

CREDIT OPINION

19 October 2020

Update

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RATINGS

Instituto Costarricense de Electricidad (ICE)

Domicile	San Jose, Costa Rica
Long Term Rating	B1
Type	LT Corporate Family Ratings
Outlook	Negative

Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

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Instituto Costarricense de Electricidad (ICE)

Update to credit analysis

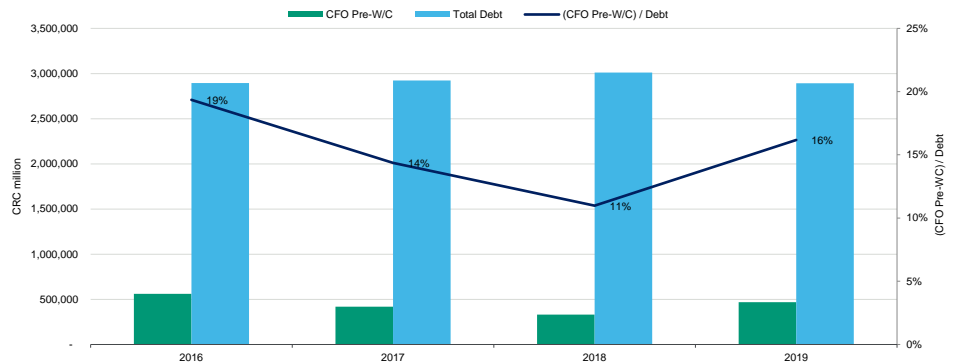
Summary

Instituto Costarricense de Electricidad (ICE)'s B1 senior unsecured and corporate family ratings with a negative outlook reflect its status as a utility owned by the Government of Costa Rica (B2 negative).

The Baseline Credit Assessment (BCA) of b1, a representation of the group's intrinsic creditworthiness, captures its key role as an autonomous government-owned entity that provides electricity and telecommunications services in Costa Rica. The BCA is tempered by ICE's modest operations and service territory. The BCA also takes into consideration certain corporate governance weaknesses and its exposure to foreign-exchange risk. ICE benefits from a manageable debt maturity profile, but relies on its access to capital markets in the absence of a sizable committed bank credit facility. The B1 rating takes into consideration ICE's high default dependence on the Costa Rican government and the high probability of ICE receiving extraordinary support from the government in case of financial distress.

Exhibit 1

Cash flow from operating activities pre-working capital to total debt and (CFO pre-WC)/debt



Source: Moody's Investors Service

## Credit strengths

- » State ownership and strategic importance
- » Diversified operations as a vertically integrated electric utility and telecommunications services provider
- » Overall credit-supportive regulatory framework for its electricity operations

## Credit challenges

- » Modest operating size compared with that of its global peers
- » Exposure to foreign-exchange risk
- » Certain governance weaknesses, including covenant violations and qualified audited financial statements

## Rating outlook

ICE's negative rating outlook is in line with the negative outlook on the Government of Costa Rica's rating.

## Factors that could lead to an upgrade

Given the negative outlook, we do not expect a rating upgrade in the next 12-18 months. Nonetheless, ICE's rating outlook could be changed to stable if the Government of Costa Rica's rating outlook is changed to stable and ICE continues to record a cash interest coverage above 3.4x and funds from operations (FFO)/debt of 16%.

## Factors that could lead to a downgrade

A further downgrade of the Government of Costa Rica's rating could lead to a rating downgrade for ICE. In addition, if ICE's debt increases significantly above the expected levels, such that its credit metrics deteriorate and cash flow interest coverage falls below 2.0x or retained cash flow/debt declines below 6% for an extended period, it could also strain the ratings.

## Key indicators

Exhibit 2

### Instituto Costarricense de Electricidad (ICE)

	2016	2017	2018	2019
(CFO Pre-W/C) / Debt	19.4%	14.4%	11.0%	16.2%
(CFO Pre-W/C - Dividends) / Debt	19.4%	14.4%	11.0%	16.2%
(CFO Pre-W/C + Interest) / Interest Expense	5.0	3.2	2.5	3.4
Debt / Book Capitalization	50.7%	51.3%	52.3%	50.3%

[1] All ratios are based on adjusted financial data and incorporate Moody's Global Standard Adjustments for nonfinancial corporations.

[2] As of 12/31/2019.

Source: Moody's Investors Service

## Profile

Headquartered in San Jose, Costa Rica, Instituto Costarricense de Electricidad (ICE) is a government-owned vertically integrated electric utility and an integrated telecommunications services provider. ICE's electric and telecommunications operations are subject to the purview of the Costa Rican regulatory bodies Autoridad Reguladora de los Servicios Publicos and Superintendencia de Telecomunicaciones, respectively. As of December 2019, ICE reported consolidated assets of around \$6.4 billion and cash flow from operations (CFO) pre-working capital (WC) of around \$467.7 million.

## Recent developments

On 5 June 2020, we affirmed ICE's B1 ratings, one notch above the Government of Costa Rica's rating of B2, and changed the outlook to negative from stable. Our rating action took into consideration ICE's stronger credit profile than the sovereign based on its dominant

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position as the largest vertically integrated utility in the country and relatively strong financial metrics. The ratings also reflect its autonomous operations regulated by an independent regulator. Importantly, the ratings take into consideration our expectation that ICE's regulatory framework will remain stable, without any negative interference that could affect its financial standing.

Notwithstanding ICE's strengths, the negative outlook is in line with that of the sovereign rating outlook, reflecting the fact that ICE has various links with the government. These include government ownership; revenue derived from the same economic base; reliance on local financing; and exposure to common risks, such as foreign exchange, interest rates and economic performance.

In August 2020, ICE announced the closing of negotiations regarding Reventazón's project debt. As part of the transaction, ICE converted 56% of Reventazón's loan to colones from dollars (reducing around 10% of ICE's overall dollar denominated debt to forging currency fluctuations) as well as a 10 year maturity extension.

## Detailed credit considerations

### State ownership and strategic importance provide a rating uplift

ICE's BCA captures its key role as an autonomous government entity; dominant position as the largest vertically integrated utility in the country; fully regulated nature; and government ownership, which leads to significant links with the Costa Rican government's creditworthiness.

Under our Government-Related Issuers rating methodology, we consider a high default dependence of ICE on the Costa Rican government, given the fact that the government and ICE are exposed to common risks. The government does not guarantee the company's \$1 billion senior unsecured international notes that we rate. However, the B1 senior unsecured rating factors in a high probability of ICE receiving extraordinary support from the government in case of financial distress.

The reasons behind this support assessment include reputational risk, because the company is a major government-owned entity, and its strategic importance to the country's overall economy and as an implementer of the government's energy policies, coupled with the low likelihood of its privatization in the foreseeable future. In our assessment, we also consider the fact that ICE effectively reinvests any generated cash flow back into its business because there are no requirements to pay any dividends. Moreover, ICE's electric operations are exempt from income tax payments. This is currently the case for ICE's telecommunications business, which will be subject to income tax only after the regulator's official declaration of full competition in the sector.

### Telecommunications operations provide diversification and cash flow, but face challenges

ICE's incumbent position in the Costa Rican telecommunications industry provides diversification benefits and enhances the company's consolidated cash flow. ICE's telecommunications operations benefit from the robust market growth rates. The company's commercial strategy is centered on expanding its available products and improving the profitability of its operations. ICE estimates that its telecommunications operations represent around 33% of its consolidated EBITDA.

Telecommunications operations continue to face medium- to long-term challenges after [America Movil, S.A.B. de C.V.](#) (A3 negative, the parent company of Empresa Claro CR Telecomunicaciones) and [Telefonica S.A.](#) (Baa3 stable, the parent company of Empresa Azules y Platas, S.A.) received government authorization to enter the Costa Rican market following the deregulation of the telecommunications sector in November 2011. Since then, ICE's market share has declined, although it still maintains a strong market position. For example, as of 2018, ICE accounted for more than 50% of the market share in terms of subscribers of the mobile telephone sector.

### Modest size exposes ICE's vertically integrated utility operations to certain risks

ICE's ratings incorporate its importance to the Costa Rican electricity sector, as reflected by its significant market shares of more than 75% in both the transmission and distribution sectors (2019). The latter takes into consideration ICE's own distribution operations and its 98.6% ownership stake in Compañía Nacional Fuerza y Luz (CNFL), which serves the San Jose city and contributes 40% of the country's distributed power. ICE's installed generation capacity aggregates almost 2.5 terawatts (TW) (72% of the country's capacity) following the commissioning of the 305.5 megawatt (MW) El Reventazón hydroelectric project (Reventazón). Similar to the country's fleet mix, hydroelectric facilities account for the bulk of ICE's installed generation capacity (69.0%, Costa Rica: 69.2%). ICE also owns thermal-fired plants (19% of its installed capacity) and geothermal plants (10.7%; Costa Rica: 13.4%), while the scale of its solar and wind farms is still modest.

The modest size of ICE's operations and service territory, particularly compared with that of its other global peer utilities, tempers its BCA. This leaves ICE somewhat more exposed to storms and other natural disasters, which affect the region. However, the 230 kilovolt transmission line (1,800 kilometers) Sistema de Interconexión Eléctrica de los Países de América Central (SIEPAC; current capacity: 300 MW, with plans to increase the capacity by an additional 300 MW in the second phase), although not free from challenges yet, enhances the reliability of the Central American power markets, which is credit positive. Exhibit 3 depicts the exchanged volume (2014-19), which is modest compared with the total national demand or total production. However, SIEPAC helps the country better cope with the inter- and intra-annual differences in its hydrological power output (which is usually at the lowest between February and May), which is credit positive. Reventazon (as of year-end 2018: 635.1 gigawatt hours or 6% of the total output) was hit by a three-month shutdown as a result of leakages, which are now resolved. In 2018, this situation led to an increase in the output of the less economically efficient local thermal-fired plants to 1.4% (from 0.3% in 2017) of the country's production. However, in 2019, the thermal-fired plants' output stabilized at 0.9% of the total production (below the 2.6% six-year average).

Exhibit 3

#### Imported and exported electricity (net), and contribution of hydroelectric to generated power in Costa Rica compared with thermal-fired facilities

	2014	2015	2016	2017	2018	2019
Exports (Imports) in GWh	-204.8	106.3	-150.4	190.8	240.8	-21.3
Imports as % of total demand	1%	2.0%	1.4%	2%	2%	2%
%-growth in power demand	1.5%	2.8%	3.1%	0.8%	0.9%	2.0%
Contribution to power production in CR of hydros	66.4%	75.3%	74.4%	77.4%	73.5%	69.2%
Thermal-fired plants	10.3%	1.0%	1.8%	0.3%	1.4%	0.9%

Source: Costa Rican Energy Control Center (CENCE)

#### Overall credit-supportive electricity regulatory framework, although subject to inconsistencies

Our opinion of the overall credit supportiveness of the Costa Rican regulated electricity framework takes into consideration the fact that ICE's tariffs are usually subject to annual reviews (unless the stakeholders agree for ICE to stay out of the rate case), while the rate cases are typically completed in less than four months (ICE's filings: September; outcome: December). This structure theoretically limits the regulatory lag in recovering capital investments, which is credit positive. ICE's base rates also take into account its planned investments for the tariff period (forward-looking), although the rates are subject to adjustments to reflect the actual capital outlays (if different from the projections).

In setting the tariffs, ICE is also allowed to recover the operating build-operate-transfer (BOT) lease payments associated with the projects developed under Law 7200 and Law 7508. Starting January 2020, ICE's tariffs include a variable generation cost, that considers fuel and net cost of imports of the regional energy market. The adjustments are made quarterly, which we consider a credit positive.

ICE's tariffs are 100% volumetric, based on the estimated demand for the following regulatory period. The absence of fixed monthly charges and true-ups reflects the actual demand, exposing the company's cash flow to the volatility in power demand, which is credit negative. However, power demand is likely to continue to grow largely in line with the country's real GDP growth. Given the impact of the pandemic, we do not expect power demand to grow in 2020; however, in 2021, we expect a recovery with a 3% growth in demand.

ICE cannot adjust its base tariffs to reflect the changes in the US dollar-colon exchange rate, unlike other utilities in the region. The absence of natural hedges is another credit negative, particularly given the issuer's significant exposure to foreign-currency exchange risk as most of its debt has been incurred in foreign currency, primarily US dollars, which is credit negative.

In 2019, two tariff reviews were approved: one to compensate for the lower tariffs charged in 2017 and the other for the current year, which was implemented in January 2019. Nonetheless, starting October 2019, a tariff reduction of 2.8% took place, in line with ICE's cost optimization program. In 2020, another tariff reduction of 8.4% occurred in line with the reduction of expenditures implemented by ICE.

#### ICE's metrics are likely to remain adequate

The 2014-35 national power generation expansion plan, published in April 2014, disclosed the pipeline of projects under consideration to meet the country's long-term power demand under different scenarios. If undertaken, the plan would double the country's installed

capacity to 6,124 MW. However, a significant portion of these projects are being undertaken by independent power producers under BOT schemes. Therefore, we expect ICE's medium-term investments to remain modest following the completion of Reventazon.

According to the Costa Rican GAAP, ICE started to report during the fourth quarter of 2016 Reventazon's project debt of around \$900 million (previously off-balance sheet), leading to a temporary deterioration in ICE's financial metrics. In 2019, cash flow interest coverage (CFO pre-WC + interest expense/interest expense) was 3.4x and CFO pre-WC/debt was 16.17%, below the historical averages but consistent with ICE's rating range. The weaker performance is explained by the consolidation of Reventazon and the unfavorable outcomes of tariff approvals. As mentioned earlier, ICE currently does not pay dividends or income tax, which will further aid its metrics.

### Risk management considerations

The BCA is also tempered by our perception of ICE's weak corporate governance practices. We take into consideration the qualified audit opinions issued with ICE's financial statements, which is credit negative. Similar to that in previous years, the qualified opinion as of year-end 2018 highlights the auditor's inability to perform sufficient audit procedures on a few items in the financial statements, such as certain account receivables, prepaid income, and property plant and equipment adjustments. We view positively the fact that these qualifications remain specific and narrowly focused on particular accounts, and that such amounts are not considered significant data points in determining ICE's overall credit ratings.

In 2018, ICE canceled the El Diquis hydroelectric project, given the slower-than-expected demand growth, reducing the need for new capacity and following a significant delay in the project because of issues with the communities in the area. The cancellation of the project resulted in a write-off of around \$150 million in 2018. Nonetheless, we do not expect any impact on ICE's current BCA or foreign-currency rating, given its one-off nature and ICE's relatively strong liquidity.

We understand that ICE obtains waivers from [Corporación Andina de Fomento](#) (Aa3 stable), Interamerican Development Bank and [Kreditanstalt fuer Wiederaufbau](#) (Aaa stable), given its inability to comply with certain leverage financial covenants. However, ICE's BCA takes into consideration the fact that multilateral financial institutions are unlikely to accelerate the outstanding balance of its loans and will continue to provide the required waivers (annual certifications). These covenants have not been met since ICE started reporting Reventazon's project debt given ICE's is currently in the process of adopting an adjusted cost method to update the reported asset values. A failure to comply with these financial covenants without the waivers is a credit concern since certain portions of ICE's outstanding debt include cross-default provisions.

ICE's exposure to foreign-exchange risk also caps the BCA. ICE has implemented a hedging strategy with derivatives as well, through clauses with respect to currency convertibility embedded in the loan contracts. Nonetheless, its hedging strategy is limited by the lack of market depth that currently exists for colones. Thus, the utility's exposure to foreign-exchange risk still remains significant. This is particularly the case for its debt denominated in US dollars, which represents around 70% of its outstanding debt.

### Liquidity analysis

As of December 2019, ICE's cash and equivalents totaled around \$203 million. The rating takes into consideration the fact that ICE will be able to maintain a robust cash balance that allows it to meet its capital requirements, particularly aided by the absence of dividend distributions. This is particularly important because, similar to other Central and Latin American issuers, ICE currently has no committed credit lines in place. Notwithstanding, as of the date of this report, ICE's cash balance and investments amount to approximately \$545 million which are sufficient to meet next debt maturities in case market conditions are not favorable.

### ESG considerations

Regulated electric and gas utilities is among the 51 sectors with a moderate exposure to environmental risks in our [environmental risk heat map](#). Nonetheless, because ICE generates mostly renewable energy, it has a low exposure to environmental risks.

ICE has a low exposure to social risks. It does not have any significant exposure to health and safety risks related to its workers or its workforce's negotiating power.

ICE has a moderate governance exposure, given the essential services it provides and its close links with the government, as reflected by the tariff review processes.

## Methodology and scorecard

We mainly evaluate ICE's BCA relative to our [Regulated Electric and Gas Utilities](#) rating methodology, published in June 2017. As depicted in the scorecard, the issuer's scorecard-indicated outcome based on the three-year average historical and projected credit metrics is Ba1.

Exhibit 4

### Rating factors

#### Instituto Costarricense de Electricidad (ICE)

		Current FY 12/31/2019
<b>Regulated Electric and Gas Utilities Industry [1][2]</b>		
<b>Factor 1 : Regulatory Framework (25%)</b>	<b>Measure</b>	<b>Score</b>
a) Legislative and Judicial Underpinnings of the Regulatory Framework	Ba	Ba
b) Consistency and Predictability of Regulation	B	B
<b>Factor 2 : Ability to Recover Costs and Earn Returns (25%)</b>		
a) Timeliness of Recovery of Operating and Capital Costs	Ba	Ba
b) Sufficiency of Rates and Returns	Ba	Ba
<b>Factor 3 : Diversification (10%)</b>		
a) Market Position	Baa	Baa
b) Generation and Fuel Diversity	Ba	Ba
<b>Factor 4 : Financial Strength (40%)</b>		
a) CFO pre-WC + Interest / Interest (3 Year Avg)	3.0x	Baa
b) CFO pre-WC / Debt (3 Year Avg)	13.8%	Baa
c) CFO pre-WC – Dividends / Debt (3 Year Avg)	13.8%	Baa
d) Debt / Capitalization (3 Year Avg)	51.3%	Baa
<b>Rating:</b>		
Scorecard-Indicated Outcome Before Notching Adjustment		Ba1
HoldCo Structural Subordination Notching		
a) Scorecard-Indicated Outcome		Ba1
b) Actual Rating Assigned		B1
<b>Government-Related Issuer</b>		
	<b>Factor</b>	
a) Baseline Credit Assessment	b1	
b) Government Local Currency Rating	B1	
c) Default Dependence	High	
d) Support	High	
e) Actual Rating Assigned	B1	

[1] All ratios are based on adjusted financial data and incorporate Moody's Global Standard Adjustments for nonfinancial corporations.

[2] As of 12/31/2019.

Source: Moody's Investors Service

## Ratings

Exhibit 5

<u>Category</u>	<u>Moody's Rating</u>
<b>INSTITUTO COSTARRICENSE DE ELECTRICIDAD (ICE)</b>	
Outlook	Negative
Corporate Family Rating	B1
Senior Unsecured	B1

Source: Moody's Investors Service



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