Principles for Responsible Investment

ESG IN CREDIT RISK AND RATINGS: BRINGING ANALYSTS AND ISSUERS TOGETHER

UTILITIES SECTOR WORKSHOP

GORDON AND BETTY MOORE FOUNDATION

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United Nations Global Compact

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NOTES FROM THE WORKSHOP

The PRI's ESG in credit risk and ratings initiative is bringing voices from the corporate side into the conversation on how to better integrate environmental, social and governance (ESG) factors into credit risk analysis. This article summarises the key points from a workshop held with utility companies, bringing together their representatives, investors, and credit rating agencies (CRAs). This workshop is the eleventh of the series Bringing credit analysts and issuers together, as part of the ESG in credit risk and ratings' initiative, which promotes a transparent and systematic consideration of ESG factors in credit risk assessment.[1]

The 14 October 2021 workshop was hosted with eight members of the Corporate Forum on Sustainable Finance (CFSF). The event attracted 44 market participants, including representatives from eight corporates from the utilities sector (see Figure 1). Seven CRAs and ten investors from various organisations were also in attendance, as well as a representative of the World Business Council for Sustainable Development (WBCSD) (see Appendix for the full list of participating organisations). The discussions were held under the Chatham House Rule and were structured around a set of guidelines that were circulated to participants prior to the event and tailored by sector.[2]

Figure 1: Participating utility companies

Companies	
EDF	SNAM
Enel	Terna
ENGIE	Thames Water
Iberdrola	Tideway

Due to their carbon- and resource-intensive nature and the critical services they provide, utilities are closely scrutinised by governments. As a result, the sector has identified material ESG and sustainability issues earlier than other sectors and has made progress in capturing opportunities and mitigating risks (including, but not limited to, stranded assets, resource accessibility, increased cost of capital, carbon taxes and increased regulatory requirements). Nonetheless, a mismatch of opinions exists between utility issuers, credit analysts and CRAs regarding the financial materiality and the time horizon of different ESG issues. Also contested is the expected impact of utilities' sustainability efforts on their creditworthiness.

[1] The workshops series follows a string of 21 roundtables organised for institutional investors' credit analysts and CRA representatives between 2017 and 2019. The discussions are documented in the trilogy, Shifting perceptions: ESG, credit risk and ratings.
[2] The PRI initially published these guidelines after the Paris workshop, the first of the series. They will be refined as the workshops continue.

This report contains highlights from discussions during the workshop, which was convened with the objectives of:

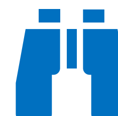
- promoting consensus around credit-relevant ESG issues in the utilities sector;
- aligning expectations around sustainability considerations (e.g. relevance of ESG questionnaires and disclosures);
- improving communication between credit analysts and issuers.

Several observations were common to those expressed in previous workshops, therefore this report focuses mostly on new or utilities sector specific, credit-relevant themes. This article also highlights some emerging solutions that participants have begun to consider.

Key discussion findings are grouped as follows:

1. Beyond climate change
2. The importance of time horizons
3. Thematic issuance and funding levels

1. BEYOND CLIMATE CHANGE



Most of the discussion focused on financially material issues related to climate change mitigation, addressing both its risks and opportunities for utility companies. Other ESG issues were tackled as well: the importance of biodiversity protection and climate change adaptation were mentioned by company representatives and investors in the water utilities breakout room. In the context of the social pillar, some companies emphasised how their license to operate is becoming increasingly prominent in the sustainability debate. Public scrutiny of company business practices and operating procedures has increased in line with social tension surrounding: water and energy price increases; construction of solar farms and other infrastructure; and challenges relating to a just transition, without leaving fossil fuel workers behind. Despite these issues, investors and CRAs seemed sceptical about the impact on cashflows, due to limited choice and high dependence of civil society on utilities. All participants agreed that the risk of qualified staff shortages is becoming increasingly material, given the need for particular skills to deliver the energy transition.

On the governance side, although there were some differences between the views of issuers, investors and CRAs, participants overall showed concern about:

- The importance of having an executive board with an upgraded set of skills, namely with knowledge about clean technology and digitalisation.
- The expectation that remuneration of board members aligns with ESG targets and metrics.
- Tensions with civil society and regulators could increase with the delivery of national roadmaps for decarbonisation and increased disclosure requirements (e.g. proportion of capital expenditure allocated to sustainable activities[3]).
- A greater vulnerability to cybersecurity threats, as digitalisation increases.

[3] As required by Article 8 of the EU Taxonomy (Regulation (EU) 2020 852), which refers to the requirement of "Transparency of undertakings in non-financial statements". Article 8 (1) requires companies covered by the Non-Financial Reporting Directive (NFRD) to disclose information on how, and to what extent their business is "associated with" environmentally sustainable activities. Under Article 8(2), non-financial undertakings are also required to disclose three KPIs: turnover, capital expenditure and operating expenditure related to environmentally sustainable activities.

“For water utility companies, we consider the social element as more relevant than decarbonisation because of water scarcity issues.” – Investor

EMERGING SOLUTIONS

During a previous workshop, with French sub-investment grade issuers, it was suggested that companies should start regularly publishing a set of ESG metrics and link them to financial items (such as how they affect production costs or earnings). Reporting over a sufficiently long historical period would produce comparable data that could be quantitatively integrated in credit risk assessments. In this workshop, investors and CRAs encouraged issuers to start a similar effort to reach an agreement on a minimum set of reporting standards tailored to the utility sector.

2. THE IMPORTANCE OF TIME HORIZONS

Whilst all participating companies, investors and CRAs stated that they perceive ESG threats and opportunities to be financially material for credit risk analysis, they also recognised that quantitative incorporation of these factors is not an easy task – especially in the long term.

Even if CRAs consider climate change mitigation strategies and related financial disclosures as increasingly important to forecasting the long-term success of utilities, they say it is still difficult for them to translate that information into the current assessment of probability of default. This is due to the lack of visibility of financial losses/gains beyond two to three years. However, they also stated that some utilities with a higher share of renewables in their portfolio are already getting a higher credit rating, as they are able to demonstrate more stable financial returns due to decreasing variable costs.

“CRAs’ role is less about driving change and more about reflecting the reality on the ground.” – CRA

Compared with previous workshops, participants were more focused on forward-looking topics, such as net-zero carbon emission strategies and report alignment with the Task Force on Climate-related Financial Disclosures (TCFD) and the Science-Based Targets intiative (SBTi). Most participating issuers are working on enhancing scenario analysis to incorporate climate risks and opportunities in decision making and corporate strategy. They also seek to involve corporate finance teams in climate scenario planning. Still, companies and some investors considered that these developments are happening at too slow a pace, given the increasing pressures to incorporate these issues into companies’ financial analysis and balance sheets. Challenges differ for each stakeholder. Corporates’ medium- to long-term planning is restricted by technological and regulatory uncertainties. For investors and CRAs, accessing consistent and comparable data from companies remains an issue.

These developments create extra work for all stakeholders. For instance, utility companies shared their frustration with the overwhelming amount of ESG-related requests from investors, CRAs, ESG information providers and regulators. Given the different goals of each of these stakeholders,

questions are different, which requires different sets of data to be collected. Also, they showed disappointment with the fact that these extra reporting efforts are not yet being reflected in credit assessements.

In particular, one industry association member challenged CRAs to reconsider their definition of "current reality," reminding them that decarbonisation is, at present, a highly certain and costly risk with a time horizon not that far away (especially in the European Union, where it is stated in law that carbon emissions must be halved in a time horizon of 8 years, i.e. by 2030). Moreover, the representative encouraged CRAs to shift their focus to the financial opportunities of sustainability, rather than considering only the risks.

EMERGING SOLUTIONS

- One participant suggested that there should be standards for each sector to improve scenario analyses and planning.
- To alleviate some of the burden associated with data requests, one issuer developed an ESG evaluation questionnaire with one CRA and delivered it to investors. This initiative has significantly decreased follow-up questions coming from investors. To cover the same problem, another company decided to start publishing an annual sustainable finance report (with all debt issued, metrics, and a climate-related financial disclosure report), which they send out to investors and credit analysts.

3. THEMATIC ISSUANCE AND FUNDING LEVELS

Utility companies are increasingly issuing thematic bonds to reflect their strategic commitments to sustainability and to attract investors. Issuers say these instruments help finance the green transition, communicate company sustainability achievements and ambitions, and link their overall strategy with their financial objectives. Moreover, they mentioned that these types of instruments are getting more attractive to investors and that they increasingly come with a discount on borrowing costs.

Most investors represented agreed that companies with strong green credentials are increasingly attracting bond subscriptions. According to one of the investors in attendance, these credentials are particularly relevant in the European market due to the new European Sustainable Finance Disclosure Regulation (SFDR), which requires investors to disclose the percentage of the volume of the investment portfolio that is aligned with sustainability objectives.[4] However, investors shared their concerns about the early-stage development of green bonds and sustainability-linked bonds (SLBs), resulting in a lack of standardisation and lack of scrutiny post-issuance. This can lead to potential greenwashing or mis-labelling.

Despite acknowledging the advantages of thematic bonds, CRAs expressed concern about the abrupt investment in the energy transition through these types of instruments, which tend to be more for

[4] The SFDR is an EU regulation adopted in 2019, consisting of a set of mandatory sustainability reporting requirements that shall be put in force gradually, by financial players and financial advisors. It came into force on 10 March 2021 and aims to ensure that investment products described as 'sustainable' truly are. In addition to fight greenwashing, this regulation seeks to reorient capital flows to achieve sustainable and inclusive growth.

longer-term financing. Given government constraints on raising prices, utilities' profit margins and liquidity can be driven down in the short term. Both investors and CRAs agreed that thematic bonds, which can be used for communication purposes, shall not replace other types of disclosure and reports.

Although most utility companies were not expecting that issuing green bonds and SLBs would directly impact their credit ratings positively, two issuers communicated their frustration with the fact that ratings do not necessarily reflect good ESG credentials, echoing remarks made elsewhere during the workshop. They shared an example of competitors with the same credit rating but with a sustainability strategy less developed than theirs.

"We are absolutely convinced that our ESG DNA and position contributes to capital markets access." – Corporate borrower

EMERGING SOLUTIONS

To improve the trust of investors and CRAs in thematic bonds, one investor pointed to the need for more material and concrete targets for issuers and for roadshows to showcase the progress made post-issuance. Moreover, to address the lack of standardisation, the WBCSD is developing sector specific standards to prevent greenwashing and improve communication between stakeholders. Finally, credit analysts would like to have more visibility on the proportion of capital expenditures allocated to the projects (renewables, digitalisation, etc), to make a better forward-looking assessment of transition capabilities and risk level.

APPENDIX

Figure 2: Other participating organisations

Investment institutions	
APG Asset Management	Janus Henderson
BlueBay Asset Management	Lombard Odier Asset Management
BNP Paribas Asset Management	Mondrian Investment Partners
Generali Investments	Ostrum Asset Management
HSBC Global Asset Management	SCOR SE
CRAs	
Fedafin	Rating-Agentur Expert
KBRA	S&P Global Ratings
Moody's Investors Service	Scope Ratings
Qivalio	
Other	
WBCSD	

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