European utilities outlook: more investment but more selective in 2024

European utilities are at the forefront of the green energy transition on the continent. Investment needs have significantly increased over the years and 2024 will see another 5% expansion in capex. Nevertheless, inflation and the higher cost of materials mean that European utilities will be more selective when it comes to renewable projects

European utilities at the forefront of the green transition

The European utilities sector is in an important transition phase towards green energy generation and transmission. The provisional agreement in March 2023 updating the European Union's Renewable Energy Directive states that the green transition needs to accelerate further. At the European level, renewables accounted for 21% of the bloc's total energy consumption at year-end 2022. The directive and its new target for 2030 now expect renewables to represent a 42.5% share of the EU's total energy mix instead of the 40% target set earlier by the RePowerEU package announced after Russia's invasion of Ukraine.

While every industrial sector is being asked to reduce CO^2 emissions by adopting green energy consumption and other climate mitigation measures, the utilities sector is at the forefront of green electrification.

Higher costs and interest rates could be threats to investment

Like many industries, soaring commodities and material costs are impacting the utilities sector. Purchasing, staff and financing costs, especially for offshore wind farms, have forced some utilities to terminate some of their projects.

Danish utility Orsted recently announced a €2.1bn impairment charge on its US offshore wind farm projects. Soaring costs, higher interest rates and uncertainty about related subsidies are having a dramatic impact on the expected return on investment.

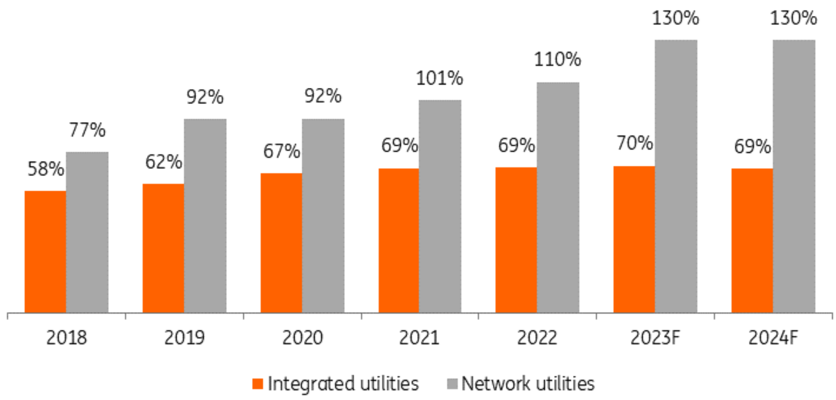
Offshore wind farm development is 40% more expensive

While Vattenfall recently opened its offshore wind farm on the Dutch coast, it announced it was suspending the development of its 1.4GW Norfolk Boreas offshore wind farm intended to power 1.5 million UK homes. According to the Swedish utility, costs on the project have increased by 40%, negatively impacting the company's future earnings on the project.

In September 2023, the United Kingdom failed to attract bids for its offshore wind power auctions. Offshore wind developers argued that the government's offer did not match the surging costs and higher funding expenses. The same reasons explain the poor auction results that Spain registered in December 2022. Only 50MW of wind projects were subscribed when authorities planned to allocate 3.3GW of new onshore wind power and solar panels.

Capital expenditure plans are financed partly by debt, especially for network utilities[1] whose regulated cash flow generation does not provide them with sufficient funds to finance investment plans in full. In 2023 and 2024, we estimate that network utilities' investment plans will surpass earnings before interest and depreciation (EBITDA) by 30%. For integrated utilities[2], earnings are sufficient to finance capital expenditure needs. However, EBITDA represents the revenues generated by activities when operating costs and taxes have been deducted. The financial indicator does not take into consideration interest expenses on financial debt, and the remuneration of shareholders.

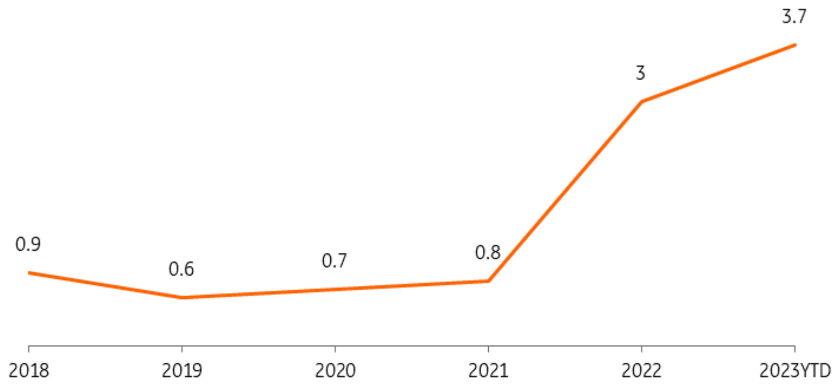
Capital expenditure to EBITDA (%)



Source: Company data, ING

The utilities sector is a capital-intensive sector and European utilities are heavy users of bonds and bank loans. While investments partly need to be financed by new financial instruments, utilities also face loan and bond redemptions. On top of higher operating costs, the sector has to refinance its debt at much higher interest rates than in the last five years. Today, the sector pays an average rate of 3.7% on new five-year senior bonds. In 2022, this rate was 3% on average. In the period 2018-2021, Utilities could issue five-year senior bonds with an average coupon rate of 0.8%.

European utilities: average coupon yield on new bond debt (%)



Source: ING

European utilities' capital expenditure needs continue to grow

In 2024, the top 40 European utilities will likely invest a total of €132bn in the maintenance and development of their grids, renewable base and conventional energy generation assets. According to their strategic plans and our estimates, this global amount compares to €126bn for the full year 2023, representing 5% growth year-on-year.

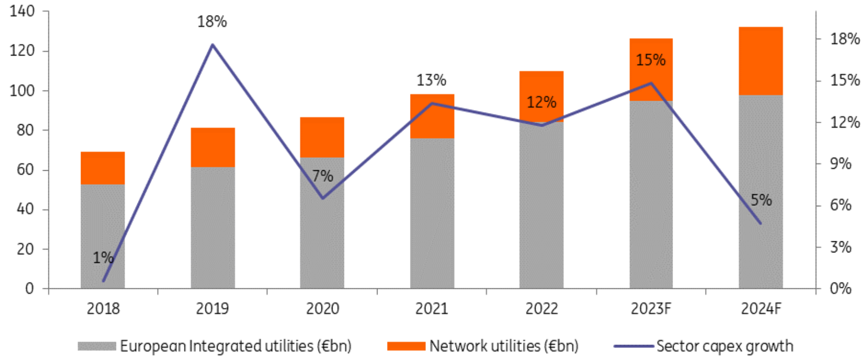
5% Investment growth in 2024

Looking back to the period 2018-2022, the sector's investment plans have grown by a staggering average of 10% per year going from c.€70bn in 2018 to €110bn in 2022.

The 5% increase that we forecast for 2024 is smaller than what we have seen in the last five years. We see two reasons for this:

1. Investments saw an exponential expansion from 2021-2023 and the growth is now returning to a more average level.
2. With (renewable) projects now more expensive, as seen with Orsted and Vattenfall, European utilities have become more selective as they want to secure an appropriate level of return on investment.

Top 40 European utilities' capital expenditure 2018-2024

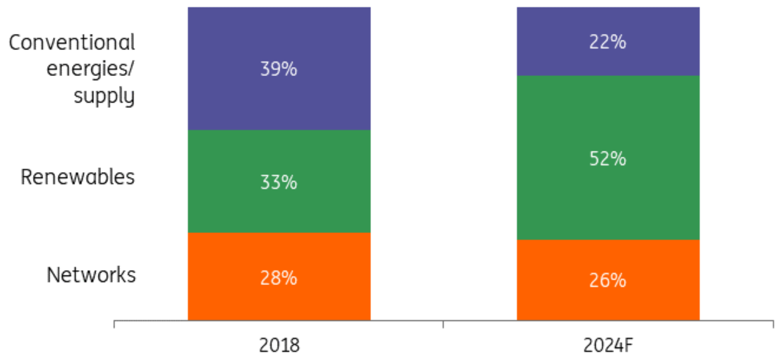


Source: Company data, ING

The share of investments dedicated to renewables is increasing

The shift in European integrated utilities' business models from conventional energy generation producers and suppliers (coal, natural gas and nuclear) towards renewables is reflected in past and future investments. In 2018, 33% of the total investment was dedicated to renewables. We forecast renewables to represent 52% of total investment in 2024. With conventional power generation plants being shut down or disposed of, capital expenditure for this segment is in significant decline, from 39% in 2018 to 22% in 2024.

Top 20 European integrated utilities' investment per activity



Source: Company data, ING

30% Share of investment forecast to be made outside of Europe next year

Not all investments are earmarked for Europe

In 2024, we estimate that 70% of the investments made by European integrated utilities will be earmarked for Europe with 30% outside the region, a ratio similar to 2023. Internationally, European integrated utilities' favourite destinations are North, South and Central America. The

United States has been an attractive place for renewable investments through fiscal incentives. At the beginning of 2023, the Biden Administration's Inflation Reduction Act restarted a US$10bn tax credit for clean energy producers. Due to their historical ties with Latin and Central America, Southern European utilities have and continue to invest heavily in these regions. With strong growth potential for renewable energy demand and grid services in these regions, Spanish, Portuguese and Italian integrated utilities are committing up to 60% of their total investments outside their European market presence.

1 *Network utilities: Alliander, Amprion, Elia Belgium, Enagas, Enexis, Eurogrid, Fingrid, Fluvius, Italgas, National Grid, Nederlandse Gasunie, Red Electrica, Redexis, REN, RTE, Snam, Stedin, TenneT, Terna*

2 *Integrated utilities: Acea, A2A, Centrica, Cez, EDF, EDP, EnBW, Enel, Engie, E.on, Fortum, Hera, Iberdrola, Naturgy, Orsted, RWE, Suez/Veolia, Vattenfall, Verbund, Statkraft*

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