

Envestra Ltd.

Rationale

The ratings on Envestra Ltd. reflect the company's strong market position as a regulated natural monopoly, high degree of cash flow certainty, geographic diversification, and low operational risks. Offsetting these strengths is Envestra's aggressive financial profile, which exhibits thin cash-flow metrics and limited financial flexibility. Envestra's financial policies and practices present little credit support above the current low investment-grade rating.

The company owns and operates natural gas distribution networks in Victoria, South Australia, Queensland, New South Wales, and a small part of the Northern Territory. Envestra Victoria Pty Ltd. (EnVic), a wholly owned subsidiary that accounts for about half the business, conducts its operations throughout Victoria and in Albury, New South Wales. With more than 90% of revenues earned from domestic and other small users, the reliability of revenue and cash flow is extremely high.

The geographic diversification of Envestra's operations benefits the company, lowering the adverse effect on its cash flows from event and industry risks such as regulatory reset, gas supply, and weather risk and its associated impact on volumes delivered.

The regulatory environment that underpins Envestra's cash flow is considered to be generally transparent and supportive of the ratings. The established stable regulatory regimes and price paths provide a high level of earnings certainty, with recent regulatory decisions for its South Australian and Queensland businesses providing certainty until June 2011. EnVic is presently undergoing a regulatory determination, expected to be finalized by late 2007, for prices commencing January 2008.

While the regulatory regimes provide a high degree of earnings certainty, Envestra's highly leveraged financial profile means the company's financial metrics can be sensitive to small changes in the variables used in the building-block return methodologies adopted by various regulators. Accordingly, any harsher-than-expected decision could place pressure on its medium-term cash flow generation; however, we consider that the current rating on Envestra can absorb some shock to its metrics that may arise as a result. It is also expected

Credit Rating:

BBB-/Stable/A-3

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Envestra would undertake the required action to preserve its current rating level in the result of any detrimental regulatory outcomes.

Envestra is subject to low operational risk. Envestra now outsources the operation and maintenance of its networks to the APA Group. The recent purchase by the APA Group (APA; not rated) of Origin Energy Asset Management (OEAM) is not expected to materially change Envestra's operational risk profile given that the OEAM business has transferred whole and APA's core business as a gas network owner and operator. Fundamental contractual terms of the services agreement, including operation and maintenance, are unaffected by the asset sale. Key performance indicators are predetermined under the services agreement, and OEAM has a record of achieving the agreed performance standards.

Envestra's financial profile is highly leveraged, reflecting its aggressive financial risk appetite and thin financial metrics. Funds from operations (FFO) interest coverage and FFO-to-debt coverages are expected to average about 1.7x and 4.8%, respectively, over the next five years. Envestra is expected to maintain credit-protection metrics at these levels, subject to the final regulatory determination for EnVic being within the company's expectations.

Envestra's financial flexibility is weak, being constrained by low cash flow generation relative to its capital expenditure and unitholder distribution requirements. Most of Envestra's FFO is distributed to shareholders, leaving limited cash available to fund investment. Accordingly, Envestra is reliant on debt and its dividend re-investment plan (DRP) to fund growth capital expenditure. The yield-like nature of the company's equity means Standard & Poor's expects Envestra to endeavor to maintain, at a minimum, its distribution at 9.5 cents per stapled security, effectively creating a fixed-like obligation. While this figure has remained constant for over five years, the DRP has resulted in a greater quantum of distributions each year. Stress to the financial metrics could occur if Envestra is unable to generate sufficient returns on capital expenditure to reverse the recent trend of cumulative distribution growth outpacing cash flow growth.

The limited financial flexibility to accommodate deterioration in credit-protection metrics is balanced by the prudent liability management and adequate liquidity position expected of a typical investment-grade company. These practices include stable levels of distributions to unitholders, actively managing the companies' debt-maturity profiles, and hedging interest-rate exposures in line with regulatory determinations.

The prospect of a deterioration in credit metrics is somewhat mitigated by Envestra's policies that describe how the interests of debtholders will be protected in the event of any financial underperformance or material stress events, such as a regulatory determination that is less favorable than the company's expectations. Any benefit to credit metrics from the stated policies is contingent on Envestra adhering to its policies when financial metrics are stressed.

Short-term rating factors

The short-term rating is 'A-3'. Liquidity is considered adequate. At Aug. 31, 2007, Envestra had in excess of A\$175 million of undrawn bank facilities and EnVic had A\$185 million of undrawn bank facilities to support current commercial paper (CP) issuance of about A\$92 million. In addition, the need for unexpected financing costs and refinancing in the short term is alleviated by a tightly managed hedged interest rate and foreign-exchange risk profile, and long-dated maturity profile. Apart from CP, Envestra's next material debt maturity is the A\$130 million of medium-term notes maturing in February 2008. All finance facilities are subject to meeting covenants within which Envestra has a low level of headroom.

Outlook: Stable

The stable outlook reflects the company's strong business profile and Standard & Poor's expectation that Envestra's credit metrics will be maintained. The 'BBB-' rating factors in a very small level of tolerance for a softening in medium-to-longer-term financial metrics. Nevertheless, this headroom will be tested if Envic's draft regulatory determination is implemented, resulting in financial metrics below our expectations. Pressure could be exerted on the rating if Envestra does not take the requisite action to preserve metrics in line with our expectations.

An upgrade in the ratings is contingent on Envestra achieving a material and sustained uplift in financial metrics and demonstrating a track record of adhering to creditor-friendly policies and practices.

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