MOODY'S
INVESTORS SERVICE

Credit Opinion: Eandis CVBA

Global Credit Research - 10 Sep 2015

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 CVBA**

	12/31/2014	12/31/2013	12/31/2012	12/31/2011
FFO Interest Coverage	**3.6x**	**4.0x**	**3.9x**	**5.4x**
Net Debt / Fixed Assets	**80.5%**	**68.0%**	**67.1%**	**62.9%**
FFO / Net Debt	**8.3%**	**11.2%**	**11.2%**	**15.8%**
RCF / Net Debt	**5.3%**	**6.8%**	**6.8%**	**10.8%**

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations, and reflect the consolidated profile of the Eandis economic group. Source: Moody's Financial Metrics

Note: For definitions of Moody's most common ratio terms please see the accompanying User's Guide.

Opinion

Rating Drivers

- Rating underpinned by strong linkage with the region through provision of essential energy network services, with three notches of rating uplift, reflecting our assumption of a high probability of support from the Community of Flanders (Aa2 stable), if required in a distress scenario.

- Transparent and supportive regulatory framework, but relatively short track record. Tariff responsibility is being transferred from national to regional regulator, creating some uncertainty in the intermediate term.

- Weakening of the financial profile, as a result of ongoing capital expenditure needs and tariff deficit accumulated since 2008. Additional debt raised in connection with Electrabel exit as ultimate shareholder resulted in further deterioration of the underlying credit quality of the Eandis economic group during 2014.

- Tender for external equity partner, following proposed merger of the DSOs by the end of 2015, could significantly improve financial metrics during 2016.

Corporate Profile

Eandis CVBA (Eandis) is a Belgian utility, established in March 2006 through the merger of GeDis, ENV and Indexis (Flanders) and fully owned by seven Flemish distribution system operators (DSOs) being Gaselwest, IMEA, Imewo, Intergem, Iveka, Iverlek and Sibelgas. The DSOs' share capital is 100% held by 234 municipalities and provinces within the Community of Flanders.

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 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 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, all financial creditors and contractual counterparties have indirect recourse to the DSOs, proportional to their respective share of obligations. In addition, the DSOs severally guarantee the debt raised by Eandis under its EMTN programme. All distribution assets are held by the DSOs and there are no meaningful assets at Eandis's level.

SUMMARY RATING RATIONALE

Eandis's A1 rating reflects Moody's assessment of the credit quality of the seven DSOs that own the company and which we consider to be of broadly similar credit strength. The A1 rating also reflects a high probability that the Community of Flanders (Aa2 stable) will ultimately support the DSOs if necessary, given the strategic and economic importance of their services for the region. This currently results in a three-notch uplift from stand-alone credit quality of the Eandis economic group (comprising the consolidated credit quality of the seven DSOs and Eandis CVBA), which is in the high-Baa range.

The credit quality of the Eandis economic group is underpinned by the low business risk profile of their regulated electricity and gas distribution operations in the Flemish market, where the DSOs generate materially all of their cash flows. The regulatory framework is supportive and transparent, albeit relatively new and untested in the context of peer European regulated assets. The ongoing transition of tariff setting responsibilities from the national to the regional regulators continues to create some uncertainty on cash flow generation capability in the medium term, but the proposed tariff setting methodology maintains established principles.

However, the stand-alone credit quality, or Baseline Credit Assessment (BCA), of the Eandis economic group, and consequently the final rating, is pressured by weak financial performance due to ongoing investment requirements and under-recovery of certain non-controllable costs in the current regulatory period. We expect the majority of these costs to be recovered over the period of 2015 to 2020, although the detailed proceedings are still being finalised by the relevant regulatory and municipal bodies. The additional EUR965 million of debt incurred due to the exit of Electrabel S.A. (A3 negative) as shareholder in the DSOs in December 2014 has further weakened credit metrics. While additional equity contributions were received during 2015 from the municipalities and provinces owning the seven DSOs, the amounts have so far been insufficient to restore the consolidated leverage of the Eandis economic group to pre-Electrabel-exit levels.

DETAILED RATING CONSIDERATIONS

THREE NOTCHES OF RATING UPLIFT REFLECTING ASSUMPTION OF HIGH SUPPORT FROM THE FLEMISH REGION

The DSOs' ownership is fairly fragmented among 234 local communities. Most municipalities are small and may not have the financial strength to support a DSO should it get into financial difficulties. However, we expect that in this event, the Community of Flanders would act, because (1) it 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) it would be indirectly affected by any difficulties (including financial problems) experienced by the entities entrusted with this task.

In assessing the financial profile of Eandis, we have applied our rating methodology for government-related issuers (GRIs) due to the ownership of the seven DSOs by predominantly Flemish municipalities and provinces. In accordance with this methodology, our assessment of the credit quality of the Eandis economic group incorporates a three-notch rating uplift. The uplift results from (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 DSOs if they were in financial distress; and (3) our assessment of a very 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 DSOs and their close association with their owners and the region.

TRANSPARENT REGULATORY FRAMEWORK, BUT LIMITED TRACK RECORD AND SOME TRANSITION RISK

The Belgian regulatory framework is transparent and designed to provide a fair remuneration for cost and investment incurred by the distribution network operators. It follows a typical `building block' approach where the DSO will earn a return on the regulatory asset base (RAB) and an allowance for operating costs. Although the regulatory regime is based on established precedents of incentive-based regulation in European countries, the Belgian regulatory framework has less 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, the responsibility for setting electricity and gas distribution tariffs passed from the CREG to the regional regulators, i.e., the VREG in the Flemish Region.

To allow for the orderly transfer of tariff setting responsibilities, the CREG agreed with all DSOs (including the seven that own Eandis), 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.

On 30 September 2014, the VREG published its proposed tariff methodology for the transitory tariff period 2015-2016, which has subsequently been 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 block comprises of an allowance for efficient opex, depreciation, a return on the RAB (based on a weighted average cost of capital, or WACC, calculation). The allowed revenues will be updated annually for changes in the retail price index, an efficiency factor and a service quality factor. Non-controllable (or "exogenous") costs include the cost of green power 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% (lower than the previous guidance of around 67%). For the transitory period 2015-2016, it is set at 4.8% nominal (post-tax). The cost of debt allowance, which was historically treated as a pass-through, is now set on the basis of a risk-free rate (3.3% for embedded cost of debt and 2% for new debt), a risk premium of 1.2%, and a fixed adjustment of 15 bps for transaction costs, resulting in an overall cost of debt allowance of 4.1%. The cost of equity allowance is set on the basis of the CAPM, with the risk-free rate calculated on the two-year average of the historical interest on 10-year German Bunds and Belgian OLO (2%), an equity premium of 5.1%, and an equity beta of 0.73, resulting in an overall cost of equity of 5.7%.

The above approach for the transitory period 2015-16 will also be followed from 2017 onwards, and reflects established principles of other incentive-based frameworks in Europe. Nevertheless, a track record of consistent and transparent application will still have to be developed.

Furthermore, existing tariff deficits from previously under-recovered revenues will still have to be rectified. Under-recovered revenues from 2008-09 (around EUR100 million) have been included within agreed tariffs for 2015 and 2016, but the recovery of the 2010-14 deficits (around EUR350 million) will still have to be finalised. Based on draft consultation documents, published by VREG in July 2015, we expect recovery of these amounts over the years 2016-18.

In addition to the above tariff deficit receivables, Eandis accrued around EUR445 million of receivables with respect to green energy certificates and cogeneration certificates (Eandis has the obligation to buy them from generators of renewable energy and sell to energy suppliers, but was subsequently unable to sell all of the certificates due to insufficient demand). Proposed changes to the Energy Act include the introduction of a surcharge to be added to user tariffs, which will include the costs for existing unsold certificates to be recovered over the five-year period 2016-2020. While the detailed proceedings of the cost recovery are still to be finalised, the DSOs' outstanding amounts should be fully recovered by 2020.

DEBT INCURRED AS A RESULT OF ELECTRABEL EXIT WEAKENED FINANCIAL PROFILE

In line with the Flemish Decree on Intermunicipal Cooperation of 6 July 2001, Electrabel, owner of a 21% stake in the seven DSOs until December 2014, agreed that it would sell its shares to the DSOs. To pay for Electrabel's

21% stake (valued at EUR910 million), Eandis raised approximately EUR965 million of additional debt by the end of 2014, resulting in an increase in the Eandis economic group's leverage (measured by net debt to RAB, with the latter largely eqivalent to the company's fixed assets) to around 80%, compared with our guidance of maximum 70% at current rating levels.

To mitigate the financial impact, the shareholding municipalities have been offered the opportunity to increase their share capital in the DSOs. The equity has been raised in stages over 2015, ultimately amounting to around EUR170 million. However, this amount has been insufficient to significantly improve metrics.

NEW EQUITY PARTNER, FOLLOWING PROPOSED DSO MERGER, MAY IMPROVE METRICS

On 19 August 2015, Eandis made a dual proposal to the DSOs and the DSOs' municipalities, comprising the (1) merger of seven DSOs into one; and (2) the merged DSO's share capital to be opened up for entry by an external partner. This proposal has been approved in principle and will go to the municipal councils for approval during September 2015, with new articles of association to be agreed for the merged DSO by mid-December 2015. The DSO merger should become effective on 1 January 2016.

Following on from the merger, Eandis intends to tender a minority ownership stake in the merged DSO to interested long-term investors.

The coalition agreement of the new Flemish government has considered the possibility of third party financial investor participation in the waste treatment and energy sectors, but the related decree will still require ratification. We expect parliament to decide upon the relevant law by the end of this year. We understand that the draft decree includes a limitation for external equity ownership not exceeding 25% of total share capital, thus maintaining significant ownership by local or regional government.

Subject to all approvals being in place and the tender process being concluded as envisaged by Eandis's management, additional equity capital could be raised during the first half of 2016. However, the exact timing, amount and identity of the provider of any such potential additional equity capital remains uncertain. Even under a scenario of full recovery of the current tariff deficit and green certificate costs, a substantial amount may need to be raised to ensure that the consolidated financial metrics of the Eandis economic group improve to levels within our guidance for the current rating, in particular leverage (measured as net debt to RAB) comfortably below 70% and funds from operations (FFO)/net debt in the low teens.

Other Considerations

The company's rating falls within the scope of Moody's methodology for Regulated Electric and Gas Networks, published in November 2014, and of Moody's methodology for Government Related Issuers published in October 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 around A3.

Liquidity Profile

Eandis's liquidity position is currently adequate, but ongoing investments and debt repayments will require continuous access to capital markets.

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 EUR500 million, renewed annually, of which around EUR58 million were drawn at June 2015.

In addition, Eandis is active in the commercial paper market, with a EUR522 million programme, of which EUR100 million were outstanding at June 2015.

Rating Outlook

The negative outlook reflects the weakened credit quality of the Eandis economic group, represented by the seven DSOs owning Eandis, as a result of the debt raised to fund the exit of Electrabel and the risk that this may not be sufficiently offset by equity injections or other balance sheet strengthening, including the proposed sale of an equity stake of up to 25%. It further takes into account an element of regulatory uncertainty as the new tariff methodology continues to evolve.

What Could Change the Rating - Up

Given the current negative outlook, any upward pressure on the rating is unlikely over the medium term. Moody's would consider stabilising the outlook, if it becomes clear that the municipalities (or a future external equity partner) will provide additional equity capital on a timely basis to support a more modest gearing profile at the DSO(s). Leverage (measured as net debt to RAB) comfortably below 70% and FFO/net debt in the low teens would support a stable outlook.

What Could Change the Rating - Down

We could downgrade the rating if the DSOs' financial metrics appeared likely to remain weak, with consolidated net debt/RAB ratios persistently above 70%, and consolidated FFO/net debt ratio below 12%. This is a significant risk absent a reduction in debt through further equity injection(s) or other balance sheet strengthening measures. 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.

Rating Factors

Eandis CVBA

Regulated Electric and Gas Networks Industry Grid [1][2]	**Current FY 12/31/2014**		[3]**Moody's 12-18 Month Forward ViewAs of September 2015**	
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	Baa	Baa
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)	3.8x	Baa	3.5x - 4.5x	A
b) Net Debt / Fixed Assets (3 Year Avg)	72.0%	Baa	70% - 75%	Baa
c) FFO / Net Debt (3 Year Avg)	10.1%	Ba	10% - 15%	Baa
d) RCF / Net Debt (3 Year Avg)	6.2%	Ba	5% - 10%	Baa
Rating:				
Indicated Rating from Grid Factors 1-4		Baa2		A3
Rating Lift		0	0	0
a) Indicated Rating from Grid		Baa2		A3
b) Actual Rating/BCA Assigned				A1/high-Baa

Government-Related Issuer	**Factor**
a) Baseline Credit Assessment	high-Baa
b) Government Local Currency Rating	Aa2
c) Default Dependence	Very High
d) Support	High

e) Final Rating Outcome	A1

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. [2] All ratios reflect the consolidated profile of the Eandis economic group as of 12/31/2014; Source: Moody's Financial Metrics [3] This represents Moody's forward view; not the view of the issuer; and unless noted in the text, does not incorporate significant acquisitions and divestitures

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