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Summary:

ENECO Holding N.V.

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Credit Rating: A/Negative/A-1

Rationale

The ratings on Netherlands-based utilities ENECO Holding N.V. and N.V. ENECO (collectively ENECO) continue to be underpinned by the stable and substantial earnings contribution of the group's monopoly energy-distribution businesses (69% of consolidated EBIT in 2006) and by its conservative financial policy. ENECO is wholly owned by Dutch municipal authorities, but no support is factored into the ratings because there is no evidence of implicit or explicit extraordinary support.

These strengths are offset by ENECO's exposure to volatile wholesale power prices, given its short power position, and the risks stemming from the forced unbundling of its regulated distribution operations from the rest of its businesses by 2011.

ENECO's regulated electricity and gas distribution operations benefit from a supportive regulatory framework, with price caps based on an annual adjustment of the consumer price index less an efficiency factor (x) as well as an allowance to retain earnings stemming from volume increases of 1%-2% per year.

However, like all Dutch utilities, ENECO will have to separate its regulated electricity and gas distribution operations from the rest of its businesses by 2011 at the latest. As a first step of the unbundling, ENECO has to transfer the management of its high-voltage grid to the Dutch transmission system operator TenneT Holding B.V. However, due to the cross-border leases attached to the grid, ENECO and TenneT failed to finalize the transfer by the Jan. 1 deadline and have postponed the transfer until July 1, 2008.

The group has a significant short power supply position, with power purchase agreements and wind farm projects accounting for only one-third of its electricity needs. In a shift in its gas-sourcing policy, where supplies have been provided by GasTerra B.V. (AA+/Stable/A-1+), ENECO has started to diversify its gas sourcing by signing a contract with Norway's StatoilHydro ASA (AA-/Stable/A-1+) on the purchase of 500 million cubic meters of gas annually over three years starting in October 2008. This is equivalent to about 10% of ENECO's total supply portfolio.

ENECO's financial risk profile is moderate. Standard & Poor's Ratings Services expects that over the near to medium term, funds from operations (FFO) to debt and FFO interest coverage will remain near the 38% and 8x levels reported in 2006. The company posted a solid half-year 2007 report, with a slight increase in revenues and earnings compared with the same period in 2006. Reported FFO increased to €301 million compared with €245 million, and unadjusted, annualized FFO to debt remained largely unchanged despite higher debt levels. However, a significant increase in capital expenditures, mainly due to investments in the Q7 wind farm, resulted in free operating cash flow decreasing to €64 million, compared with €167 million in the same period in 2006.

Short-term credit factors

The short-term rating is 'A-1'. ENECO's liquidity profile is sound, with very limited long-term debt maturities before 2010 and limited recourse to short-term debt. The group is arranging a €1.5 billion revolving credit facility to refinance the existing €1 billion facility maturing in 2009. The facility serves mainly as a back-stop for its €750 million global commercial paper program. ENECO's letter of credit (LOC) bank commitments relating to its cross-border leases' early termination exposure of $1.06 billion, although manageable, remain a negative credit factor. The current LOC facilities would cover additional commitment needed ($75 million) in the event of a one-notch downgrade.

Outlook

The negative outlook reflects the likely significant credit implications of the government plans to split the country's energy companies into separate distribution and supply-and-generation entities by January 2011. Given that the ratings reflect to a large degree the significant contribution of the regulated operations, the stand-alone rating on the unregulated operations would probably be markedly lower. On the network side, the potential negative effects of the heightened transparency and tightened regulatory parameters (owing to full ownership unbundling) as well as more aggressive capital structures are likely to be partially mitigated by the imposition of regulatory minimum financial requirements. In this context, to sustain the 'A' rating level, ENECO needs to maintain a robust financial profile. The ratings offer no upside potential.

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