

Credit Opinion: Eandis CVBA

Global Credit Research - 20 Dec 2011

Belgium

Ratings

Category	Moody's Rating
Outlook	Negative
Bkd Issuer Rating -Dom Curr	A1
Bkd Senior Unsecured -Dom Curr	A1

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Key Indicators

[1]Eandis	12/31/2010	12/31/2009	12/31/2008
(FFO + Interest) / Interest Expense	4.8x	6.0x	5.6x
Net Debt / Fixed Assets	56.0%	53.8%	54.7%
FFO / Net Debt	15.4%	16.8%	15.9%
RCF / CAPEX	0.6x	0.8x	0.6x

[1] All ratios are calculated using Moody's Standard Adjustments. Source: Moody's Financial Metrics TM

Note: For definitions of Moody's most common ratio terms please see the accompanying [User's Guide](#).

Opinion

Corporate Profile

Eandis CVBA (Eandis) is a Belgian utility company that was established in March 2006 through the merger of GeDis, ENV and Indexis (Flanders) and is fully owned by seven mixed Flemish Distribution System Operators (DSOs). The DSOs' share capital is 79% held by municipalities and provinces and 21% by Electrabel SA (Electrabel). Eandis operates, maintains and develops the regulated electricity and gas distribution networks on behalf of the seven DSOs in the Flanders Region of Belgium. In addition, Eandis is responsible for the metering activity and the operation of social public service obligations.

The DSOs are strategically important as they fulfil municipalities' obligations to provide the public service of energy distribution and are therefore also key in the implementation of the Flemish Region's energy policy.

Recent Developments

As of 30 June 2011, Electrabel reduced its shareholdings in the DSOs from 30% to 21%, for an associated amount of EUR 404 million, thereby lowering the DSOs' average equity/assets ratio to 47.8% from 50%. Electrabel is required by law to fully exit the ownership of the DSOs by the end of 2018. On 19 December 2011, the rating of the Flemish Region was downgraded to Aa2 from Aaa and the outlook was changed to negative from 'on review for downgrade'.

Rating Rationale

Eandis's backed A1 long-term issuer rating is driven by our assessment of the credit quality of the seven DSOs that own the company and which we consider to be of comparable credit strength. Through the Flemish Energy Decree of 8 May 2009, and with the explicit permission of the regional regulator VREG, Eandis is appointed as the sole operator of the DSOs' networks. In addition, through the DSOs' articles of association, Eandis operates at cost basis, whereby all costs incurred by the company, including financing costs, are passed through to the DSOs. Therefore, we understand that all financial creditors and contractual counterparties have indirect recourse to the DSOs proportional to their respective share of obligations. Eandis's DSO owners are Gaselwest CVBA, IMEA, Imewo, Intergem, Iveka, Iverlek and Sibelgas CVBA. All distribution assets are held by the DSOs and there are no meaningful assets at Eandis's level.

The DSOs' credit quality is underpinned by the low business risk profile of their regulated electricity and gas distribution operations in the Flemish market where the DSOs generate almost 100% of their cash flows under a supportive, transparent, cost efficiency oriented but relatively new and untested regulatory framework. We view the credit quality of the DSOs as commensurate with the high Baa rating range and we further incorporate a three-notch rating uplift, reflecting the potential support from the Flemish Region (Aa2, negative outlook).

Eandis's management strategy is straightforward focusing on DSOs core business of: (i) managing and developing the gas & electricity distribution networks in the Flemish region; and (ii) delivering on their public service mission, which is tightly supervised by VREG and by the federal regulator (CREG). This strategy is viewed as supportive of the rating, as it reduces the risk of the company entering into new, higher-risk businesses, although Eandis is not prohibited from doing so.

The A1 rating further factors in our expectation that: (i) the DSOs' medium-term financial profiles will reflect a gradual increase in leverage and their ability to achieve, on a sustainable basis, the following consolidated credit metrics: net debt/fixed assets between 60% and 70%; and funds from operations (FFO)/net debt between 13% and 15%.

Rating Drivers

Methodology for Regulated Electric and Gas Networks

When assessing the DSOs' credit strength, we apply our Rating Methodology for Regulated Electric and Gas Networks. This methodology identifies key areas for assessing the relative fundamental credit quality of regulated electric and gas network companies. Particularly, the methodology focuses on the assessment of the regulatory environment, ownership model, operational performance, stability of business model and key credit metrics. Based on the DSOs' consolidated average ratios from 2008-10 historical financial results, the rating methodology grid indicates a credit strength in the A rating range. However, our view of the credit quality of the DSOs as commensurate with the high Baa rating range reflects an expectation of a moderate weakening in credit metrics as further discussed under rating factor

4 below.

RATING FACTOR 1 - Regulatory Environment and Asset Ownership Model

Since 1 January 2009, a new regulatory framework was introduced for the DSOs under the oversight of the VREG and the national Belgian electricity and gas market regulator, the CREG. The regulation is regulatory asset base (RAB) based, 'regulates' tariffs for regulatory periods of four years (first regulatory period 2009-12) and replaces the old cost-plus regulation, which was on an annual (or even quarterly) basis. This new regime allows the system operator during a regulatory period total revenues sufficient to perform its statutory duties under a comprehensive cost recovery approach, which includes remuneration for the capital invested in the network. The regulation is akin to the RAB-based regulatory system for utilities we see in the UK, the Netherlands, Germany and a number of other European countries.

We note that 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, the CREG being principally responsible for tariff setting in respect of the DSOs and the VREG for licensing issues. This situation may result in inconsistencies between measures taken by these regulatory bodies if certain areas of responsibilities overlap. We understand that, in the context of the ongoing negotiations for institutional changes among Belgian political parties, there is also the possibility that the CREG's tariff setting responsibilities may be passed on to the VREG. Although it is uncertain if and when this might happen, we expect that any transition process would seek to ensure a smooth transfer of regulatory responsibilities. Nevertheless, the possibility creates some additional uncertainty on what is a young framework.

Although the regulatory regime is based on established precedents of incentive-based regulation in European countries and eliminates exposure to volume risk, providing a stabilising factor to the DSOs' financial performance, the relatively untested nature of Belgium's regulatory framework and some uncertainties relating to possible changes as discussed above, constrains the scoring of the methodology sub-factor "Stability and Predictability of Regulatory Regime" to A.

The DSOs own the distribution networks and are appointed as distribution system operators by decision of the VREG for a period of 12 years. Although this appointment may not be renewed upon expiry, it seems highly likely that the appointment is renewed given that ownership of network (or rights of use) is prerequisite for obtaining a licence. The DSOs are established for the maximum duration of 18 years. At the end of this 18 year period, the administrative lifetime of a DSO can be extended, provided that this is approved by its municipal shareholders. If some or all of the municipalities decide to exit, then there is a procedure in place, defined by decree, through which the DSO's assets and liabilities will be distributed over the participating municipalities. Although the DSOs own the network, because running the network is subject to a 12 year licence and the DSOs are subject to an 18 year administrative life, we have assigned a score of Aa to the sub-factor "Asset Ownership Model". We believe that there are strong mitigants in place to materially reduce renewal risks.

The tariff formula, through which regulated entities can recover costs and investments, are clearly stipulated by law for both the gas and electricity market. The incentive-based regulatory framework allows the DSOs a comprehensive cost recovery and the ability to earn a return on invested capital based on the WACC applied by the regulator to their RAB. We assign a score of A to the sub factor "Cost and Investment Recovery", in line with most peers.

The DSOs cover around 78% of the Flemish market for electricity and gas and therefore have a relatively wide geographic reach that should reduce volume volatility. Through the regulatory system and the wide geographic coverage, the DSOs are largely sheltered from volume risk, although any under- or over-recovery is adjusted for in the following regulatory period. We score this factor A. The DSOs therefore score slightly lower than some of their peers due to this time lag.

RATING FACTOR 2 - Efficiency and Execution Risk

Efficiency incentives are set through a bonus/malus system. Achieving efficiencies is focused on controllable costs that are a small percentage of all costs. Scores of the data envelopment analysis approach, which measure relative efficiency of mixed Flemish DSOs, are reaching 100% in case of electricity distribution for almost all DSOs. However, in case of gas distribution those scores are below 100% for four out of the seven DSOs. The regulator expects the DSOs to achieve an efficiency target of 100%. The sub-factor "Cost Efficiency" thus scores Baa.

The DSOs' capex reached EUR 1,544 million over the past three years, with approximately 70% of the total investment program invested in electricity networks and the remaining 30% in gas distribution networks. The consolidated capex/PPE ratio is expected to be approximately 8-9% in 2011-12 and in terms of percentage of sales around 30%. We therefore score the "Scale and Complexity of Capital Programme" factor Baa.

RATING FACTOR 3 - Stability of Business Model and Financial Structure

Through the Flemish Energy Decree of 8 May 2009, and with the explicit permission of the VREG, Eandis has been appointed as the sole executor of the public mission on behalf of the seven DSOs. DSOs are not involved in the competitive generation, trading and sales activities. By law, there is currently no risk of privatisation. Given that the DSOs are exclusively involved in regulated activities and given their strong public mandate and direct public ownership, it seems highly unlikely that the DSOs will engage in significant corporate activities. We therefore score the sub-factor "Ability and willingness to pursue opportunistic corporate activity" as A.

The CREG's targeted debt/equity (D/E) leverage ratio is 67/33 because, given the way equity and debt is rewarded under the regulatory system, a 67/33 leverage ratio is regarded as the most efficient. We understand from management that the DSOs' consolidated leverage level will gradually be increased towards that target level, likely by 2018, as discussed below. There are no regulatory or covenant restrictions on the DSOs' leverage. However, given the DSOs' public mission and public shareholders, it seems very unlikely that leverage levels will go beyond these projected targets. We therefore score the sub-factor "Ability and willingness to increase leverage" as Baa.

Eandis realises almost no operating profit outside its core regulated business and by law there is currently no risk of privatisation. The DSOs operate within their regulated business. There are no covenants restricting Eandis to strictly regulated activities. The regulator may allow the company to engage in unregulated businesses which are closely linked to its regulated business (for example installing smart metering). We therefore score the sub-factor "Targeted proportion of operating profit outside corporate activity" as Aa.

RATING FACTOR 4 - Key Credit Metrics

The DSOs historically exhibited low leverage levels. The DSOs' capital structures currently exhibit a net debt/fixed assets in the low fifties in percentage terms. However, we expect this ratio to increase to 60-70% as a result of the DSOs' investment programmes and the additional debt to be raised by the companies to buy back Electrabel's shares, as the latter is required by law to exit the ownership of the DSOs by 2018.

GRI Factors

In assessing the financial profile of Eandis, Moody's has applied its rating methodology for government-related issuers (GRIs), given the ownership of the seven DSOs by the Belgian municipalities and provinces.

The DSOs' ownership is relatively fragmented among 234 local communities. Given that most municipalities are relatively small, on an individual basis they may not have the financial strength to support a DSO should it get into financial difficulties. However, we expect that, if the DSOs were to

require timely financial support, the Flemish Region would act for the following reasons: (i) given that the Flemish Region is responsible for the organisation of the electricity and gas market and for the distribution of energy, which is considered a public service, the Region would be indirectly affected by any difficulties (including financial problems) experienced by the entities entrusted with this task; and (ii) the Flemish Region has a track record of providing support and in recent years was significantly involved in helping its financial institutions.

In accordance with this GRI methodology, our assessment of the credit quality of the DSOs incorporates a three-notch rating uplift. The uplift results from: (i) the credit quality of the Flemish Region (Aa2/negative outlook); (ii) our assessment that there is a high probability that the Flemish Region would provide support to the DSOs if they were in financial distress; and (iii) our assessment of a very high level of default dependence (i.e., the degree of exposure to common drivers of credit quality) given the entirely domestic operations of the DSOs and their close association with their owners and the Region.

Liquidity Profile

For the first half of 2011, the Eandis economic group (consolidating the DSOs) reported EUR 471 million of operating cash flow and EUR 3.9 billion of gross debt. Principal cash calls anticipated during the period Q4 2011-Q3 2012 include dividend payments of around EUR 250 million (90% of net income), approximately EUR 360 million in debt repayments and extensive capital expenditure (capex), estimated in the region of EUR 700 million. We caution that Eandis has historically relied on the successful placement of its commercial paper programme, which is partially backed by bank facilities, to support its liquidity needs. However, Eandis enhanced its liquidity by issuing a EUR 500 million note, under its EMTN programme, in October 2011.

Rating Outlook

The negative outlook on Eandis's A1 rating is driven by our negative outlook of the Aa2 rating of the Flemish region.

What Could Change the Rating - Up

Given the current negative outlook, we do not expect any upward rating pressure in the near term.

What Could Change the Rating - Down

The rating could come under downward pressure if the DSOs': (i) cash flow generation were to weaken as a result of operational underperformance or an unfavourable development in the regulatory framework; (ii) consolidated net debt/fixed assets ratio were to increase to more than 70%; and/or (iii) consolidated FFO/net debt ratio were to fall below 12% on a permanent basis. In addition, we could adjust Eandis's rating downwards if we were to assess that there were a lower probability of support from the Flemish Region or if the rating of the Flemish Region were subject to a further downward adjustment.

Rating Factors

Eandis

Regulated Electric and Gas Networks [1][2]	Aaa	Aa	A	Baa	Ba	B
Factor 1: Regulatory Environment & Asset Ownership Model (40%)						
a) Stability and Predictability of Regulatory Regime			X			
b) Asset Ownership Model		X				
c) Cost and Investment Recovery			X			

d) Revenue Risk			X			
Factor 2: Efficiency & Execution Risk (10%)						
a) Cost Efficiency				X		
b) Scale and Complexity of Capital Programme				X		
Factor 3: Stability of Business Model & Financial Structure (10%)						
a) Ability and Willingness to Pursue Opportunistic Corporate Activity			X			
b) Ability and Willingness to Increase Leverage				X		
c) Targeted Proportion of Operating Profit Outside Core Regulated Activities		X				
Factor 4: Key Credit Metrics (40%)						
a) (FFO + Interest) / Interest Expense (3-Year Average)		5.4x				
b) Net Debt / Fixed Assets (3 Year Avg)			54.8%			
c) FFO / Net Debt (3 Year Avg)			16.0%			
d) RCF / CAPEX (3 Year Avg)					0.7x	
Rating:						
a) Indicated Credit Strength from Grid			A range High Baa			
b) Actual Credit Strength Assigned						

Government-Related Issuer	Factor
a) Actual Credit Strength Assigned	High Baa
b) Supporter Rating	Aaa
c) Default Dependence	Very High
d) Support	High

[1] All ratios are calculated using Moody's Standard Adjustments. [2] As of 12/31/2010. Source: Moody's Financial Metrics



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