Moody's
INVESTORS SERVICE

Rating Action: Moody's changes Fluvius's outlook to negative, affirms A3 ratings

10 Sep 2020

Paris, September 10, 2020 -- Moody's Investors Service, ("Moody's") has today affirmed Fluvius System Operator CV's ("Fluvius") backed (P)A3 senior secured MTN program rating, A3 backed long-term issuer rating and backed senior unsecured ratings and changed the outlook to negative from stable.

RATINGS RATIONALE

RATIONALE FOR CHANGING OUTLOOK TO NEGATIVE FROM STABLE

The outlook change reflects Moody's expectation that, absent mitigating measures, the cash-flow based metrics for the Fluvius Economic Group may not meet the guidance for the current rating over the next regulatory period starting 2021 as a result of the recently announced decision of the VREG, the economic regulator of the Fluvius Economic Group. The decrease in earnings, combined with the increase in investment requirements to support the energy transition, including smart metering, as well as the currently expected level of dividend payments will lead to an increase in net debt which may result in metrics falling short of the guidance for the current rating. The regulator's decision will result in reduced remuneration of the Regulated Asset Base (RAB) and more demanding operating efficiencies. In particular, the split of the RAB into "historical cost" RAB and revaluation surpluses, the allowed return of the former being cut by 150 basis points to 3.5% (nominal, pre-tax), and the allowed return of the latter decreasing from 3.5% to an expected 0% over 8 years, will significantly reduce earnings over the 2021-24 period. While revaluation surpluses accounted for around 20% of the RAB in 2019, their share in total RAB will decrease over time as they depreciate and new investments are made. We view the regulator's decision regarding the revaluation surpluses as resulting in a somewhat less predictable regulatory environment, but still consider the regulatory framework as generally supportive of Fluvius's credit quality.

Nevertheless, certain aspects of the regulatory decision are yet to be finalized, such as the level of potential advances on costs granted by the regulator or potential special financial incentives. Furthermore, Fluvius's future financial policy, in particular dividend policy, in the light of the lower revenues over the next regulatory period, will be an important factor in determining likely credit metrics.

Following the merger of Eandis System Operator CVBA with the lower-geared Infrax CVBA in July 2018 to create Fluvius, Fluvius has significantly lower balance sheet leverage than its predecessor, as measured by Net Debt / Fixed Assets, which has reached 58.5% in 2019 compared to 69.4% in 2017 and 77.6% in 2016. As revaluation surpluses will earn a decreasing return over time and eventually earn no return, we consider in our revised guidance the ratio of Net debt / Fixed Assets less revaluation surpluses which stood at c. 70.3% at end 2019.

RATIONALE FOR RATING AFFIRMATION

Fluvius's A3 ratings continue to reflect the robust credit quality of the distribution system operators (DSOs) which currently own the company and severally guarantee its liabilities. This is underpinned by the low business risk profile of their regulated electricity and gas distribution network operations in Flanders, Belgium. We view the regulatory framework as transparent and generally supportive 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.

Following the merger of Eandis and Infrax, ex-Eandis bonds continue to be guaranteed by its original owners, the DSOs Gaselwest, Imewo, Intergem, Iveka, Iverlek, Sibelgas and Fluvius Antwerpen (the later a result of the merger of IMEA, Integan and Iveg).

Fluvius's A3 rating incorporates a two-notch uplift for potential state support from its standalone credit quality (baseline credit assessment) of baa2. This is based on Moody's assessment of high dependence between Fluvius and its owners, all 300 municipalities within the Community of Flanders (Aa2 stable), and a strong likelihood of Fluvius receiving support in the event this were needed to avoid a debt payment default.

RATING OUTLOOK

The outlook is negative, reflecting Moody's expectation that, absent mitigating measures, cash-flow based financial metrics may fall below the guidance for the current rating i.e., funds from operations (FFO) / net debt may fall below 8%, in the next regulatory period starting 2021.

FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATINGS

A rating upgrade is unlikely in the near term given the expected decrease in earnings in the next regulatory period starting in 2021. However, the outlook could be changed to stable if the company was able to maintain FFO / net debt of at least 8% and Net debt / Fixed assets less revaluation surpluses were to remain below 80%. This could arise from (1) mitigating the increase in leverage via a change in its dividend policy, or (2) getting significant support from the advances mechanism introduced in the regulatory determination for the period 2021-24 so that cash-flows are maintained. Downward rating pressure could arise if metrics for the Fluvius Economic Group appeared unlikely to meet the requirements for the current ratings, namely FFO / Net Debt was to fall below 8% or Net Debt / Fixed Assets less revaluation surpluses was to be above 80%. The ratings may also come under downward pressure if Moody's assessed a lower probability of support from the Community of Flanders or if the rating of the sub-sovereign was downgraded.

Fluvius System Operator CV (ex Eandis System Operator CVBA) is a Belgian utility established in March 2006, which provides the regulated activities of operating the electricity and gas distribution networks in the Community of Flanders, Belgium. Fluvius was formed through the merger of Eandis and Infrax CVBA in July 2018 and is 100% owned by the municipalities of the Community of Flanders. Fluvius, together with its eleven DSO shareholders form the Fluvius Economic Group which derives around 90% of its operating profit from the regulated energy distribution activities, with the remaining 10% derived predominantly from regulated sewerage and contract-based CATV network operations. The group also holds small district heating infrastructure in selected areas.

The methodologies used in these ratings were Regulated Electric and Gas Networks published in March 2017 and available at https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1059225 , and Government-Related Issuers Methodology published in February 2020 and available at https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1186207 . Alternatively, please see the Rating Methodologies page on www.moodys.com for a copy of these methodologies.

REGULATORY DISCLOSURES

For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and Definitions can be found at: https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_79004.

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Moody's general principles for assessing environmental, social and governance (ESG) risks in our credit analysis can be found at https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1133569 .

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