

Global Credit Research - 31 Jul 2015

Arnhem, Netherlands

## Ratings

| Category                       | Moody's Rating |
|--------------------------------|----------------|
| Outlook                        | Stable         |
| Issuer Rating                  | Aa2            |
| Senior Unsecured -Dom Curr     | Aa2            |
| Jr Subordinate -Dom Curr       | A2             |
| ST Issuer Rating               | P-1            |
| <b>Alliander Finance B.V.</b>  |                |
| Outlook                        | Stable         |
| Bkd Senior Unsecured -Dom Curr | Aa2            |

## Contacts

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## Key Indicators

| [1]Alliander N.V.       | 12/31/2014 | 12/31/2013 | 12/31/2012 | 12/31/2011 |
|-------------------------|------------|------------|------------|------------|
| FFO Interest Coverage   | 6.8x       | 7.6x       | 6.3x       | 6.2x       |
| Net Debt / Fixed Assets | 28.9%      | 33.7%      | 35.8%      | 34.0%      |
| FFO / Net Debt          | 28.8%      | 30.7%      | 28.3%      | 36.6%      |
| RCF / Net Debt          | 21.6%      | 26.6%      | 22.5%      | 32.1%      |

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. 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

- Low business risk profile supported by predictable cash flows due to predominantly regulated activities
- Stable and transparent regulatory regime, though allowed returns are decreasing
- Moderate investment requirements and conservative distribution policy underpin strong financial profile going forward
- Asset swap transaction with network peer Enexis expected to conclude by 1 January 2016, which will result in payment to Alliander

- Two notches of rating uplift reflecting potential support from government shareholders

## **Corporate Profile**

Alliander N.V. (Alliander) owns and manages low and medium voltage electricity and gas distribution networks in the Dutch provinces of Gelderland, Noord-Holland and large parts of Flevoland, Friesland, Zuid-Holland and Noord-Brabant. Alliander is fully owned by Dutch provinces and municipalities, with the largest owners being the provinces of Gelderland (45%), Friesland (13%), Noord-Holland (9%), and the City of Amsterdam (9%). The remaining 24% share is owned by 54 small municipalities where Alliander provides its network services. Alliander is the largest electricity and gas network operator in the Netherlands with approximately 3.1 million electricity and 2.6 million gas connections and it has a combined market share of 37% in the Netherlands.

## **SUMMARY RATING RATIONALE**

Alliander's Aa2 issuer rating is underpinned by a combination of (1) the low-risk business profile of Alliander's domestic electricity and gas regulated distribution network operations; (2) the well-defined and transparent Dutch regulatory framework; and (3) the company's conservative financial profile with relatively modest leverage for the sector and solid liquidity position.

During the current regulatory period 2014-2016, returns will gradually reduce from previously 6.2% to 3.6% (real, pre-tax) by the end of the three-year period. In addition, revenue allowances will decrease to reflect cost efficiency savings being passed through to the end consumers. Despite the lower allowed returns, we expect Alliander to maintain a strong financial profile over the medium term, supported by limited investment requirements and a conservative distribution policy. The company's financial profile will likely strengthen further, once the agreed asset swap with its peer network operator Enexis Holdings N.V. (Enexis, Aa3 stable) completes, as this will involve a payment of around EUR365 million from Enexis to Alliander to compensate for higher earnings potential of Alliander's assets to be transferred to Enexis.

The Aa2 rating also incorporates a two-notch rating uplift under our rating methodology for Government-Related Issuers (GRI), published October 2014, reflecting the potential support from Alliander's owners.

At Aa2, Alliander's rating is materially higher than those of many of its European peers, whose ratings are generally in the low single-A/high Baa categories, primarily as a result of Alliander's significantly lower financial leverage.

## **DETAILED RATING CONSIDERATIONS**

### **LOW BUSINESS RISK PROFILE SUPPORTED BY PREDICTABLE CASH FLOWS DUE TO PREDOMINANTLY REGULATED ACTIVITIES**

Regulated activities (i.e., the operation of energy distribution networks) contribute more than 90% of Alliander's revenues, providing relatively stable and predictable cash flows under a transparent regulatory regime, and medium term visibility over investment requirements.

Alliander's unregulated activities represent less than 10% of revenues and the company strategy does not envisage material growth of such activities in the medium term. Alliander disposed of the non-core unregulated KEMA business in H1 2014 and is adopting an asset-light strategy with respect to its entry in the German market where strategic partnerships would be preferred to outright asset acquisitions.

### **STABLE AND TRANSPARENT REGULATORY REGIME THOUGH ALLOWED RETURNS ARE DECLINING**

The Dutch framework has been applied since 2000 and 2001 for electricity and gas respectively and allows the country's energy distribution companies to earn a return on their regulated asset base adjusted for a consumer price index (CPI). The regulation incorporates incentives based on a "yardstick" mechanism, which defines the efficiency X and quality Q factors based on industry averages and encourages network companies to improve profitability by outperforming the sector through improved efficiency and increased quality. This CPI-X approach is typical of peer regulatory regimes in Europe and we consider that the application of the Dutch regulatory methodologies by the regulator, the Authority for Consumers and Markets (ACM), has to date been transparent and consistent.

The current price control period, from January 2014 to December 2016, allows for lower returns than in the previous periods. Most notably, the weighted average cost of capital (WACC) for network companies is being reduced to 3.6% in real terms by the end of 2016, from a level of 6.2% previously. This translates into an overall

reduction in regulated revenue of about EUR50 million per year on a cumulative basis during the current regulatory period.

While this represents a decline in allowed returns, Alliander has demonstrated its ability to fund comfortably around the cost of debt of ultimately 3.85% incorporated in the new WACC allowance. The company's most recent debt issuance was the EUR500 million 3.25% perpetual hybrid bond in November 2013. Alliander's average cost of debt, including the hybrid, is around 3.7% (nominal), broadly in line with the regulatory cost of debt assumptions.

#### LIMITED INVESTMENT REQUIREMENT AND CONSERVATIVE FINANCIAL POLICY SUPPORT STRONG FINANCIAL PROFILE

The technical operating performance of the Dutch networks is excellent when compared to other European peers, demonstrated by the networks' high reliability and lower unplanned interruptions time. The generally good condition of the Dutch energy network assets reduces necessary maintenance requirements. Total capital expenditure was stable around EUR500 million in the past few years (EUR490 million in 2014, net of customer contributions) and is expected to broadly remain around this mark over the medium term. The biggest single investment project for Alliander is the smart-meter roll-out which is expected to slightly increase investment needs after its estimated start in 2015. Investment implications from decentralised energy generation as well as integration of renewable generation is mitigated by ongoing technology updates to the existing network.

The modest investment requirements, particularly when compared with transmission networks operators, underpin our expectation of a continuously strong financial profile. In addition, the management maintains a conservative dividend policy, with distributions around 45% of net income.

Over the medium term, we expect Alliander to continue to exhibit strong financial metrics, although operational cash flows may be lower due to the reduction in allowed returns and the composition of the asset swap with Enexis. We forecast Alliander to maintain funds from operations (FFO)/net debt above 25%, and RCF/net debt in excess of 20% over the medium term, creating a slightly stronger stand-alone financial profile than exhibited by its peer Enexis, recognised in the one-notch higher rating.

#### PROPOSED ASSET SWAP WITH ENEXIS MAY FURTHER IMPROVE ALREADY STRONG METRICS

In July 2015, Alliander and Enexis announced that they have signed the asset sale and purchase agreement that will allow them to swap certain assets within their areas. The transaction will see Enexis transfer its networks in the Friesland province and the Noordoostpolder area, in exchange for Alliander's network in the Eindhoven and southeast Brabant region (operated by Endinet). This is part of the Dutch government's wider policy to arrange network operations along provincial borders.

Alliander's Endinet business serves a larger number of customers (108,000 electricity and 398,000 gas connections) than the Enexis assets to be transferred (combined 79,000 electricity and 223,000 gas connections). Therefore, Enexis will have to compensate Alliander for the larger revenue generation capability of the latter's assets to be transferred by paying around EUR365 million. Depending on the funding of this payment, Enexis's financial metrics may weaken marginally, while Alliander's metrics will likely improve. Due to the relatively small size of the assets to be swapped when compared with the companies' existing businesses we expect any direct financial implications stemming from the agreement to be modest, and thus unlikely to materially alter either companies' overall credit quality. It does, however, strengthen Alliander's already solid financial profile further.

#### TWO NOTCHES OF UPLIFT REFLECTING POTENTIAL SUPPORT FROM GOVERNMENT SHAREHOLDERS

Given its 100% ownership by Dutch provinces and municipalities, Alliander falls within the scope of our rating methodology for government-related issuers (GRIs), published in October 2014. Alliander's Aa2 rating incorporates two notches of uplift on its standalone credit quality, which is expressed as a baseline credit assessment (BCA) of a1, reflecting our assessment of a strong probability of potential extraordinary support from its owners should this be needed.

Our assessment of strong level of expected systemic support to Alliander reflects the strategic importance of the company and its assets to the regions in which it operates. Although the ownership of Alliander is relatively fragmented among 58 provinces and municipalities, we believe the shareholders would be capable and motivated to act in conjunction with one another in case of need. Furthermore, 76% of Alliander's shares is concentrated in relatively small number of provinces and is owned by the 4 largest shareholders.

Our assessment of very high level of default dependence reflects 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 number of common drivers of credit quality.

### Liquidity Profile

Alliander continues to maintain a strong liquidity position. This is supported by large committed liquidity facilities and solid cash flow generation, although we expect cash generation to decline over the current regulatory period. As of 30 June 2015, the company had EUR159 million of cash (plus EUR50 million of short-term deposits) and a EUR600 million revolving credit facility - fully undrawn and available until July 2018. In addition, the company is an active issuer of commercial papers (CP) under its established EUR1.5 billion ECP programme.

The next significant bond maturity is EUR400 million due in April 2016. Liquidity in place is sufficient to cover in excess of 12 months' scheduled cash requirements.

Alliander has exposure to contingent liabilities represented by three cross-border leasing (CBL) arrangements. In the case of an unscheduled early termination of all of these CBLs at the same time this could give rise to a total exposure (maximum strip risk) of US\$210 million as of 30 June 2015. 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. We note that the company currently has availability under its EUR600 million revolving credit facility to cover potential financing needs stemming from the CBLs, including a sufficient limit for issuing related letters of credit.

### Rating Outlook

The stable outlook for Alliander reflects our expectation that the company will maintain focus on its regulated business and continue to follow its conservative financial policy.

### What Could Change the Rating - Up

FFO/net debt comfortably above the mid-thirties and RCF permanently in the high-twenties in percentage terms may put upward pressure on the ratings, provided that such metrics are combined with a still conservative approach to the business, with continuing focus on the core regulated activities, and a prudent financial and dividend policy.

### What Could Change the Rating - Down

To be safely positioned within its current BCA of a1, we would expect Alliander to maintain the following minimum credit metrics: FFO/net debt above 25% on a sustainable basis and net debt/fixed assets below the low forties in percentage terms. A downward rating pressure could also arise if the potential support from Alliander's government shareholders were to be seen less likely to be obtained.

### Other Considerations

The principal methodologies used in rating Alliander were Moody's "Regulated Electric and Gas networks" rating methodology, published in November 2014 and "Government Related Issuers", published in October 2014. Over the next 12-18 months, we expect Alliander to exhibit a financial profile broadly in line with historical metrics.

The indicated rating from the regulated networks methodology grid is Aa3, one notch higher than the assigned a1 BCA.

## Rating Factors

### Alliander N.V.

| Regulated Electric and Gas Networks Industry Grid [1][2]          | Current FY 12/31/2014 |       | [3]Moody's 12-18 Month Forward ViewAs of July 2015 |       |
|---|-----------------------|-------|--|-------|
| Factor 1 : Regulatory Environment and Asset Ownership Model (40%) | Measure               | Score | Measure  | Score |
| a) Stability and Predictability of Regulatory Regime              | Aa                    | Aa    | Aa   | Aa    |
| b) Asset Ownership Model  | Aa                    | Aa    | Aa   | Aa    |

|   |       |     |           |        |
|---|-------|-----|-----------|--------|
| c) Cost and Investment Recovery (Ability and Timeliness)        | A     | A   | A         | A      |
| d) Revenue Risk   | Aa    | Aa  | Aa        | Aa     |
| <b>Factor 2 : Scale and Complexity of Capital Program (10%)</b> |       |     |           |        |
| a) Scale and Complexity of Capital Program                      | Baa   | Baa | Baa       | Baa    |
| <b>Factor 3 : Financial Policy (10%)</b>                        |       |     |           |        |
| a) Financial Policy   | A     | A   | A         | A      |
| <b>Factor 4 : Leverage and Coverage (40%)</b>                   |       |     |           |        |
| a) FFO Interest Coverage (3 Year Avg)                           | 6.9x  | Aa  | 6x - 8x   | Aa     |
| b) Net Debt / Fixed Assets (3 Year Avg)                         | 32.7% | Aa  | 25% - 35% | Aa     |
| c) FFO / Net Debt (3 Year Avg)                                  | 29.3% | Aa  | 25% - 35% | Aa     |
| d) RCF / Net Debt (3 Year Avg)                                  | 23.6% | Aa  | 20% - 25% | Aa     |
| <b>Rating:</b>  |       |     |           |        |
| Indicated Rating from Grid Factors 1-4                          |       | Aa3 |           | Aa3    |
| Rating Lift   | 0     | 0   | 0         | 0      |
| a) Indicated Rating from Grid                                   |       | Aa3 |           | Aa3    |
| b) Actual Rating/BCA Assigned                                   |       |     |           | Aa2/a1 |

| Government-Related Issuer           | Factor    |
|-------------------------------------|-----------|
| a) Baseline Credit Assessment       | a1        |
| b) Government Local Currency Rating | Aaa       |
| c) Default Dependence               | Very High |
| d) Support                          | Strong    |
| e) Final Rating Outcome             | Aa2       |

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. [2] 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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