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Research Update:

Ratings On Netherlands-Based TenneT Holding Affirmed At 'A-/A-2'; Outlook Stable

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Overview

- Dutch regulated electricity transmission system operator TenneT Holding B.V. (TenneT) has recently exhibited a good operating performance.
- We note, however, that current strong financial metrics may come under pressure in the medium to long term, given TenneT's uniquely high level of capital expenditure (capex) and the regulated remuneration of this capex, in both Germany and The Netherlands.
- We are affirming our 'A-/A-2' ratings on TenneT.
- The stable outlook reflects our view that TenneT will continue to operate with some headroom at the current rating level, while noting that this will reduce in the medium term.

Rating Action

On May 25, 2016, S&P Global Ratings affirmed its 'A-/A-2' long- and short-term corporate credit ratings on Dutch regulated electricity transmission system operator TenneT Holding B.V. The outlook remains stable.

We also affirmed the 'A-' issue credit rating on the senior debt, the 'BBB' issue credit rating on the €500 million hybrid capital instrument, and the 'BB+' issue credit rating on the €1.8 million hybrid instrument. We also affirmed our 'A-2' issue credit rating on the €2.2 billion commercial paper program.

Rationale

The affirmation reflects TenneT's strong financial performance for its rating level, with S&P Global Ratings-adjusted funds from operations (FFO) to debt of 13%. Cash flow generation is being driven by the significant increase in TenneT's regulated asset base in The Netherlands and Germany. We note, however, that high capex of €2.5 billion has led to a strongly negative discretionary cash flow, of minus €1.4 billion in 2015.

We understand that TenneT plans to further its investment effort in the next 10 years. It has an estimated €22 billion investment program in total for both in Germany and The Netherlands, including about €8 billion-€10 billion in offshore investments. This level of investment will likely lead to a significant increase in debt that will unlikely be matched by an equivalent increase in operating cash flow generation, thereby leading to reduced profitability as measured by return on capital. If we were to view the level of profitability for the new investment as not sufficiently high, we could consider revising up the financial ratio levels TenneT would need to keep its existing aggressive financial profile, by using our medial volatility table instead of the low table we currently use. Such a move could reflect our concern about the level of return of investments and TenneT's specific geographical position which leads to higher investment needs than its European TSO peers. Given the headroom in TenneT's current financial profile, this would not immediately affect our rating.

We base our ratio calculations on IFRS' published data, which show some volatility as IFRS recognizes cross-border interconnection auction receipts as revenue--although the company will need to return them. In addition, IFRS data are not adjusted for revenue surpluses and deficits resulting from differences between expected and realized electricity transmission volumes, which will be included in the tariffs of subsequent years in both Germany and The Netherlands. We believe that, on average, IFRS data will be smoothed and that higher revenue in one year will be compensated by lower income the next year.

We still view TenneT's business risk profile as excellent, supported by its almost 100%-regulated activity. TenneT derives about 20% of EBITDA from The Netherlands and 80% from Germany. TenneT's status as The Netherlands' only power transmission and system operator (TSO) and as Germany's largest TSO, along with its monopolistic positions in both markets conferred by law, support our assessment of TenneT's strong competitive position. TenneT is one of the largest TSOs in Europe and the only one in the world with a fully contiguous, cross-border transmission grid.

We also continue to view that there is a moderately high likelihood of The Netherlands' providing support to TenneT, based on our assessment of its important role for the government, given the company's strategic importance for the domestic energy sectors as the monopoly owner and operator of the Dutch electricity transmission network; and strong link with The Netherlands, given our view that TenneT is likely to remain majority state-owned. Our assessment of the likelihood of extraordinary support is lower for TenneT than for other European TSOs because of the increasing dominance of TenneT's German operations, which we consider higher risk than those in The Netherlands, due to TenneT's large offshore wind-connection activities. We believe that the Dutch government could find it politically difficult to provide full and timely support to TenneT if it encounters financial difficulty due to problems in its German operations. This said, The Netherlands has a proven track record of supporting TenneT and has regularly contributed equity in recent years.

In our base case, we assume:
- Macroeconomic conditions, in particular low power prices, will not affect TenneT's financial results given that the bulk of its revenue is derived from regulated activities.
- Stable revenue generation as investments in both The Netherlands and Germany increase the size of TenneT's regulated asset base.
- Sustainable very negative free operating cash flow (FOCF) generation, notably driven by offshore investments.

- Reduced dividend payout.
- Good operating profitability supporting interest coverage despite high leverage.

Based on these assumptions, we arrive at the following credit measures:

- We assume that FFO to debt will remain comfortably at or above 10%.
- We assume very negative cash flow generation after dividend payments and capex.

Liquidity

TenneT has adequate sources of liquidity for the next 12 months, in our view. We expect that the company's sources of liquidity will exceed uses by about 1.4x over this period.

We understand that there are no restrictive covenants in the documentation for the group's debt.

Principal liquidity sources for the next 12 months include:

- Unrestricted cash of about €114 million as of March 31, 2016.
- FFO of about €1.0 billion.
- An available €2,300 million under committed bank facilities maturing in more than 12 months.

Principal liquidity uses for the next 12 months include:

- About €2.0 billion-€2.5 billion in capex, in line with previous years.
- About €1.0 billion in debt maturing over the 12 months from March 31, 2016.

In addition, the company has issued €500 million of long-term debt in May 2016 that is not included in this data.

Outlook

The stable outlook reflects our expectation that operating and regulatory conditions for transmission activities in The Netherlands and Germany will remain unchanged in the coming years. In particular, our base-case scenario assumes that TenneT's unique shareholder, the Dutch Ministry of Finance, continues to consent to lower dividends to mitigate any unexpected increase in the holding's already-high leverage and credit metrics.

The stable outlook also reflects our expectation that TenneT will continue to benefit from a moderately high likelihood of extraordinary support from the Dutch government in the event of financial distress.

Downside scenario

We could lower the ratings on TenneT if we revised down its stand-alone credit profile (SACP) to 'bbb-' or lower. This could result from an adverse overhaul of the regulatory framework in Germany or in The Netherland's or from a marked deterioration in TenneT's credit metrics. We would consider downgrading TenneT if its adjusted ratio of FOCF to debt was to decline further from current levels or if its ratio of FFO to debt falls to less than 6% on a prolonged basis. This could occur, for example, if TenneT further increased the size of its capex plan or faced unexpected delays or cost overruns on existing projects that were not passed on, in a timely fashion, to regulated tariffs.

We would also consider a downgrade if the likelihood of extraordinary support from the Dutch government materially weakened. Under our government-related entity criteria, a two-notch downgrade of The Netherlands would not trigger a downgrade of TenneT, assuming an unchanged SACP.

Upside scenario

Substantial working capital movements related to Germany's Renewable Energy Act* ("Erneuerbare-Energien-Gesetz" or EEG), as well as auction proceeds earmarked to finance future investments, have distorted TenneT's IFRS-based credit metrics more so than we anticipated in recent years. However, we see rating upside as remote in light of TenneT's extensive investment program. This will maintain debt coverage ratios commensurate with highly leveraged companies over the medium term, leading to a material increase in debt by 2020. Given the size of TenneT's capex and of its negative FOCF, we view an upgrade as unlikely in the medium term. That said, we would consider revising the SACP upward if TenneT demonstrates that it can sustain S&P Global Ratings-adjusted FFO to debt of more than 10%, while maintaining FOCF to debt of no lower than minus 10%. This assumes an unchanged business risk profile.

We would also consider upgrading TenneT, assuming an unchanged SACP, if we believed that the likelihood of extraordinary support from the Dutch government had materially strengthened, although we consider this unlikely in the near term.

*Germany's Renewable Energy Act requires TSOs to buy and transmit renewable energy prior to other kinds of energies--at full price, including the renewable subsidy. The TSOs then sell the renewable energy onto exchanges at market price, which excludes the subsidy. The TSOs recover the subsidy through consumers on a monthly basis.

Ratings Score Snapshot

Corporate Credit Rating: A-/Stable/A-2

Business risk: Excellent
- Country risk: Very low
- Industry risk: Very low
- Competitive position: Strong

Financial risk: Aggressive

- Cash flow/Leverage: Aggressive

Anchor: bbb

Modifiers
- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: bbb

- Related government rating: AAA
- Likelihood of government support: Moderately high (+2 notches from SACP)

Related Criteria And Research

Related Criteria

- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers - December 16, 2014
- Criteria - Corporates - Utilities: Key Credit Factors For The Regulated Utilities Industry - November 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments - November 19, 2013
- General Criteria: Methodology: Industry Risk - November 19, 2013
- Criteria - Corporates - General: Corporate Methodology - November 19, 2013
- General Criteria: Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers - May 07, 2013
- General Criteria: Methodology And Assumptions: Assigning Equity Content To Corporate Entity And North American Insurance Holding Company Hybrid Capital Instruments - April 01, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers - November 13, 2012
- General Criteria: Criteria Clarification On Hybrid Capital Step-Ups, Call Options, And Replacement Provisions - October 22, 2012
- Criteria - Financial Institutions - General: Methodology: Hybrid Capital Issue Features: Update On Dividend Stoppers, Look-Backs, And Pushers - February 10, 2010
- Criteria - Insurance - General: Hybrid Capital Handbook: September 2008 Edition - September 15, 2008
- Criteria - Corporates - General: 2008 Corporate Criteria: Rating Each Issue - April 15, 2008
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions - March 25, 2015
- General Criteria: Country Risk Assessment Methodology And Assumptions - November 19, 2013
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009

- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating - October 01, 2010

Related Research

- How Lower Commodity Prices Will Affect Europe's Unregulated Power And Gas Sector, March 5, 2015
- Centrica, Energias de Portugal, And Gas Natural Ratings Unchanged After S&P Portfolio Review, Feb. 26, 2016
- Weak Power Prices And Regulatory Risks Trigger Mainly Negative Rating Actions On European Utilities, Feb. 26, 2016

Ratings List

Ratings Affirmed

TenneT Holding B.V.	
Corporate Credit Rating	A-/Stable/A-2
Senior Unsecured	A-
Subordinated	BBB
Junior Subordinated	BB+
Commercial Paper	A-2

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at spcapitaliq.com. All ratings affected by this rating action can be found on the S&P Global Ratings public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.