S&P Global Ratings

Sustainable1

Environmental, Social, And Governance Evaluation

EP Infrastructure

Summary

EP Infrastructure (EPIF) is a Czech Republic-based diversified energy infrastructure group that operates across four core segments: gas transmission, gas and electricity distribution, gas storage, and heat generation and distribution. It also has interests in Slovakia and Germany, and until 2020 also was active in Hungary. Its subsidiaries have long operational histories, although the group in its current form was founded in 2013. EPIF is majority owned (69%) by EPH, a vertically integrated energy company. Macquarie Infrastructure and Real Assets (MIRA) acquired a 31% interest in 2017.

EPIF's ESG Evaluation of 66 reflects a governance structure that has enabled the group to realize its strategy, but that lacks formal independence; it also reflects our view that EPIF is adequately prepared for potential disruptions, and has a still-developing approach to long-term sustainability. While the group's handling of environmental risk focuses largely on regulatory compliance, EPIF recently set decarbonization targets, which will likely fuel improvements in its environmental performance. As for social risk, in our opinion, the group lacks a clear, long-term approach to talent development and places limited emphasis on improving diversity. That said, the group has recently appointed female CEOs in two of its divisions. In addition, we understand that EPIF has a clear commitment to safety.

Finally, the governance framework reflects a strong shareholder agreement between EPIF and MIRA. In our view, the group has made concerted progress on mitigating the key-person risk that came from the dual chairman-CEO role that EPIF's majority owner, Daniel Kretinsky, formerly held, by separating these roles earlier this year. Nevertheless, we believe that the board, despite its strong industry and regional expertise, lacks independence, diversity, and an effective system of checks and balances. These limitations notwithstanding, we acknowledge that the group has demonstrated its proficiency in deal due diligence and execution, and has become a prominent energy infrastructure utility in Central Europe.

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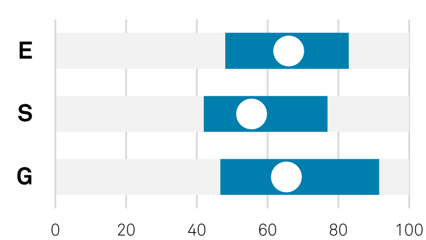
ESG Profile Score

63 /100



Company-specific attainable and actual scores

Preparedness Opinion (Scoring Impact)

Adequate (+ 3)

ESG Evaluation

66/100

A higher score indicates better sustainability

Component Scores

Environmental Profile		Social Profile		Governance Profile	
Sector/Region Score	**33/50**	**Sector/Region Score**	**27/50**	**Sector/Region Score**	**27/35**
Greenhouse gas emissions	**Good**	Workforce and diversity	**Lagging**	Structure and oversight	**Good**
Waste and pollution	**Good**	Safety management	**Good**	Code and values	**Developing**
Water use	**Good**	Customer engagement	**Good**	Transparency and reporting	**Good**
Land use and biodiversity	**Good**	Communities	**Good**	Financial and operational risks	**Neutral**
General factors (optional)	**3**	General factors (optional)	**None**	General factors (optional)	**3**
Entity-Specific Score	**33/50**	**Entity-Specific Score**	**29/50**	**Entity-Specific Score**	**39/65**
E-Profile (30%)	**66/100**	**S-Profile (30%)**	**56/100**	**G-Profile (40%)**	**65/100**

ESG Profile (including any adjustments) **63/100**

Preparedness Summary

EPIF is adequately prepared to remain resilient as the European energy system decarbonizes to net-zero emissions by 2050. Though the group's strategy to date has involved the acquisition of midstream and generation assets that in their current guise are not aligned with this net-zero trajectory, the group is beginning to implement decarbonization targets that will gradually bring its district heating plants and gas infrastructure into alignment. EPIF is also allocating investment to enhance its gas network's hydrogen carrying capabilities. Though such sustainability enhancements are a positive step, we have yet to see complete integration of sustainability considerations into the group's long-term strategy. Finally, our assessment also incorporates our view of EPIF's experienced board with a successful track record of deal execution.

Capabilities	
Awareness	**Excellent**
Assessment	**Good**
Action plan	**Excellent**
Embeddedness	
Culture	**Developing**
Decision-making	**Good**

Preparedness Opinion (Scoring Impact) **Adequate (+3)**

ESG Evaluation **66/100**

Note: Figures are subject to rounding.

Environmental Profile

66/100

Sector/Region Score (33/50)

EPIF operates mainly in gas transmission and storage (58% of 2020 EBITDA), gas and electricity distribution (36%), and coal-based heat generation and distribution (6%). The energy transition is the most material environmental risk for these sectors given toughening greenhouse gas (GHG) regulations globally. They also face waste impacts, such as air emissions from the burning of fossil fuels, along with land and biodiversity impacts as biomass becomes a greater part of the power generation sector's fuel mix.

Entity-Specific Score (33/50)

Note: Figures are subject to rounding.

Greenhouse gas emissions	Waste and pollution	Water use	Land use and biodiversity	General factors
Good	**Good**	**Good**	**Good**	**3**

EPIF is progressing in its transition from fossil fuels. The group has implemented targets to gradually fuel switch from coal to gas, biomass and waste, and to reach net-zero emissions across its direct operations by 2040. These targets are broadly aligned with generation peers, but lag stronger peers whose net-zero targets apply to all scopes. Notwithstanding its decarbonization aims, EPIF currently underperforms its non-Czech Republic-based power generation/district heating sector peers on scope 1 emissions intensity, and though the group is committed to phasing out lignite in its generation assets by 2030, this target lags more advanced peers that have already phased out coal. We also note the sale in 2020 of two district heating plants in Budapest and Prague, which led to an improvement in the group's direct and indirect emissions footprint. In its gas storage, transmission, and distribution operations, EPIF uses predictive maintenance to gauge leaks and has policies to avoid venting, which is aligned with advanced peers. The emissions from these assets, such as through leaks, though quite low for the transmission system, are comparatively high for the distribution system relative to peers. In addition, we factor in EPIF's modern gas infrastructure--50% of its pipes in Slovakia are plastic--which should enable a swift incorporation of hydrogen into the fuel mix as momentum on hydrogen develops.

We anticipate EPIF will continue lowering its air emissions. We expect the group will continue to improve its air emissions performance as it moves away from coal as a primary energy source, but its current and historic nitrogen oxide, sulphur dioxide, and dust emissions on a revenue-intensity basis are demonstrably higher than those of peers outside of the Czech Republic, largely driven by the country's current fuel mix. That said, EPIF has consistently reduced its air emissions across all of these pollutants since 2015, mostly through technology enhancements. EPIF's actions on air emissions are primarily in response to regulatory requirements, which lags some more proactive peers. EPIF has yet to track mercury emissions but will do so in line with incoming regulations, but strong peers have tracked both mercury and cadmium emissions for some time.

EPIF's actions to preserve biodiversity remain in line with regulatory requirements. EPIF's strategy involves the acquisition and refurbishment of operational assets, and it typically does not develop greenfield sites, and so carries minimal risk to nature. That said, as the group transitions to using biomass as a primary energy source, we believe that its impact on land use and biodiversity could increase, but note its use of timber felled due to a bark beetle outbreak.

Social Profile

56/100

Sector/Region Score (27/50)

The most material social risks for the gas storage, transmission, and distribution sectors involve maintaining reliable and affordable networks. Community relations can also be a material risk, especially during network upgrades. Safety is generally well managed, but high-impact events, such as gas leaks or explosions, can occur and have financial and reputational consequences. Strikes from largely unionized workforces, aging talent, and skill shortages also pose risks to the sector.

Entity-Specific Score (29/50)

Note: Figures are subject to rounding.

Workforce and diversity	Safety management	Customer engagement	Communities	General factors
Lagging	**Good**	**Good**	**Good**	**None**

Though EPIF has a highly skilled workforce, it lags peers on a range of diversity metrics. A material risk for EPIF and the sector more generally is an aging workforce. EPIF has yet to implement strategies to attract younger talent, unlike sector peers, which suggests their metrics are unlikely to improve materially in the near term. As a result, EPIF's workforce is heavily skewed above 50 years old compared with its peer group. Similarly, EPIF still lags stronger peers in its total share of females in the workforce, with the figure remaining flat at 20% since 2018. We believe it is unlikely to improve materially in the future given the absence of initiatives to attract female talent or targets to increase the number of women at various levels of seniority, but note its recent appointment of two female CEOs in its heating plant, Elektrárny Opatovice, and renewables division. Similarly, EPIF has yet to implement a formal employee engagement survey, which lags stronger performing peers.

Safety management is a priority for EPIF, and its procedures are in line with the sector. The group's long-term injury frequency rate has fluctuated in recent years, but from 2019 to 2020 has trended downwards, although it remains high compared with that of its sector peers. We view EPIF's integration of health and safety into its incentive schemes as being a notable strength compared with its peers. We note too that safety management is a core feature of EPIF's management, which is a common feature among peers. Though we see steps being made to enhance the group's safety performance, such as through the introduction of a procurement policy that addresses supplier safety performance, we note that EPIF lacks targets on safety management that go beyond a goal of zero accidents, and that EPIF had one fatality in 2017 and another in 2019, when most peers had none. There have been no fatalities since 2019.

EPIF has good links with the communities it operates in. The group showcased its commitment to the regions where it operates through a donation to support the purchase of ventilators and masks in the initial stages of the COVID-19 pandemic. The company has however experienced some issues with local environmental lobbies, which could lead to reputational risk for EPIF, especially as decarbonization becomes a more mainstream concern.

EPIF has consistently exceeded regulatory requirements for system reliability. Though EPIF does not engage directly with retail customers, its electricity distribution subsidiary has delivered a consistent supply of power and communicated with consumers regarding potential disruptions, which we view as positioning EPIF in line with its sector peers.

Governance Profile

65/100

Sector/Region Score (27/35)

EPIF is headquartered in the Czech Republic, but also operates across Slovakia, Hungary, and Germany. Governance standards in the Czech Republic are somewhat behind the EU's generally high standards. About 90% of the group's EBITDA in 2020 came from its operations in Slovakia, which has a higher level of perceived corruption and weaker political institutions.

Entity-Specific Score (39/65)

Note: Figures are subject to rounding.

Structure and oversight	Code and values	Transparency and reporting	Financial and operational risks	General factors
Good	**Developing**	**Good**	**Neutral**	**3**

EPIF is a private group with a strong shareholder agreement and the board has a good balance of skills and expertise. We believe that the recent appointment of a new CEO (Gary Mazzotti), paired with an effective shareholder agreement between MIRA and EPH, lessens the key-person risk at EPIF. However, the group lacks a formal system of checks and balances. EPIF's governance consists of a two-tier structure, with a board of directors in charge of the group's management and the true driver of the group, and a nonindependent supervisory board primarily tasked with approving the dividends and accounts, but with an ultimately limited oversight function. The seven-person management board has an effective blend of regional expertise and infrastructure knowledge, provided by two representatives from MIRA and five directors from EPH—even though he does not represent any of the shareholders, we do not consider Mr Mazzotti independent since he is the CEO of the group. Strategic decision-making rests in the hands of the two shareholders, and EPIF's strong shareholder agreement requires unanimous consent for major decisions. The recent appointment of Mr. Mazzotti as CEO of EPIF somewhat mitigates the key-person risk that came with Daniel Kretinsky, the majority owner, previously holding a dual role as CEO and chair of the management board. However, Mr. Kretinsky still has a prominent role in the group and serves on multiple subsidiary boards. While we recognize the solid management of the group in practice, the lack of a formalized institutional system of independent checks and balances weighs on our assessment. We are aware of EPIF's strategic review, but we have based our assessment on the current governance structure. However, we believe that should there be an IPO, it could strengthen the current governance structure.

EPIF is working to embed a unified set of codes and values across the group, but has yet to demonstrate the efficacy of its new ESG policies. Though the framework covers its core values, such as offering a reliable service that is in line with regulatory requirements, and has clauses for all of its major stakeholders, EPIF has yet to implement a mechanism to track and ensure compliance among its workforce. EPIF also lacks a track record on the efficacy of its recently published ESG policies, such as its anti-corruption and bribery policies. Finally, in our view, EPIF's remuneration structure remains opaque, with alignment with the group's strategy unclear.

The disclosure of nonfinancial information is improving at EPIF. This improved transparency is typified by EPIF's announcement of a set of decarbonization targets, and the actions it seeks to take to achieve those targets, which, collectively, compare well with those of peers. Though EPIF's level of disclosure of nonfinancial data is broadly aligned with its sector peers', considering that it is a private group, we see EPIF as demonstrating a commitment to transparency and disclosure.

Preparedness Opinion

Adequate
(+3)

Preparedness	Low	Emerging	Adequate	Strong	Best in class

EPIF's strategy is rooted in acquiring and operating high-quality regulated or midstream companies in Central European countries with supportive regulatory and structural factors, but its strategic emphasis on long-term sustainability is still developing. The group has effectively established itself as a leading player in the markets where it operates with assets that are strategically important for the region. However, its asset base is predominately gas oriented, which carries long-term climate-related risks as the EU accelerates its decarbonization agenda. That said, the group is gradually decarbonizing its footprint through fuel switching its heat infrastructure assets to biomass, communal waste, and natural gas, and is exploring alternative sources of energy and investing in research and development activities aligned with the energy transition, such as blue hydrogen as a replacement for gas. However, in our view, it is not clear how the group explicitly integrates long-term sustainability objectives into its strategic decision-making.

The blend of considerable regional and deep industry knowledge from EPIF's board provide a balanced understanding of the unique risk landscape of the regions and assets it operates. The board views protracted tensions between Russia and Ukraine, decarbonization (including the introduction of hydrogen into gas networks), and the future of gas in Europe as material risks, and its members showcase a keen awareness of the complicated nuances underpinning these risks. Board members also show strategic flexibility in their thinking and while they use an informal approach to analyze scenarios, in-depth strategic discussions at the board level support resilience in their thinking about the impact of risks they face from major projects on the group's performance, and the long-term viability of potential acquisition targets.

Its management team has a track record of executing strategic acquisitions of operational and regulated assets in Central Europe in response to evolving market dynamics and contingency plans that mitigate potential disruptions. Through acquisitions, it has positioned itself among the key utility players in Central Europe. In addition, the group's networks are generally new and efficient, resulting in a relatively long remaining useful life, low capital expenditure, and high cash flow conversion for the foreseeable future, in our view. The group has a rigorous and disciplined approach to deal due diligence and applies strict investment criteria to ensure deals are suitable for the risk appetite of EPIF's key shareholders and aligned with the long-term strategy, although we note that sustainability is yet to be a core feature of this process.

The desired culture is still being shaped across the group's subsidiaries, and is largely influenced by its ultimate owner, Daniel Kretinsky, who promotes the strategy and vision of both of EPIF's shareholders that emphasizes entrepreneurship and innovation. While we recognize that EPIF has a strong team in place and it has effectively improved efficiency and communicated the group's goals for middle management and employees at all its acquired subsidiaries in the past few years, it is unclear the extent to which communications focus on the desired culture and efforts to track whether that culture is well understood are lacking. In addition, the group's efforts to integrate long-term sustainability objectives into its decision-making are relatively nascent, and it faces unique challenges as a relatively new group composed of subsidiaries with long operating histories, as it seeks to meet increasingly prescriptive regulatory requirements and to transition from fossil fuels.

Sector And Region Risk

Primary sector(s)	Utility Networks
Primary operating region(s)	Slovakia Czech Republic Hungary

Sector Risk Summary

We base our sector analysis on EPIF's operations in the utility networks and oil and gas infrastructure (midstream) sectors, and we split exposure across these sectors according to the company's EBITDA in 2020.

Environmental exposure

The regulated utility network sector's exposure to environmental risks stems from its infrastructure assets and exposure to the environmental characteristics of entities across value chains. These networks are generally viewed as having high responsibility for ensuring clean water and air and helping to transition to a lower carbon economy. While electric, gas, and water networks each have unique environmental risk drivers, the most material environmental risks facing these subsectors are the physical effects of climate change and mitigation policies.Each subsector also faces some land-use risk; as they grow they risk encroaching on habitable or undeveloped lands that are more exposed to biodiversity issues in some parts of the world. Electric and gas utilities are exposed to significant energy transition risks, indirectly, through their upstream partners. These risks to networks are moderated, at least financially, by the regulatory support they enjoy and their ability to absorb costs through rate increases. However, less direct reputational effects can be significant given utilities' strong brand recognition. For electric transmission and distribution networks, the physical effects of climate change, including more frequent and severe wildfires, storms, hurricanes, and tornadoes, have the potential to disrupt the functioning of critical equipment and processes. Battery storage has its own set of environmental risks, stemming from mining and end-of-life disposals of materials used in battery units. For natural gas networks, we focus on gas explosions and leaks that emit highly potent greenhouse gases and may adversely affect local biodiversity, leading to costly penalties and reputational damage. For water networks, environmental risks are mainly water quality and availability, sometimes because of inefficient and aging infrastructure. Both water quality and availability--essential for this sector--can be impaired by climate-related factors, including droughts and floods.

Social exposure

The regulated utility network sector plays a crucial community role by providing essential services that must remain affordable and reliable to ensure conciliatory regulatory and customer relationships. This is the essence of utilities' social license to operate. However, as infrastructure ages, utilities must also ensure safety as leaks, explosions and fires can yield very material financial and reputational consequences. Water utilities may also face public health risks if they are unable to avoid drinking water contamination or stop wastewater from polluting supplies. Governments and regulators focusing increasingly on affordability, which we believe could create barriers to regulated networks' cost recovery. This is especially so in areas facing upward cost pressures from ongoing high investments in renewables and grid strengthening. Longer term, increased costs and improved solar and battery technology could result in some downstream residential, commercial, and industrial customers partially defecting from electric utilities. Utilities also face significant workforce issues. Amid an unrelenting energy transition, electric utilities, specifically, must develop employee bases with appropriate skills to operate the grid of the future, as well as retain employees. Given the sector's high unionization, companies have to focus on labor-relations management to avoid labor disruptions and related costs. Given that utilities are local in nature, they play a prominent role in communities and have large numbers of local employees. This can often result in regulatory support, but also carries a responsibility to contribute to the community and support low income customers, as well as tactfully mitigating disputes around land use as they expand. Finally, given the social responsibility of providing continuous electricity, gas, and water supply, preventing any risk that could lead to a power blackout or water shortage is an important consideration. Cyber-attacks are therefore increased threats for the sector, more so than in many other sectors.

Regional Risk Summary

Slovakia

Corporate governance legislation in Slovakia is primarily based on the Securities Act, the Accounting Act, and the Commercial Code. In 2002, the Stock Exchange and the Financial Market Authority adopted a first version of a corporate governance code. It was then adapted by the Central European Corporate Governance Assn., which released the latest version in 2016. Mostly principle-based, the Code works on a comply-or-explain basis. Although companies are required by law to report annually on their compliance with the Code, the level of adoption and quality of disclosures are low. Companies operate under a dual-board system with a supervisory board overseeing a management board. However, the supervisory board's role is ill-defined by the law and shareholders can still elect and remove members of both boards. This takes an important responsibility away from the supervisory board of directors. Boards often lack independence--there is no independence requirement--and female participation is significantly lower than for the rest of Europe. Corruption perception levels are relatively high and the country ranks in the bottom half of EU countries (59 out of 180 on the Transparency International 2019 Corruption Perceptions Index).

Czech Republic

The country's key political and economic institutions have a good track record of independence and effectiveness despite the greater instability of Czech governments, historically. Based on OECD principles, the 2018 Czech corporate governance code is the reference document for best practices. It operates on a comply-or-explain basis, but companies are required to publish an annual statement on their alignment with it. Companies can choose between one- or two-tiered governance structures where a supervisory board oversees the executive board. At companies with over 500 employees, employees can elect one-third of the supervisory board. While the stock exchange doesn't have specific ESG requirements in its listing rules, companies of over 500 employees are implementing the EU Non-Financial Reporting Directive's recommendations, which mandate disclosing ESG risks. The Czech Republic's perceived corruption levels are higher than other EU countries (it ranks 49 out 180 on the Transparency International 2020 Corruption Perceptions Index).

Hungary

Hungary has been increasingly centralizing decision-making and weakening checks and balances, including diminishing judicial independence. Government controls, not only of the judiciary but also the media, have attracted significant criticism including from the EU. Hungary’s record on human rights has also been worsening, along with the rule law. For corporate governance, Act V of the Civil Code, Capital Market Act CXX and the Act No. C on Accounting are the primary legislative bases. In addition, the Budapest Stock Exchange issued a set of governance recommendations in 2004, which were last revised in 2012 and operate under a comply-or-explain basis. The application of these guidelines is limited, however, and overall governance practices are weaker than European standards, particularly regarding the structure and functioning of boards and female participation. Boards are typically organized under a two-tier system, with a supervisory board and a management board. However, the role of the supervisory board in Hungary is very limited and marginal, given that management typically holds all decision-making powers. In terms of corruption, Hungary has one of the worst performance in the EU. It ranks 70 out of 198 on the Transparency International 2019 Corruption Perceptions Index, in the bottom three of EU members.

Related Research

- "The ESG Risk Atlas: Sector And Regional Rationales And Scores," published July 22, 2020
- "Our Updated ESG Risk Atlas And Key Sustainability Factors: A Companion Guide," published July 22, 2020
- "Environmental, Social, And Governance Evaluation: Analytical Approach," published Dec. 15, 2020
- "How We Apply Our ESG Evaluation Analytical Approach: Part 2," published June 17, 2020

This report does not constitute a rating action.