Research Update:

Vier Gas Transport Outlook Revised To Negative On Weaker Expected Financial Performance; 'A-/A-2' Ratings Affirmed

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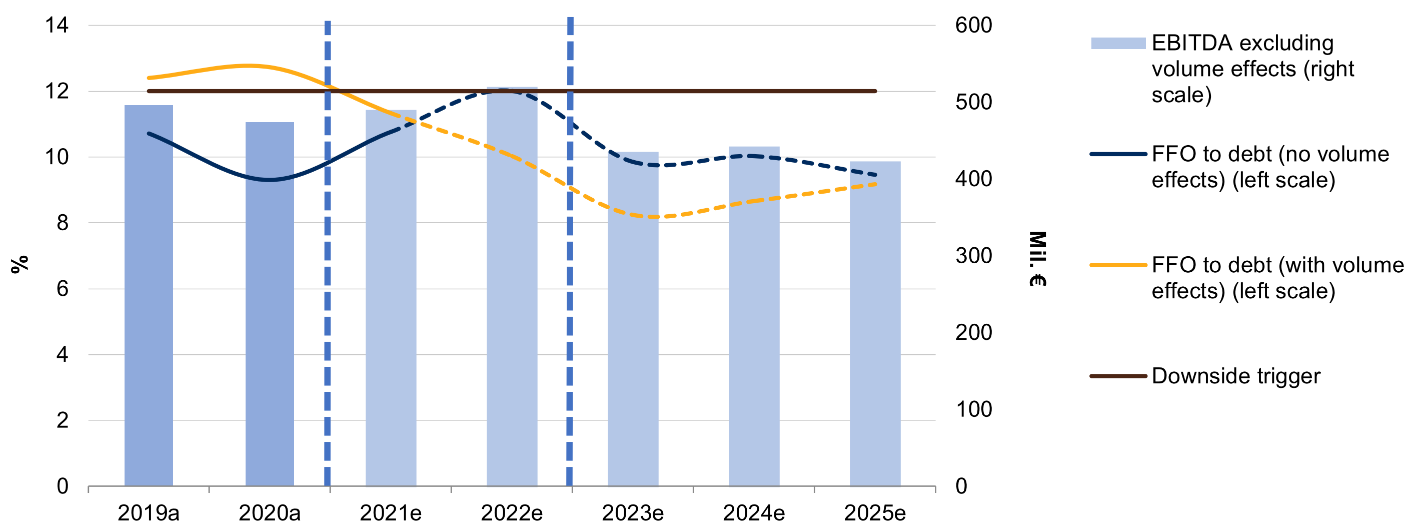
Rating Action Overview

- We expect the financial performance of Vier Gas Transport GmbH (VGT) will deteriorate over the medium term because of continued pressure on regulatory returns, limited financial flexibility, and lower investment opportunities.
- Although there is uncertainty around the parameters for the next regulatory period, we believe a favorable review of the parameters for the regulatory period starting in 2023 could partially mitigate the drop in financial performance.
- We have revised our liquidity assessment to strong from adequate.
- We have revised our outlook on VGT to negative from stable and affirmed the 'A-/A-2' ratings.
- The negative outlook reflects our view that lower regulatory returns, limited dividend flexibility and limited growth opportunities could result in a funds from operations (FFO) to debt trajectory consistently below 12%, which we see as consistent with the 'A-' rating.

Rating Action Rationale

The outlook revision reflects our expectation that VGT's financial performance will deteriorate over the medium term, both including and excluding regulatory account effects. VGT's metrics are influenced by volume effects under the German regulatory framework, which result in artificial volatility in credit metrics and in a difference between the group's reported results and sustainable financial performance (which excludes volume effects). These deviations cancel out over time. As such, we forecast the group's metrics will be at or below 12% under both optics in 2021-2022, due to a reduction in lump-sum remuneration for investment measures (IMA) as of 2020, which will slash about €140 million in profits from the change in regulation in 2020 until the end of 2022, which marks the end of the current regulatory period. We believe the group will struggle to reverse the trend in the event of an unfavorable regulatory outcome for the period starting in 2023. We see an unfavorable outcome as likely, given our expectation that the regulator, Bundesnetzagentur (BNetzA), will reduce the return on equity (ROE). All other things remaining equal, such a reduction would result in lower remuneration for VGT.

FFO To Debt Trends Below Our Downside Trigger For The Rating
We expect the trend to continue over the regulatory period starting in 2023



a--actual. e--Estimate. FFO--Funds from operations. Source: S&P Global Ratings.
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Declining investment opportunities limit EBITDA growth potential over the medium to long term. We view the German regulatory framework as more favorable than other European frameworks because of its transparency, stability, and because it still fosters the expansion of gas transmission infrastructure. This is reflected in the €8.5 billion required investments in the gas grid over the 2020-2030 network development plan (NDP). Nevertheless, we believe investments are declining for VGT, reflecting that the business is reaching maturity. In our opinion, this will limit VGT's capacity to counterbalance a potential unfavorable regulatory outcome by expanding its regulated asset base (RAB), as it has done in the past. We expect the group to finalize 50% of the €1.8 billion investments planned under the 2020-2030 NDP by 2021, which includes its ZEELINK gas transmission pipeline. Although there are still some medium-size projects over 2021 and 2022, such as the expansion of the TENP transmission pipeline and the Rimpar compressor station under the MEGAL pipeline, we expect VGT's yearly investments to decline to about €300 million over 2021-2023 from a yearly average of €450 million in 2019 and 2020, and continue declining after 2023.

The group has limited financial flexibility to maintain the rating at the 'A-' level. VGT has in the past shown willingness to reduce shareholder remuneration to protect its credit metrics, which we see as an indication of the group's commitment to retaining its credit quality. However, we estimate that any dividend cut would at most improve FFO to debt by about 20-40 basis points over the next two years, which would be insufficient to reverse the current deteriorating trend. In addition, we believe there would be less incentives to reduce dividends in the short term if

Macquarie decides to divest its 24.13% stake in VGT.

We see the setting of regulatory parameters and capital expenditure (capex) remuneration framework as key milestones for VGT's credit quality. There are still factors that could help mitigate the declining trend in financial metrics over the medium term. For example, BNetzA has yet to approve regulated costs resulting from photo year 2020. The photo year is the benchmark year used by the regulator to measure regulated costs, and determine the revenue cap over the next regulatory period. In addition, a lower-than-expected decline in ROE rates, or a favorable revision of the efficiency factor (X-gen), which is the rate at which regulated revenue annually declines for a grid operator over a regulatory period, could mitigate the drop in profitability. We will update our base-case scenario once BNetzA determines these parameters, which we expect to occur over the next 12-18 months. Moreover, we understand that there are ongoing discussions to change the capex remuneration methodology from IMA to capital cost adjustment (CCA) from 2023. Under a CCA mechanism, the RAB is updated every year for replacement capex, which could bode well for VGT's maturing business. However, there are other aspects regarding capex remuneration pending of revision for the next regulatory period. The outcome of this revision could have positive or negative effects on VGT's revenue cap, but we cannot quantify the effect in our base-case scenario with the information available today. A regulatory framework to remunerate and recover costs on hydrogen infrastructure could also provide further investment stimulus; however, we don't see this as a realistic opportunity at least over the next three years.

Outlook

The negative outlook on VGT reflects our view that likely lower regulatory returns, limited dividend flexibility, and declining growth opportunities could result in an FFO-to-debt trajectory trending toward 10%-11% on average over the medium term, which is below our 12% downside trigger for the 'A-' rating.

Downside scenario

We could downgrade VGT over the next 12-18 months if an unfavorable outcome of the regulatory revision for the next regulatory period results in parameters such that the group is unable to regain FFO to debt above 12% on sustainable basis.

As such, a determination for capex remuneration over the next regulatory period that reduces VGT's profitability could also result in a downgrade. In addition, lack of growth prospects due to political decisions that soften the relevance of gas infrastructure or a new shareholder not committing to VGT's credit strength, for example via dividend flexibility, could also pressure metrics and result in a downgrade.

Upside scenario

We would revise the outlook to stable if VGT posted FFO to debt above 12% on average. This could result from a favorable regulatory reset, or further investment stimulus over the medium term coming from the adoption of a regulated framework for hydrogen infrastructure.

Company Description

VGT is the parent company of Open Grid Europe GmbH (OGE), the largest of Germany's 16 gas transmission system operators. Through OGE, the group designs, constructs, operates, and markets gas transmission networks. As of 2020, almost all of VGT Group's revenue come from its gas transportation business, with services to pipeline companies and third parties accounting only for a small part of the remainder.

OGE transmits gas through its 12,000-kilometer network, making it the largest supraregional pipeline network in Germany. Its pipeline systems connect the border-crossing points to cities, municipalities, and industrial users in German regions and to pipeline systems of neighboring countries, such as Netherlands, Belgium, France, Switzerland, Austria, and the Czech Republic.

The Vier Gas Transport Group comprises VGT (the parent), its subsidiary OGE, and its equity investments, which include a number of gas transmission assets with different levels of ownership. VGT largely performs a holding company function for OGE. Vier Gas Services GmbH & Co. KG is the sole shareholder of VGT. It is a long-term investment consortium including British Columbia Investment Management (32.15%), Abu Dhabi Investment Authority through Infinity Investments (24.99%), Macquarie and associated LP (24.13%), and Munich Re (18.73%).

Our Base-Case Scenario

Assumptions

- We assume ROE I on new assets at 6.9% and ROE II on existing assets, activated before 2006, of 5.1% until 2022, which marks the end of the current regulatory period. An Xgen factor of 0.49% and individual efficiency factor of 100%.
- We assume reduced lump-sum operating expenditure allowances on IMA investments until 2022.
- EBITDA margins declining to 47% in 2021 and 43% in 2022, mostly due to regulatory account effects. We expect EBITDA to increase excluding regulatory account effects until 2022.
- Capex at about €330 million-€340 million in 2021, declining to €240 million- €250 million in 2022 as the ZEELINK project is completed. In 2022, we expect the TENP expansion and the MEGAL Rimpar project to consume most of the capex.
- Dividend distributions of about €100 million in 2020 and about €60 million in 2021
- Capex intensity, coupled with sustained shareholder remuneration, to result in negative discretionary cash flows and slightly increase the group's financing needs in 2021 and 2022.

Key metrics

Vier Gas Transport GmbH -- Key Metrics*

(Mil. €)	2019a	2020a	2021f	2022f
EBITDA	542.8	577.2	495-515	450-470

Vier Gas Transport GmbH -- Key Metrics* (cont.)

(Mil. €)	2019a	2020a	2021f	2022f
Funds from operations (FFO)	381.7	418.3	365-385	325-345
Capex	472.4	419.9	330-340	240-250
Debt to EBITDA (x)	5.7	5.7	6.4-6.6	7.1-7.3
FFO to debt (%)	12.4	12.7	11-12	10-11
DCF to debt (%)	(8.5)	(5.7)	0-(2)	0-(2)

*All figures adjusted by S&P Global Ratings. Credit metrics are reflected including regulatory account effects (i.e. on accounting basis)
a--Actual. f--Forecast. Capex--Capital expenditure. DCF--discretionary cash flow.

Credit metrics will improve until 2022 without regulatory account effects. Over 2021 and 2022, credit metrics including and excluding regulatory account effects will show opposite trends. We estimate FFO to debt at about 10.5%-11% in 2021 and 11.5%-12% in 2022 excluding regulatory account effects (see chart above). The main difference is explained by €17 million returned to the market in 2021 and €59 million recovered in 2022, which we assume directly flow to EBITDA.

Liquidity

We now assess VGT's liquidity as strong, from adequate previously, because we forecast sources to uses over 2.0x over 2021 and 2022. The liquidity position has improved following refinancing of €750 million in 2020. Our assessment also includes qualitative factors, such as proven access to debt capital markets and sound relationships with banks, reflected in the group's diverse sources of funding. We also believe the group displays prudent risk management that underpins its liquidity position. There are no major refinancing needs until 2023, when a €750 million bond is due.

Although the sources to uses and sources minus uses tests are above 2.0x over the next 24 months, we believe that the group's liquidity commitment is not strong enough to sustain an excellent score.

Principal liquidity sources:

- Reported access to unrestricted cash and short-term marketable securities of about €69 million.
- Positive operating cash flow generation of above €391 million annually over the next 12 months.
- Access to unused revolving credit facilities totaling about €600 million.
- Working capital inflows of about €10 million.

Principal liquidity uses:

- Debt maturities in the next 12 months of about €72 million.
- Capex of about €340 million-€350 million.
- Cash dividend payments of about €100 million in 2021.

Issue Ratings - Subordination Risk Analysis

Capital structure

As of Dec. 31, 2020, the group's capital structure consists of:

- €3 billion bonds issued at the VGT level; and
- €224 million at the pipeline company level, which is reported at pro-rata share (51%).

Analytical conclusions

We rate VGT's debt at the level of the issuer credit rating, because we believe debt sitting at pipeline companies does not represent a material disadvantage to bondholders.

Ratings Score Snapshot

Issuer Credit Rating: A-/Negative/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: Strong (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- 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
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- Criteria | Corporates | Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010

Related Research

- Vier Gas Transport GmbH, May 7, 2020

Ratings List

Ratings Affirmed; Outlook Action

	To	From
Vier Gas Transport GmbH		
Issuer Credit Rating	A-/Negative/A-2	A-/Stable/A-2
Senior Unsecured	A-	

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. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 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.

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