Israel Electric Corp. Ltd.

Rating Report | July 2010

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ISRAEL ELECTRIC CORPORATION LTD.

Issuer Rating	Aa2 with Negative Outlook

The State of Israel has a closed electricity economy. The Company is a monopoly in the electricity sector, both in market terms and in terms of infrastructure ownership, and it has been designated as an essential service provider in the economy.

The Company is under government ownership and receives government support. The government of Israel throughout the years has demonstrated reliability in backing the obligations of government companies. The government's support of and relationship with Israel Electric Corporation are significant factors in the rating, since they reflect the Company's strategic importance. The negative outlook results from the regulatory uncertainty surrounding the structural change in the Company, the disagreement over electricity rates, the Company's poor financial ratios and its low liquidity.

Corporate Profile

Israel Electric Corporation Ltd. (the "Company" or "IEC") is a government- owned company (the State of Israel holds approximately 99.85% of its shares[1]) engaging in the production, conveyance, distribution and supply of electricity, in electricity trading and in the setup of the infrastructure required for these activities. The Company was incorporated in Israel in 1923, and its activity is regulated and controlled under the 1996 Electricity Economy Law ("the Electricity Economy Law"), which replaced the Electricity Concessions Ordinance. The Electricity Economy Law places the Company under the supervision of the Public Utilities (Electricity) Authority ("the Electricity Authority"), which is responsible for regulating and controlling the provision of public utilities in the electricity sector. Among its other functions, the Electricity Authority sets the electricity rates and the ways of adjusting them, issues conditional and permanent licenses for electricity production, distribution and supply to all electricity producers in the economy and supervises them based on criteria established by it. The current chairman of the IEC is Dr. Amnon Shapira, who has filled this position since April 2007.

[1] The Company estimates that the rest of its shares are held by the public, and it is not possible to identify their holders.

The Company is a monopoly in the Israeli electricity economy, producing, conveying, distributing and supplying the absolute majority of electricity consumed in Israel. As of the date of this report, the Company faces competition only in the production segment from private electricity producers (not including producers for self-consumption), who, based on the Company's financial statements for 2009, produced as of 2009 approximately 0.5% of the electricity actually supplied in Israel (approximately 1.9% of the installed production capacity in Israel in 2009).

The Company's operations comprise three main operating segments:

- **Electricity production** – including all the activity involved in electricity production at the Company's production sites.
- **Electricity conveyance and transformation** – including the conveyance of electricity from the production sites, via high voltage (161 kilowatt) and ultra high voltage (400 kilowatt) conveyance lines to the switching stations, and from the switching stations to the substations.
- **Electricity distribution** – including the conveyance of electricity from the substations to the consumers via high voltage and low voltage lines.

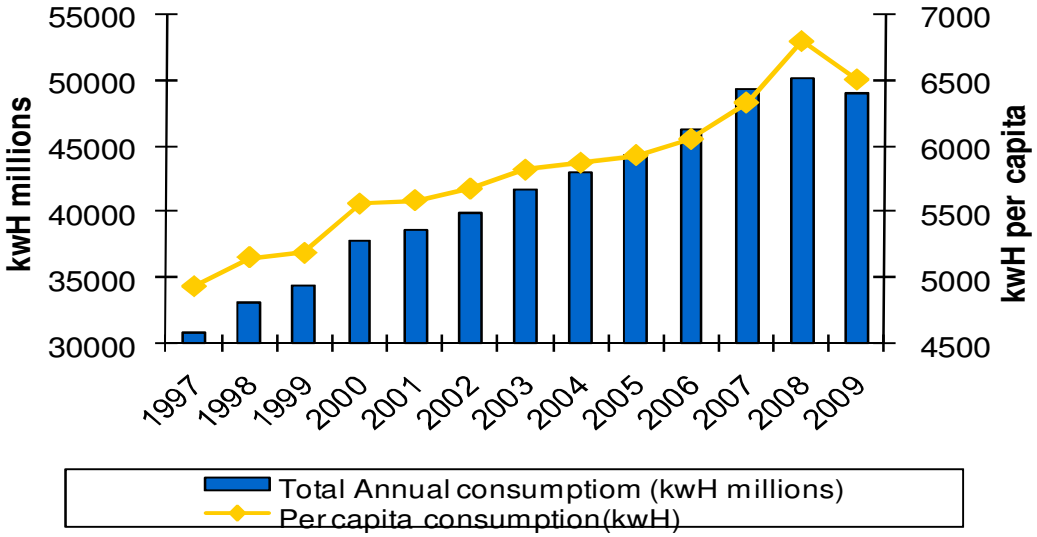
Israel's Electricity Economy

Electricity is the engine of growth and activity in all sectors of the economy. The electricity system provides the first and main input for all production systems and services in all sectors of the economy and is an essential household service. Israel has a closed electricity economy, with all electricity needs supplied by the Company and by private electricity producers.

Electricity Consumption

In 2009 electricity consumption totaled 48.95 million kWh compared to 50.16 million kWh in 2008 (a decrease of 2.4% in consumption, compared to an average increase of 4.2% between 2005 and 2008). This is the first ever decrease in consumption since the establishment of the Israeli electricity economy, and it is attributed by the Company to the global economic crisis that has led to a reduction in general consumption and to electricity cuts, mainly in industry.

Below are the consumption levels in 1997-2009 (in millions of kWh for the entire public and in kWh per person);



Source: Company reports and Midroog processing.

The following table shows data on electricity consumption (in millions of kWh) for 2007-2009, broken down by consumer categories:

	% Consumption in 2009	2009	% Change	2008	% Change	2007
Public-commercial	32%	15,624	0.8	15,499	5.0	14,766
Household	31%	15,117	(0.6)	15,201	1.0	15,049
Industrial	21%	10,329	(7.9)	11,218	0.4	11,178
Palestinian Authority	8%	3,783	3.2	3,666	6.0	3,457
Water pumping	5%	2,404	(12.6)	2,749	(9.0)	3,021
Agriculture	3%	1,690	(7.5)	1,827	(1.4)	1,852
Total	**100%**	**48,947**	**(2.4)**	**50,160**	**1.7**	**49,323**

Source: Company's annual report for 2009

Conventional Private Electricity Producers (PEPs)

As part of the trend of promoting competition in the electricity production sector, and with a view to encouraging the setup and operation of private electricity production facilities, in accordance with the principles of minimizing production costs in the economy and encouraging the sale of electricity of private producers to consumers, the Minister of National Infrastructures enacted the Electricity Economy Regulations (Conventional Private Producer) in 2004 ("the PEP Regulations"), pursuant to which the Company, as an essential service provider, is obligated to purchase electricity produced by PEPs, to allow them to use its conveyance and supply network and to provide their customers with backup power.

As of December 2009, the volume of installed production capacity of private producers amounted to 228 megawatts, equivalent to 1.9% of the total installed production capacity in the State of Israel (12,014 megawatts). However, to the best of the Company's knowledge, as emerges from its quarterly statements, additional conditional licenses have been issued to private producers for a total of 3,492 megawatts, as of February 2010, equivalent to 28% of the installed production capacity in the economy. Furthermore, additional entrepreneurs are set to construct power stations based on tenders for a total of 650 megawatts. According to statements of the Ministry of National Infrastructures, these projects are slated to begin in the course of the coming decade.

Renewable Energy Producers

According to government policy, by the year 2020, 20% of all energy in Israel will be produced form renewable sources. The definition of "renewable sources" includes all sources from which energy can be produced without harming existing resources or damaging the environment. Renewable energy sources include solar energy produced from the sun, energy generated by wind turbines and the like. To encourage the production of electricity from renewable energy and preserve the quality of the environment, the government of Israel, like many other governments around the world, has decided to grant financial incentives that will encourage, support and reduce the cost of the construction of installations and development of technologies for the production of electricity from renewable sources. These incentives include preferential rates, tax breaks and the allocation of budgets to R&D in the field.

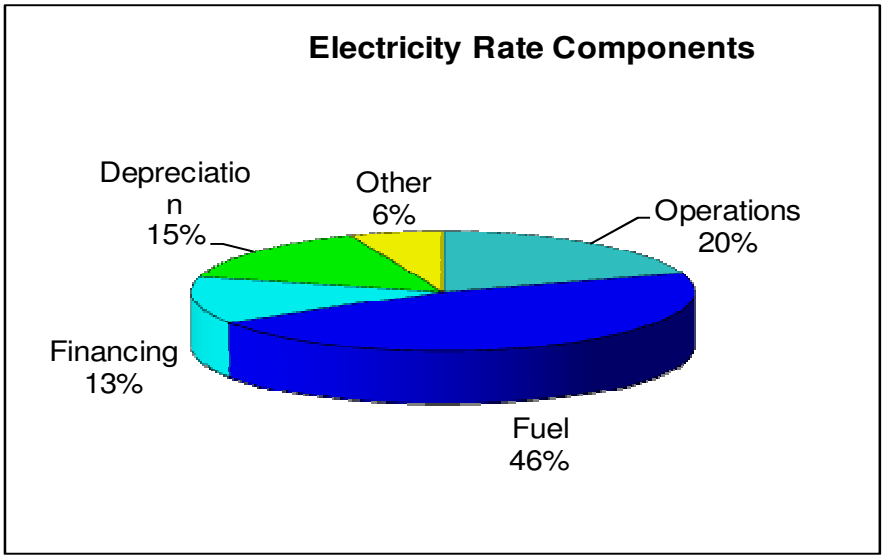
The main renewable energy project is planned at the Ashalim site in the Negev, involving the construction of solar power stations expected to generate approximately 250 megawatts by means of a thermosolar technology and up to 30 megawatts by means of a photovoltaic technology. The project is expected to be on a BOT basis, with a private entity receiving a concession for the financing, planning, construction and operation of the power stations for a fixed period of 25 years, after which ownership of the installation will be transferred to the state.

Electricity Tariff

The electricity rates are supposed to reflect all the costs incurred by the Company from the operation of its assets (including return on equity), such as the cost of fuels, operation and maintenance, capital costs, etc. The rates are determined by the Electricity Authority, using normative cost models, based on past costs of the Company, estimated costs according to a world benchmark and operational forecasts of the Company. The rates are designed to include incentives for increasing the Company's operational and financial efficiency. Different rate bases are set for the different operating segments: production, conveyance, transformation, distribution and supply.

The rate basis takes into consideration the asset base and depreciation rates, fuel costs (in the production segment), capital costs and operation and service costs. In addition, there are reduction factors at the Company's expected efficiency rate, as well as a compensation mechanism for costs incurred by delays in the current adjustment of the rates.

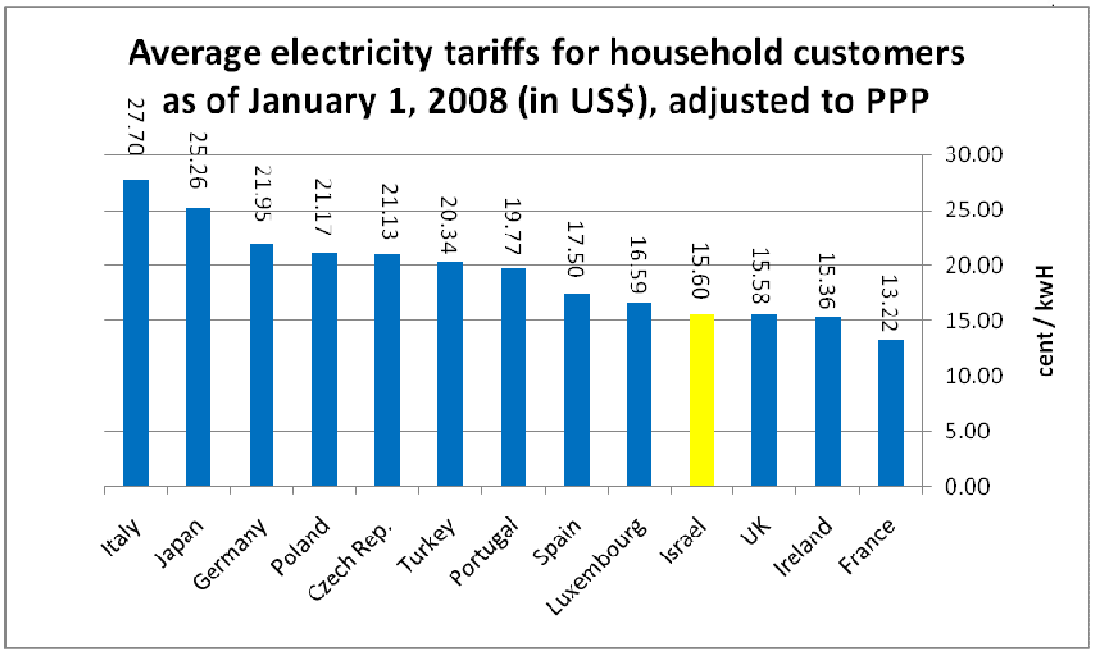
In determining the rates, the Electricity Authority recognizes financing costs for the construction of new power stations and the development of existing production units and their conversion to gas technology, according to criteria and timetables set by the authority.



Source: Company data based on new rates for the production segment

Rate adjustment – The rate base is adjusted once in several years. A current adjustment is made at the earlier of: a) a given percentage change in the cost of the basket of inputs or b) the lapse of half a year from the date of the last adjustment. An annual adjustment is supposed to be made every year in April.

Based on an international comparison, electricity rates in Israel are lower than in other Western world countries.



* PPP – Countrywide purchase power parity

Source: Company data and Midroog processing

The last rate adjustment, which was due in February 2005, was made in February 2010 for the production segment, in respect of the years 2010-2014. This adjustment and the rates derived from it went into effect on February 15, 2010. In the framework of this adjustment, the components of the production segment were adjusted, including capital costs, operating costs, the mix of fuels, etc. No adjustment in the conveyance and distribution segments is expected to be published at least until the end of 2010.

Following the setting of a new rate base for the production segment, and in like manner, the authority also adjusted some of the components of the conveyance and distribution segments. The Electricity Authority several years ago appointed a consultant, who recently formulated (following discussions with the Company's professional staff) final recommendations regarding the physical models for the recognition of property in the distribution segment. The Company is unable at this stage to assess the scope of the property that will not be recognized in the framework of the next rate base.

It should be noted that there is a disagreement regarding the new rate applying, as stated above, from February 2010.

Main changes in the new rate base:

- Wider use of normative costs in the recognition of power station costs
- Recognition of fixed assets according to the operating dates in the Company's development plan
- Change in the efficiency coefficient in the production segment relative to operating costs only and its reduction to 2%
- Gradual cancellation of the hedging component in the rate over three years
- Increase in the net return to equity in the production segment to 7.8%
- Incentive for signing new gas agreements

Management Strategy, Targets and Challenges for the Future

Startup of a structural reform with the collaboration of the Company's management and employees and the regulatory authorities

Since 1996, there have been several proposals for structural changes in the electricity economy, but these were not implemented mainly due to opposition and protest measures by the Company's employees.

According to the Company's management, as of today there is general understanding among the parties involved in the Company's activity (management, employees and the government) that the continued advancement of the Company and its workers will be achieved through a consensus of all the parties. It appears that the emerging structure of the future electricity economy is one in which the conveyance and distribution system will remain in the Company's hands, while regarding the production segment, there is still disagreement as to its operating structure, the scope of privatization it will undergo and the manner of splitting up the activity.

Internal efficiency – the "Matzpen" plan

Given the difficulties in advancing the above reform, the Company's management decided to implement an independent internal efficiency plan – the "Matzpen" plan.

In May 2008, the Company's board of directors approved in principle the organizational change outlined in the plan, which, among other things, calls for the retirement of 2,000-2,500 employees (about 15% of the Company's workforce), as part of a downsizing process to be spread over several years, and for a reorganization of the Company's units. Management estimates the cost of the plan at NIS 2.3-4 billion. Implementation of the plan is expected to result in savings for the Company and in improved operating efficiency on a scope of hundreds of millions of shekels per year and up to NIS 6.9 million in the aggregate over the next nine years (as a function of the number of retiring employees). As of the date of this report, no real progress has been made in implementing the structural change, and, according to the Company, it is unable to estimate when these steps will be implemented.

Development of new areas of activity in the Company as a counterweight to the possible impairment of its monopolistic standing in the electricity economy

According to the Company's management, reducing the degree of concentration in the electricity economy will enable the Company to develop new revenue channels in noncore areas of its activity. Among the areas under consideration:

Communications – In February 2010 the Company received a license from the Ministry of Communications to perform a technological trial to test the Company's ability to provide broadband communication and cellular communication services based on the existing infrastructure. The Company regards the communications industry as a future potential source of significant profit, which it estimates could generate revenues of around one billion shekels starting from 2015, provided that operating licenses are received. The Company's activities in the field of communications will be conducted through a subsidiary.

Overseas projects – The Company possesses significant technological and engineering capabilities, which it intends to utilize to expand its operations in foreign energy markets. Since 2007, the Company has been involved in a number of overseas projects. Its activity in this area is currently being subjected to regulatory scrutiny.

Technological Incubator – The Company set up at the end of 2008 a technological **incubator** in the fields of energy and environmental quality. The Company's activity in this area is in the initial stages.

Seawater desalination – The Company is considering the possibility of entering into the area of construction and operation of seawater desalination plants. The subject is undergoing a regulatory examination.

The challenge in changing the mix of fuels – assimilation of new technologies, discovery of offshore reserves, and dependency on a conveyance system that needs improvement

Beginning in 2005, as a result of incentives granted by the Electricity Authority, the Company has been setting up and converting production units for the production of electricity from natural gas. This trend has strengthened in recent years, and as of December 2009, the installed output of natural gas turbines accounts for 34.9% of the Company's total production capacity. This trend is expected to increase in the coming years, such that by the end of 2010, the total installed production capacity using natural gas is expected to account for 54% of the Company's total production capacity, whereas the installed production capacity using coal is expected to decrease to 38% in 2010 compared to 41% in 2009.

Nevertheless, it should be noted that production from natural gas has been limited by a management decision to up to 40% of total electricity production, in order to prevent loss of electricity production due to a high dependency on natural gas combined with production and supply irregularities that characterize the gas economy today. The Company's gas suppliers, as of the date of this report, are Yam Thetis, which is owned by the Delek Group, and the Egyptian company EMG. In addition, a letter of intent has been signed with the partnerships holding the recently discovered Tamar and Dalit reserves, however the commercial production of gas from these reserves has still not begun. This, together with positive indications received regarding the

possible presence of natural gas deposits on an international scale in the Levitan reserve, has increased the possibility of reliance on natural gas as a main energy source in addition to coal.

The gas supply system, which is operated today by Israel Natural Gas Lines, suffers from various reliability problems, among them irregularities in supply and conveyance malfunctions. In 2009 there were several hitches in the supply of gas, among them some that resulted in financial losses. This risk factor is mitigated by the Company's proven ability to anticipate and deal with malfunctions, and by the expense recognition mechanism which allows the Company to receive financial indemnification for irregularities in gas conveyance that caused it unplanned expenditures.

Main Supporting Factors

Absolute natural monopoly in a closed electricity economy with especially high entry barriers

The Company is a monopoly in the electricity sector, both in market terms and in terms of infrastructure ownership, with no possibility for creating alternatives. Attempts made over the years to change this state of affairs have failed, and even if a reform, as described above, should be implemented in the electricity economy, the Company will remain a monopoly in the field of electricity conveyance and possibly also in the field of distribution.

The State of Israel has a closed electricity economy. The Company was designated as an essential service provider in the economy, and its role in the Israeli economy is greater than that of a commercial company.

The high entry barriers in the sector are due both to regulation and to the need for a major investment in capital-intensive production infrastructures (such as those owned by the Company) as well as knowledge and experience.

Government company that enjoys broad support due to its essentiality for the proper functioning of the economy and its international standing

The Company is government owned and receives government support. Over the years, the government of Israel has demonstrated reliability in backing the obligations of government companies. Government support is a significant factor in the rating, since it reflects the Company's strategic importance. Impairment of the Company's debt is liable to affect its future ability to raise capital for investing in the country's electricity infrastructure. As of December 31 2009, the state is guarantor for an (unrated) debt of NIS 5.9 billion. This means that the state has an economic incentive to back the Company's other obligations. Nevertheless, it should be noted that in the past (2002-2003), there were cases in which the state at its initiative deferred debt payments of government companies, albeit not in sectors of strategic importance such as the electricity economy. Having said that, the state has no legal obligation to back the Company's obligations, apart from guarantees given to private electricity producers as part of the process of opening up the electricity economy to private entities. The rating assumption is that the government will continue to back the Company's debts to a significant extent, should this be necessary.

Increase in consumption along with near absolute rigidity in demand

Despite the decline in consumption in 2009 by 2.4% (compared to a negative growth of 0.2% in the economy in 2009), the Company's updated forecast foresees a return to increased demand at a rate of 3.5%-4% starting already in 2010.

Proven high operational efficiency

The Company enjoys high operational efficiency, reflected in a malfunction rate that is lower than the world average (2% compared to a malfunction rate of 6%-8% in the Western world) and in a negligible rate of unsupplied electricity (0.0011% of total electricity demand). This efficiency protects the Company's revenues and prevents operational penalties.

Managerial and regulatory motivation to improve results

The management and the Electricity Authority are highly motivated to improve the Company's results and to develop its activity. This is indicated by the management's intention to implement an internal efficiency plan and its willingness to commission a study from the World Bank for recommending improvements and drawing conclusions.

Key Risk Factors

Regulatory uncertainty, low flexibility in setting rates and an unclear outlook on the business environment

- As stated, authority to set electricity rates is not given to the Company but to the Electricity Authority, which determines the rates based on the normative cost principle. The rates paid to the Company are supposed to cover its expenses and ensure an appropriate return to capital. Nevertheless, the Electricity Authority is entitled to determine the rates without taking into account expenses which in its opinion are not necessary for the fulfillment of the Company's obligations, and to set various reduction factors. In addition, the cost of the Company's investments is recognized partly on the basis of past data and partly on the basis of normative data, without any assurance of full coverage of its future costs. This risk is mitigated by the Electricity Authority being required, when determining the rates, to give weight to a full array of considerations designed to regulate activity in the electricity economy for the public benefit, assuring availability, quality and efficiency and creating conditions for competition and cost minimization. These considerations include, among others, the preservation of the Company's financial strength.
- The Israeli electricity economy and IEC's activity are subject to broad supervision, inter alia as a result of the Electricity Economy Law. There is no certainty that these supervisory provisions, relating inter alia to licensing, competition, rates and the like, will not have a negative impact on the Company's business results, business operations and financial position. Furthermore, in recent years the Company's license has been renewed

on a half-yearly basis, a fact that adds to the instability and uncertainty regarding its future.

- As stated in this report, the amendments to the Electricity Law established provisions for instituting a structural change in the electricity economy and increasing competition. As of the date of this report, there has been no actual progress in implementing the structural change, among other reasons because of employee sanctions over the proposed structural change (the Company's applications to the labor courts on structural change issues have not met with success), and since the negotiations with the various government officials on issues relating to the structural change have still not yielded agreements. Even if the change should come about, it is not known what effect it will have on the Company. Moreover, the Ministry of National Infrastructures is liable to impose on the Company emergency plans, such as the emergency plan for the development of the electricity economy, that will cause changes in the Company's development plans, or to grant private electricity producers further incentives, creating a situation in which the Company invests substantial amounts in the development of a reserve but, in practice, suffers from reduced demand for electricity production. The uncertainty regarding the future electricity economy is making it difficult for the Company to act in a consistent and planned manner.

Necessity to make, and to finance, extensive investments

To meet electricity demand, the Company will need to invest large amounts in the coming years (2010-2014), and it will require external financing in significant amounts for financing its development and investment plans. The Company's ability to raise long-term financing, both in and outside Israel, depends on a variety of factors, among them its business results and financial position, economic, security, legal and political conditions in Israel, the government's privatization policy, and its ability to obtain funding from banks and other financial institutions in Israel, which is affected by "single borrower" restrictions and the like. As detailed in this report, the Company's financial results are weak and low relative to other electricity and energy companies around the world. Moreover, notwithstanding the many capital offerings held by the Company, it suffers from low liquidity due to inelasticity in the use of the capital that was raised. The scope of the Company's debt (over NIS 41 billion as of March 2010) makes it difficult for the Company to raise debt in the local capital market. However, the Company has shown an ability to raise debt in the international markets, even in periods of difficulty in raising debt, as reflected in the debt issue of USD 500 million in January 2009 (although this debt was raised at a relatively high interest rate compared to the usual rate for company offerings).

Furthermore, in light of the Company's strategic importance and the fact that it is a monopoly in the vital electricity economy, Midroog estimates that should the Company not be able to obtain the financing required by it, the state will step in with financing for the Company in order to ensure its continued orderly activity.

Dependence on a complex system of labor relations and significant involvement of the workers union in the management of the Company and implementation of reforms

The Company has a significant dependency on the IEC workers union, which, by means of sanctions and work disruptions, could prevent the Company from accepting and implementing efficiency plans and structural changes that would benefit it. Furthermore, the Company's employees are signed on collective labor agreements with the Ministry of Finance rather than with the Company's management, impairing managerial flexibility and the management's ability to reduce costs and motivate to higher performance. In the course of 2009 several work disruptions occurred at the Company, due to internal labor disputes and disagreements with the supervisor of wages and labor agreements in the Finance Ministry. Based on the IEC financial statements for 2009, the worker sanctions in March-May 2009, on the background of the implementation of the Company's efficiency plan, caused the Company losses of NIS 192.3 million and ended in the parties' agreement to put the plan on hold until further notice. The state also stated its willingness to tie the Company's efficiency plan to the planned structural reform and to implement them together, in cooperation with the workers union.

Increased competition and the planned reform are expected to undercut the Company's monopolistic standing

One of the aims of the structural change discussed in this report is to achieve greater efficiency in the IEC's functioning, in order to add production capacity to the economy at minimal cost to electricity consumers. This development could have significant implications for the Company, because of the structural change per se and the splitting of the Company's operations among separate corporations, as well as the resulting increase in competition in the industry (at least in the production segment), and also as regards the state's willingness to support the Company. Nonetheless, the planned structural change is expected to take shape in a way that will not harm the Company's ability to repay its creditors (e.g. – sale of the Company's property to the subsidiaries that will be established and repayment of the debt from the consideration that will be received). At the same time, the planned reform in the electricity economy relates to the production segment only, while the Company's other operating segments (conveyance and distribution), which constitute natural monopolies, are expected to retain their present structure. Possibly, a more competitive environment will improve the Company's operational efficiency and enable an increase in reserves as planned.

Pursuant to the legal provisions and the criteria of the Electricity Authority, subsidizing rate arrangements and significant infant-company protections have been instituted for private entrepreneurs, to support the setup of power stations by private producers. In addition, the Company is required to provide a "safety net" to PEPs by purchasing a fixed or variable availability capacity according to the definition in the criteria. The payment is supposed to cover all, or at least most, of the cost of the setup of a private production unit. The Company will be required to meet the demand, even if producers who were slated to set up power stations go back on their plans or in case of the failure of existing power stations of private producers. The Company is also responsible for supplying electricity to customers of private electricity producers while they are carrying on maintenance works and/or are inoperative due to malfunctions.

Activity within a lower range of reserves than accepted in the world

The Company operates within a range of reserves that is lower than accepted around the world. In other words, the amount of electricity used at peak demand times is closer to the Company's maximum production capacity than in equivalent electricity economies around the world. This could lead to operational malfunctions, which could affect the Company's position due to the entailed costs. This risk factor is moderated by higher operational capabilities compared to equivalent electricity systems around the world, as well as by the cost recognition mechanism applied in the electricity rates, that compensates the Company for costs arising from malfunctions, up to a certain rate of malfunctions (4%, with the Company standing today at 2%).

The reserve percentage in 2009 stood at 12%. According to a study commissioned by the Company shortly before the report issuance date, the reserve percentage, based on a high load forecast for 2010-2015, will be in the range of 11% to 17%, compared to a reserve percentage of 16% to 18% recommended by the World Bank.

Financial Analysis

Reduction in current liabilities and increase in equity

The Company's balance sheets show a notable reduction in current liabilities in 2009, amounting to NIS 3 billion, mainly due to a decrease in current maturities of loans and bonds. Under issued debt, bonds were repaid for a total of US$ 1.1 billion, while long-term bonds were issued for a total of NIS 2.5 billion (total net repayment of NIS 1.8 billion). Current assets contracted, mainly due to a decrease of NIS 12 billion in the stock of fuels. The Company's equity rose by NIS 4.2 billion, following the restatement of the financial statements for 2007 and onwards, mainly due to changes in the actuarial liabilities. The data for the first quarter of 2010 show an increase in current liabilities, mainly due to an increase in current maturities of bank loans. Concurrently, a decrease was recorded in bonds (minus NIS 1 billion) and in bank loans (minus NIS 700 million).

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Condensed Balance Sheet, in NIS M

	Q1/2010	% Change	FY 2009	% Change	FY 2008	% Change	FY 2007
Cash and cash equivalents	3,980	2.4%	3,885	5.8%	3,670	646%	492
Trade & Accounts Receivable	3,450	(15.7%)	4,094	(7.7%)	4,437	3.9%	4,270
Inventory	1,928	2.4%	1,882	(39.9%)	3,132	17.8%	2,659
Severance benefits assets, net	4,195	(1.2%)	4,248	3.5%	4,103	15.4%	3,554
Fixed assets, net	59,707	(1.4%)	60,537	(0.4%)	60,752	(1.8%)	61,875
Intangible assets, net	782	0%	782	(0.9%)	789	(1.4%)	800
Current Liabilities	9,064	12.5%	8,058	(27.7%)	11,146	43.2%	7,784
Bonds	29,392	(3.2%)	30,375	4.2%	29,160	2.5%	28,446
Liabilities to banking corporations	9,406	(7.7%)	10,195	(0.3%)	10,229	(14.8%)	12,005
Total Non-Current Liabilities	52,666	(3.6%)	54,632	0.2%	54,498	(1%)	55,001
Equity	16,031	(4.7%)	16,829	7.9%	15,591	5.2%	14,821
Balance sheet total	77,761	(2.2%)	79,519	(2.1%)	81,235	4.7%	77,006

Source: Company's annual financial statement for 2009, adjusted to December 2009 and Company's quarterly statements for 2010 adjusted to March 2010

Increase in working capital due to a reduction in supplier credit days versus an increase in customer days

The average range of customer credit in the year ended December 31, 2009 was 61.6 days, compared to 53 days in 2008. The average amount of customer credit stood at NIS 4,004 million, compared to NIS 3,604 million in 2008.

The average range of supplier credit in the year ended December 31, 2009 was 39 days, compared to 46 days in 2008. The average amount of supplier credit stood at NIS 1,427 million, compared to NIS 1,633 million in 2008.

The increase in the amount of customer credit versus the decrease in the amount of supplier credit stems from the economic crisis that marked the year 2009 and places an additional cash flow burden of NIS 606 million on the Company's core activity.

Revaluation of pension liabilities and cash flow exposure due to the switch to an independent provident fund

The scope of the Company's pension liabilities and the liability calculation method are the subject of a disagreement between the IEC and the Electricity Authority. During the second quarter of 2009, the Securities Authority demanded that the Company restate its pension liabilities. Accordingly, the Company's actuary restates the pension liabilities in every quarter and presents the profit and loss from the revaluation of the liabilities.

The total change in the Company's pension liabilities due to the above changes is estimated at NIS 9 billion.

The Company has a cash flow exposure due to the need to deposit the full amount of the actuarial liability, following the transition to accumulation and management of pension moneys in an independent provident fund of the IEC employees, which is managed by the Infinity Company.

The Company makes contributions to the independent fund managed by Infinity, to secure the employees' pension rights. In case a gap develops between the Company's actuarial liabilities as estimated by it (through the fund's actuary) and the assets in the Infinity provident fund, the Company transfers the full difference, as provided in the articles of the provident fund.

Decrease in revenues at a higher rate than the decrease in operating expenses, affecting the EBITDA

There was a notable decrease in the Company's revenues in 2009, at a rate of 22.5%. This decrease is attributable to a 2.4% reduction in consumption compared to 2008, mainly in the industrial sector (down 7.9% from 2008), in agriculture (down 7.5% from 2008) and in water pumping (down 12.6% from 2008), as well as a real decrease of 20.56% in the average revenue per kWh compared to 2008. There was a real decrease of 10% in the electricity rates in 2009, mainly due to a drop in fuel expenses. It should be noted, in this connection, that the Company's financial data in 2008 were significantly better than in 2007, with 15.7% higher revenues than in 2007. The drop in revenues in 2009 was accompanied by a 21.6% decrease in the electricity system operating costs (attributable mainly to a turnover in manpower, which resulted in a 5% reduction in wage costs compared to 2008, following a 4% decrease in wage costs in 2008 compared to 2007, and to a change in the mix of fuels due to the switch from the use of diesel and crude oil to natural gas consumption, as well as a decrease in coal prices and in the level of coal consumption, which brought down fuel costs by 32% compared to 2008).

The higher decrease in revenues than in expenses reduced operating profit by 27.6% compared to 2008 (whereas operating profit in 2008 was 19% higher than in 2007). EBIDTA decreased by 9.6%, a lower rate than the rate of decrease in operating profit, due to an increase in depreciation expenses deriving from the scope of investments in fixed assets during 2009, including due to the emergency plan.

A 30% decrease in the Company's revenues is apparent in the first quarter of the year compared to the same quarter last year. Consumption by a quarterly comparison declined only 1.2%, from 11,451 million kWh in the first quarter of 2008 to 11,312 million kWh in the same quarter in 2009. The average electricity rate was reduced to 13.75% on February 15, leading to a decrease in the average gross revenue per kWh, from 44.50 agorot to 38.31 agorot. The difference is even greater after accounting adjustments meant to create a

more proper timing match between the charging of expenses and revenues, which leads to an average revenue of 31.66 agorot compared with 44.47 agorot in the same quarter in 2009. This explains the decrease in revenues for year end. On the other hand, fuel costs, which constitute a significant component of the electricity system operating costs, decreased by NIS 1,083 million following a changeover to a cheaper mix of fuels. In addition, a provision of NIS 529 million was made in respect of the Electricity Authority's non-recognition of actual construction costs incurred by IEC, in the new rate base for the production segment. Disregarding this provision, the profit rate from the operation of the electricity system is 16.7%, which more closely approximates the 20% annual rate that is characteristic of the Company.

Condensed Statement of Income and Profitability Ratios, in NIS M and Percentages

	Q12010	Q1/2009*	FY 2009	% Change	FY 2008	% Change	FY 2007
Revenues	3,611	5,166	18,704	(22.5%)	24,142	15.7%	20,870
Cost of operating the electricity system	3,537	4,109	14,788	(21.6%)	18,851	14.2%	16,507
Profit from operating the electricity system	74	1,057	3,916	(26%)	5,291	21.3%	4,363
Selling and marketing expenses	185	202	749	(3.9%)	779	0.8%	773
G&A expenses	150	204	816	21.1%	674	(5.2%)	711
Financial liabilities for retirees, net	3	(33)	(215)	(173.6%)	292	(386.3%)	(102)
Profit from routine activity	(264)	684	2,566	(27.6%)	3,546	19%	2,981
Financing expenses, net	561	861	2,390	(6.2%)	2,548	35.5%	1,880
Profit before income tax	(825)	(177)	176	(82.4%)	998	(9.4%)	1,101
Income tax	(172)	(47)	(1,062)	(566%)	228	(18%)	278
Net Profit	(653)	(130)	1,238	60.8%	770	(6.4%)	823
EBITDA	978	1,700	6,493	(9.6%)	7,184	7.2%	6,700
% Profit from operating the electricity system	2.05%	20.46%	20.94%	(4.5%)	21.92%	4.8%	20.91%
% Profit from routine activity	(7.3%)	13.2%	13.7%	(6.6%)	14.7%	2.8%	14.3%
% EBITDA	27.1%	32.9%	34.7%	16.7%	29.8%	(7.3%)	32.1%
% Net Profit	(18.1%)	(2.5%)	6.6%	107.5%	3.2%	(19.1%)	3.9%

Source: Company's annual financial statement for 2009 adjusted to December 2009 and Company's quarterly statement adjusted to March 2010

* Restatement

High positive cash flow used for investment and debt repayment

Cash flows from operating activities increased by 185% in 2009, to NIS 6,691 million, while cash flows from investing activities and financing activities increased at rates of 36.6% and 174%, resulting in a lower cash increase (by 93%) than in 2008. The Company's activity generated a significantly higher surplus of cash from operating activities than in previous years, which together with long-term loans received and overseas bond issues, was used by the Company to finance its investment plan for the development of the electricity system and to refinance debts (repayment of loans, as indicated by the cash flow from financing activities). An improved cash flow from operating activities and FFO in 2009 compared to previous years, together with an examination of alternatives for cutting back on the extensive investment plans, in respect of which a first discussion was held by the Company board, could improve the Company's financial position.

Key Cash Flow and Coverage Ratio Data, NIS M

	Q12010	FY 2009	FY 2008	FY 2007
Cash flow from operations	1,026	6,691	2,345	4,095
Cash flow from investment activity	(1,015)	(3,809)	(2,788)	(3,701)
Cash flow from financing activity	117	(2,667)	3,621	(711)
Change in cash	128	215	3,178	(317)
FFO	1,106	5,385	3,324	3,931
Capex	(989)	(3,702)	(2,374)	(3,525)
FFO + financing expenses/financing expenses	2.97	3.25	2.3	3.09
Net debt-to-FFO	NR	7.13	12.76	10.77
EBITDA-to- Net debt	NR	5.92	5.91	6.32
Capex-to-depreciation	79.63%	94.27%	65.26%	94.78%

Source: Audited financial statements, not including data for Q1 2010, which are from reviewed quarterly statements

Low liquidity affecting operational flexibility

It is apparent from the cash flow ratios that the Company's liquidity continues to be weak, in spite of the improvement in some of the cash flow measurements in 2009, such as FFO and net-debt/FFO. The liquidity reflects the Company's massive investment plan in 2009 and for 2010-2014, for which the Company will need external financing sources, creating a squeeze in credit lines and the utilization of (mainly local) financing sources. The Company's potential for obtaining loans in the local market is significantly lower than its needs, considering its development plans. The Company raised capital in the international markets in 2009, but at relatively high interest rates. The expected repayment burden in 2010 stands at NIS 4 billion (principal and interest), whereas the operating surplus in that year amounts only to NIS 7 billion. In these circumstances, and considering the contemplated investment plan, the Company's operational flexibility is limited and sensitive to changes in market conditions (such as an increase in interest rates on offerings, a further decline in consumption levels or unforeseen onetime expenses). This could lead the Company, especially at times of immediate need, to hold offerings under non-optimal conditions.

Condensed Leverage & Financial Strength Data, NIS M and Percentages

	Q12010	FY 2009	FY 2008	FY 2007
Net debt	37,396	38,412	42,424	42,356
Debt to total balance sheet assets	53.2%	53.2%	56.7%	55.2%
Debt-to-CAP	67.73%	67.12%	69.16%	68.64%
Net debt to CAP	61.21%	60.95%	63.65%	67.86%
Equity-to-balance sheet total	20.62%	21.2%	19.2%	19.1%
Working capital	2,799	3,147	4,380	3,238
Working capital needs-to-revenues	NR	16.8%	18.1%	15.5%
Current ratio	1.03	1.22	1.01	0.95
Quick ratio	0.82	0.99	0.73	0.61

Source: Company's annual statement for 2009, Quarterly statement for Q1/2010 and Midroog processing

Outlook

Factors likely to upgrade the rating:

- Strengthening of the Company's capital and debt structure.
- Regulatory stability in the sector, including in the structure of the electricity economy and following agreements with the workers union.
- Significant sustained improvement in the Company's financial results, including liquidity.

Factors likely to downgrade the rating:

- Continuing significant erosion in the Company's financial results, including failure to maintain liquid balances at an adequate rating level relative to the expected scope of activity and repayment burden.
- Deterioration in government support of the Company
- Slow and incomplete assimilation of the new rate structure and of the rate structures which are expected to be published for the conveyance and distribution segments.
- Difficulty in refinancing the existing debt.
- Wider expansion and development plans than envisaged, necessitating additional financing sources.

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Obligations Rating Scale

Investment grade	Aaa	Obligations rated Aaa are those that, in Midroog's judgment, are of the highest quality and involve minimal credit risk.
	Aa	Obligations rated Aa are those that, in Midroog's judgment, are of high quality and involve very low credit risk.
	A	Obligations rated A are considered by Midroog to be in the upper-end of the middle rating, and involve low credit risk.
	Baa	Obligations rated Baa are those that, in Midroog's judgment, involve moderate credit risk. They are considered medium grade obligations, and could have certain speculative characteristics.
Speculative Investment	Ba	Obligations rated Ba are those that, in Midroog's judgment, contain speculative elements, and involve a significant degree of credit risk.
	B	Obligations rated B are those that, in Midroog's judgment, are speculative and involve a high credit risk.
	Caa	Obligations rated Caa are those that, in Midroog's judgment, have weak standing and involve a very high credit risk.
	Ca	Obligations rated Ca are very speculative investments, and are likely to be in, or very near to, a situation of insolvency, with some prospect of recovery of principal and interest.
	C	Obligations rated C are assigned the lowest rating, and are generally in a situation of insolvency, with poor prospects of repayment of principal and interest.

Midroog applies numerical modifiers 1, 2 and 3 in each of the rating categories from Aa to Caa. Modifier 1 indicates that the bond ranks in the higher end of the letter-rating category. Modifier 2 indicates that the bonds are in the middle of the letter-rating category; and modifier 3 indicates that the bonds are in the lower end of the letter-rating category.

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