MOODY'S
RATINGS

Rating Action: Moody's Ratings changes outlook on Fluvius System Operator to negative from stable; affirms A3 ratings

30 Sep 2024

Frankfurt am Main, September 30, 2024 -- Moody's Ratings (Moody's) has today changed Fluvius System Operator CV (Fluvius)'s outlook to negative from stable. Concurrently, the A3 backed long-term issuer and backed senior unsecured debt ratings, the (P)A3 backed senior unsecured MTN program ratings and the baa2 Baseline Credit Assessment (BCA) have been affirmed.

RATINGS RATIONALE

The outlook change to negative reflects that the financial metrics of the Fluvius Economic Group are currently below our guidance for the current rating, i.e. to maintain Funds from operations (FFO) / net debt of at least 8% while maintaining a ratio of net debt / fixed assets less revaluation surpluses of a maximum of 80%, and are not expected to recover sustainably to the hurdle levels within the upcoming regulatory period 2025-28, absent balance sheet strengthening measures. This projected financial profile reflects a challenging regulatory settlement and a significant increase in required capital expenditure needed to accommodate the energy transition in the Community of Flanders region.

Nevertheless, the rating affirmation recognizes that Fluvius is actively looking for capital injections to maintain its equity cushion in an attempt to maintain a financial profile in line with the current rating. However, the negative outlook further recognizes that there are downside risks to this plan, which include uncertainties as to the size and timing of capital increases, and the nature of such capital increases, particularly given the Fluvius Economic Group's organizational structure and ownership.

Fluvius targets to preserve an equity ratio of 40%, which according to company information requires additional capital of approximately €1.7 billion over the next ten years. As a consequence, Fluvius is considering different options to raise capital, i.e. a capital injection by its current shareholders or alternatively Flemish authorities, the entry of private investors, or a combination of these. Presently, there is uncertainty as to the outcome of these deliberations, and further clarity on them in the course of 2025 will be important to maintaining the A3 rating.

On 24 June 2024, the Flemish regulator Vlaamse Regulator van de Elektriciteits- en Gasmarkt (VREG) published the tariff methodology for the regulatory period 2025-28, which in huge parts carries forward core features of the previous regulatory framework.

The revenue cap model will comprise an allowance for operational expenses (both controllable and non-controllable), regulatory depreciation and an allowed return on the Regulated Asset Base (RAB) of 5.2% (pre-tax weighted average cost of capital [WACC], nominal), which is 1.7% higher than the previous period, driven by a higher risk-free rate and notably an increase of the cost of equity (post-tax) to 7.37%, up 3.29% from 4.08%. In the upcoming regulatory period, the WACC will be re-calculated annually. The introduction of a cumulative net efficiency factor of 1.1% for electricity puts Fluvius under strong cost pressure. In the 2021-24 regulatory period only an efficiency factor of 0.4% for gas was applied.

Under the new regulatory framework Fluvius is still allowed to apply for advanced payments to cover certain investment projects, with advances only to be repaid in the subsequent regulatory period. These payments partially help to fund significantly increasing capital expenditure, which ultimately lead to an expected RAB growth to around €14 billion at the end of 2028.

More generally, Fluvius's A3 ratings reflect the robust credit quality of the distribution system operators (DSOs) which currently own the company and severally guarantee its liabilities (and form the Fluvius Economic Group). This is underpinned by (1) the low business risk profile of their regulated electricity and gas distribution network operations in Flanders, Belgium, which account for around 95% of revenues in 2023 and (2) a transparent and generally supportive regulatory framework albeit with a still limited but extending track record in the context of European regulated network peers following the transition of tariff-setting responsibilities from the national to the regional regulators. The ratings are however constrained by (1) Fluvius' high leverage compared with the wider European peer group, (2) the significantly rising capital expenditure to support the Flemish Region's energy transition and (3) the need for external financing, as a consequence of negative free cash flow over the next regulatory period.

Fluvius's A3 rating incorporates a two-notch uplift for potential state support from its BCA of baa2. This is based on our assessment of high dependence between Fluvius and its owners, 300 municipalities within the Community of Flanders (Aa3 stable) through ownership of the DSOs, and a strong likelihood of Fluvius receiving support in the event this were needed to avoid a default.

RATIONALE FOR THE NEGATIVE OUTLOOK

The outlook is negative, reflecting our expectation that, absent balance sheet strengthening measures, the financial metrics of the Fluvius Economic Group will remain below those appropriate for the current rating level during the regulatory period 2025-28.

The outlook could be changed to stable if capital raising plans of sufficient size become sufficiently developed and are likely to suggest that the Fluvius Economic Group will be able to maintain financial metrics in line with those expected for the current rating.

LIQUIDITY

As of June 2024, Fluvius' cash and cash equivalents amounted to EUR13 million. Additionally, the company has access to EUR525 million of overdraft and revolving credit facilities, of which EUR511 million were undrawn. In addition, Fluvius has an uncommitted commercial paper program in the amount of EUR500 million with EUR110 million drawn as at June 2024.

Because of Fluvius' sizeable capital expenditure program, which will result in negative free cash flow at least over our projection period 2024-2027, we expect that the company will need to make use of its short term funding options, i.e. drawing significantly under existing credit facilities and / or under the commercial paper program for periods of time before refinancing with medium term debt. This leaves Fluvius with a somewhat high exposure to debt market access. This may be mitigated to some extent by (1) its good access to capital markets given its strategic importance and ownership, (2) the ability to reduce capital expenditure somewhat from time to time, and (3) expected sizeable cash inflows after the execution of the potential capital increase.

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

A rating upgrade is unlikely in the near term given the expected pressure on financial metrics during the next regulatory period. However, the BCA could be upgraded if the Fluvius Economic Group is able to maintain FFO/net debt in the low teens in percentage terms and net debt/fixed assets less revaluation surpluses remains below 70% on a sustained basis. An upgrade of the BCA would not necessarily lead to an upgrade of the final ratings.

The BCA and ratings could be downgraded, if the planned capital increase is significantly delayed or uncertain, resulting in a failure of the Fluvius Economic Group to meet the requirements for the current ratings, namely FFO / Net Debt was to remain below 8% or Net Debt / Fixed Assets less revaluation surpluses was to be above 80%.

The ratings may also come under downward pressure if we assess that there is a lower probability of support from the Community of Flanders or if the rating of the sub-sovereign was downgraded significantly.

The methodologies used in these ratings were Regulated Electric and Gas Networks published in April 2022 and available at https://ratings.moodys.com/rmc-documents/386754, and Government-Related Issuers methodology published in January 2024 and available at https://ratings.moodys.com/rmc-documents/406502. Alternatively, please see the Rating Methodologies page on https://ratings.moodys.com for a copy of these methodologies.

Fluvius System Operator CV is a Belgian utility which operates the electricity and gas distribution networks in the Community of Flanders, Belgium, and is 100% owned by the municipalities of the Community of Flanders. For year ending 31 December 2023 the Fluvius Economic Group had revenues of EUR2.3 billion and an operating profit of EUR544 million.

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 on https://ratings.moodys.com/rating-definitions.

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