

CREDIT OPINION

19 August 2016

Update

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RATINGS

Electricity Supply Board (ESB)

Domicile	Dublin, Ireland
Long Term Rating	Baa1
Type	LT Issuer Rating
Outlook	Positive

Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

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Electricity Supply Board (ESB)

Annual update

Summary Rating Rationale

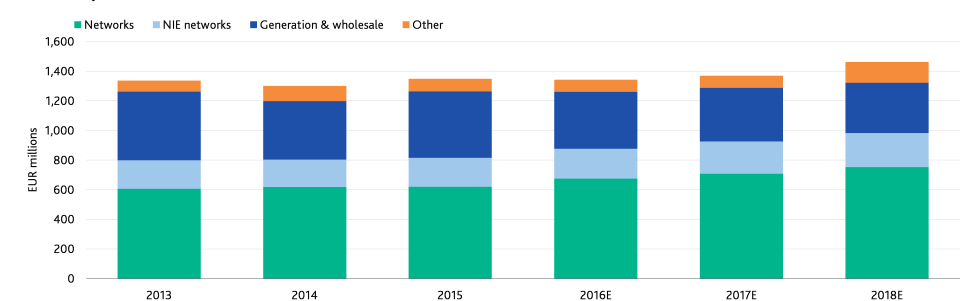
Electricity Supply Board (ESB)'s Baa1 rating reflects (1) the significant proportion of earnings generated through its regulated transmission and distribution operations in the Republic of Ireland (RoI, A3 positive) and Northern Ireland; (2) the low business risk profile of these businesses; and (3) the company's strong liquidity and access to a diversified range of funding sources.

The ratings also more negatively reflect (1) the relatively higher business risk profile of ESB's generation and wholesale business (33% of 2015 EBITDA) which we expect to be affected by low power prices for at least the next five years; (2) uncertainty for the generation business resulting from the ongoing re-design of the Irish electricity market; and (3) the challenges associated with a large capital investment programme (albeit mostly in the lower risk regulated business).

The current Baa1 rating reflects ESB's stand-alone credit quality with no uplift for potential government support under Moody's methodology for Government-Related Issuers. The positive outlook reflects, however, the positive outlook on the government's bond rating and that notch of support could be incorporated into ESB's rating if Ireland's government bond rating were to strengthen further.

Exhibit 1

Regulated networks will continue to dominate ESB's EBITDA



Source: Company data, Moody's estimates

Credit Strengths

- » Two-thirds of earnings from price-regulated networks businesses supported by a consistent and transparent regulatory framework
- » Solid financial performance against an improving macroeconomic environment

- » Prudent financial policy
- » Diversified funding sources and sound liquidity position

Credit Challenges

- » One-third of EBITDA from generation and wholesale business, exposed to low power prices
- » Uncertainty in the generation business resulting from a potential re-design of the Irish Single Electricity Market (SEM)
- » Challenges associated with a large capital investment programme

Rating Outlook

The positive outlook on ESB's ratings reflects (1) the positive outlook on Ireland's long-term government bond ratings and (2) Moody's expectation that ESB will maintain a credit profile consistent with guidance for the Baa1 rating level, which includes FFO interest cover of above 3.5x and FFO to net debt of at least the mid-teens.

Factors that Could Lead to an Upgrade

Upwards pressure could develop on ESB's ratings if (1) Ireland's long-term government bond ratings were to be raised, assuming unchanged support and ESB maintains a credit profile consistent with guidance for the Baa1 rating level; or (2) ESB's underlying credit profile was to strengthen such that FFO interest cover and FFO / net debt were expected to be sustainably above 4.5x and 20%, respectively and no material negative consequences arise from the review of the Irish Single Electricity Market design.

Factors that Could Lead to a Downgrade

Although not currently expected, downward rating pressure could arise from (1) the downward movement in the Government of Ireland's rating by more than two notches; (2) a material debt-funded acquisition or capital investment that eroded ESB's financial flexibility; (3) material unfavourable changes in the regulatory framework in Ireland; (4) an increase in the proportion of non-regulated activities within ESB's business mix; (5) a substantial and persistent deterioration in the group's credit metrics.

Key Indicators

Exhibit 2

	12/31/2015	12/31/2014	12/31/2013	12/31/2012	12/31/2011
FFO Interest Coverage	4.6x	4.4x	4.6x	4.4x	4.4x
Net Debt / Fixed Assets	53.9%	52.4%	51.6%	52.7%	52.3%
FFO / Net Debt	17.8%	16.9%	20.0%	16.3%	15.7%
RCF / Net Debt	13.1%	11.8%	17.2%	15.0%	14.3%

All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations
Source: Moody's Financial Metrics

Detailed Rating Considerations

Two-thirds of earnings from price-regulated networks business supported by a consistent and transparent regulatory framework

Approximately two-thirds of ESB's earnings before depreciation and amortisation (EBITDA) in 2015 came from the group's price-regulated transmission and distribution businesses. Regulated revenues, cost allowances and operational incentives are subject to five-year price controls imposed by regulators in RoI (Commission for Energy Regulation, CER) and in Northern Ireland (Utility Regulator, UR).

The current five year regulatory period in RoI, PR4, started in January 2016 following the final determinations published by the CER in December 2015 for both the distribution and transmission businesses. The final determinations support our view of a consistent and

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predictable regulatory framework, with no material changes to the regulatory principles implemented in previous price controls, and limited evolutionary reforms of the kind introduced for recent energy networks price controls in Great Britain.

Overall, we view the PR4 settlement as challenging, but manageable. Positively, all capital expenditure (capex) and operating expenditure (opex) spent by ESB during the previous period, PR3, was allowed on the basis that it was necessary and efficient. With respect to PR4, overall allowed revenues of €5.3 billion (real, 2014) are in line with ESB's submission. As expected, given the low interest rate environment, the allowed WACC of 4.95% (pre-tax, real) was lower than PR3's 5.95% (revised to 5.2% for 2014/15). In addition, the CER set opex and capex allowances for PR4 that will require ESB to cut costs; however these targets are achievable in our view, and there remains some potential upside from incentive mechanisms. CER is still to make a decision on certain outstanding items, although these seem unlikely materially to affect ESB over the next 2-3 years, including: (1) recovery of pension costs associated with a 2010 staff agreement (which are currently not covered by the tariffs, and about which ESB is still discussing with the regulator); (2) a bonus and penalty scheme in relation to certain qualitative targets; and (3) whether a €500 million investment programme for the roll-out of smart meters should be implemented.

The capex allowance provides for a significant investment programme, which in part reflects an element of 'catch-up' following the underspend in PR3. The final determinations' projections for the regulated asset base (RAB) imply a growth over the five year period of 12% to €6.0 billion (real, 2014) on the distribution side, and of 32% to €2.8 billion (real, 2014) on the transmission side. Growth on the transmission side reflects the need to accommodate new wind farms, many of which are to be commissioned by 2017 in order to benefit from the REFIT tariff scheme.

ESB's Northern Ireland business (NIE), has good visibility over cash flows until 2017 following the publication in April 2014 by the UK Competition and Markets Authority of its Final Determination in relation to the 2012-2017 period. A decision by the UR to adopt in future a methodology more similar to that used by the Office of Electricity and Gas Markets (Ofgem) in Great Britain would reduce regulatory risk and hence be credit positive. The regulator's consultation, published in September 2015, suggests that it is likely to adopt a balanced approach.

Remaining one third of earnings from higher-risk generation and wholesale businesses exposed to lower power prices and market reforms

The majority of group earnings not derived from regulated network businesses are from ESB's power generation business (ESB Generation and Wholesale Markets), which accounted for 33% of EBITDA in 2015.

As we wrote in our report "Europe's Electricity Markets: In Ireland, power prices to remain low" on 19 July 2016, power prices in Ireland have fallen significantly over the last three years. We expect prices to remain within a range of €35-40/MWh in the five years to 2021, which will have a negative impact on ESB's earnings from power generation. We expect the contribution of this division to fall to less than 25% of group EBITDA by 2017.

The current capacity payment mechanism helps stabilise generation earnings even as load factors for some of ESB's older gas-fired power plants decline as they have been pushed out of merit. The level of potential remuneration under this mechanism is likely to fall from the end of 2017 as part of the re-design of the Irish electricity market (the I-SEM reforms). However, we expect payments for ancillary services (needed to manage intermittent renewable generation) will increase, potentially offsetting the lower capacity payments. At this stage, the impact of the I-SEM reforms on the wholesale power price is unclear; our power price forecasts assume it will be neutral.

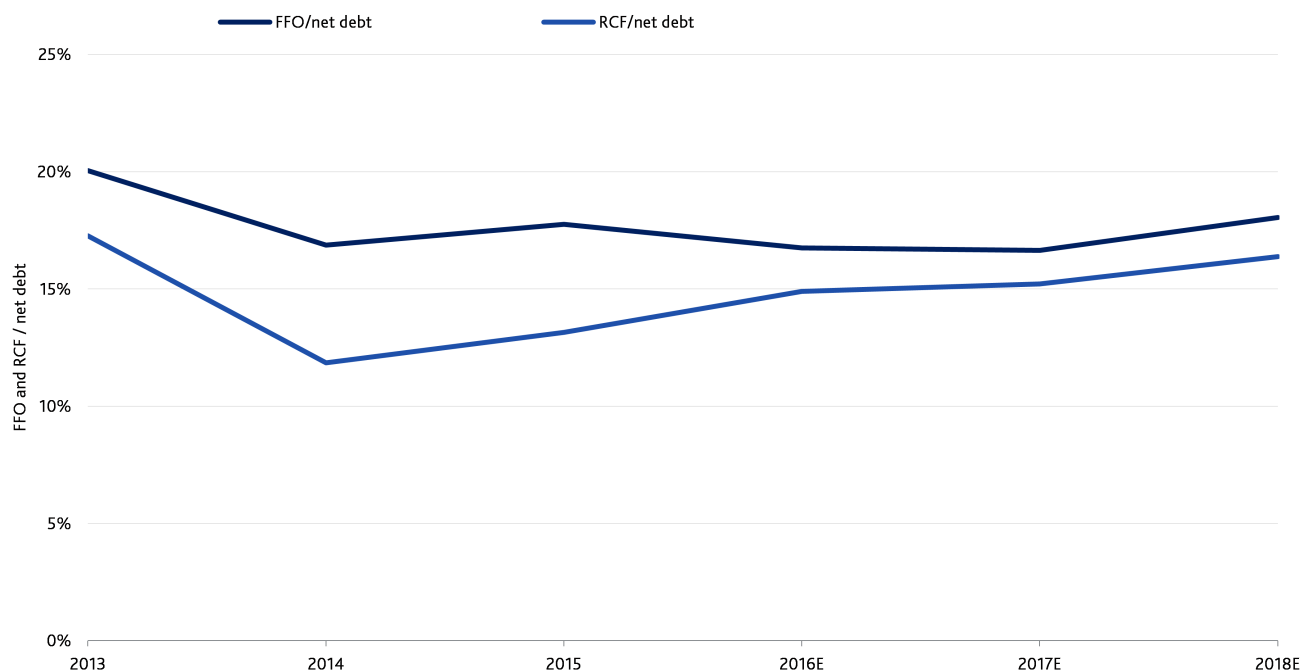
Solid financial performance against an improving macroeconomic environment

ESB's financial profile improved in 2015, with FFO to net debt increasing to 17.8% from 16.9%, consistent with Moody's guidance for a Baa1 rating, notwithstanding that net debt rose by €336 million to €4,975 million.

Exhibit 3

We expect both FFO / net debt and RCF / net debt to improve over the coming years

FFO / net debt and RCF / net debt for ESB



Source: Moody's Financial Metrics, Moody's assumptions

EBITDA rose by 3.6% on a like-for-like basis to €1,348 million in 2015, thanks mainly to improved availability across the generation fleet, the non-recurrence of 2014's storm related costs, and an improving macroeconomic environment which Moody's estimates will be reflected in GDP growth of 5% and 3.5% in 2016 and 2017 respectively. These positive elements more than counteracted the negative effect on Networks' earnings of the lower PR3 interim WACC review.

A new 880 megawatt combined cycle gas-fired plant at Carrington, near Manchester is due to be fully commissioned around Q3 2016 at which point the impact of the project on group credit metrics should turn positive as it starts to generate earnings (we estimate around €50-60 million EBITDA per annum) and repay associated debt.

Prudent financial policy means leverage will remain moderate despite significant capital expenditure programme

In January 2015, ESB completed the payment of €421 million of special dividends to its shareholders, which it agreed in 2013 to fund through the sale of non-core assets. The final tranche was partially funded by a drawdown of ESB's credit facilities rather than, as originally envisaged, through the sale of the peat-fired generation assets at West Offaly and Lough Ree.

We expect the Irish government to act in a flexible manner and to support ESB in its explicit aim to sustain a minimum Baa1 rating. To this end, we expect the company to remain moderately levered (with net debt to fixed assets below 60%) for the foreseeable future despite what we consider to be a material capital investment programme agreed with the CER as part of the RoI networks price control. The company will need regular access to capital markets to fund what we expect to be around €1 billion capital outlay per annum.

Government-Related Issuer methodology considerations

ESB is 95%-owned by the Irish government, and as such Moody's considers the company's rating according to its methodology for Government-Related Issuers (GRIs), published in October 2014. In view of this and the critical importance of ESB's assets to the Irish state, we consider there to be a clear linkage between the credit profile of the company and that of the A3-rated Irish government.

At Baa1, ESB's rating is based upon Moody's evaluation of the company's standalone credit strength and does not incorporate any uplift for ownership by the government. The positive outlook on ESB's Baa1 ratings mirrors the positive outlook on the government's

bond rating, and reflects that a notch of support could be incorporated into the rating in accordance with the GRI methodology, if Ireland's government bond rating were to strengthen further from its current positioning at A3.

Liquidity Analysis

We consider ESB to have a sound liquidity position. As at 31 December 2015, the company reported approximately €134 million of cash and cash equivalents and €1.39 billion of undrawn committed facilities, including a €1.44 billion revolving credit facility extended to 2020 in January 2015, with an option for a further two year extension to 2022.

We estimate that ESB would have sufficient liquidity through cash, committed facilities and approximately €1.6 billion of retained cash flow to fund approximately €1.5 billion of capital expenditure and €500 million of debt amortisations and maturities over the next 18 months if it did not have access to capital markets or other sources of funding not already committed.

Following the issuance of a €500 million bond in June 2015 and the refinancing of bonds maturing in 2017, the next maturity concentration is in 2019.

Corporate Profile

ESB is the former incumbent vertically integrated electric utility in the RoI, which holds leading market positions in power generation and electricity supply, as well as being the monopoly owner of electricity distribution and transmission networks across RoI and Northern Ireland.

The group's regulated businesses contribute the majority of the group's earnings. Across RoI and Northern Ireland, ESB's network assets (which include over 180,000 km of power lines in RoI and over 47,000 km in Northern Ireland) had a combined regulatory asset base (RAB) of approximately €9.3 billion as at the end of December 2015.

In addition, the group had a market share of 49% across the Irish Single Electricity Market (SEM) during 2015 and served 1.5 million electricity and gas customer accounts across Ireland, which equated to a 38% electricity market share.

ESB is majority owned (95%) by the Government of Ireland through the Minister for Public Expenditure Reform (85%) and the Minister for Communications, Climate Change and Natural Resources (10%). The remaining 5% stake is held by an employee share ownership trust.

Rating Methodology and Scorecard Factors

Whilst the methodology grid maps ESB to an A2 based on three years of historic metrics and an A2 based on our forward view of financial metrics, the assigned rating of Baa1 is lower. This is because the grid does not specifically take into account the additional risk compared to peers rated under the methodology posed by the material contribution to group earnings from unregulated businesses, such as power generation and electricity supply.

Exhibit 4

	Current FY 31/12/2015		Moody's 12-18 Month Forward View As of 15/8/2016 [3]	
	Measure	Score	Measure	Score
Regulated Electric and Gas Networks Industry Grid [1],[2]				
Factor 1 : Regulatory Environment and Asset Ownership Model (40%)				
a) Stability and Predictability of Regulatory Regime		Aa		Aa
b) Asset Ownership Model		Aa		Aa
c) Cost and Investment Recovery (Ability and Timeliness)		A		A
d) Revenue Risk		Aa		Aa
Factor 2 : Scale and Complexity of Capital Program (10%)				
a) Scale and Complexity of Capital Program		Baa		Baa
Factor 3 : Financial Policy (10%)				
a) Financial Policy		Baa		Baa
Factor 4 : Leverage and Coverage (40%)				
a) FFO Interest Coverage (3 Year Avg)	4.5x	A	4.1x - 4.3x	A
b) Net Debt / Fixed Assets (3 Year Avg)	52.6%	A	53% - 55%	A
c) FFO / Net Debt (3 Year Avg)	18.2%	A	15% - 18%	Baa
d) RCF / Net Debt (3 Year Avg)	14.0%	Baa	14% - 16%	A
Rating:				
Indicated Rating from Grid Factors 1-4		A2		A2
Rating Lift		0		0
a) Indicated Rating from Grid		A2		A2
b) Actual Baseline Credit Assessment Assigned		baa1		baa1
Government-Related Issuer				
		Factor		
a) Baseline Credit Assessment		baa1		
b) Government Local Currency Rating		A3		
c) Default Dependence		High		
d) Support		Mod		
e) Final Rating Outcome		Baa1		

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

[2] As of 31/12/2015; 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

Source: Moody's Investors Service

Ratings

Exhibit 5

Category	Moody's Rating
ELECTRICITY SUPPLY BOARD (ESB)	
Outlook	Positive
Issuer Rating	Baa1
Senior Unsecured MTN -Dom Curr	(P)Baa1
ST Issuer Rating -Dom Curr	P-2
ESB FINANCE LIMITED (ESB FINANCE)	
Outlook	Positive
Bkd Senior Unsecured	Baa1

Source: Moody's Investors Service

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