MOODY'S
INVESTORS SERVICE

CREDIT OPINION
5 July 2016

Update

Rate this Research

RATINGS

Eandis System Operator CVBA

Domicile	Belgium
Long Term Rating	A1
Type	LT Issuer Rating - Dom Curr
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.

Analyst Contacts

Stefanie Voelz 44-20-7772-5555
Senior Credit Officer
stefanie.voelz@moodys.com

Velina Karadzhova 44-20-7772-5478
Analyst
velina.karadzhova@moodys.com

Neil Griffiths-Lambeth 44-20-7772-5543
Associate Managing Director
neil.griffiths-lambeth@moodys.com

Eandis System Operator CVBA

Update following announcement of new equity partner

Summary Rating Rationale

The A1 rating of Eandis System Operator CVBA (Eandis) reflects Moody's assessment of the credit quality of the distribution system operator (DSO), Eandis Assets, which owns the company and guarantees its liabilities.

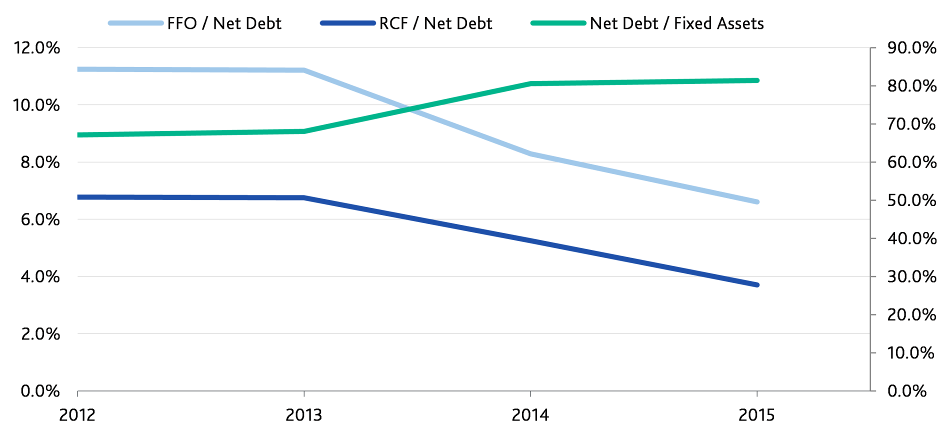
This assessment is underpinned by the low business risk profile of Eandis's regulated electricity and gas distribution network operations in Flanders, Belgium. The regulatory framework is supportive and transparent, albeit relatively new and untested in the context of European regulated network peers following the transition of tariff setting responsibilities from the national to the regional regulators in 2014.

The rating is constrained by the high level of gearing and weak cash flow generation. Eandis's most recent financial results showed net debt to regulated assets of around 80% and funds from operations (FFO) to net debt below 10%, evidencing limited financial flexibility.

Exhibit 1

Financial metrics have deteriorated since Electrabel exit in 2014

FFO/net debt and RCF/net debt shown on left-hand scale; net debt/fixed assets on right-hand scale



Note: All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations.
Source: Moody's Financial Metrics TM

Further to the company's announcement on 29 June 2016, State Grid International Development Limited (SGID, Aa3 negative) will take a 14% equity stake in Eandis Assets, subject to approval by existing shareholders in an extraordinary meeting in October this year. We expect the transaction, if concluded, to provide a substantial equity contribution and create headroom at the current rating level to allow Eandis to accommodate a more challenging regulatory decision for the period commencing in 2017 as well as slower regulatory tariff deficit recovery than management anticipated.

The assigned A1 rating reflects around three notches of uplift from the stand-alone credit quality of the Eandis economic group (comprising the DSO and Eandis), which is in the high-Baa range. This uplift is based on Moody's view that there is a high probability that the Community of Flanders (Aa2 stable) will ultimately support the DSO should that become necessary in exceptional circumstances, given the strategic and economic importance of the provided services for the region.

Credit Strengths

» Rating underpinned by strong linkage with the region through provision of essential energy network services.

» Transparent and supportive regulatory framework, but relatively short track record, with tariff responsibility transferred from national to regional regulator in 2014.

Credit Challenges

» Financial metrics have deteriorated over recent years with increasing levels of debt. Absent balance sheet strengthening, such as the planned share sale, recovery will likely be very slow.

» Cut in allowed returns as proposed in draft regulatory proposals, and continuing high dividend payout will weigh on financial flexibility.

Rating Outlook

The current negative outlook reflects the weakened credit quality of the Eandis economic group as a result of the increase in debt and the risk that this may not be sufficiently offset by equity injections or other balance sheet strengthening. It further takes into account an element of regulatory uncertainty as the new tariff methodology continues to evolve.

Factors that Could Lead to an Upgrade

Given the current negative outlook, upward pressure on the rating is unlikely over the medium term. We will likely stabilise the outlook if it becomes clear that additional equity capital, in particular from the proposed transaction with SGID, will support leverage comfortably below 70% and FFO/net debt in the low teens. The company expects to conclude this sale by year-end.

Factors that Could Lead to a Downgrade

We could downgrade the rating if the economic group's financial metrics appeared likely to remain weak, with consolidated net debt/ RAB ratios persistently above 70%, and consolidated FFO/net debt ratio below 12%. Downward pressure could also result if underlying cash flow generation continued to weaken as a result of operational underperformance or unfavourable developments in the regulatory framework. Finally, we could adjust Eandis's rating downwards if we were to assess a lower probability of support from the Community of Flanders or if the rating of the sub-sovereign was downgraded.

Key Indicators

Exhibit 2
Eandis System Operator CVBA
Financial information presented on the basis of the Eandis Economic Group

	12/31/2015	12/31/2014	12/31/2013	12/31/2012
FFO Interest Coverage	3.0x	3.6x	4.0x	3.9x
Net Debt / Fixed Assets	81.4%	80.5%	68.0%	67.1%
FFO / Net Debt	6.6%	8.3%	11.2%	11.2%
RCF / Net Debt	3.7%	5.3%	6.8%	6.8%

Note: All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations.
Source: Moody's Financial Metrics TM

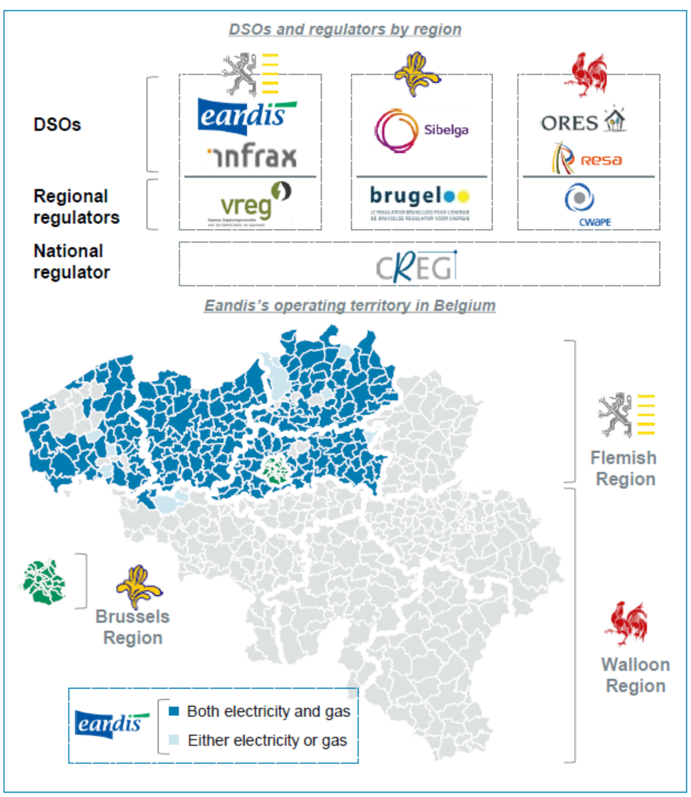
Detailed Rating Considerations

Transparent regulatory framework, but limited track record

Historically, the federal state and each of the Belgian regions have set up their own regulatory body for the electricity and gas market with complementary competencies, with the national regulator CREG being principally responsible for tariff setting in respect of the DSOs and the regional regulators for licensing issues. As part of a decentralisation of powers from the federal to the regional Governments, on 1 July 2014, responsibility for setting electricity and gas distribution tariffs passed from the CREG to the regional regulators, i.e., the VREG in the Flemish Region (see Exhibit 3).

To allow for the orderly transfer of tariff setting responsibilities, the CREG agreed with all DSOs, in April 2012, that the tariffs for the regulatory period 2009-12 would be carried forward into 2013 and 2014, with the option of further extension into 2015, should the tariff setting process be delayed.

Exhibit 3
Overview of Belgian energy distribution market and regulatory responsibilities



Source: Eandis

On 30 September 2014, the VREG published its proposed tariff methodology for the transitory period 2015-2016, which was subsequently formally confirmed in December 2014. Key highlights include the introduction of a revenue-cap model (from a partial cost-plus arrangement until the end of 2014), with certain defined non-controllable costs remaining a pass-through. The revenue building blocks comprise (1) an allowance for efficient opex, (2) depreciation, and (3) a return on the RAB (based on a weighted average cost of capital, or WACC, calculation). Allowed revenues will be updated annually for changes in the consumer price index over controllable opex, an efficiency factor and a service quality factor. Non-controllable (or "exogenous") costs include the cost of renewable energy certificates, and subsidies for the rational use of energy. Historically accumulated regulatory balances (from over- or under-recovery of costs in previous periods) are also considered non-controllable. The WACC is set ex-ante on a theoretical gearing assumption of 55%.

This approach will also apply to regulatory periods from 2017, which will follow a four-year cycle. It reflects established principles of other incentive-based frameworks in Europe. Nevertheless, most otherwise comparable regimes benefit from a track record of consistent and transparent application than has yet to be established here.

On 4 May 2016, VREG published draft proposals for the regulatory period 2017-20. Compared with 2015-16, VREG is proposing a cut of around 110 basis points on the allowed return, but improved timeliness in recovery of non-controllable costs.

Exhibit 4

Weighted average cost of capital will reduce in low interest rate environment

	VREG (2015-16)	VREG Draft Proposals (2017-20)
Risk-free rate	3.30%	3.04%
Risk premium	1.20%	0.64%
Transaction fee	0.15%	0.15%
Cost of debt (historical)	4.65%	3.83%
Risk-free rate	2.00%	0.80%
Risk premium	1.20%	0.61%
Transaction fee	0.15%	0.15%
Cost of debt (new)	3.35%	1.56%
Historical : new debt ratio	60:40	65:35
Cost of debt (allowed)	**4.13%**	**3.04%**
Premium for ECB purchase		0.63%
Market risk premium	5.10%	5.01%
Asset Beta	0.33	0.38
Equity Beta	0.73	0.76
Equity risk premium	3.74%	3.79%
Cost of Equity (post-tax)	**5.74%**	**5.22%**
Cost of Equity (pre-tax)	**8.70%**	**7.91%**
Gearing	55%	60%
DSO tax rate until 31 Dec 2014	0%	
WACC (nominal, post-tax)	**4.85%**	**3.91%**
Tax rate from 1 Jan 2015	33.99%	33.99%
WACC (nominal, pre-tax)	**6.18%**	**4.98%**

Notes: The risk-free rate of embedded cost of debt is calculated on the ten-year average historical interest on 10-year German Bunds and Belgian OLO; while the risk-free rate of new debt reflects the two-year average of 10-year Bonds and OLO. Until December 2014, the DSOs were not subject to corporate tax; however, from 1 January 2015 a 33.99% tax rate applies. Accordingly, VREG determined that the 4.8% (nominal) WACC determined for 2015-16 will be post-tax, and the pre-tax WACC would be 6.1% (nominal).
Source: VREG

Outstanding tariff deficits expected to be recovered by 2021

During the transition between national and regional regulators, cost allowances were not updated and Eandis accumulated tariff deficits of €450 million. Under-recovered revenues from 2008-09 (around €100 million) have been included within agreed tariffs for 2015 and 2016, while recovery of the 2010-14 deficits (around €350 million) will be included in the tariffs for 2016-20. During 2015, Eandis accumulated further regulatory receivables of close to €260 million, linked primarily to non-controllable costs. Whilst timely recovery for these costs will improve based on draft regulatory proposals, the regulator may still review the amount before allowing recovery.

In addition to the above, by the end of 2015, Eandis has accrued around €627 million of receivables with respect to renewable energy and cogeneration certificates (Eandis is obliged to buy certificates from generators but was subsequently unable to sell all of these due to insufficient demand from energy suppliers). The amended Energy Act introduces a surcharge to be added to user tariffs to allow recovery of the costs for unsold certificates over a five year period 2017-21. However, as the company continues to sell certificates in the market and it is unclear what portion of the costs will be covered by the surcharge, and the amount and timing of recovery for these receivables may shift. This creates some uncertainty on the speed of financial recovery for the Eandis economic group.

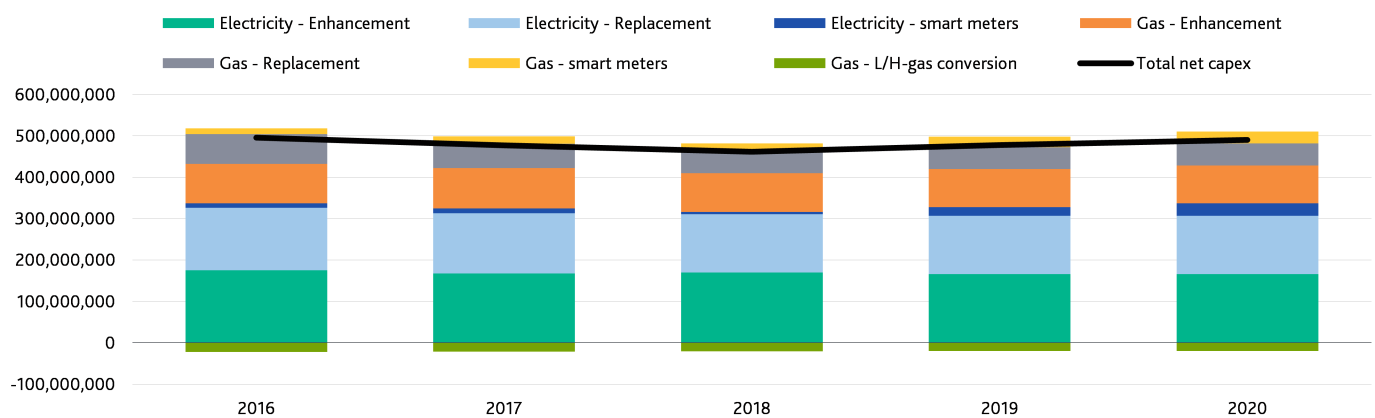
Modest capex programme, balanced between maintenance and expansion investments

Annual capex will be approximately €450-500 million over the next five years, equivalent to around 6% of the company's RAB. The capex programme is not particularly challenging and relatively balanced between replacement and enhancement investments.

Exhibit 5

5-year capex programme (net of contributions)

Amounts in €



Source: Eandis, Moody's calculations

We note that the VREG plans to introduce a quality factor into the revenue formula to reflect asset performance and customer service and ensure that companies do not deliberately postpone investment spending to the detriment of asset quality. During the next period 2017-20, companies will report performance against certain measures, with a quality factor to incentivise above-average performance to be included in the following period from 2021.

Debt incurred on Electrabel exit weakened financial profile

In line with the Flemish Decree on Intermunicipal Cooperation of 6 July 2001, Electrabel, ultimate owner of a 21% stake in the Eandis economic group until December 2014, agreed that it would sell its shares to the seven DSOs (later merged into Eandis Assets). To pay for Electrabel's 21% stake (valued at €910 million), Eandis raised approximately €965 million of additional debt, resulting in an increase in the economic group's leverage to around 80% (measured by net debt to RAB, with the latter largely equivalent to the company's fixed assets).

The increase in gearing was only marginally mitigated by the shareholding municipalities increasing their share capital in the DSOs. The additional equity, raised in stages over 2015, amounted to around €100 million, with an additional net equity contribution of around €62 million at the end of June 2016 (stemming from a capital injection of €100 million from the intermunicipal financing associations and capital outflow of around €38 million due to the exit of two provinces.

Cash inflows from new equity partner would significantly improve financial metrics and create headroom to offset regulatory pressures

Following the merger of the seven DSOs (Gaselwest, Imea, Imewo, Intergem, Iveka, Iverlek and Sibelgas) into Eandis Assets, effective on 1 January 2016, Eandis initiated a tender process to sell a minority ownership stake in the merged DSO to interested long-term investors.

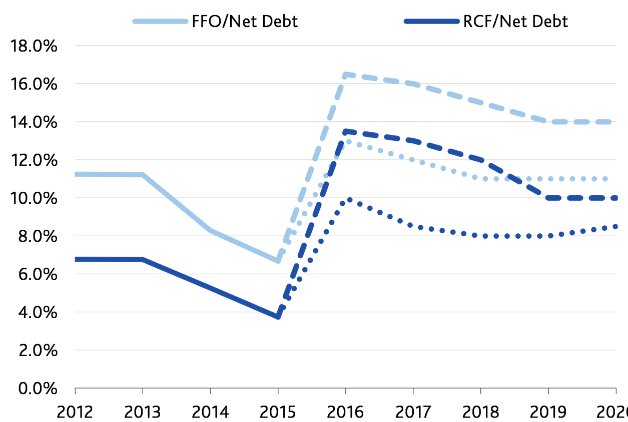
The coalition agreement of the new Flemish government considered the possibility of third party financial investor participation in the waste treatment and energy sectors, and the relevant decree was ratified in April 2016. This decree restricts external equity ownership to a maximum of 49% of total share capital and 25% of voting rights, thus maintaining significant influence from local or regional government.

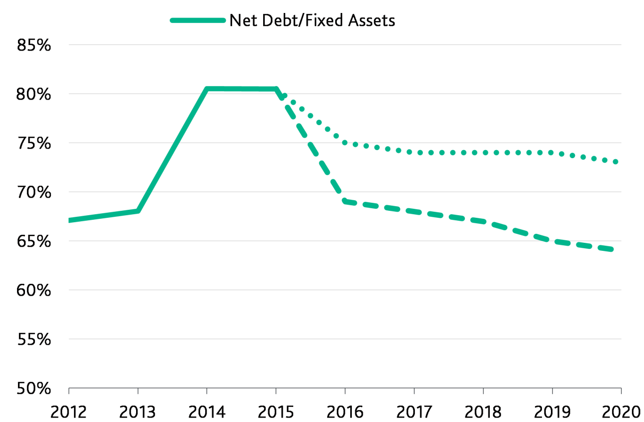
On 29 June 2016, Eandis announced that it has signed a subscription agreement with State Grid International Development Ltd (Aa3 negative), a wholly-owned subsidiary of State Grid Corporation of China (Aa3 negative), for the former (through State Grid Europe Ltd.) to become a shareholder in Eandis Asset for a new equity stake of 14%. The transaction remains subject to shareholder approval in October 2016, such that the transaction might close before year-end. We expect that proceeds of an undisclosed amount will likely be applied to reduce existing debt at Eandis as it falls due.

Taking into account the aggregate amounts to be raised, we expect Eandis to significantly improve its financial profile, such that it will have headroom to accommodate (1) remaining uncertainty around timing and amounts to be recovered from the sizeable renewable certificate receivables; and (2) a challenging draft regulatory determination at current rating levels.

Exhibit 6

Eandis's financial metrics will improve significantly after receipt of the equity proceeds





Note: All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations.
Source: Moody's Financial Metrics TM

However, we also note the company's dividend policy with high payout ratios compared with network peers continues, which limits cash retention within the business. Aside from additional cash flows through recovery of tariff deficits or renewable energy certificates, free cash flow generation may, therefore, be limited.

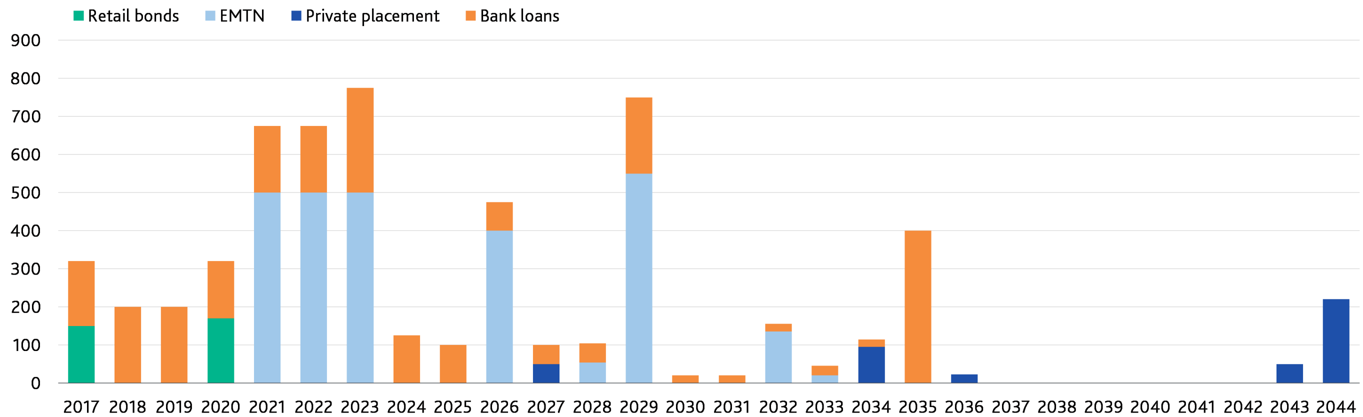
Overall, for Eandis to maintain its current A1 rating we expect the company to exhibit leverage (measured as net debt to fixed assets, as a proxy for the regulated asset base) comfortably below 70%, FFO/net debt in the low teens and RCF/net debt at least in high single digits in percentage terms.

Liquidity Analysis

Eandis's liquidity position is currently adequate, assuming some flexibility on dividend payments and capex. Ongoing investments and debt repayments will require continuous access to capital markets, although the expected capital increase will provide substantial relief.

Exhibit 7

Eandis's debt maturity profile



Source: Eandis economic group, annual report and company presentations, Moody's calculation

Aside from ongoing cash flows generated from the DSOs' monopoly network activities, the economic group's primary sources of committed liquidity are revolving credit facilities in an aggregate amount of €500 million, renewed annually, of which around €58 million were drawn at December 2015.

In addition, Eandis is active in the commercial paper market, with a €522 million programme, of which €167 million were outstanding at December 2015 (but repayable during January 2016). The company maintains average amounts outstanding in the range of €100-200 million.

Profile

Eandis System Operator CVBA (previously Eandis CVBA) is a Belgian utility, established in March 2006 and fully owned by Eandis Assets, an entity created through the merger of seven Flemish DSOs Gaselwest, IMEA, Imewo, Intergem, Iveka, Iverlek and Sibelgas, which took effect on 1 January 2016. Eandis Assets' share capital is currently 100% held by 229 municipalities and provinces within the Community of Flanders.

Eandis operates, maintains and develops the regulated electricity and gas distribution networks on behalf of Eandis Assets, which owns the distribution network assets. In addition, Eandis is responsible for the metering activity and the operation of some other public service obligations. Through the Flemish Energy Decree of 8 May 2009, and with the explicit permission of the VREG, the Flemish region's electricity and gas distribution regulator, Eandis is appointed as the sole operator of Eandis Assets' networks. In addition, through Eandis Assets' articles of association, Eandis operates at `cost' basis, whereby all costs incurred by the company, including financing costs, are passed through to Eandis Assets. Therefore, all financial creditors and contractual counterparties have indirect recourse to Eandis Assets, which also guarantees the debt raised by Eandis under its €5 billion EMTN programme.

Rating Methodology and Scorecard Factors

The company's rating falls within the scope of Moody's methodology for Regulated Electric and Gas Networks, published in November 2014. The assigned BCA is in the high-Baa range. Historical financial metrics, taking into account the additional debt raised from the Electrabel exit results in a Baa2 grid-indicated rating under Moody's methodology. Improvement in metrics under an assumption of recovery of tariff deficits as well as additional equity being raised would generate a grid-indicated rating of A3-Baa1.

Exhibit 8
Rating Grid for Eandis System Operators CVBA

Regulated Electric and Gas Networks Industry Grid [1][2]	Current FY 12/31/2015		Moody's 12-18 Month Forward View As of July 2016 [3]	
Factor 1 : Regulatory Environment and Asset Ownership Model (40%)	Measure	Score	Measure	Score
a) Stability and Predictability of Regulatory Regime	A	A	A	A
b) Asset Ownership Model	Aa	Aa	Aa	Aa
c) Cost and Investment Recovery (Ability and Timeliness)	A	A	A	A
d) Revenue Risk	A	A	A	A
Factor 2 : Scale and Complexity of Capital Program (10%)				
a) Scale and Complexity of Capital Program	Baa	Baa	A	A
Factor 3 : Financial Policy (10%)				
a) Financial Policy	Baa	Baa	Baa	Baa
Factor 4 : Leverage and Coverage (40%)				
a) FFO Interest Coverage (3 Year Avg)	3.5x	Baa	4x - 5x	A
b) Net Debt / Fixed Assets (3 Year Avg)	76.8%	Ba	70% - 80%	Ba
c) FFO / Net Debt (3 Year Avg)	8.5%	Ba	10% - 15%	Baa
d) RCF / Net Debt (3 Year Avg)	5.9%	Ba	8% - 12%	Baa
Rating:				
Indicated Rating from Grid Factors 1-4		Baa2		Baa1
Rating Lift				
a) Indicated Rating from Grid		Baa2		Baa1
b) Actual Rating/BCA Assigned				A1/high-baa

Government-Related Issuer	**Factor**	**Factor**
a) Baseline Credit Assessment	high-baa	high-baa
b) Government Local Currency Rating	Aa2	Aa2
c) Default Dependence	High	High
d) Support	High	High
e) Final Rating Outcome	A1	A1

Note: (1) All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. (2) At at 12/31/2015. (3) This represents Moody's forward view; not the view of the issuer; and unless noted in the text, does not incorporate any significant acquisitions or divestitures.
Source: Moody's Financial Metrics TM

Given Eandis Assets' (which acts as guarantor for Eandis's debt) ownership, the Eandis economic group falls within the scope of our rating methodology for Government-Related Issuers (GRIs), published in October 2014.

The A1 ratings incorporate around three notches of uplift from the Eandis economic group's stand-alone credit quality, taking into account (1) the credit quality of the Community of Flanders (Aa2 stable); (2) our assessment that there is a high probability that the Community would provide support to the DSO and/or its shareholding municipalities if either were in financial distress; and (3) our assessment of a high level of default dependence (i.e., the degree of exposure to common drivers of credit quality) because of the entirely domestic operations of the Eandis economic group and its close association with its owners and the region.

The Community of Flanders (1) is ultimately responsible for the organisation of the electricity and gas market and for the distribution of energy, which is considered a public service; and (2) would be indirectly affected by any difficulties (including financial problems) experienced by the entities entrusted with this task.

Ratings

Exhibit 9

Category	Moody's Rating
EANDIS SYSTEM OPERATOR CVBA	
Outlook	Negative
Bkd Issuer Rating -Dom Curr	A1
Bkd Senior Unsecured -Dom Curr	A1

Source: Moody's Investors Service

REPORT NUMBER 1023321

Moody's
INVESTORS SERVICE