Rating Action: Moody's downgrades Eandis to A3 from A1; stable outlook

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London, 14 December 2016 -- Moody's Investors Service (Moody's) has today downgraded to A3 from A1 the backed long-term issuer and the backed senior unsecured debt ratings of Eandis System Operator CVBA (Eandis) as well as to (P)A3 from (P)A1 the guaranteed senior unsecured programme rating of the company's EUR5.0 billion medium term note programme. The outlook on all ratings is stable.

This action concludes the rating review, initiated on 6 October 2016, following the company's announcement that the planned merger between the seven distribution system operators (DSOs) that own Eandis, to form Eandis Assets, would not take place. This in turn prevented the planned entry of State Grid International Development Limited (A1, negative) through State Grid Europe Limited, a wholly-owned subsidiary of State Grid Corporation of China (Aa3 negative), as a new shareholder for a 14% stake in Eandis Assets and a substantial equity injection.

RATINGS RATIONALE

RATIONALE FOR RATING DOWNGRADE

Today's rating action reflects that measures anticipated by Moody's and expected to restore Eandis's credit quality after Electrabel SA's exit in 2014 will not be implemented and a near-term strengthening of the company's balance sheet now appears unlikely. Key financial metrics are likely to remain close to levels reported by the company for 2015 when leverage measured by net debt to fixed assets (as a proxy for the company's regulated asset base, or RAB) was around 80% and funds from operations (FFO) to net debt was below 10% as at December 2015. These ratios are relatively weak in the context of rated peers.

Following an extraordinary shareholder meeting on 3 October 2016, Eandis announced that the governing bodies of the Economic Group Eandis, which comprises Eandis and its seven owners, the DSOs Gaselwest, Imea, Imewo, Intergem, Iveka, Iverlek and Sibelgas, decided that the merger between the DSOs into Eandis Assets could not be concluded due to two conditions precedent not being fulfilled. Firstly, four Walloon municipalities have not been successful in setting up their own operational entity and remain members of DSO Gaselwest. Secondly, DSO Imea concluded that, based on a recent statement by the Flemish regulatory body, its requirement for maintaining separate tariff levels as part of a merged DSO is unlikely to be fulfilled.

As a consequence of the merger not concluding, the capital increase, which would have seen State Grid Europe Limited acquire a 14% stake in the merged DSO Eandis Assets, will also not go ahead as planned. In addition, a EUR100 million capital increase, received from the intermunicipal financing associations in July 2016 as part of the merger and recapitalisation of the business, had to be reversed and repaid in December 2016.

While immediate balance sheet strengthening appears unlikely, the latest regulatory tariff methodology for the period 2017-20 provides certainty over cash flows for the coming years. Allowed returns will reduce by around 120 basis points compared with the current tariff settlement, but a conclusion on the timing for recovering outstanding regulatory receivables and costs for renewable energy certificates will help boost cash flows to 2020 and somewhat offset the impact of lower returns. Regulatory receivables of ca. EUR350 million, linked to lower revenues in 2010-14, will be recoverable over five years from 2016 (another EUR50 million of under-recoveries from 2008-09 will also be repaid through tariffs in 2016), and Eandis will be able to deposit outstanding renewable energy certificates (around EUR630 million at December 2015) with the Flemish regulatory bodies for up to EUR105 million p.a., beginning Dec 2016.

Notwithstanding the additional cash flows from the recovery of regulatory balances, Moody's believes that Eandis will continue to exhibit leverage in excess of 70% net debt to fixed assets until at least 2020.

In addition, the rating agency has re-assessed the support assumptions, embedded in Eandis's long-term issuer and debt ratings, primarily reflecting the difficulty experienced by Eandis to close the DSO merger, in spite of a large majority of its municipal shareholders initially supporting it.
Given the DSOs’ (which act as guarantors for Eandis’s debt) ownership, the Economic Group Eandis falls within the scope of our rating methodology for Government-Related Issuers (GRIs), published in October 2014.

Aside from Eandis’s stand-alone credit quality, we also consider (1) the credit quality of the Community of Flanders (Aa2 stable); (2) our assessment of the probability that the Community would provide support to the DSOs and/or its shareholding municipalities if either were in financial distress; and (3) 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 Eandis and its close association with its owners and the region.

While each of the seven DSO’s ownership is relatively fragmented across a number of local communities, primarily in the Flemish region, the Community of Flanders 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 would be indirectly affected by any difficulties (including financial problems) experienced by the entities entrusted with this task.

Moody's believes that the region holds a strong interest in maintaining a solid financial standing for the DSOs, given their essential task. While it remains highly likely that extraordinary financial support would be forthcoming when needed to support additional investment and service requirements of the Flemish distribution network, this does not, however, -- in Moody's view -- guarantee protection of very high investment-grade rating levels. Indeed, the planned DSO-merger and subsequent equity injection by a new shareholder was derailed, inter alia, by politically motivated decisions at the regional level.

Consequently, today's two-notch downgrade reflects the combination of a weak financial profile and a lower overall support assumption at the current rating level. The final A3 rating still includes two-notches of rating uplift from the stand-alone credit quality of the Economic Group Eandis for potential extraordinary financial support from the Community of Flanders.

RATIONALE FOR STABLE OUTLOOK

The rating outlook is stable reflecting Moody's view that, (1) agreed recovery of regulatory receivables and renewable energy certificate costs will support cash flows in a lower return environment over the medium term; and (2) overall, Eandis will maintain a stable operational and financial profile, taking into account ongoing high distributions to its ultimate municipal shareholders, to position the company in line with the A3 rating.

WHAT COULD CHANGE THE RATING UP/DOWN

Given the ongoing financial pressure in a low regulatory return environment, coupled with a high dividend payout ratio, Moody's sees limited upward rating pressure over the medium term. The ratings could be upgraded, if balance sheet strengthening measures are implemented that would support leverage comfortably below 70% and FFO/net debt in the low teens in percentage terms.

Conversely, Moody's could downgrade the rating if the Economic Group Eandis's financial metrics weakened further, with consolidated net debt/RAB likely to be persistently above 80%, and consolidated FFO/net debt ratio below the high single-digits in percentage terms. Eandis’s rating may also come under downward pressure if the rating agency assessed a lower probability of support from the Community of Flanders or if the rating of the sub-sovereign was downgraded.

The methodologies used in these ratings were Regulated Electric and Gas Networks published in November 2014, and Government-Related Issuers published in October 2014. Please see the Rating Methodologies page on www.moodys.com for a copy of these methodologies.

Eandis System Operator CVBA (previously EANDIS CVBA) is a Belgian utility, established in March 2006 and fully owned by the seven Flemish DSOs Gaselwest, Imea, Imewo, Intergem, Ivecia, Iverlek and Sibelgas, whose share capital is currently 100% held by 233 municipalities and one province, predominantly within the Community of Flanders.

Eandis operates, maintains and develops the regulated electricity and gas distribution networks on behalf of the DSOs, which own the distribution network assets. Through the DSOs' articles of association, Eandis System Operator CVBA operates at 'cost' basis, whereby all costs incurred by the company, including financing costs, are passed through to the DSOs.

Therefore, all financial creditors and contractual counterparties have indirect recourse to the DSOs, which also severally guarantee the debt raised by Eandis under its EUR5.0 billion EMTN programme.
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