STANDARD & POOR'S

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Research Update:

Italian Utility Hera SpA Outlook To Negative On Weakened Financial Profile; 'A/A-1' Affirmed

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Rationale

On June 17, 2008, Standard & Poor's Ratings Services revised its outlook on Italian multiutility Hera SpA to negative from stable. At the same time, the 'A' long-term and 'A-1' short-term corporate credit ratings were affirmed.

The outlook revision reflects Standard & Poor's concern about Hera's ability to maintain an adequate financial profile for the current ratings, owing to weaker-than-expected credit metrics, the potential for operating underperformance in 2008, and the risks associated with the ongoing discussions for a merger with two other Italian utilities.

The ratings on Hera reflect its relatively strong business profile, which is underpinned by a well-balanced portfolio to which low-risk monopoly-regulated operations contribute about 50% of EBITDA. The ratings also take into account Hera's strong franchise in the wealthy and populated northern Italian Region of Emilia-Romagna (A+/Stable/--).

These positive factors are offset, however, by Hera's increasing involvement in the riskier electricity generation business; a weakened financial profile; and a very aggressive dividend policy.

Hera is Italy's largest regional utility and serves about 70% of Emilia-Romagna's territory. The company's portfolio mix is balanced, with one-third of EBITDA stemming from waste, one-third from energy (gas and electricity), and one-third from water and other businesses in 2007.

Hera has started to discuss a merger with Iride SpA (not rated) and Enia SpA (not rated). We have not factored such a merger into the current ratings and would expect any transaction to be predominantly in shares.

Hera's performance was disappointing in 2007 and average in the first three months of 2008. At year-end 2007, funds from operations (FFO) to debt was about 17.5%, well below the level that we deem commensurate for the 'A' rating. A recovery of the financial profile could prove difficult in 2008 due to expected negative free cash flow, expected limited delays in some projects, and still high dividend payouts.

Liquidity

Liquidity is adequate. At Dec. 31, 2007, financing needs for the following 12 months included €249 million in short-term debt (including leases), approximately €85 million of dividend payments, and slightly negative free operating cash flow. These were fully covered by about €211 million in cash and cash equivalents, and €250 million in unused three-year committed credit lines. There are no financial covenants in the company's financing agreements and other covenants are easily manageable.

Hera's €800 million bonds contain a put option whereby bond investors can put the bonds back to Hera if the long-term corporate credit rating falls below 'BBB-' following a change of control.

The €300 million of puttable bonds issued in 2007 include a €200 million put bond where the bondholder will have the right to exercise its put (at par) every two years starting in August 2009, and a €100 million bond where the put can be exercised once, in May 2010. We would expect undrawn committed lines to fully cover the combined amount of puttable bonds well ahead of the first put date.

Outlook

The negative outlook is based on the current financial profile, which is not adequate for the rating. The ratings could be lowered if the company's financial profile does not improve substantially or if there is any operating underperformance or further credit-dilutive acquisitions/investments. To revise the outlook back to stable, we would need to feel comfortable that Hera can strengthen its FFO debt coverage to close to 25% over the next couple of years.

In addition, discussions about a merger with Enia and Iride lead to a number of uncertainties and may prevent Hera from reaching a financial profile commensurate with the ratings.

Possible Merger

Following years of small to midsize acquisitions, a merger with Iride SpA and Enia SpA would be a significant transaction for Hera, thus incurring more operational risks than previous deals. We expect the combination, if well executed, to be positive from a business perspective, given the companies' geographic proximity and the similarity of their portfolios. This should strengthen Hera's competitive position and create synergy opportunities. We understand that no progress on the potential merger is expected in the near future.

Ratings List

	To	From
Corporate credit ratings	A/Negative/A-1	A/Stable/A-1

NB: This list does not include all ratings affected.

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