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Research Update:

Open Grid Europe Group Outlook Revised To Stable From Negative On Increased Visibility After Regulatory Reset

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Research Update:

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Overview

- Germany-based gas transmission system operator Open Grid Europe Group (OGE), which comprises Vier Gas Transport GmbH and its subsidiary Open Grid Europe GmbH, has increased visibility on regulatory remuneration.
- The company is still exposed to elevated investments during the next regulatory period starting 2018. However, we forecast metrics will be in line with our expectations for the ratings.
- We are affirming our 'A-' long-term and 'A-2' short-term ratings on OGE, and revising the outlook to stable from negative.
- The stable outlook reflects our view that OGE's credit metrics will gradually recover following a decline in 2018 due to a regulatory period reset and increasing regulatory asset base (RAB).

Rating Action

On April 30, 2018, S&P Global Ratings revised its outlook on Germany-based gas transmission system operator Open Grid Europe Group (OGE) to stable from negative. At the same time, we affirmed the 'A-/A-2' long- and short-term issuer credit ratings on OGE, which comprises Vier Gas Transport GmbH and its subsidiary Open Grid Europe GmbH.

We also affirmed our 'A-' issue ratings on OGE's senior unsecured debt.

Rationale

The outlook revision reflects increased visibility on the impact of a regulatory period reset beginning 2018, and our expectation of the company's ongoing solid cash flow generation from regulated earnings. Although we see limited financial headroom within the rating in the near term due to elevated investments, we believe recent developments should be credit supportive for metrics to recover starting after 2018, somewhat mitigating the impact of significant lower equity remuneration upon regulatory period reset.

We continue to assess OGE's financial risk profile as significant, although we expect the adjusted funds from operations (FFO)-to-debt ratio to decline toward 10% in 2018 from 12.2% in 2017. The forecast decline is mainly driven by the continuation of the extensive investment program as per the German Network Development Plan, of which OGE shoulders the lion's share, and lower remuneration.

We would expect the company to keep annual dividends below €80 million (about €55 million in 2016/2017) until the FFO-to-debt ratio returns sustainably to 12%.

In the coming two years about 70%-80% of the company's total capital expenditures (capex) will fall under the so-called "investment measures" (IM), for which we see limited execution risk and anticipate full and immediate cost recovery. IMs allow gas and electricity transmission system operators to increase the revenue cap under the German regulatory framework to account for full coverage of growth and extraordinary expenditures; more specifically, investments that are deemed necessary for energy transition in Germany, grid stability, and international integration of the German network.

The Bundesnetzagentur, the German regulator, has reduced the return on equity to 6.91%/5.64% from 9.05%/7.39% (pretax/post-tax on new assets) and to 5.12%/4.17% from 7.14%/5.83% (pretax/post-tax on old assets), which we consider in our base case. Following the ruling of the Higher Court in Dusseldorf, Germany, the remuneration was, however, considered too low. As a result, the regulator appealed the decision at the German Supreme Court on April 25, 2018. A resolution of the dispute could be delayed until 2020, which then would be implemented retroactively. We understand this could be credit positive compared with the initial determination, however this is currently not included in our base case. Further, we have incorporated in our base case the regulator's decision to set the general efficiency target to 0.5% from currently 1.5% and set the company's individual efficiency factor at 100% for the regulatory period starting in 2018. Cash flow volatility due to regulatory-account effects should be reduced from 2018 because deviations from anticipated transport volumes are being compensated over a period of three years with a two-year delay as opposed to within one year.

We continue to view OGE's business risk profile as excellent, which benefits from the low-risk environment in the regulated utilities industry, including our view of the regulatory framework for the group's gas transmission network being relatively stable and predictable (see "Why We See Germany's Electricity And Gas Regulatory Framework As Supportive," published Nov. 21, 2016, on RatingsDirect). OGE is Germany's largest gas transmission network operator, with a grid length of about 12,000 kilometers, covering about 70% of gas transport in transmission networks. Almost all of OGE's operations stem from German regulated gas transmission activities.

In our base case, we assume:

- An efficiency factor of 100% for the regulatory period 2018-2022 (the third regulatory period).
- An average productivity factor of 0.49% over the third regulatory period.
- An imputed return on equity on new assets of 9.05% for the second

regulatory period and 6.91% for the third.

- A return on excess equity of 3.03% for the third regulatory period.
- Extensive capex of about €1.35 billion over 2018 and 2020, above 70% of which falls under "investment measures".
- Increased capex driving the RAB increase.
- High capex relative to expected operating cash flow, leading to negative free operating cash flow of about €100 million-€200 million in 2018 and 2019.
- Expected dividend outflow of approximately €70 million-€80 million annually.
- Significant negative cash flow after capex and dividends over the coming two years.

Based on these assumptions, we arrive at the following credit measures:

- Adjusted FFO to debt of above 10% in 2018, gradually increasing to about 12% by 2020; and
- Debt to EBITDA of 6.0x-6.5x.

Liquidity

We view OGE's liquidity as adequate and project that the group's ratio of liquidity sources to uses is above 1.1x for the 12 months ending March 31, 2019.

OGE's liquidity profile is further supported by its well-established relationships with its core banks, no financial covenants, and prudent risk management.

We note that the OGE has increased its committed revolving credit facility (RCF) to €600 million from €200 million, which we view as beneficial to liquidity.

The next major debt maturity is the 2020 €750 million bond refinancing.

We calculate the following principal liquidity sources for the 12 months from March 31, 2018:

- Reported access to unrestricted cash and short-term marketable securities of about €200 million.
- Positive operating cash flow generation of above €300 million over the next 12 months.
- Access to unused RCFs totaling €625 million, of which about €25 million matures in 2019.

We calculate the following principal liquidity uses as of the same date:

- Debt maturities of about €60 million.

- Capex of about €500 million.
- Expected cash dividends of €70 million-€80 million in 2018.

Outlook

The stable outlook reflects our view that OGE's credit metrics will gradually recover following a decline in 2018 due to lower remuneration after a regulatory period reset beginning in 2018, as well as elevated capex as per the Network Development Plan (NDP). We expect adjusted FFO to debt will remain above 10% in 2018, and thereafter recover to about 12% by 2020 thanks to increasing regulated earnings.

Downside scenario

We will consider a downgrade if we believe that OGE's credit metrics will not steadily recover post 2018, with FFO to debt set to reach about 12% by 2020. This could occur due to any of the following reasons, or a combination thereof: lower dividends received from equity accounted investees; significant increases of debt-financed investments, especially non-IM capex, which expose the company to higher execution risk; adverse regulatory decisions; or any further increase in dividend payments.

Upside scenario

Rating upside appears remote currently, but could result from a sustained improvement in credit metrics, such that the financial risk profile improved to intermediate, including adjusted FFO to debt of at least 15%. This could result from lower dividend payments and capex, which would in turn lead to a significant reduction in adjusted debt.

Ratings Score Snapshot

Issuer Credit Rating: A-/Stable/A-2

Business risk: Excellent
- Country risk: Very low
- Industry risk: Very low
- Competitive position: Strong

Financial risk: Significant
- Cash flow/Leverage: Significant

Anchor: a-

Modifiers
- Diversification/Portfolio effect: Neutral (no impact)

- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable ratings analysis: Neutral (no impact)

Issue Ratings--Subordination Risk Analysis

Capital structure

Above 90% of financial debt outstanding is at the HoldCo Vier Gas Transport GmbH.

Analytical conclusions

The issue rating on OGE's senior unsecured debt is 'A-', in line with the issuer credit rating, as no significant elements of subordination risk are present in the capital structure.

Related Criteria

- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Corporates - Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Ratings Affirmed; Outlook Action

	To	From
Open Grid Europe Group		
Issuer Credit Rating	A-/Stable/A-2	A-/Negative/A-2
Senior Unsecured	A-	A-

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Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.