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Credit Opinion: Gas Natural de Lima y Callao S.A. (Calidda)

Global Credit Research - 30 May 2014

Peru

Ratings

Category	**Moody's Rating**
Outlook	Stable
Senior Unsecured	Baa3

Contacts

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Key Indicators

[1]**Gas Natural de Lima y Callao S.A. (Calidda)**

	12/31/2010	12/31/2011	12/30/2012	12/31/2013	LTM 3/31/2014
CFO pre-WC + Interest / Interest	3.6x	5.0x	4.4x	1.5x	1.5x
CFO pre-WC / Debt	15.9%	22.2%	19.7%	2.0%	2.1%
CFO pre-WC - Dividends / Debt	15.9%	22.2%	19.7%	2.0%	2.1%
Debt / Capitalization	50.6%	54.8%	49.6%	57.3%	56.4%

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

Note: For definitions of Moody's most common ratio terms please see the accompanying User's Guide.

Opinion

Rating Drivers

- Outcome of ongoing tariff review will be a key consideration

- Modest sized LDC with growing footprint amid increasing exposure to unregulated ancillary services

- Low business risk profile albeit exposure to unregulated customers is material

- Cash flow visibility enhanced by the terms of the BOOT agreement and its May 2010 addendum

- Credit metrics expected to remain commensurate with the Baa-rating category despite anticipated deterioration during ramp-up of services

- Expected prudent dividend policy will allow for maintaining an adequate liquidity profile

Corporate Profile

Headquartered in Lima, Gas Natural de Lima y Callao S.A. (Calidda; Baa3, stable) started commercial operations in 2004 after a two year construction period. Calidda is currently the largest Local Distribution Company (LDC) of natural gas in Peru (Baa2, positive) as measured by number of customers (year-end 2013: around 164,000) and volume of natural gas supplied (market share 2013: 81%). With around 3,400 km natural gas distribution network with a 420 million cubic feet per day (MMCFD) system capacity Calidda currently provides its services to residential end-users in 15 out of the 49 districts in the Department of Lima and the Constitutional Province of Callao, while its natural gas vehicle (NGV) stations and industrial customers extend over 34 districts. Calidda's service territory accounts for around 34% of the country's total population (around 30 million) and 44% of GDP.

Calidda's revenues further include fees for rendering services ancillary to its LDC operations mainly related with installation and connections as well as the interest received for providing financing to new residential end-users for funding connection devices, as well as fees for providing integrated solutions and consulting services to industrial customers.

Calidda operates under a 33-year Build Operate Own and Transfer (BOOT) concession agreement and its May 2010 Addendum. Calidda's tariffs are subject to regulatory purview of the Peruvian regulatory body, Organismo Supervisor de la Inversión en Energía y Mineria (OSINERGMIN), while its pre-agreed five year capital expenditure (capex) program is monitored by the Ministry of Energy and Mines (MEM).

Calidda's majority shareholder is Empresa de Energia de Bogota (EEB; Baa3, stable) with an indirect and direct ownership stake of 66.2% given its 15.6% equity interest in Calidda's minority shareholder, Promigas S.A. E.S. (not rated; 40% interest).

For more details about the company, the terms of the BOOT concession agreement and 2010 Addendum and/or the key Peruvian natural gas provisions underpinning Calidda's operations please refer to the March 2013 Presale-Report available on our website.

SUMMARY RATING RATIONALE

Calidda's Baa3 rating factors its overall low business risk profile and that the bulk of its revenues are derived from its regulated NG distribution operations. It further considers that the company's cash flow visibility is enhanced by the terms of its concession and tax stability agreements as well as the overall credit supportive regulatory environment under which it operates. The rating is tempered by Calidda's overall modest albeit growing footprint, its significant exposure to unregulated end-users despite its growing residential customer base, and the increasing contribution to Calidda's cash flows of unregulated ancillary services. Importantly, the rating assumes that Calidda will report credit metrics that are commensurate with the lower-end of the Baa-rating category following the deterioration registered last year amid the increased leverage and partially due to some one-time items that negatively affected its cash flows. To that end, the rating assumes a prudent financial policy to fund its planned material capex as well as responsible dividend distributions over the medium term. We consider credit positive the implementation of a new hedging program that will allow the utility to better manage some currency risk exposure associated with the local currency payments received from its regulated customers

DETAILED RATING CONSIDERATIONS

MODEST SIZED LDC BUT GROWING FOOTPRINT AMID CREDIT SUPPORTIVE BOOT-CONCESSION TERMS

alidda's rating factors the terms of its BOOT-agreement that will not expire before 2033, which is 10 years after the maturity of the US$320 million Yankee notes issued last year. The BOOT-agreement is subject to 10-year extensions until 2060. We also consider the risk of an early termination of the BOOT agreement as low given the LDC's operational performance to-date and our understanding of an overall constructive relationship with the MEM. Calidda's cash flow visibility is further enhanced by the terms of its Tax Stability Agreement.

The rating factors Calidda's significant expansion program that between 2009 and 2013 added 2,430km of NG distribution network (2013:+854km). This network consists of 408km of high pressure steel pipes (2013: +21km) to serve NG vehicle (NGV) stations and industrial customers and almost 3,000km of polyethylene network pipe. As a result, Calidda's total customer base has also grown significantly not only in terms of new connections (during 2013: +60,099) to 163,823 at year-end 2013 (2009: 19,188) but also has allowed the LDC to gain access to potential new end-users (during 2013: +86,361). The latest network expansion includes areaswhere connection to the NG network will not require significant further investment given their relatively close location to Calidda's mains. According to Calidda, this addition creates access to approximated 330,700 potential customers (2009: around 93,761). At the end of last year, Calidda reported a 50% penetration rate (2009: 20%). This is defined as the number of connected customers versus potential new end-users.

To service its growing customer base, Calidda also successfully increased last year its system's capacity to 420MMCFD (+65%) from 225MMCFD, a credit positive. We understand that its peak system needs approximate 300MMCFD. It has also transportation contracts in place with Transportadora de Gas del Peru (TgP; Baa2, stable) that secures its access to sufficient amounts of TgP's NG pipeline capacity. This is a credit positive given the constraints faced by other users until TgP completes its recently resumed capex program to increase that system's overall capacity.

The current expansion is not without risks including performing construction work in densely populated areas; however, we note that Calidda has discretion over the areas for growing its customer base which has resulted in its commercial strategy being primarily focused on those areas where end-users have higher incentives for switching to natural gas. This is particularly the case for low to medium income residential end-users as they benefit more from promotional discounts and the installation financing arrangements provided by Calida. This makes the aggregate costs more affordable and fosters the switching from alternative fuel sources amid the country's low natural gas prices and the Government various initiatives to extend the use of NG throughout the country. In August 2013, the number of monthly promotional discounts was increased to 10,000 for low to medium income families. Calidda further expects that its growth strategy will benefit from recent simplifications of the building standards and the requirements that new multifamily buildings include natural gas installations.

Calidda has an aggressive expansion strategy that targets to have over 600,000 end-users by 2017 (which equates to adding around 100,000 connections annual over the next four years). While this is not without risks, we note that failure to implement it would not negatively impact its BOOT-agreement as its customer base already exceeds the expansion target (91,000 end-users by 2015) agreed to under the 2010 BOOT-addendum mentioned earlier; however, it could negatively impact its relationship with OSIGNERGMIN. We understand that the regulator would like Calidda's expansion program to progress at a faster pace. We note that as part of the ongoing tariff review for the 2014-2018 period the OSINERGMIN's goal is for the company to reach a 70% penetration level.

OVERALL CREDIT SUPPORTIVE REGULATORY ENVIRONMENT

Calidda's rating also reflects our opinion that the Peruvian regulatory environment is overall credit supportive albeit it also captures its limited historical track-record and some inconsistency in the application of some of the regulatory mechanisms.

Regulatory features supporting our opinion about its credit supportiveness include the LDC's ability to adjust annually the bills of the captive regulated customers with demand under 30,000 Standard cubic meter (SCM) for which it procures NG and transportation services. The latter includes not only residential, commercial end-users but also small and medium size industries as well as NG stations. This annual frequency matches the suppliers' contractual adjustments reducing the LDC's cost recovery lag and enhancing its cash flow visibility. Another credit positive is Calidda's ability to recoup and to generate returns (based on a 12% annual rate and a 30-year recovery period of the capital investments) not only on its past but also on those capital outlays earmarked for the next four years. A five-year capex program is pre-agreed with the MEM but this is also subject to OSINERGMIN's consideration during the tariff review process. This theoretically should help mitigate the risk of investment disallowances, a credit positive. While OSINERGMIN's biannual review of Calidda's actual investments, operating costs and demand assumptions versus forecasted amounts used in setting the tariffs increases regulatory scrutiny; we believe it also helps to smooth the tariff review setting process that takes place every four years. During the 2012 biannual review tariffs were adjusted (effective in 2013) to reflect actually higher than anticipated volumes (used in setting the 2008 tariffs).

Moreover, the current tariff-review (that started in October 2013) has progressed significantly smoother than the previous tariff-review which was not completed until May 2010 (tariff adjustments were due in 2008). The OSINERGMIN published in May the initial tariffs applicable for the 2014-2018 period albeit pending motions to be filed by the stakeholders, including Calidda. The new tariffs are not expected to become final until mid or the end of July. We understand that, if implemented, these initial tariffs would result in an aggregate average rate hike of around 20%. The changes vary by customer category with a more significant hike (>35%) for very large demand customers (large industrial and power generators) while the tariffs for residential customers (with lowest demand) would drop. The latter group includes a reduction in rates for very small residential customers (-1.4%) but also for NG stations (1.3%) with a cut of up to 4% for smaller industrial end-users (between 300,000 and 900,000 SCM-demand).

However, the gap between the initial and Calidda's proposed tariffs would aggregate 5% considering that for certain categories the new tariff increase would exceed the requested hike. We understand that some of the differences result from OSINERGMIN's higher approved 2014-2018 capex program (gap aggregates about

US$27.5 million). This is credit neutral as we understand that these additional investments will befully recoverable in rates. OSINERGMIN's lower approved investments related to the promotional discounts in order to expand services among the low and mid-income categories also contributed to the difference. However, the key deviation results from lower authorized operational expenses (opex) as OSINERMIN's tariffs which reflect higher efficiencies than assumed by the LDC. The later is a credit negative but the LDC plans to file a motion and if OSINERGMIN does not reconsider the company will reassess its cost structure in order to reduce the negative impact on its financial performance. We consider credit positive the LDC's ability to adjust tariffs quarterly to reflect changes in the US Producer Price Index (US-PPI), the Peruvian Wholesale Prices Index, the Steel and the polyethylene indexes; however, OSINERGMIN's decision places a higher weight on the local (79%) and US-PPI (13.1%) rates compared to Calidda's proposed actualization weights for those same factors of 53.3% and 9.5%, respectively. The regulator also reduced the relative weight of the polyethylene (1.4% versus Calidda's proposed 2.7%) and steel-index (34.3% versus Calidda's submitted 6.5%). The latter is a credit negative considering that polyethylene and steel are key components of Calidda's capex program; however, we also acknowledge that changes in steel prices are a component included in the US-PPI-index calculations, slightly offsetting our concerns.

Calidda's cash flows are exposed to some currency risk associated with the payments received from its regulated customers. These revenues are invoiced in nuevos soles after monthly adjustments of the charges that are initially calculated in US$. This is a credit negative since the bulk of Calidda's cost structure is largely in US-dollars; however, we also believe that the monthly adjustment process helps to reduce the impact of any potential nuevos soles devaluation which somewhat lessens our credit concerns.

MATERIAL EXPOSURE TO NON-RESIDENTIAL CUSTOMERS AND GROWING UNREGULATED ANCIALLIARY REVENUES

The rating is tempered by the significant exposure of Calidda's cash flows to unregulated ancillary services, largely associated with connecting new customers. We acknowledge that the issuer benefits from a competitive advantage over other potential service providers such that these services are expected to remain a key component of its gross profit margin defined as revenues after pass-through cost components (2018 around 40%; 2013: 32.7%).

Despite Calidda's current focus on growing its residential and commercial customer base (2013: <1% of its distributed volumes and 4.5% of its margins) its exposure to its unregulated customers is expected to remain material (at least 30% of its operating margin), particularly to power generation companies (2013: 72.5% of distributed volumes and 27% of its adjusted revenues) while industrial end-users accounted for the next largest segment (2013: 17.2% and 16.6% of volumes and adjusted revenues). This exposure ranks among the highest across Moody's rated universe of regulated LDCs in the Americas. Industrial end-users. NGV stations are expected to further account for a material portion of the LDC's revenues (2013: 9.6% and 13.9% of volumes and adjusted revenues) going forward.

The bulk of the country's natural gas fired power generation facilities are located in Calidda's service territory. Somewhat offsetting this credit concern is the growing contribution to Calidda's cash flows of the revenues generated under firm contracts (take-or-pay agreements) that at year-end 2013. Their terms currently average around 17 years, and have been mainly executed with the NG-fired power generation companies. The important role they play in the Peruvian energy mix (historically at least 30% of the total output regardless of the season) further mitigates our credit concerns. We also note that no new NG-fired facilities are expected to come online for the next several years after two new plants start full operations during 2014, namely the 534MW Fenix and 200MW Termochilca facilities (+126MMCFD). Calidda estimates that over time non-volumetric revenues will represent about 54% of its operating margin down from the 62% registered last year, a credit positive given the expected steady growth of its residential customers.

CREDIT METRICS EXPECTED TO REMAIN COMMENSURATE WITH THE LOWER-END OF THE Baa-RATING CATEGORY

As depicted in the table above Calidda's key credit metrics deteriorated during 2013 when it reported a negative CFO of US$4.082 million. However, we note that this amount included US$7.8 million fees related to the prepayment of its outstanding debt and the issuance of the Yankee bonds in April 2013. In addition, Calidda paid out last year the interest accrued (around US$10.4 million) between 2010 and May 2013 under its shareholders' loans (payment were subject to restrictions) while it also paid in April 2013 the interests (around US$4.7 million) for the period October-December 2013 payable in semiannual arrears under its previously outstanding indebtedness with financial institutions (including multilaterals). Furthermore, Calidda's operating cash flows were negatively impacted compared to the previous year by higher outflows associated with prepaid taxes (cash outflow in 2013:

$22.5 million vs. 2012: $14.3 million), a larger employee pension related payment (+$1.2 million) and the tariff reduction (effective in 2013) that followed OSINERGMIN's 2012 biannual review (see above) because actual demand exceeded the forecasted volumes used in setting the 2008 tariffs.

That said, its financial performance has been also negatively impacted by an increase (+16%) in the contracted expenses related to the outsourced construction works that contributed to the deterioration in Calidda's cost structure and EBITDA-margin last year as well as the increase in its indebtedness (+US$120 million) following the yankee notes issuance.

Given the onetime items incurred in 2013 the 3-year average metrics are more appropriate to assess Calidda's financial performance as it smoothes out some of these cash distortions. Its 2011-2013 cash flow from operations pre W/C (CFO pre-W/C) to debt and interest coverage averaged 12.1% and 3.5x, respectively. These are commensurate with the lower end of the Baa-rating category according to the guidelines provided for low business risk in the updated Regulated Electric and Gas Utility Methodology published in December 2013. Given the absence of dividend payments Calidda's 2011-2013 Retained Cash Flow (RCF) to debt of 12.1% is well positioned within the rating category.

Calidda's cash flows will increase this and next year amid growing demand (new customers) and following the implementation of new tariffs (expected in June of this year); however, the improvement in its credit metrics will largely depend on whether the OSINERMIN reconsiders its previous decision regarding the recoverable amount in tariffs costs associated with opex (mentioned earlier) in its final decision.). If not, the final impact will depend on Calidda's ability to improve its cost structure. The rating considers management's commitment to return by 2015 to record a total debt/EBITDA that is comparable to its historical levels (2012: 3.0x) given the substantial deterioration registered during 2013. Calidda's rating assumes that despite the increased indebtedness to fund its ongoing capex program the LDC will be able to record 3-year average CFO pre-W/C to debt and interest coverage of at least 11% and 3.0x, respectively. Importantly, we assume a prudent dividend policy that will be sized to allow the company to record a RCF to debt of at least 7% while also allowing the company to maintain adequate cash balances in the absence of any committed credit facilities to meet any unanticipated cash shortfalls.

Liquidity Profile

Calidda has currently no material debt maturity before 2023 when the Yankee notes become due. The proceeds of that debt issuance were used to repay outstanding senior (US$150 million) and shareholders' subordinated loans (US$47 million) and accrued interest as well as to help the company fund its material capex program. This reduced its immediate dependence on the capital markets to fund its capital needs. At year-end 2013, the issuer recorded a cash balance that approximated US$105 million. However, the company will still need to incur new indebtedness (starting next year) to continue funding its capital outlays (around US$100 million per year.). We understand that the shareholders do not plan to make any new equity contributions going forward (2013: US$35 million; 2012: US$25 million); however, they expect the utility to start making dividend distributions over the medium term. It should be noted that we have taken into consideration EEB's historical proven track-record of forgoing dividend distributions and providing subordinated shareholder loans to its other controlled subsidiaries.

Another important rating consideration is that in the absence of a committed credit facility Calidda is expected to maintain an adequate liquidity profile (in the form of a prudent cash balance) that will allow it to meet any unexpected cash flow shortfalls.

Rating Outlook

The stable outlook reflects our expectation that Calidda will successfully implement its expansion plans within the residential segment and that the regulatory environment will remain overall credit supportive. The stable outlook further considers management's target for Calidda to report over the medium term a Debt/EBITDA below 3.5x. It also reflects our expectation that, in the absence of committed credit facilities, the company will maintain adequate cash balances amid a responsible dividend policy so as to remain in a position to cope with any external shocks, particularly given its substantial capex program. The stable outlook assumes that Calidda will record credit metrics (mentioned earlier) that are appropriate for the rating category.

What Could Change the Rating - Up

The rating could be upgraded if the Peruvian government's sovereign rating is upgraded, if Moody's observes a more consistent application of all the regulatory mechanisms embedded in the framework, and if, upon completion of its current ongoing investment program, Calidda's liquidity profile over the medium term is very strong along with a significant improvement in its credit metrics such that its CFO pre-W/C to debt, interest coverage and RCF to debt exceed 17%, 4.5x, and 13%, respectively, on a sustainable basis.

What Could Change the Rating - Down

Calidda's rating could be downgraded if Moody's perceives that the issuer's liquidity profile is insufficient to comfortably cope with potential external shocks. Negative rating momentum could also result from unexpected changes in the regulatory framework that negatively impacts its ability to generate sufficient cash flows to help carry-out its planned capital investment program . Other negative events would include a downgrade of the Peruvian sovereign ratings, and/or if Calidda's majority shareholder, EEB, were to experience a multi-notch downgrade. Failure over the medium term to report credit metrics that are commensurate with the Baa-rating category, such that its CFO pre-W/C-to-debt and interest coverage that remain below 11% and 3x for an extended period, would likely trigger a downgrade. An aggressive future dividend distribution policy that results in the issuer reporting RCF to-debt below 7% on a sustainable basis, could also trigger a downgrade.

Other Considerations

The rating considers that Calidda's functional currency is the US$. This provides a natural hedge given that the bulk of its payables and 100% of the company's currently outstanding indebtedness is also denominated in that currency. However, as mentioned earlier, the company is exposed to some currency risk because of the mechanics of the payments of the residential customers bills. That said, we consider credit positive that a new hedging program based on the forecasted exchange rate Nuevos Solese/US$ (reviewed on a monthly basis) was approved and implemented starting this year.

As mentioned earlier, Moody's evaluates Calidda's financial performance relative to the low business risk option under the updated Regulated Electric and Gas Utility Methodology published in December 2013. As depicted in the grid below the company's indicated rating based on historical and projected credit metrics is Baa3. That is the same as the currently assigned senior unsecured rating.

Rating Factors

Gas Natural de Lima y Callao S.A. (Calidda)

Regulated Electric and Gas Utilities Industry Grid [1][2]	**Fiscal Year 12/31/2013**		[3]**Moody's 12-18 Month Forward ViewAs of May 2014**	
Factor 1 : Regulatory Framework (25%)	**Measure**	**Score**	**Measure**	**Score**
a) Legislative and Judicial Underpinnings of the Regulatory Framework	Baa	Baa	A	A
b) Consistency and Predictability of Regulation	Baa	Baa	Aa	Aa
Factor 2 : Ability to Recover Costs and Earn Returns (25%)				
a) Timeliness of Recovery of Operating and Capital Costs	Ba	Ba	A	A
b) Sufficiency of Rates and Returns	Baa	Baa	A	A
Factor 3 : Diversification (10%)				
a) Market Position	Ba	Ba	Baa	Baa
b) Generation and Fuel Diversity	N/A	N/A	N/A	N/A
Factor 4 : Financial Strength (40%)				
a) CFO pre-WC + Interest / Interest (3 Year Avg)	3.5x	Baa	3x-4.5x	Baa
b) CFO pre-WC / Debt (3 Year Avg)	12.1%	Baa	11%-19%	Baa
c) CFO pre-WC - Dividends / Debt (3 Year Avg)	12.1%	Baa	7% - 15%	Baa
d) Debt / Capitalization (3 Year Avg)	54.3%	Baa	50% - 59%	Baa
Rating:				
Grid-Indicated Rating Before Notching Adjustment		Baa3		Baa
HoldCo Structural Subordination Notching		0		0

a) Indicated Rating from Grid		Baa3		Baa
b) Actual Rating Assigned		Baa3		Baa

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. [2] As of 03/31/2014 (LTM); 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.