Israel Electric Corporation Ltd.

Monitoring and Rating Action Report | February 2016

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Israel Electric Corporation Ltd.

Series	Interest rate	Indexation [1]	Debt balance as of September 30, 2015 (NISm)[2]	Outstanding repayment[3]	Rating	Outlook
2022	6.0%	CPI	3,897	2020-2023	Aa3.il	Positive
2029	6.0%	CPI	767	2024-2029	Aa3.il	Positive
26	4.8%	NR	437	2016-2023	Aa3.il	Positive
27	3.9%	CPI	406	2017-2029	Aa3.il	Positive
25	1.2%	CPI	1,018	2017	Aaa.il	Stable

Midroog reaffirms its Aa3.il/positive rating for Series 2022, 2029, 26 and 27.

Midroog also reaffirms its Aaa.il/stable rating for government-guaranteed Series 25.

Midroog announces that it is assigning an Aa3.il/positive rating for the expansion of Series 26 and 27 by up to NIS 2 billion in par value[4] (hereinafter: "the Expansion") to be issued by Israel Electric Corporation Ltd. (hereinafter: "the IEC" or "the Company") in or around February 2016. The Expansion will be carried out in order to refinance debt and for other ongoing needs.

The State's support for the Company (hereinafter: "the Support") and the dependency between the State and the Company (hereinafter: "the Dependency") (hereinafter, together: "the Relationship") are significant foundations for the rating. Midroog assesses the Support and the Dependency to be very high. Midroog will continue to monitor the extent of the Support and the Dependency and stresses that any weakening of its assessment of the Support and the Dependency could significantly lower the rating. Note that in Midroog's opinion, the Relationship between the Company and the State is very strong, but is not absolute, and their interests are not fully identical. The rating is based on data submitted to Midroog until February 15, 2016.

[1] All the bonds were issued denominated in shekels.

[2] Excluding accounting premium

[3] The Company makes ongoing interest payments on the bonds.

[4] An estimated amount of ILS 1 billion and another ILS 1 billion depending on market conditions.

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1. Key Rating Rationale

In the rating process, the following factors, *inter alia*, were taken into account: (1) The IEC is a government company with a monopolistic, almost absolute, status in the value chain of Israel's electricity sector. However, the Company's share of the electricity production market has been diminishing over the years as private power plants come online; (2) The transparency of the regulatory environment is reasonable, and general guidelines are executed; (3) plans of structural change in respect to the regulators of the energy market[5]; (4) the Company's importance to the Israeli electricity economy, and consequently, the state's Support for the Company's activity over the years; (5) the regulated tariffs the Company charges for electricity by and large cover its costs, but there are disputes between the regulators and the Company over the extent of recognized costs. Also, sometimes there are timing differences in the Company recouping expenses; (6) the Company's tariffs result in returns below the norm for its industry; (7) suitable dispersal of production means and the mix of fuels, which rely heavily on production using coal and natural gas. Transition to production using fuels such as fuel oil (mazut) and diesel will lead to a significant increase in energy costs and periodic exposure to incorporating the extra costs in electricity prices; (8) relying almost entirely on a single supplier for natural gas, Tamar, while maintaining a secondary supply LNG supplier, with limited supply volume, enables some degree of operational flexibility; (9) sustained improvement in the Company's financial policy including, *inter alia*, maintaining a minimal liquidity balance, a minimal fuels inventory and providing underwritten bank credit facilities. The Company also improved its financial access to the market, mainly through issuing tradable bonds. This policy improves the Company's ability to cope during times of crisis; (10) An MoU in respect to the Make Up Aggregate and the marketing and sales agreement, and implementing the Energy Minister's decision in respect to reducing the use of coal, somewhat mitigate exposure stemming from the TOP mechanism; (11) promotion and execution of an early retirement plan for veteran workers should lower the Company's wage costs in the long run. However, a great many disputes remain open between the Company's labor representatives and management; (12) setting a system-wide price and updating the production price in 2015; (13) the Company has a significant volume of debt and a heavy repayment load (principal and interest payments) in the years to come; (14) further improvement in the Company's profitability and coverage ratios compared to the period of the energy crisis.

Beyond the above, Midroog assesses the state's dependency and support as very high. The dependency between the Company and the state is expressed, *inter alia*, in their facing similar credit risks, significant in degree, and also exposure to geopolitical crises; in the dependence of the Company and the state on identical sources of income, namely the entire Israeli economy; and in

[5] See Midroog's Sector Comment, "The Importance of Regulator Independence and Transparency in the Energy Market", August 2015.

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the state's full ownership (99.85%). Special Support by the state, its extent and timing, is reflected first and foremost in the Company's criticality (as an essential service provider) to the functioning of the Israeli economy; in statements by senior officials in government authorities about support for the Company, if needed; in the state's reluctance to institute material changes to the Company's structure, including because of the organized, powerful labor committee, which has political clout; in the history of state support and intervention during crises, through guarantees. Note that erosion in Midroog's view of the relationship between the state and IEC could lead to a significant rating downgrade. Note too that the Relationship between the state and Company, reflected *inter alia* in guaranteeing the Company's debt, is a supporting factor for the rating.

2. Main Business Developments

2.1 Market share – The advent of private power stations

In 2015, the extent of production by private power producers increased significantly as power stations run by Dalia Power Energies Ltd. (approximately 910 MW), Ramat Negev Energy Ltd. (120 MW), Ashdod Energy Ltd (approximately 55 MW) and the solar stations Ketura Solar (approximately 40 MW) and Halutziot (approximately 55 MW). As of September 30, 2015, private power stations had production capacity of approximately 3,146 MW[6], constituting 21% of all installed power generation capacity in Israel. Total actual electricity production by them in the third quarter of 2015 and the third quarter of 2014 was approximately 21% and 15% respectively.

2.2 Collection bargaining agreement: Early retirement

In May 2015, a collective bargaining agreement[7] was approved by the wages director at the Finance Ministry and by the Government Companies Authority. In September 2015, an addition to the collective agreement was signed, under which the Company would increase the number of workers taking early retirement by 20. According to the Company, as of the date of this report, about 440 workers took early retirement under the collective bargaining agreement in 2015. The Company assesses that the early retirement plan should reduce its wage costs in the long-term, but in the short run, it faced substantial nonrecurring expenses.

2.3 Power rate updates in 2015

In August 2015, the Public Utilities Authority (Electricity) (hereinafter: "the PUA") published a decision regarding systemic tariffs for all electricity consumers and private power companies

[6] Not including the power stations Ramat Negev Energy Ltd. and Ashdod Energy Ltd., which began commercial operation in the last quarter of 2015.

[7] For more details on the collective agreement, see the rating action from April 2015.

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(hereinafter: "the Systemic Tariff")[8]. In September 2015, an updated resolution was published, which stated that the private power companies would be expected to pay approximately ILS 465 million retroactively for use of system management fees between the years 2013 and 2015, not including interest and indexation. Also, in September 2015, PUA published a decision updating power prices, which led to an aggregate reduction of approximately 15.6%[9] in 2015. The pricing update was due mainly to a drop in coal prices, change in the shekel-dollar exchange rate and the institution of the Systemic Tariff, described above.

2.4 Reducing the use of coal by Israeli power stations

In December 2015, the Energy Minister declared an immediate decrease of 15% in use of coal to produce power in 2016 compared with 2015. According to the directive, the reduced use of coal would continue until scrubbers could be installed at the IEC's coal-fired power plants, while increasing the use of natural gas. Based on the decision, the PUA will reconsider revising power rates following the change in mix of fuels, and is likely to raise them by at least 1.5%[10].

2.5 Project to reduce emissions by the coal-fired plants

In July 2015, the Company gave the Environment Ministry alternative schedules for completing the project at units 5 and 6 of the Orot Rabin and Rutenberg power plants. It also requested that the final decision be brought forward about executing the project in units 1-4 at Orot Rabin with new scheduling and reexamination of the plan to reduce emissions by these units. As of the date of this report, no agreement had been reached on schedule and emissions reduction for the interim period.

2.6 MoU about the Make Up Aggregate and the marketing and sales agreement

According to the Company's projections, the minimum quantity of natural gas for which the Company will have to pay the Tamar partnerships (hereinafter: "the Partnerships") according to the TOP[11] mechanism that exists in the natural gas procurement agreement between the Company and the Partnerships (hereinafter: "the Procurement Agreement") should be higher than the quantity the Company expects to actually consume in some of the years. The Company is therefore holding ongoing negotiations with the Partnerships, which led in to an MoU in November 2015, which confirms that in the event that when the procurement agreement expires, the Company has an unutilized right to use natural gas for which it had to pay under the TOP agreement (hereinafter:

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[8] The PUA announcement on the systemic tariff.

[9] The PUA announcement on the rate change.

[10] Announcement About Reducing The Use Of Coal, December 2015

[11] Take or Pay

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"the Make Up Aggregate"), the Company may extend the agreement term until full utilization of the quantity (hereinafter: "the MUA memo"). The MUA memo is subject to approval by the Antitrust Authority, if required under law, and by the Partnerships' bankers. Note that if the approvals are not forthcoming, the parties will discuss an alternative mechanism that would enable the Company to utilize the MUA. At the same time, in November 2015, the natural gas authority at the National Infrastructure, Energy and Water Ministry (hereinafter: "the Gas Authority") updated the approval for sales and marketing of natural gas granted to the Company in 2014 (hereinafter: "the Marketing and Sales Agreement"). The main thrust of the changes touch on extending the deadline in the agreements for selling or marketing to July 1, 2020 by the latest, regarding limited amounts, according to the approval of the Gas Authority. Also, the sales and marketing permit was expanded for LNG as well, for consumers that are not private power stations. It bears noting that the possible actual sale of natural gas may require regulatory approval. As of July 2015, the Antitrust Authority had stated that allowing the IEC to withdraw gas beyond the quantities actually required to produce electricity in its facilities could arouse competitive concerns in the electricity production market due to decrease in the quantity of gas available for the private power stations. In Midroog's opinion, the MUA memo and marketing and sales agreement update give the Company some degree of operational flexibility in respect to its exposure arising from the TOP mechanism. Also, implementation of the minister's resolution about reducing the use of coal could reduce the exposure to the MUA, to a degree.

2.7 Key appointments and terminations

- On January 15, 2015, the Company board of directors approved the appointment of Adv. Ms. Yael Nevo as legal counsel of the Company, and on April 15, 2015, Ms. Nevo began her job.
- On March 15, 2015, the Company board of directors approved the appointment of Mr. Ofer Bloch as CEO of the Company, and on June 10, 2015, Mr. Bloch began his job.
- On March 29, 2015, Mr. Tamir Polikar stopped serving as the Company's chief finance and economics officer. On December 31, 2015, the board approved the appointment of Mr. Avi Doitchman as CFO.
- On June 25, 2015, Mr. Amit Oberkovich was appointed as VP human resources.
- On September 17, 2015, Mr. Yitzhak Balmas was appointed as deputy CEO and VP of customer relations.

3. Quantitative Analysis

3.1 Condensed financial figures[12]

Shekels (millions)	Q1-Q3/2015	Q1-Q3/2014	Q1-Q3/2013
Revenues	17,839	19,528	21,147
Profit from operating the electricity system[13]	4,054	6,749	3,070
Profit (loss) from ongoing operations[14]	2,275	5,203	1,790
Financing costs, net	1,512	2,725	1,830
Net profit (loss)	553	1,794	(367)
FFO	3,107	5,806	4,816
EBITDA	6,194	8,486	5,184
CAPEX	2,387	2,758	3,693

Shekels (millions)	30/09/2015	30/09/2014	30/09/2013
Total assets	84,560	83,372	88,873
Of which: Fixed assets, net	62,739	64,250	64,544
Of which: Assets stemming from benefits after the transaction date, net	4,105	(596)	862
Of which: Cash and cash equivalents	1,337	2,345	4,514
Of which: Short-term investments	956	385	226
Liabilities (current and otherwise)	65,525	67,337	73,462
Of which: Financial debt	49,208	52,377	57,145
Shareholders equity	16,777	13,120	15,411

[12] The figures presented for the first three quarters of 2013 do not comply with IFRS standards, which the Company adopted from January 2014. The rest of the data, from 2014 onwards, were adjusted according to IFRS.

[13] Revenues less direct costs of operating the electricity system.

[14] Profit from running the electricity system less sales and marketing costs, administration & general costs and early retirement costs.

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During the first three quarters of 2015, the Company's revenues decreased by approximately 9% versus the same period of the year before, due to decreases in electricity prices during 2015 and due to the advent of the private power stations. Profit from regular activity decreased by 56% in the first three quarters of 2015 against the same period of 2014, mainly due to an increase in expenses on fuel and buying electricity, and one-time provisioning for early retirement under the collective bargaining agreement. Also, net financing costs decreased by about 45% against the corresponding period of 2014 because of depreciation of the shekel against the USD and change in the interest rate curves in 2014. Because of the above, net profit decreased by approximately 70% in the period in question against the same period of 2014. Note that the fluctuation in the Company's FFO over the years is due mainly to the drop in the Company's revenues and changes in the fuel costs.

As of September 30, 2015, the Company's total balance sheet assets had increased by about ILS 1.1 billion against the same period of the year before. Total assets from benefits after the transaction date increased by approximately ILS 4.5 billion during the period in question due to implementation of Deep Market regulations[15] in respect to capitalization of the Company's pension liabilities. The Company's total liquid balance[16] came to approximately ILS 2.3 billion, in compliance with the financial goals of the Company's board of directors. Moreover, the Company had unutilized bank credit totaling approximately ILS 1.4 billion. Also, the trend of reducing debt over the years continues, reflected in a reduction of approximately ILS 3.2 billion against the corresponding period of 2014. The Company's total shareholders equity grew during the period in question to approximately ILS 16.8 billion, due to implementing the Deep Market regulations.

3.2 Analysis of financial ratios

	Q1-Q3/2015P*	Q1-Q3/2015	Q1-Q3/2014	Q1-Q3/2013
FFO + Int / Int[17]	2.34	2.47	3.69	2.53
FFO/debt	7.7%	8.4%	14.8%	6.5%
Debt/CAP	69.4%	68.5%	74.8%	73.4%
Gross margin %[18]	52.4%	52.4%	62.4%	54.8%
Operating margin[19]	12.8%	12.8%	26.6%	8.5%

*Note: Proforma, added debt of NIS 2,000 million.

[15] A resolution from the Israel Securities Authority in November 2014.

[16] Cash and cash equivalents, and short-term investments.

[17] Actual cash flow expense.

[18] Gross profit defined as income less fuel costs and electricity purchases.

[19] Profit from operations less provisioning for non-recognition of fixed assets costs.

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The Company's financial ratios are influenced by changes that happened after the energy crisis in 2011-2012, mainly in respect to electricity rates, costs and mix of fuels, and the continuing decrease in the Company's debt. The 2014 financial ratios are biased upward and do not permanently reflect the state of the Company. The Company's profitability and coverage ratios improved to some degree in the first nine months of 2015 versus the same period of 2013, after the energy crisis peaked.

4. Company Profile

Israel Electric Corporation Ltd. is a government company (the State of Israel holds approximately 99.85% of its shares[20]) that generates, transmits, distributes, and supplies electricity, trades in electricity and builds the infrastructure required to do so. The Company was incorporated in 1923. Its activity is regulated and supervised under the Electricity Law, which replaced the Electricity Concessions Ordinance. Under the Electricity Law, the Public Utilities Authority (Electricity) sets electricity rates and the methods for their revision, and also sets the criteria by which the Company operates. In addition, the Public Utilities Authority (Electricity) grants licenses, conditional or permanent, for the generation, distribution and supply of electricity to all power producers, and supervises them based on the criteria that it set. The Company is a monopoly in the Israeli electricity economy in the production, transmission, distribution and supply of the absolute majority of electricity consumed in Israel. The Company is subject to a regulatory framework that is managed by the Public Utilities Authority (Electricity) under the Electricity Law 5756-1996, enacted about 20 years ago.

5. Rating Outlook[21]

Series 2022, 2029, 26 and 27

Factors likely to improve the rating:

- Strengthening the Company's capital and debt structure (reducing the Company's leverage)
- Sustaining a liquidity profile appropriate to the Company's operations in a permanent manner
- Regulatory stability regarding the sector, including in respect to the structure of Israel's electricity economy and agreements with labor representatives

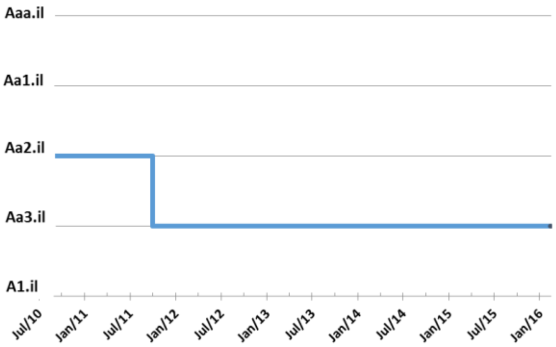
[20] The Company believes that the rest of the shares are dispersed among the general public and that some of the shareholders cannot be identified.
[21] The rating outlook applies to bond series without guarantees. The rating of the guaranteed series is the same as the country rating.

Factors likely to lower the rating:

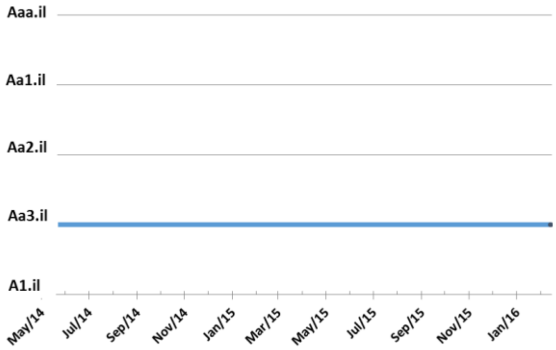
- Change for the worse in the State's Support for the Company, including in respect to recognition of Company's expenses and investments in tariff and structural change
- Persisting, significant erosion in the Company's financial results, including failure to maintain liquid balances appropriate to its rating level, relative to anticipated volumes of activity and the anticipated repayment burden
- Difficulty in raising capital and/or significant increase in issuance costs

6. Rating History

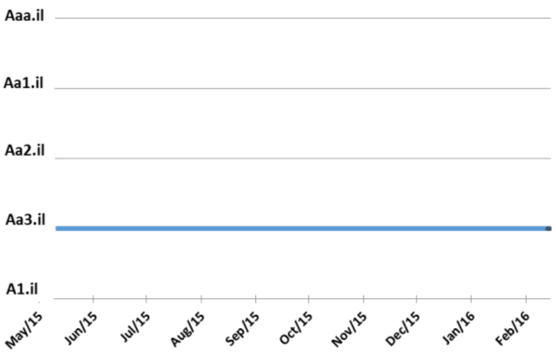
Series 2022:



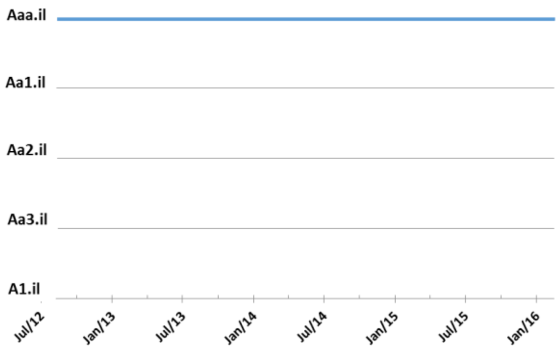
Series 2029:



Series 26, 27:



Series 25 (state guaranteed):



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7. Related Reports

Israel Electric Corporation – Rating Action, May 2015

Israel Electric Corporation – Initial Rating Report, July 2010

Rating Regulated Power and Natural Gas Companies– Methodology Report, April 2015

Rating Government Affiliated Issuers (GRI) - Methodology Report, October 2013

Midroog Rating Scales and Definitions, August 2015

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Obligations Rating Scale

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Aaa.il	Issuers or issues rated Aaa.il are those that Midroog judges to have superior creditworthiness relative to other local issuers.
Aa.il	Issuers or issues rated Aa.il are those that Midroog judges to have very strong creditworthiness relative to other local issuers.
A.il	Issuers or issues rated A.il are those that Midroog judges to have relatively high creditworthiness relative to other local issuers.
Baa.il	Issuers or issues rated Baa.il are those that Midroog judges to have relatively moderate credit risk relative to other local issuers, and could involve certain speculative characteristics.
Ba.il	Issuers or issues rated Ba.il are those that Midroog judges to have relatively weak creditworthiness relative to other local issuers, and involve speculative elements.
B.il	Issuers or issues rated B.il are those that Midroog judges to have relatively very weak creditworthiness relative to other local issuers, and involve significant speculative elements.
Caa.il	Issuers or issues rated Caa.il are those that Midroog judges to have extremely weak creditworthiness relative to other local issuers and are very near default, and involve very significant speculative elements.
Ca.il	Issuers or issues rated Ca.il are those that Midroog judges to have extremely weak creditworthiness and very near default, with some prospect of recovery of principal and interest.
C.il	Issuers or issues rated C are those that Midroog judges to have the weakest creditworthiness and are usually in a situation of default, with little prospect of recovery of principal and interest.

Note: Midroog appends numeric modifiers 1, 2, and 3 to each rating category from Aa.il to Caa.il. The modifier '1' indicates that the obligation ranks in the higher end of its rating category, which is denoted by letters. The modifier '2' indicates that it ranks in the middle of its rating category and the modifier '3' indicates that the obligation ranks in the lower end of that category, denoted by letters.

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