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Fluvius System Operator CV

Proposed cut in allowed return will be credit negative if implemented

On 4 May 2020, the Flemish energy regulator Vlaamse Regulator van de Elektriciteits- en Gasmarkt (VREG) published a consultation on the tariff methodology for the next regulatory period 2021-2024 for electricity and gas networks operators (DSOs) in Flanders (Aa2 stable). Following the merger of Eandis System Operator (Eandis) and Infrax in July 2018, Fluvius System Operator CV (Fluvius, A3 stable) is the only operating company for electricity and gas distribution to which the new tariff methodology will apply.

We view the proposed changes, if implemented, as credit negative because they will reduce operational cash flow due to the following:

» A lower allowed return (weighted average cost of capital or WACC), previously set at 5.0%[1] on the whole Regulated Asset Base (RAB) and now 3.5% on the majority of the RAB, and an even lower (and declining) rate on the remaining RAB;

» Lower allowed revenue due to assumed lower costs arising from synergy benefits as a result of the merger of the two predecessors of Fluvius;

» Lower regulatory cost allowances from assumed annual productivity improvements.

The changes will be only partially offset by our expectation that the RAB will increase by around 6% over the period, as a result of a step-up in Fluvius' capital expenditure programme. Our pro-forma estimate of Fluvius' underlying Funds From Operations (FFO) / net debt ratio assuming the proposed changes and increase in RAB, and assuming a constant net debt at the year-end 2019 amount, averages 9.2% over the period, compared to an estimated 10.6% in 2020.

However, as detailed in exhibit 2 below, the actual FFO / net debt has been and will continue to be impacted by the recovery or give back of past regulatory balances through tariffs, leading to some material, and somewhat volatile, differences with the estimated underlying FFO / net debt.

The document published by the regulator is a consultation which remains open until the 18th of June, and the final tariff methodology may differ from the consultation following responses from stakeholders. The VREG is expected to publish its tariff methodology decision in July 2020 and the new tariff period will start on 1 January 2021.

150 basis point cut in WACC reflects the low interest rate environment

The components of Fluvius' allowed return have been updated to reflect current market conditions. As a result, the WACC (nominal, pre-tax) has been reduced by 150 basis points (bps) to 3.5% in the 2021-24 period from 5.0% originally set for the 2017-20 period[2] (exhibit 1).

Exhibit 1

Proposed weighted average cost of capital (WACC) is 150 bps lower than in the previous regulatory period

WACC applied to RAB at historical cost

	VREG (2015-16)	VREG (2017-20)	VREG consultation (2021-24)
Risk-free rate	3.30%	3.04%	2.11%
Risk premium	1.20%	0.64%	0.58%
Transaction fee	0.15%	0.15%	0.15%
Cost of debt (historical)	4.65%	3.83%	2.84%
Risk-free rate	2.00%	0.80%	0.09%
Risk premium	1.20%	0.61%	0.85%
Transaction fee	0.15%	0.15%	0.15%
Cost of debt (new)	3.35%	1.56%	1.09%
Historical: new debt ratio	60:40	65:35	60:40
Cost of debt (allowed)	**4.13%**	**3.04%**	**2.14%**
Premium for ECB purchase		0.63%	0.00%
Market risk premium	5.10%	5.01%	4.81%
Asset Beta	0.33	0.38	0.39
Equity Beta	0.73	0.76	83%
Equity risk premium	3.74%	3.79%	3.99%
Cost of Equity (post-tax)	**5.74%**	**5.24%**	**4.08%**
Cost of Equity (pre-tax)	**8.70%**	**7.94%**	**5.44%**
Gearing	55%	60%	60%
WACC (nominal, post-tax)	**4.85%**	**3.92%**	**2.92%**
Tax rate from 1 Jan 2015	33.99%	33.99%	25.00%
WACC (nominal, pre-tax)	**6.18%**	**5.00%**	**3.5%**

Note: the risk-free rate for new debt and equity is calculated as a weighted average of the 10-year German Bund and the 10-year Belgian OLO (25:75 over a one-year period for 2017-20 and for 2021-24); the risk-free rate for historical debt is calculated as a weighted average of the same bonds (25:75 over 10 years for 2017-20, over the 2010-16 period for 2021-24 (see below).
Note 2: the WACC was updated to 4.9% in 2018 and 2019 and 4.8% in 2020 to reflect the decrease in corporate tax rate to 29.58% and 25%, respectively
Source: VREG

The main changes to the components of the WACC are the following:

» **The risk-free rate for new debt and equity has been reduced to 0.09%** from 0.8% reflecting the low interest rate environment.

» **The risk-free rate for historical debt has been reduced to 2.11%** from 3.04% reflecting the low interest rate environment. This was partly mitigated by the decision to consider average rates over the period 2010-2016 rather than 2010-2019 (+52 bps effect on WACC) to reflect an increase in permitted income over 2016-20 for recovery of regulatory deficits and government support for the purchase of green and cogeneration certificates.

» **The premium for ECB purchase has been removed** following VREG's consultant Europe Economics' statement that, considering the longer-than-expected quantitative easing from the European Central Bank (ECB) and the low interest rate environment, it is not warranted anymore.

» **Tax rate**: The tax rate in Belgium has been progressively reduced from 33.99% to 29.58% in 2018-19 and 25% from 2020 onwards. This change reduces the WACC by 30 bps, but as the WACC is pre-tax the decrease in EBITDA will be smoothed at the (after-tax) FFO level.

With an average cost of debt of 2.89% in 2019, we expect Fluvius will manage to progressively reduce its cost of debt to below the allowance for the next regulatory period as a €170 million 4.25% bond and a €500 million 4.5% bond mature in December 2020 and November 2021, respectively, and will likely be refinanced at lower rates. The cut of allowed equity return, however, will result in a permanent loss of operating cash flows. Based on a projected total RAB of c. €10.3 billion at end 2020, the cut in WACC (from 4.8% in 2020 to 3.5% in 2021-24) would lead to a reduction of c. €130 million per annum in Fluvius's EBITDA over the period, equivalent to around 1.5 percentage point in the FFO to Net debt ratio.

Earnings will fall further due to the lower return on revaluation surpluses

In its proposed tariff methodology, the VREG proposes to split Fluvius's RAB into its net historical value (remunerated at the WACC of 3.5%) and a revaluation surplus. Fluvius' RAB includes c. €1.9 billion of revaluation surpluses which were accrued between the 1970s and 2003 when the RAB was annually indexed to CPI, and a one-off revaluation in 2003 at replacement cost. The revaluation surpluses should be fully depreciated by 2056.

In the VREG's opinion, the revaluation surpluses should not be remunerated as no capital spending was involved in the value creation. The reduction in remuneration rate for regulatory surpluses will be gradual, from the WACC value of 3.5% (nominal pre-tax) in 2021 to 0.88% in 2024, and should not be remunerated in the following regulatory period.

The additional impact on earnings of this change will correspond to the amount of revaluation surpluses, net of depreciation, multiplied by the difference between the applicable rate of the year and 3.5%. We estimate the additional negative impact on Fluvius' FFO to range between €11 million in 2022 and €33 million in 2024.

More challenging cost incentives should be manageable for Fluvius

The allowance for controllable costs (so called "endogenous costs") for Flemish DSOs already incorporates an x factor: the annual correction for an assumed evolution of controllable costs, excluding inflation. In the consultation, the VREG proposes the introduction of a new x' factor : a correction to give back the remainder of the benefit from economies of scale (estimated at €83.5 million at the start of the new regulatory period) achieved through the merger of Eandis and Infrax that created Fluvius. Fluvius' allowed income would be reduced by c. €21 million per annum over 2021-24 which will prove demanding if the company's planned synergies from the merger are not achieved.

In addition to the x and x' factors, the VREG proposes to introduce an x'' factor: a frontier shift mechanism to incentivise further productivity gains from the monopoly DSO. Based on observations and recommendations from its consultant Oxera, the VREG has concluded that the efficient DSO should provide a minimum productivity improvement of 0.4% per annum for gas distribution. No additional productivity improvement has been considered needed under this incentive for electricity distribution.

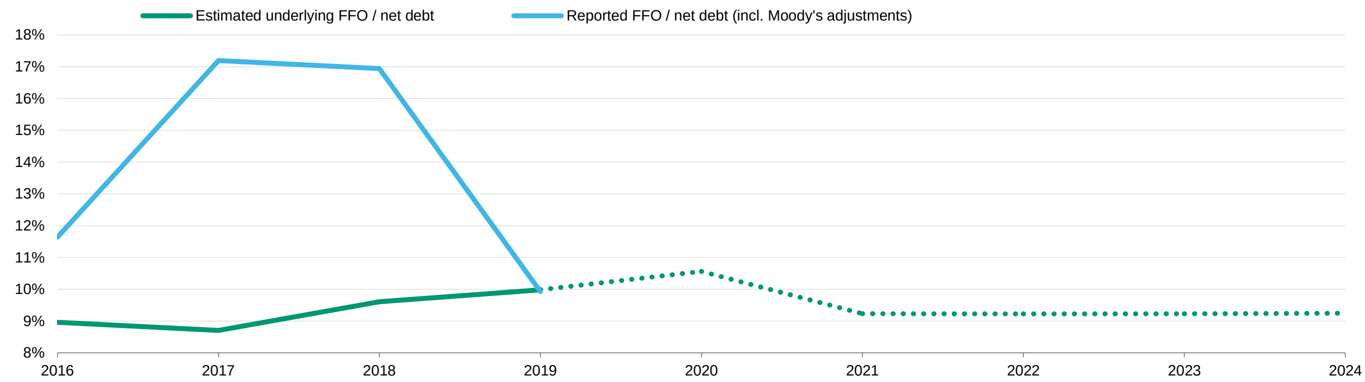
Reported FFO / net debt will continue to be impacted by movements in regulatory balances

The impact of the above proposed changes on underlying FFO will be partially mitigated by the increase in RAB as a result of the significant capex programme planned by Fluvius. Based on our estimates, the underlying EBITDA (excluding the impact of regulatory balances and green/cogeneration certificates) of the group would be c. €850 million per annum over 2021-2024. This translates into c. 9.2% FFO to net debt on average over the period (using adjusted net debt as at year-end 2019 as a proxy).

However, and as in previous years, reported FFO / net debt can materially differ from underlying FFO as a result of recovery and give back of regulatory balances, green certificates and cogeneration certificates.

Exhibit 2

FFO / net debt has benefitted from regulatory recoveries in the past



Note 1: Underlying FFO is estimated as the sum of RAB x WACC, EBIT of non-DSO activities, depreciation and amortisation, less interest expense; after tax at prevailing corporate tax rate, the impact of lower remuneration on revaluation surpluses is included in the calculation

Note 2: The dotted line represents Moody's projected underlying FFO / net debt, assuming stable adjusted net debt from 31/12/2019. Moody's projections reflect Moody's view, not the view of the issuer.

Source: Moody's Investors Service

While metrics were inflated by these recoveries until 2018, the slowdown in recovery from green/cogeneration certificates and the adverse allocation of old regulatory balances [3] has led to a cut in tariff from 2019 and hence FFO / net debt fell below the underlying level of c. 10%. We expect this to continue in the next period as 50% of remaining regulatory balances at 31 December 2020 will be clawed back in each of 2021 and 2022. At 31 December 2019, regulatory balances amounted to €210.6 million of liabilities (or 2.7% of reported gross debt at end 2019).

The proposed tariff methodology also includes a new tariff structure from 2022, which determines how electricity network users are charged. This change is not expected to have an impact on Fluvius' earnings.

The consultation remains open until the 18th of June. The VREG is expected to publish its tariff methodology decision in July 2020.

Endnotes

1 The WACC was reduced to 4.9% for 2018 and 2019 and 4.8% for 2020 to reflect the decrease in corporate tax rate

2 The WACC was reduced to 4.9% for 2018 and 2019 and 4.8% for 2020 to reflect the decrease in corporate tax rate

3 See: Moody's changes Fluvius's outlook to stable, affirms A3 ratings, 25 July 2019

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