much lower.

Local utilities have benefited from obligation on ENEL to sell some distribution networks

The Bersani Decree also provided for a restructuring of distribution activities, a fully regulated business with an implicit low credit risk. Until 1999, roughly 95% of electricity distribution was operated by ENEL. However, the decree obliged ENEL to sell some of its distribution networks (including Rome, Milan, Turin and Brescia) in light of a very fragmented distribution presence in some major municipal areas. The assignment of single concession licences to local municipalities increased the market share of local utilities to around 20%. Distribution is generally carried out under long-term concessions and competition is very low.

Figure 2: Market Shares in Electricity Generation, Transmission, Distribution and Supply

Company	Installed Capacity	Market Shares % (2003)			
		Production	Trans.	Distribution	Supply
ENEL	62%	49%	92% *	82%	51%
Edison	14%	19%		Na	18%
ENI Power	3%	2%		Na	3%
Endesa	9%	6%		Na	6%
Others (including municipal-owned entities)	12% **	24%		18%	22%

* Terna (in the process of being merged with GRTN and privatised). The remaining 8% is spread among various municipal-owned entities.
 ** ACEA/Electrabel (3%), AEM Milano (4%), AEM Torino (2%), ASM Brescia (1%), Energia (2%), ATEL (2%).

GAS DISTRIBUTION AND SUPPLY: MARKET OVERVIEW

ENI remains dominant gas operator despite new regulatory framework and introduction of liberalisation

The so-called *Letta* Decree established a new regulatory framework for natural gas and provided for the full liberalisation of the Italian gas market. The new framework also introduced certain accounting requirements and the corporate separation of storage, distribution and sales from transport.

Dominant gas operator ENI was obliged to create *Snam Rete Gas*³, which operates the high-pressure natural gas pipeline network, while the gas storage assets were transferred to *Stocaggi Gas Italia*, which is still fully owned by ENI. As in the case of the Terna electricity transmission network, ENI will have to reduce its stake in *Snam Rete Gas* ownership by 2007.

Figure 3: Market Shares in Gas Imports, Supply and Distribution

Company	Market Shares		
	Import	Supply	Distribution (Retail)
ENI (including Italgas)	*	69% **	c25%
- final customers		37.5bcm***	
- wholesalers		15.3 bcm	
Others ****		31%	c75% *****

* Total demand Italy: 77bcm – ENEL and Edison are the two major players after ENI which is still dominant.
 ** Total demand 77bcm; ENI volumes 53bcm (including internal consumption)
 *** 8.4bcm Italgas, 1.9bcm ENI internal consumption
 **** Including municipal-owned companies
 ***** ENEL-Camuzzi Group (c10%), AEM Milano (c4%), HERA (c3%), Italcogim (c2%). The remaining is spread among roughly 600 corporates and municipal entities

However, Italy’s gas sector is still not operating under conditions of true and effective competition, with ENI’s continued dominant competitive position being the major factor. Nonetheless, most other operators now boast higher market shares, either directly or through different consortiums, than in 2002.

Smaller operators to benefit from ongoing consolidation, as competition intensifies

Moody’s expects competition to intensify over the medium term as a result of the ongoing consolidation process between small- and medium-sized gas operators (including municipal-owned utilities), which are aiming to enhance synergies, enlarge their customer bases, and thus increase their sales volumes, and benefit from more convenient gas procurement contracts.

Top-tier local utilities – for example AMGA Genova, ASM Brescia, ACEGAS Trieste and ACEA Rome – have been the most active in the consolidation process. Edison Group has focused its gas business commercial strategy on targeting small-to-very-small non residential customers (primary target) and residential clients (secondary target) through joint venture operations with second-tier local utilities, leveraging upon the favourable combinations of its consolidated experience and a larger clients base. Italgas and Thuga Italia, which together account for most of the acquisitions over the past two years, have also made some progress in this area.

Given that advantageous gas supply contracts are a key factor in enhancing the very narrow margins in this business, many local utilities have formed operational joint ventures with a view to ensuring economically viable gas resources. However, we note that in such cases, the decision to undertake a long-term “take-or-pay” supply contract may result in a utility being locked into high-price gas contingent liabilities. If this is the case, it could negatively impact the credit risk profile of the entity in question.

Figure 4: Strategic Alliances in the Gas Procurement Sector

PLURIGAS	AEM Milano 40%, AMGA Genova 30%, ASM Brescia 30%
METAENERGY	META Modena 50%, ACEA Electrabel 50%
ESTGAS	AMGA Udine 34%, ACEGAS Trieste 34%, AMG Gorizia 10%, Edison Gas 10%
BLUGAS	AEM Cremona 25%, Astem Lodi 25%, TEA Mantova 25%, ASM Pavia 25%

INTEGRATED WATER SERVICES: MARKET OVERVIEW

Galli Law governs this fragmented sector, managed directly by each municipality

Italy’s Integrated Water Services, a highly fragmented sector with around 8,000 operators, are governed by the so-called Galli Law (Law nr. 36 – January 1994). The municipalities retain direct management of the services, in a system that covers roughly 50% of the Italian population. Concessions can be granted to private operators or to entities whose capital is partially or totally held either directly by the State or by sub-sovereign entities.

3. An IPO of 40% of *Snam Rete Gas* was launched in 2001.

The key elements of the Galli Law reforms were as follows:

- Introduction of water system zones known as *Ambiti Territoriali Ottimali* (ATOs), each of which is a large area determined by the relevant region and managed by a single water and sewerage operator (WASC or *gestore unico*) under a long-term concession.
- Greater vertical integration, with each WASC being entitled to manage the full range of integrated water services encompassing water abstraction and production, distribution and wastewater collection and treatment.
- Greater stability through the introduction of a legal regulatory framework based on long-term concessions and a transparent tariff system.
- Creation of local regulatory entities (ATO Authorities or *Autorità d'ATO*). Out of 91 designated ATOs, so far about 50% have fully prepared their investment programmes and 30% have already granted the concessions to a water operator.

The Galli Law also established a tariff regulation system, which is viewed positively by Moody's, as it is based on certain criteria that provide for operational balance and business efficiency. We note that it not only grants an adequate return on investments but also, by means of a price-cap mechanism, prevents profits from rising too high and prices from overshooting. The current tariff mechanism is in place for an initial three-year regulatory period, which should be long enough to guarantee adequate stability for both revenues and operating profits.

Delays in assigning water concessions are adversely impacting service quality

By the end of 2002,⁴ 84 of the 91 water system zones (ATOs) set up by the Galli Law had been defined. Of these, 66 had concluded the recognition of the network maintenance status, 47 had approved the investment plan, and only 25 had awarded the concessions for the service. Of these 25 ATOs, only one had assigned the concession to an independent water operator. All the others had granted the concessions to joint-stock entities entirely controlled by the State or the relevant local authority (region, province or city). We view the slow assignment of concessions as having a significant adverse impact on service quality as it has resulted in a major delay in realising the substantial investment requirements for network maintenance and improvement.

Significant consolidation process anticipated, with some input from global players

Similar to the situation in the gas sector, Moody's expects the water sector to undergo a significant consolidation process over the coming years, with local operators forming joint venture operations or consortiums with a view to being assigned long-term concessions in different ATOs (as in the case, for example, of *Publiacqua*). Some international players such as Water-RWE, Severn Trent Thames, Suez and Vivendi have demonstrated interest in entering the Italian market, typically teaming up with local domestic operators. Once again, top-tier Italian local utilities – including ACEA Rome, Acquedotto Pugliese,⁵ AMGA Genova, Publiacqua and ACEGAS – have been the most active in this process.

4. Latest available official information from the Comitato di Vigilanza delle Risorse Idriche

5. Rated by Moody's Baa3 – Long-Term

Ongoing Structural Changes in Italian Local Utilities Sector: The Key Dynamics

LOCAL UTILITIES OF ALL SIZES HAVE BEEN FORMING ALLIANCES AND MERGERS AND/OR DIVERSIFYING IN RECENT YEARS...

Between 2000 and 2003, the Italian local utilities sector underwent a significant consolidation and collaboration process, characterised by numerous operational alliances and friendly/no-premium mergers among several players. Both top-tier and small local utilities opted to combine their asset bases and service provision operations with a view to achieving greater critical mass and broadening their client bases.

Furthermore, many of these utilities have been and are still seeking diversification into analogous activities such as heating services, facilities management and merchant power. Moody's notes a shift in focus that has prompted a dramatic decrease in expansion into non-core activities such as cable television and telecommunications-related operations.

...SOMETIMES IN PARTNERSHIP WITH INTERNATIONAL OPERATORS

In addition, a relatively significant number of international players have entered the market through several joint ventures and equity investments in newly formed consortiums, prompting consolidation in all sectors of the utility value chain (electricity, gas and water). The international players with the highest level of Italian market exposure are: EDF, Suez, E.ON, RWE Group, Endesa, GDF and VEOLIA.

Most such collaboration transactions occurred in the electricity sector, with some implications for the supply and distribution of gas to residential clients, given the multi-utility model adopted by most former municipal-owned utilities. In the gas sector, 2003 was characterised by a relatively significant growth in not only (i) alliances with and acquisitions by foreign groups (e.g. Thürga, Gas Natural and GDF) but also (ii) various alliances and acquisitions among municipal-owned companies and other independent operators (e.g. ASM, AEM Milano, ACSM and Bas Bergamo).

Two notable examples of the ongoing consolidation process in the local utilities sector are the creation of HERA, from the merger of 12 multi-utility local companies in the Emilia-Romagna region, and the merger between ACE-GAS Trieste and APS Padova at the end of 2003. Other operations such as the proposed merger of ACSM Como and BAS Bergamo proved abortive for different reasons, while various potential transactions are still under evaluation (e.g. a merger between BAS Bergamo and ASM Brescia). AMGA Genova and AEM Torino are also rumoured to planning to merge their assets – taking the form of a horizontal integration, given the strong prevalence of AMGA in the water sector and that of AEM Torino's operations in electricity and gas. Additionally, there is talk of a new entity called NewCo Emilia being created, through an alliance of local utilities in Modena (META), Reggio Emilia (AGAC) and Piacenza (TESA).

Moody's expects competition to intensify in the following areas: electricity generation following the construction of new plants and the re-powering of existing plants; merchant power; electricity/gas supply; and some collateral activities such as residential heating and facilities management.

THIS PROCESS HAS, IN MANY CASES, RESULTED IN INCREASED DEBT AND WEAKER RISK PROFILES

Some of the operations involving increased vertical integration of some of the top-tier local utilities required large investment programmes. Such cases included the acquisition of some of ENEL's electricity/gas distribution networks in certain major cities (i.e. Rome, Milan, Turin and Brescia) and of equity participations in former ENEL 'gencos' through dedicated consortiums, as happened for ACEA, AMGA, Energia, HERA, AEM Milano, AEM Torino, and ASM Brescia.

These transactions, some of which were particularly sizeable, were in many cases funded in the debt markets, using both bank and capital market finance. This increased debt has impacted these companies' credit profiles, which had historically been very conservative.

Figure 5: Top-Tier Municipal-Owned Italian Utilities		
	Activities / Degree of Integration	Weight of Regulated Activities (% 2003 EBITDA)
AEM Milano	Power / Heat gen. Power/Heat/Gas distr. Gas procurement High	Medium Regulated @ 50% Power/Gas distr.
ASM Brescia	Power/Heat gen./WTE Power/Gas/Heat distr. Gas procurement High	Low Regulated @ 25% Power/Gas distr. Water distr. Sewage
HERA Bologna	Power/Heat gen./WTE Power/Gas distr. High	Very High Regulated @ 95% Power/Gas distr. Waste
ACEA Roma	Power / Heat gen. Power distr. Water distr. Sewage Low	Very High Regulated @ 95% Power/Gas distr. Water distr. Sewage
AEM Torino	Power / Heat gen. Power/Gas/Heat distr. High	Medium Regulated @ 40% Power/Gas distr.
AMGA Genova	Power / Gas distr. Water distr. Gas procurement Sewage Low	High Regulated @ 75% Power/Gas distr. Water distr. Sewage
META Modena	Power / Heat gen. Power/Gas/Heat distr. Waste Medium	High Regulated @ 85% Power / Gas distr. Waste
ACEGAS – APS	Power / Gas distr. Water / Waste Medium	Very High Regulated @ 95% Power / Gas distr. Waste
ACSM Como	Gas distr. Water Waste Low	Medium Regulated @ 60% Gas-Water distr.

Italian Local Utilities Sector: Regulatory Implications

LOCAL AUTHORITIES CANNOT RELINQUISH LEGAL OWNERSHIP OF THEIR DISTRIBUTION ASSETS BUT CAN TRANSFER NETWORK OWNERSHIP TO JOINT STOCK CONTROLLED COMPANIES

Under the new regulatory regime, local authorities cannot abandon legal ownership of the physical network infrastructure. However, they have the option to transfer their shareholding to joint stock controlled companies.

The assignment of the concessions for services supply is supposed to be subject to public tender process. However, local utilities - in which local authorities retain a controlling ownership - have been historically directly awarded the concession licence for the provision of services. In order to respond to increasing pressures from the EU Authorities, Art. 35 of Law 448/2001 introduced new rules to limit the direct assignment of service provision concessions with a transition period – until 2006 – by the end of which all service provision concessions directly awarded by local municipalities terminate and new concessions are to be tendered through an open bid.

RECENT LEGAL AMENDMENTS ON NEW CONCESSIONS ASSIGNMENT RULES (LAW 326 NOVEMBER 2003) DO NOT EFFECT THE ELECTRICITY AND GAS DISTRIBUTION SECTORS. THIS ALLOWS LOCAL UTILITIES TO RETAIN SERVICE PROVISION CONCESSIONS UNTIL ORIGINAL EXPIRY DATE – A POSITIVE CREDIT FACTOR

The gas and electricity distribution businesses are not affected by the introduction of Law 326/2003 and continue to be ruled by the *Letta* and *Bersani* decrees, respectively. This allows local utilities to retain their concessions until the original expiry date (for electricity distribution at least – year 2030). This factor is, in Moody's opinion, a supportive credit element as it allows access to stable and predictable profits and cash flows, thus ring-fencing these entities from effective competition for a relatively long time. However, for the gas distribution business, local utilities face a different situation whereby existing concessions have shorter expiry dates after which they need to be tender in a public process. This is the main rationale supporting Moody's belief that there will be more competition in this sector.

ASSET UNBUNDLING EXEMPTION FOR TOP-TIER LISTED LOCAL UTILITIES OFFERS A BUSINESS ADVANTAGE BUT POSES RISK OF INCREASED LEVERAGE FROM FURTHER ACQUISITIONS

Furthermore, the legal separation of service management and network ownership has in theory been introduced with Art. 35 - Law 448/2001. Nonetheless, top-tier listed municipal-owned utilities still benefit from an exemption from the asset unbundling requirement (i.e. separation of infrastructure ownership) and therefore enjoy discretionary usage of networks and other property assets – a significant advantage, in Moody's view.

This exemption could also encourage these entities to pursue more asset acquisitions, which would, in turn, further increase their size and competitive advantage but also raise potential credit issues if aggressively debt-financed.

The network infrastructure business has the largest capex requirements of all the utilities businesses. On the other hand, service provision is much less capital-intensive but carries the highest business risk, given that is potentially exposed to much higher competition in the future as a result of full and effective market liberalisation.

Local Public Service Companies: Potential Strategies And Credit Implications

MUNICIPALITIES CAN OFFER PUBLIC SERVICES IN THREE DIFFERENT WAYS

The legal framework for municipalities engaged in the provision of public services has been radically transformed. As a result of the reforms, these entities were obliged to choose one of three different legal statuses. Municipalities had the option of providing public services (i) directly, (ii) by granting licences to public or private companies, and/or (iii) by means of a joint stock or limited liability company, owned or controlled by the municipality itself.

OF THESE, THE JOINT STOCK COMPANY ENJOYS SEVERAL ADVANTAGES, BUT ALSO FACES GROWING SHAREHOLDER PRESSURE

From a credit perspective, the joint stock company – which could also be partially privatised, as is the case for most top-tier local utilities – enjoys some positive implications. Firstly, such entities benefit from greater financial power, with the IPO process having enabled many companies to raise new cash resources available for investments and acquisitions. Another benefit is increased transparency and efficiency, thanks to cross-ownerships and more experienced industrial partners.

However, such entities typically face increasing pressure from shareholders⁶ to upstream dividends to either remunerate investments or compensate for the weak public finances. Moody's views this factor as an important consideration in its evaluation of overall credit protection metrics. Furthermore, shareholders' appetite for higher returns on their investments may lead to aggressive and potentially risky M&A transactions and/or business diversifications into non-core riskier operations.

LOCAL UTILITIES HAVE CHOICE OF FOUR KEY BUSINESS MODELS, WITH VARYING CREDIT RISK IMPLICATIONS

We regard the steady increase in competition in the electricity, gas and water sectors as the main driver of the ongoing consolidation/collaboration process among many Italian local municipal-owned entities. In line with current trends in the adoption of different business models, Moody's views four key strategic approaches, each of which has different credit implications.

6. *Not only private shareholders but also public shareholders, as in the case of many local utilities whose controlling shareholders are still the municipalities.*

The four basic business models being adopted are as follows, from the most conservative model to the most aggressive:

- (A) Focus on core business with selected collaborations (operational alliances or no-premium mergers) and/or operating partnerships
- (B) Expansion into adjacent regional markets (domestic or international)
- (C) Integration approach (typically multi-utility model)
- (D) Diversification strategy into different businesses (multi-businesses)

- (A) **Collaborations/Partnerships.** This strategy is, in Moody's view, the most conservative and least aggressive of the possible options, requiring low, if any, debt-funded capital spending and thus implying very limited negative credit implications. It involves small- and medium-sized municipal companies entering into partnerships and/or combining asset-based operations (distribution networks) with other operators in the same sector(s). The key goals here are to achieve larger market shares, benefit from operating synergies and cost-cutting through the building-up of more significant critical mass (e.g. volumes, client bases, procurement contracts).
- (B) **Expansion** into new markets has been almost negligible except for some cross- regional border bolt-on acquisitions in Italy, mainly in certain regulated activities (e.g. distribution) and the supply of electricity and gas (very often driven by new regulatory requirements as in the case of the Bersani Decree on distribution networks). Depending on the size of the transaction and thus its investment requirements, the key factors in determining the impact on the credit profile of the entities involved will be the source of funding (debt/equity mix) and management expertise in implementing complex integration processes. Cross-border expansions in any given European countries may add further uncertainties given different regulatory and country risk implications. However, there may be specific cases in which geographical and operating synergies can be positively factored into the analysis.
- (C) **Multi-utility model** (integration approach). This model appears to be the preferred approach followed by top-tier municipal-owned entities, given that the integration of operations in converging sectors typically offers significant synergies. From a credit standpoint, downstream integration (distribution and supply to non-eligible clients) incorporates a lower business risk – given the stability and predictability of implicit cash flows – while generation and upstream integration generally exposes any given entity to a higher credit risk profile. However, the benefits of downstream integration can sometimes be offset by excessive costs related to acquisition strategies, which are often funded in the debt markets, thus exposing companies to unusually high leverage.
- (D) **Multi-businesses model.** Many of those local utilities that had previously engaged in diversification strategies, many of which were particularly aggressive, have recently abandoned this route. One such example is AEM Milano, which has recently decided to exit the telecoms business. The theory behind such diversification strategies was that municipal companies should have been able to use a wide customer base to cross-sell not only traditional utility services (electricity, gas and water) but also other customer-oriented services such as telecoms, internet and cable TV services. However, from a credit standpoint, this diversification strategy into non-core utility businesses is often considered negative as a result of several different factors such as high capital spending requirements (funds otherwise available for core-operations), poor economic results and a requirement for different management skills that are not always available within the company. Moody's notes that none of the existing top-tier Italian local utilities is currently pursuing this business model.

Figure 6: Respective Credit Risk Implications of the Key Strategic Business Models Available to Italian Local Utilities

Strategic Business Model	Credit Risk
Collaboration/Partnership	Low (if through no-premium merger)
Expansion	High (if expensive and debt-financed)
Multi-utility	Downstream: low-medium Upstream: medium-high
Multi-business	High

MOODY'S VIEWS THE CONSOLIDATION APPROACH THROUGH NO- OR LOW-PREMIUM MERGERS AS OFFERING MANY BENEFITS FOR LOCAL UTILITIES...

In conclusion, Moody's believes that one of the major growth drivers for Italy's local utilities is the process of consolidation, in the form of no- or low-premium mergers of operations with other local entities. This particular strategy offers many benefits including the following:

- Rationalisation of corporate structures, with related efficiencies and synergies
- Expanded client bases
- Diversification of concessions – sometimes lengthening the average duration of concessions, as in the case of gas distribution
- Reduction of raw material and general procurement costs – enabling an increase in volumes
- Economies of scale

...THOUGH MANY WILL COMBINE THIS APPROACH WITH A VERTICAL INTEGRATION STRATEGY

However, Moody's also notes that some of the entities in question are likely to pursue a mixed strategy incorporating not only the combination of assets and client bases but also the enhancement of vertical integration through the acquisition of power generation capacity (new assets or re-powering). Indeed, some of them have already opted for such an approach.

Moody's Approach To Assessing Local Utilities' Credit Risk Profiles

When assessing the credit risk profile of a utility (including those that are municipal-owned), Moody's first analyses the intrinsic business risks in each of the company's activities. These risks are assessed in the context of the utility's market position and the degree of competition in that specific market.

The regulatory framework and the entity's relationship with the local authorities (municipalities) are also examined carefully as these may enhance its stand-alone credit profile.

Given that our main objective is to assess any company's ability to meet debt obligations in a timely manner, we also carry out a scrupulous and detailed analysis of its current and forward-looking financial profile. Furthermore, we pay particular attention to corporate and diversification strategy.

In fact the company's ability to position itself successfully in any given market and to sustain cash generation in adverse market conditions is significantly affected by its management strategies.

Any Moody's rating is a forward-looking combination of quantitative and qualitative factors which are fully analysed and weighted in our rating opinions.

In summary, our main areas of analytical focus are as follows:

- Ownership support (if any)
- Industry trends and business risk profiles
- Regulatory framework
- Corporate strategy (business model) and management quality
- Financial performance
- Liquidity
- Corporate and capital structures

OWNERSHIP SUPPORT

Over the past decade, numerous Italian municipal-owned local utilities have begun to privatise public utility franchises, opening up these companies to all of the efficiencies, investment opportunities and risks of private-sector operations. The move from full ownership by a municipal entity towards any degree of partial privatisation typically increases the utility's implicit credit risk profile. This is because a (partially) privatised company not only has a greater focus on shareholder value, which frequently results in aggressive targets for growth rates, returns and leverage, but also operates in markets that are increasingly deregulated.⁷

7. Deregulated markets include generation, supply (for eligible clients), and trading.

However, Moody's also notes that many local utilities that are still under the majority control of municipal entities face the same shareholder return pressure as those utilities with a greater level of private ownership. As a general rule, we assign a rating based on the freestanding business and financial profile of any given issuer. We will then measure the weight to be assigned, if any, of the relationship with the municipal entity. Moody's will examine any existing legal obligation and/or explicit guarantee issued by the local municipal entity.

We have also recently elaborated specific guidelines for corporate entities that are owned by sovereign/sub-sovereign governments (SQEs – State-Owned Quasi-Corporate Entities).⁸ SQEs fall into three broad categories in terms of features that determine Moody's ability to rate the entity at or near the level of the respective sovereign/sub-sovereign issuer.

- **Those that have a legal status that enables Moody's to rate them at the level of their sovereign/sub-sovereign.** Typical features here include: 100% sovereign/sub-sovereign ownership; no plans for privatisation over the next three to five years; budget approval by the state legislature; laws explicitly expressing the state/municipal entity's intent to support externally financed obligations and vehicles to provide such support; government/local authority provision of subsidies and payments for investment. Some of the entities in this category also have direct access to liquidity lines provided by the state / local authority.
- **Those whose legal status permits a rating near, but not at, the level of the sovereign/sub-sovereign.** Typical features include: 100% sovereign/sub-sovereign ownership; possible plans for privatisation within the near term; no explicit state/municipal entity agreement to support externally financed obligations, though possibly implied is less than clear; government/local authority provision of some level of subsidy that may not fully cover operating/investment needs or a critical part of infrastructure.
- **Those whose legal status is insufficient to enable a rating either at or near the level of the sovereign/sub-sovereign rating.** Here, state/local authority ownership may provide a one- or two-notch uplift from the fundamental rating. Typical features include: majority ownership by the state/local authority; privatisation either under way or a near-term prospect; no state/local authority promise to provide support; possibility of the state/local authority electing to provide limited support in order to continue provision of infrastructure-related services. Those entities that are less than 50% owned by the state/local authority would typically be rated at their own fundamental rating level.

INDUSTRY TRENDS AND BUSINESS RISK PROFILES

Depending on the degree of market liberalisation, competitive threats can vary significantly. A market that is partially or fully liberalised implies higher potential negative credit implications. However, different areas of business – i.e. electricity generation and gas import/production, electricity transmission and gas transportation, electricity and gas supply, electricity and gas distribution, Integrated Water Service – pose different degrees of implicit risk.

Generation and production carry the highest risks, based on their capital-intensive nature and the intrinsic volatility of profits in a competitive market, whereas electricity transmission, gas transportation and distribution activities are regulated activities with low risk profiles. Electricity and gas supply have high-risk characteristics when considered in a competitive environment (eligible market), whilst merchant power and trading are considered very high-risk businesses, although not capital-intensive, due to their embedded high financial risk.

REGULATORY FRAMEWORK

The regulatory framework plays a primary role in shaping the competitive environment and identifying opportunities for new entrants. Regulators aim to ensure the quality and ongoing improvement of services and thus require that adequate investments are made to guarantee them. For these purposes, utilities should be allowed to earn an adequate (fair) return on their investments, without any abuse.

The regulators' approach is thus a critical factor. Tariffs and regulations establish revenues and directly impact a company's ability to maintain adequate cash flows to service debt obligations. Regulated businesses are, in Moody's opinion, a supportive and protective strength for local utilities. In Italy, the tariff system is based on revenue caps (in electricity, gas distribution and water). Parameter adjustments are made periodically but are not always completely predictable, which means that credit profiles can theoretically face sudden changes. From a ratings perspective, Moody's evaluates whether the tariff mechanisms ensure an adequate return on existing assets and new investments.

8. See Moody's Rating Methodology, "State-Owned Quasi-Corporate Entities (SQEs): Moody's Rating Approach," May 2003.

CORPORATE STRATEGY (BUSINESS MODEL) AND MANAGEMENT QUALITY

In light of the growing competitive pressure and increased deregulation, local utilities have been increasingly pursuing profit opportunities and implementing measures to counter stable or declining market shares. In such a context, many of them have adopted diversification strategies involving both new markets and new businesses via either organic growth or acquisitions.

Whilst the organic growth option is conservative from a credit standpoint, it may take some time to deliver satisfactory results and could also expose the company to competition risk and market share erosion. By contrast, diversification through acquisitions typically helps increase the overall risk of any given entity (particularly if such acquisitions are aggressively debt-financed, therefore weakening debt protection metrics and offsetting business risk benefits).

Diversification into new businesses – which may not be directly correlated to the company's core products – is considered by Moody's as the most aggressive strategy, implying an even higher overall credit risk profile. On the contrary, the multi-utility model whose main characteristics are the integration of converging sector operations offers opportunities for synergies, cost-cuttings and cross-selling. However, upstream integration could potentially raise the overall credit risk profile of any given local utility as a result of the large investment requirements and the higher business risk profiles of upstream activities.

In summary, Moody's considers the following approaches to a utility's business model as either a negative or positive rating factor:

Negative rating factors

- Sizeable and aggressive acquisitions that are largely debt-financed
- Expansion into non-core businesses and or in non-core markets (different regulatory frameworks)
- Aggressive expansion into riskier activities (generation, trading, supply to the free market)

Positive rating factors

- Combinations of low-capital spending assets, or friendly and low- or no-premium mergers
- Balanced growth (in terms of size and without aggressive recourse to debt markets) in regulated activities that offer stable and predictable cash flows (e.g. distribution)
- Balanced expansion into core businesses

In addition, management quality is one of the most important and critical factors in an assessment of any given issuer's credit strength, although it is not easy to translate it into any specific metric measure. Indeed, an analysis of management strategy offers an opportunity to understand not only the company's ability to compete in a deregulated market but also how and to what level it will use its debt capacity, its expansion and diversification ambitions and also its ability to interact with regulators.

In the local utilities sector, management teams are frequently obliged to adjust and evolve in order to respond to developing market changes and different business strategies that imply both diverse risk profiles and challenges.

Moody's focuses on understanding a management's business and financial strategies and examining its past performance on plan in order to form a view of its likely future performance, even in adverse conditions.

FINANCIAL PERFORMANCE

Our financial analysis will focus on the issuer's ability to generate cash flows at different levels (e.g. working capital movements, funds generated by operating activities, interest, tax and dividend payments, investment requirements). We also aim to determine what will ultimately be the principal source of debt service (leverage and coverage metrics), which will indicate the issuer's ability to repay and/or reduce its debt burden over time.

Appropriate adjustments for "debt-like obligations" (i.e. operating leases, pension liabilities, tolling agreements, and other off-balance-sheet commitments) are also taken into consideration. Integrated utilities, in which regulated businesses such as transmission, transport and distribution typically provide for stable and reliable cash flow contributions, frequently have higher financial leverage than those companies primarily engaged in riskier sectors such as generation, supply and trading.

Moody's looks at financial ratios as one way of assessing relative and comparative credit metrics. Key ratios here include the following:

- Operating margin
- Adjusted Retained Cash Flow / Adjusted Debt
- Adjusted Funds From Operations Interest Coverage
- Adjusted Retained Cash Flow / Capex (including Investments) – Disposals
- Debt/Capitalisation
- Free Cash Flow

Moody's focuses on a detailed analysis of historical financial statements. However, this primarily serves as the starting point for a thorough interpretation and analysis of forward-looking internal and external projections, which are among the key rating determinants.

ALTERNATE LIQUIDITY

One of Moody's key concerns is the company's financial flexibility, which is its ability to maintain sufficient liquidity to meet debt obligations in a timely manner. Liquidity comes primarily from internal cash flow generation (as well as cash/cash equivalent assets) and the ability to access committed and unconditional bank financing.

The stronger an issuer's liquidity cushion is, the more able it will be to meet maturing debt obligations in potentially adverse conditions (i.e. when it has no access to both equity and debt capital markets).

The strength of a company's liquidity facility depends on its availability during periods of market stress and company-related setbacks. However, alternate liquidity agreements often contain clauses that enable liquidity providers to step back from their commitments should the risk profile of the company increase. Provisions such as MAC clauses, restrictive covenants and other funding-inhibiting legal language in the back-up line documentation may significantly lessen, if not almost entirely eliminate, the effectiveness of credit facilities as a source of alternate liquidity.

For this reason, the stability of a company's banking relationships and legal covenants are important factors in our analysis. Moody's considers:

- The facility type
- The nature of the banking/company relationships in the country or region involved
- Covenants embodied in the credit facilities – or in a company's existing indentures – that might disrupt a company's access to liquidity

Highly rated credits commonly have a combination of 364-day and multi-year committed back-up facilities, while lower-rated credits generally have multi-year facilities. For a borrower with a 364-day liquidity back-stop facility, we examine how soon the company customarily renews its facility prior to expiration. Moreover, subject to the satisfaction of certain conditions that may include the provider's willingness to extend, many 364-day facilities contain options that enable a borrower to extend the facility – those 364-day facilities without a term extension feature raise maturity mismatch concerns.

CORPORATE AND CAPITAL STRUCTURES

Given the tendency to adopt more complex corporate structures (largely as a result of the recent asset unbundling exercise and M&A transactions), municipal-owned utilities frequently rely on the upstreaming of cash from their own subsidiaries in cases where bank financing is predominantly raised. If operations are conducted through subsidiaries that do not provide guarantees, the holding company debt may be structurally subordinated to subsidiary debt obligations.

The position of a debt instrument within the capital structure thus affects the priority of claim of the debt holder and is therefore a key factor in Moody's rating assessment – hence, our notching practices.

Appendix 1

Italian Local Utilities' Business Risk			
Sub-Sector	Market	Business Risk	Sector Outlook
Electricity			
<p>Generation and supply are exposed to competition and price volatility. As non-eligible clients (residential) will be free to choose their supplier only as from 2007, they do represent a monopolistic and stable business for local utilities.</p>			
• Generation	Competitive	High	Negative
• Distribution	Regulated	Low	Stable
• Supply	Competitive	High	Negative
• Transmission	Regulated	Low	Stable
Natural Gas			
<p>The gas sector is undergoing a significant consolidation period. Various acquisitions and strategic alliances / mergers among small local utilities are re-shaping the market. The supply market is open to full competition since 2003, although margins are very thin.</p>			
• Import / prod.	Monopoly (quasi)	Medium-High	Negative
• Transport	Monopoly	Low	Stable
• Distribution	Regulated	Low	Stable
• Supply	Competitive	High	Negative
Water			
<p>Very fragmented sector. The Galli Law created 91 ATOs but only a small number of concessions have been awarded so far (25 – Dec. 2002). This is a highly regulated activity with tariffs set by the regulator, allowing guaranteed returns on investments and coverage of operating costs. Further consolidation is expected.</p>			
• Integrated Service	Regulated	Low	Stable

Related Research

Special Comment:

[Italy's Corporate Bond Market: Continued Promise, Continued Uncertainty, July 2003 \(78831\)](#)

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