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Israel Electric corporation Ltd.

# Debt Management at Israel Electricity Corporation Ltd.

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## Background

The Israel Electricity Corporation Ltd (IEC) is a government and public company, with 99.85% of its shares held by the Israeli Government. The company generates electricity and provides it to all sectors of the Israeli economy. At the beginning of the previous decade the IEC faced a severe crisis following cessation of natural gas supplies from Egypt. The crisis reached its peak in 2012 and was one of the causes of severe deterioration in the company's financial position: its net financial debt totaled approximately NIS 52 billion, however since then there has been a significant improvement in its financial position. In 2018 two agreements were signed – an assets settlement between the State and the IEC and a structural change of the electricity sector arrangement (the electricity sector reform). One of the main principles of the reform is strengthening the IEC's financial position. These agreements brought a further reduction in the company's debt and improved its financial resilience.

## Key figures

**NIS 36 billion**

The IEC net financial debt in December 2019. In December 2020[1] – the debt decreased to NIS 30 billion, a decrease of 42.3% compared to its level in 2012.

**69%**

The actual leverage rate[2] at the IEC in 2020, and 72% in 2019. The financial leverage rate[3] in 2020 totaled 57% compared to 62% in 2019.

**4.4**

The debt ratio to EBITDA[4] in 2019 compared to a ratio of 8 in 2013. In 2020 the ratio was 3.99.

**3.79%**

The average interest rate on debt capital[5] in 2019. In 2020 the average interest rate was 3.49%.

1 The debt includes revenue's surplus following sale of the Ramat Hovav power generation plant – a total of NIS 2.433 billion.

2 Debt capital relative to the balance sheet.

3 The ratio between the financial debt and the financial debt with added owners' equity.

4 This index is not based on accepted accounting practices, and therefore there may be changes in the index values calculated by various bodies. The debt ratio to EBITDA in 2019 totaled 4.4 according to the IEC data compared to 5 according to the S&P rating company data. In 2018 the ratio was 4.82 according to the IEC data, but was 5.6 according to the Government Companies Authority data (which took the gross debt to EBITDA into account. The IEC relied on the net debt). In this report we have presented data from various sources and we have used the data from the same source to indicate trends.

5 Capital from external sources.

**50%**

The rate of debt in 2019 held by IEC out of the total company's debt issued in interest rate of 5% or more.

**61%**

The rate of decrease in debt from 2012–2019 due to tariff return. Of which 46% derived from return of costs caused by the fuels crisis and 15% from advance tariff payments given to IEC by the Electricity Authority. Alongside this, 17% of the decrease is explained by the assets settlement between the company and the State, 6% from sale of the Alon Tavor power plant, and the remaining decrease (16%) from additional actions taken by the IEC.

**NIS 5.9 billion**

The safety cushion held by IEC in December 2019. In December 2020 IEC held a safety cushion of NIS 6.46 billion.

**BBB**

The IEC international credit rating according to S&P company. The rating is higher by four notches[6] than the Stand Alone Credit Profile (SACP) of IEC, bb-.

## Audit actions

From April to December 2020 the State Comptroller's office audited the debt management at IEC. Among others, the actions taken by the IEC and the regulators to decrease the debt and reduce its costs were examined. The audit was carried out at the IEC, the Electricity Authority and the Government Companies Authority.

## Key findings

**The IEC risk level –** despite the improvement in the IEC's financial position between 2012–2019, the company's risk is perceived as high compared to that in similar electricity companies in Europe.

**Factors contributing to decrease in the IEC debt –** the decrease in debt and improvement in the financial position of the IEC over the past decade were achieved mainly as a result of tariff returns due to the fuels crisis and advance payments the company received from the Electricity Authority (total 61% of the decrease). The assets

6 The credit rating is divided into levels and each level is called a notch.

settlement contributed additional 17% to the decrease in debt, and sale of the Alon Tavor power plant provided further decrease of 6%. These actions together contributed in total 84% of the total decrease in debt. The remaining decrease is explained by actions taken by the company, most of which were at the expense of developing the electricity sector. This signifies that the decrease in debt is explained mainly due to disposable measures and not as a result of steps that are part of the company's ongoing operating activities.

**The interest rates in the company's bonds series at end of 2019 –** 12% of the company's bonds issued at a high interest rate of 7% – an interest rate that is much higher than the interest rate of bonds issued by the company in 2018, which decreased over the years following the improvements in the company's financial position and as a result of the relatively low interest rate in the financial markets. Half of the company's debt carries an interest rate of over 5%, which is twice the marginal interest rate in 2018.

**Resources allocated by IEC to improve its financial position from 2012–2019 and the development plan for 2018–2022 –** the planned investments for 2018–2022 total an average of NIS 3.2 billion annually. This level of investments is lower than the average of investments planned for 2013–2017, which totaled an average NIS 5.09 billion annually (for the maximum investments alternative) and are slightly higher than the minimal investments alternative set to reach an average annual investment of NIS 2.9 billion. Yet, the average investments between 2013–2017 was partial and totaled only NIS 1.8 billion annually. This indicates that the planned level of investments does not, therefore, compensate for the sub-investments in the previous development plan and it is doubtful whether the current development plan provides a sufficient response to the needs of the electricity sector. The audit raised a concern that the company is expected to fulfill the goals defined within the reform and the goals set by the board of directors, inter alia by postponing important projects.

**The IEC's safety cushion –** the five-year financial plan approved by the IEC board of directors, which presents the liquidity sources and uses by the company, and according to which the bond issuing plan, that is also included in the is five-year financial plan, is determined, do not reflect a ratio of 1.2, but a lower ratio.

**Normative average bond maturity of the IEC debt –** the Electricity Authority determined a normative average maturity that reflects the preference of mid-term structure of capital raising (7.1 years). The normative average maturity is short relative to the project life span and creates a disparity between the depreciation period on the asset and the debt repayment period, which increased the company's refinancing risks however reduces the capital costs and prevents tariff increase.

**The Stand Alone Credit Profile (SACP) of IEC –** the SACP (bb-) is lower by 4 notches than its general rating (BBB)[7] and belongs to the Below Investment Grade category. The rating indicates a high risk level in the absence of government support that the company receives.

**Risks to the continued improvement in the company's financial position –** major changes are occurring on the electricity sector, particularly concerning the government target of July 2020 to generate 30% of the electricity from renewable energies in 2030, entailing major investments, for a total of NIS 20 billion according to an initial estimate, by the IEC as the supplier of a vital service and as a monopoly in the transmission segment. The changes may affect the company's financial position and its ability to fulfill its goals as the supplier of a vital service.

**From 2012–2019 there was an improvement in the IEC financial position** expressed in a decrease of NIS 16 billion in its financial debt and improvements in the leverage level and in the company's liquidity. The raising terms of the Company were therefore improved, and its marginal interest for 2018 was 2.5%, the lowest since the company issued bonds for the first time.

# Key recommendations

It is recommended that IEC continue to act to improve its financial indicators, particularly the debt coverage ratios, the company's profitability and leverage, and at the same time examine its position from time to time compared to electricity companies worldwide. This examination may serve as an index for Company performance. It is further recommended that the company will base its continued activity to improve its financial resilience on efficiency and optimal management – and not by postponing vital activities in the electricity sector. Within this framework, it is recommended that the IEC examine the parameters that affect its stand-alone credit rating and continue to act towards its improvement, and reduce its dependence on government support.

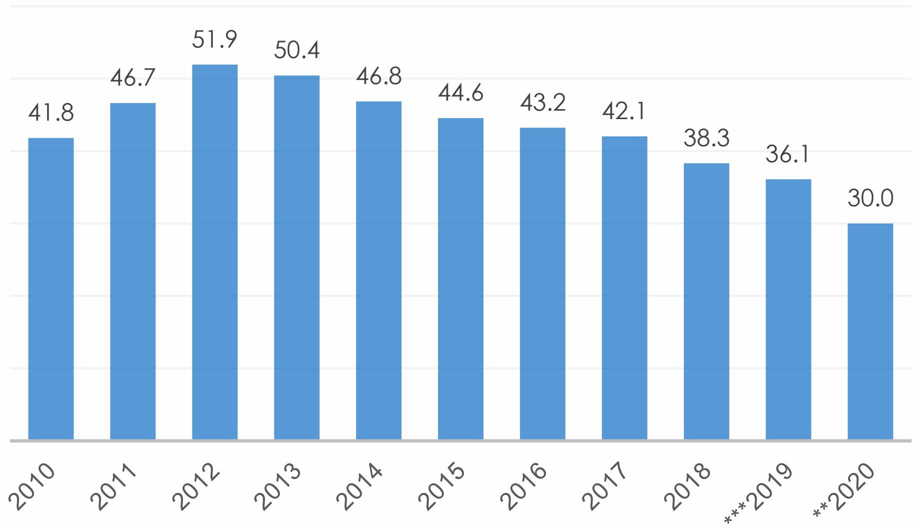
It is recommended that the IEC formulate a coherent procedure for ongoing examination of the benefits from taking actions to reduce debt costs.

Holding a sufficient safety cushion reduces the Company's risks and allows it to maintain its credit rating. At the same time, holding a safety cushion in surplus entails costs. IEC should continue to hold a safety cushion that will balance these two considerations.

7 Rating according to S&P. The credit rating by MOODY'S also shows that the baseline credit assessment (self-rating) (ba3) is 4 notches lower than the general rating (Baa2).

- The three entities – the IEC, the Ministry of Energy and the Electricity Authority – should examine the disparities between the development plans for the transmission grid for 2013–2017 and the development plan approved for 2018–2022. They should examine the effect of postponing the various projects in the electricity system and what measures are required in order to compensate these differences.
- It is recommended that the Government Companies Authority together with the Capital Market Authority, the Bank of Israel and IEC, examine the barriers IEC is facing in the process of raising capital in Israel. The Electricity Authority and the Companies Authority should examine the IEC bond raising characteristics and the average bond duration so that the Company's bond raising model will be optimal.
- The three entities – IEC, the Electricity Authority and the Ministry of Energy – should examine the challenges the electricity sector is facing in the coming years and their effect on the Company's financial position, and prepare for them alongside preserving IEC's financial resilience.

### The IEC's net financial debt, 2010–2020, in billions of NIS*




The source: the IEC financial statements for 2011–2020 processed by the State Comptroller's office.

* The data for 2014–2019 are according to the IFRS (International Financial Reporting Standards), whereas the data for 2010–2013 are according to the Government Companies Regulations in adjusted NIS.

** The debt in 2020 includes surplus collection due to the sale of the Ramat Hovav power plant for a total of NIS 2.433 billion, that will be returned to electricity consumers.

*** The debt in 2019 includes a surplus due to sale of the Alon Tavor power plant, which was returned to consumers in 2020.

## Summary

Over recent years the IEC debt decreased and its financial indicators improved. As a result, the company's capital raising conditions improved and its recent interest rates were at the lowest since the Company commenced raising capital. The improvement in the financial position of IEC over recent years and the reduction of its debt by 2017 are an amendment to the deterioration in its financial position following crises that the company faced, and a return to the situation prior to the fuel crisis and the global financial crisis of 2008 and 2009. In 2018 two agreements were signed between the IEC and the State, settlement of the assets and the reform on the electricity market, which lead to an additional improvement in the financial position of the IEC and to further reduction in the debt.

An analysis of the factors that brought about the debt reduction shows that most of the improvement is explained through disposable measures and not the result of routine measures taken in the company's ongoing operating activity. The operating actions taken to reduce the debt level contributed 16% of the debt decrease, which was done, among others, at the expense of investments in developing the electricity grid.

The audit also raised a concern that some of these requirements are not being resolved in the development plans for the coming years as well. At the same time, major changes occur in the electricity sector and these require extensive investments. This places the continued improvement in the company's financial situation at risk, and solutions will be required to carry out these changes without deteriorating the company's position. The IEC and government entities must provide the electricity economy requirements while at the same time maintaining the company's financial resilience.