MOODY'S
INVESTORS SERVICE

## Credit Opinion: Alliander N.V.

Global Credit Research - 29 Dec 2010

*Arnhem, Netherlands*

### Ratings

| Category | Moody's Rating |
|---|---|
| Outlook | Stable |
| Issuer Rating | Aa3 |
| Preferred Stock -Dom Curr | A3 |
| ST Issuer Rating | P-1 |
| **Alliander Finance B.V.** | |
| Outlook | Stable |
| Bkd Senior Unsecured -Dom Curr | Aa3 |
| Bkd Other Short Term -Dom Curr | (P)P-1 |

### Contacts


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### Key Indicators

**Alliander N.V.**

| | Dec-2009 | Dec-2008 |
|---|---|---|
| EBIT Margin | **23.2%** | **31.6%** |
| FFO Interest Coverage | **5.8x** | **6.4x** |
| Net Debt / Fixed Assets | **35.0%** | **54.4%** |
| FFO / Net Debt | **38.0%** | **18.9%** |
| RCF / Capex | **0.9x** | **0.0x** |
| RCF / Net Debt | **16.4%** | **0.1%** |

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

### Opinion

#### Corporate Profile

Alliander N.V. (Alliander) owns and manages, through its fully owned subsidiaries of Liander and Liandon, electricity and gas distribution networks in the Dutch provinces of Gelderland, Noord-Holland and large parts of Flevoland, Friesland and Zuid-Holland. Alliander is fully owned by Dutch provinces and municipalities, with the largest owners being the provinces of Gelderland (44%), Noord-Holland (10%), Friesland (13%) and the Municipality of Amsterdam (10%). The remaining 23% share is owned by approximately 54 small municipalities where Alliander provides its network services. Alliander is one of the three largest electricity and gas network operators in the Netherlands, responsible for the maintenance, management and development of the medium and low-voltage electricity and gas distribution grids. During the `unbundling' process, the vertically integrated utility, previously known as Nuon, spun off and sold its generation and supply activities, and since 1 July 2009 has operated under a new name, Alliander. It delivers electricity to approximately 2.8 million and gas to 2.1 million customers.

#### Recent Developments

UNBUNDLING

Under the Independent Grid Management Act, adopted by the Dutch parliament in November 2006 and amended by the Royal Decree of 3 August 2007, the decision to proceed with the unbundling of Dutch electricity companies was taken. The unbundling requires the country's utilities to implement full legal and ownership separation of regulated network activities from commercial activities by 1 January 2011. Alliander has already finalised the process, operating as a fully legally and operationally independent entity since June 2009. Based on the case brought by some of the utilities in the Netherlands, The Hague Court of Appeal found provisions of the Dutch Electricity and Gas Act relating to the separation of companies' power production and network divisions to be in conflict with European law and, therefore, non-binding. Moody's perceives the ruling to be particularly pertinent to the two utilities that have yet to separate their network and energy production divisions. We expect Alliander's independent position and ownership structure to remain intact, as the court ruling should not have a direct impact on the already unbundled utilities, and the privatisation restrictions for network companies remain in place.

ACQUISITION OF ENDINET

An agreement with the municipality of Eindhoven and 11 other municipalities was reached in March 2010 regarding the transfer of their shares in the grid company Endinet B.V. to Alliander for an acquisition price of EUR 712 million. Finalisation of the transaction is expected by July 2010. Endinet, which was formed in November 2009 as a result of the merger of NRE and ObN-NetH, is responsible for the management and maintenance of the gas and electricity grids in the regions of Eindhoven, Helmond and Haarlemmermeer. It transports gas and electricity to approximately 4% of the market, which represents approximately 560,000 connections and a total annual turnover of around EUR 110 million.

Given that Alliander's financial position is supported by its cash reserve, which has to a large extent been accumulated through the sale of high-voltage grid assets, Moody's perceives it as strong enough for the company to absorb the EUR 712 million acquisition price of Endinet B.V. without its current rating position being materially threatened. We recognise that the Endinet acquisition is in line with Alliander's strategy of becoming one of the leaders in the long-term development of the Dutch regional network sector.

**Rating Rationale**

Alliander's Aa3 issuer rating is underpinned by a combination of: (i) the low-risk business profile of Alliander's domestic electricity and gas regulated distribution network operations; (ii) the well-defined, transparent, but strongly cost-efficient-oriented, Dutch regulatory framework; and (iii) the company's conservative financial profile, reflected by its strengthened capital structure and very solid liquidity position. The Aa3 rating also incorporates a two notch uplift for potential support from its owners.

**DETAILED RATING CONSIDERATIONS**

Given its 100% ownership by Dutch provinces and municipalities, Alliander falls within the scope of Moody's rating methodology for government-related issuers (GRIs). In accordance with the methodology, Alliander's rating incorporates uplift for potential support from its owners to its standalone credit quality, which is expressed by Moody's as a BCA of 6 (on a scale of 1 to 21, where 1 represents the lowest risk and 6 is equivalent to an A2 rating).

Although the ownership of Alliander is relatively fragmented among approximately 58 provinces and municipalities, Moody's perceives the shareholders to be capable and willing to act in conjunction with one another. Furthermore, the 77% ownership share of the four largest provinces and their historically proven ability to reach consensus provides Moody's with comfort for the assignment of a strong level of expected systemic support to Alliander in case of a distressed situation.

This assessment considers Alliander's strategic importance and our view that extraordinary support from its governmental owners is more likely for a pure electricity and gas distribution network company compared to a vertically integrated utility. In addition, the two-notch uplift to Alliander's BCA incorporates the credit quality of the company's shareholders and Moody's assessment of a very high level of default dependence, reflecting Alliander's significant exposure to the Dutch economy, as almost all of the company's revenues and cash flows are generated from domestic activities and have a high level of correlation to common drivers of credit quality.

When assessing Alliander's BCA, Moody's applies its Rating Methodology for Regulated Electric and Gas Networks, which identifies key areas of focus for assessing the relative fundamental credit quality of regulated electric and gas network companies. The methodology focuses on the assessment of the regulatory environment, ownership model, operational performance, stability of business model, financial policy and key credit metrics. Based on historical financial performance, the methodology grid indicates a BCA of 5 for Alliander. Moody's anticipates the difference between the methodology grid outcome and the actual BCA of 6 narrowing in the future, as we expect Alliander's historically strong debt protection metrics to weaken as a result of the Endinet acquisition.

At Aa3 Alliander is rated at the same level as Enexis, also one of the principal electricity distribution network utilities in the Netherlands. The business and financial risk profile of the two companies is very similar, as both operate under the same regulatory model and follow prudent financial policies as encouraged by their local government owners. Both Alliander's and Enexis's ratings also benefit from uplift due to the potential for systemic support given their ownership model and the clear policy choice made in the Netherlands to maintain network utilities in public ownership. Moody's ratings of the Dutch electricity grids are thus materially higher than those of many of their European peers, which have private shareholders and exhibit higher leverage and whose ratings are generally in the low single-A/high Baa categories.

**Rating Drivers**

RATING FACTOR 1 - Regulatory Environment and Asset Ownership Model

The regulatory framework for network companies, applied in the Netherlands since 2001, allows them to earn a return on their regulated asset base, adjusted for the CPI and an efficiency incentive X factor. Regulation, now in its fourth period (2008-10), has incentives for the electricity and gas network companies: based on a `yardstick' mechanism, it defines the efficiency X and quality Q factors according to industry averages and encourages companies to improve profitability by outperforming the sector through improved efficiency and increased quality. The solid score (Aa) within the `Stability and Predictability of Regulatory Regime' sub-factor reflects consistent application of transparent regulatory methodologies by the Dutch regulator. Although the tariff formula allows for recovery of operating expenditures and a fair return on investments, the strong focus of the regulation on efficiency gains restricts Alliander's score under the `Cost and Investment Recovery' sub-factor to A.

The regulatory mechanism based on a revenue cap model and the gradual introduction of capacity-based payments reduces exposure of network companies to volume volatility risk, thus resulting in Alliander scoring Aa the `Revenue Risk' sub-factor. Moody's has assigned the same score to Alliander for the `Asset Ownership Model' sub-factor, given the company's full ownership of the network assets under a licence.

RATING FACTOR 2 - Efficiency and Execution Risk

Moody's overall score of Alliander within Factor 2 is supported by the high technical operating performance of Dutch networks, which is generally very solid in the context of their European peers. The company's very low average annual outage time reflects the extremely high reliability of its network assets. Alliander's score of A for the sub-factor `Cost Efficiency' further reflects its historically consistent outperformance of the regulatory targets and its Dutch peers, which has resulted in the Dutch regulator assigning the lowest X factor to the company for the current regulatory period.

Although Alliander does not plan any significantly large, single projects as part of its capital investment programme, its Baa score for the `Scale and complexity of Capital Programme' sub-factor reflects Moody's expectation that Alliander's annual investment plan, currently at the level of

EUR 350 million, is set to gradually increase over the next five years.

RATING FACTOR 3 - Stability of Business Model and Financial Structure

With the exception of the public lighting and traffic management services, which do not exceed 10% of its revenues, Alliander strategically focuses on its core business of regulated activities based on its distribution network assets, which justifies its solid A score within the sub-factor `Proportion of Activities outside the Core Network Segment'.

Although Alliander's strategy is fully focused on its core business of regulated network activities, the company's acquisition of Endinet demonstrates a greater willingness on behalf of management to pursue acquisition activity, as well as an appetite to increase leverage, though within the Alliander financial policy framework. Although the acquisition is in line with the government's and owners' view of long-term consolidation of the Dutch distribution network sector in the Netherlands, Moody's has assigned a rating of Baa to Alliander for the sub-factors `Ability and Willingness to Pursue Opportunistic Corporate Activity' and `Ability and Willingness to Increase Leverage'.

RATING FACTOR 4 - Key Credit Metrics

Based on Alliander's historical financial performance, the methodology indicates a BCA level of 5 (A1-equivalent). Although Alliander's capital structure and liquidity have strengthened as a result of an equity injection and the successful sale of high-voltage network assets in 2009, Moody's incorporates in its assessment of the company's BCA the expected impact of the acquisition of Endinet. Moody's perceives Alliander's financial position, supported by its cash reserve, as strong enough to absorb an acquisition of such a size without materially threatening its positioning within its BCA category of 6.

**Liquidity Profile**

Alliander's strong liquidity position is supported by solid cash flow generation, the favourable maturity profile of its EUR 2 billion notes issued under the EUR 3 billion euro medium-term note (EMTN) programme, an almost undrawn ECP programme of EUR 1.5 billion and a currently undrawn committed facility of EUR 600 million, which matures in 2015. Furthermore, Alliander's liquidity position has been strengthened by the recent successful issue of EUR 500 million Perpetual Capital Securities. Based on its features, the instrument qualifies for basket "C" treatment under the revised Moody's Hybrid Tool Kit, published on 1 July 2010 and are treated as 50% equity and 50% debt, when Moody's applies its adjustments to Alliander's financial statements.

Moody's expects Alliander's cash cushion of approximately EUR 800 million accumulated in 2009 has been largely consumed to finance the acquisition of Endinet in 2010.

Alliander's capex plan, which represents major cash outflow, is forecasted to remain at the stable level of approximately EUR 350-450 million annually within next five years. The company's solid liquidity position is further supported by a reasonable dividend policy, outlined by the shareholders, of 45% of net income.

CROSS-BORDER LEASE AGREEMENTS (CBL)

Moody's notes that Alliander has exposure to contingent liabilities represented by six CBLs. In the unlikely case of an unscheduled early termination of all of these CBLs at once could give rise to a total exposure of US$467 million. In addition, market-to-market changes in valuations of underlying investments could lead to a higher strip risk and increase Alliander's total exposure to US$640 million. According to the conditions of some of the CBLs, the company would need to post additional letters of credit if its ratings were to drop below certain minimum levels. Currently, Alliander posts US$170 million of letters of credit. In this context, Moody's notes that the company currently has solid liquidity within its EUR 600 million credit facility to cover potential financing needs stemming from the CBLs, including a sufficient limit for issuing related letters of credit. The documentation of the credit facility includes certain financial covenants that the company is required to maintain. Alliander is in compliance with all the covenants with comfortable headroom.

**Rating Outlook**

The stable outlook for Alliander reflects Moody's expectation that the company will remain a pure electricity and gas distribution network operator that derives most of its revenues and cash flow from regulated activities. Furthermore, we expect Alliander to continue to follow its conservative financial policy, building on the successful developments of the unbundling process.

**What Could Change the Rating - Up**

For any upward pressure on the rating to occur, Alliander would need to consistently achieve high ratios well above its credit metrics, set by the company within its financial policy and incorporated in its business plan (FFO interest coverage at or above 3.5x and FFO/net debt above 20%) on a sustainable basis.

**What Could Change the Rating - Down**

To be safely positioned within its current BCA of 6, Moody's expects Alliander not to materially divert below its minimum credit metrics, set within its financial policy: FFO interest coverage at or above 3.5x and FFO/net debt above 20% on a sustainable basis. If the debt protection metrics decline substantially below these levels, mainly due to a significant increase in indebtedness above the forecast levels and/or weakening of cash flow generation, the BCA and rating might come under downward pressure.

**Rating Factors**

**Alliander N.V.**

| Regulated Electric and Gas Networks | Aaa | Aa | A | Baa | Ba | B | Caa |
|---|---|---|---|---|---|---|---|
| **Factor 1: Regulatory Environment and Asset Ownership Model (40%)** | | | | | | | |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| a) Stability and Predictability of Regulatory Regime (15%) | | x | | | | | |
| b) Asset Ownership Model (10%) | | x | | | | | |
| c) Cost and Investment Recovery (Ability and Timeliness) (10%) | | | x | | | | |
| d) Revenue Risk (5%) | | x | | | | | |
| **Factor 2: Efficiency and Execution Risk (10%)** | | | | | | | |
| a) Cost Efficiency (6%) | | | x | | | | |
| b) Scale and Complexity of Capital Programme (4%) | | | | x | | | |
| **Factor 3: Stability of Business Model and Financial Struct (10%)** | | | | | | | |
| a) Ability & Willingness to Pursue Opportunistic Corp Activ (3%) | | | | x | | | |
| b) Ability and Willingness to Increase Leverage (3%) | | | | x | | | |
| c) Proportion of Oper. Profit outside Core Reg. Activities (3%) | | | x | | | | |
| **Factor 4: Key Credit Metrics (40%)** | | | | | | | |
| a) FFO Interest Cover (15%) | | x | | | | | |
| b) Net Debt / Fixed Assets (15%) | | x | | | | | |
| c) FFO / Net Debt (5%) | x | | | | | | |
| d) RCF / Capex (5%) | | | | | x | | |
| **Rating:** | | | | | | | |
| a) Indicated BCA from Methodology Grid | | | **A1** | | | | |
| b) Actual BCA | | | **A2** | | | | |