

Research Update:

# Germany-Based Vier Gas Transport Downgraded To 'BBB+' On Weaker Financial Performance

July 8, 2022

## Rating Action Overview

- We expect the financial performance of transmission system operator Vier Gas Transport GmbH (VGT) to weaken over 2022 and 2023 because of continued pressure on regulatory returns, limited financial flexibility, and lower investment opportunities.
- Although the parameters for the next regulatory period starting in 2023 are uncertain, we don't believe they could mitigate the drop in financial performance. We now expect FFO to debt in the 9%-11% range on average over the coming years, compared with 12%-14% in 2019-2021, due to lower regulatory returns.
- We therefore lowered our rating on VGT to 'BBB+' from 'A-' and affirmed the 'A-2' short-term rating.
- The stable outlook indicates that we expect VGT to be in a position to keep its FFO to debt within 9%-12% on average over the next two years.

## Rating Action Rationale

**We downgraded Vier Gas because its financial performance is deteriorating, both including and excluding regulatory account effects, and we now expect FFO to debt to remain in the range of 9%-11% on average.** We expect VGT's credit metrics will deteriorate over the medium term as compensation from the regulator shrinks (see chart). The decrease in profitability was the reason behind our outlook revision to negative from stable in April 2021, and we expect this trend will continue over 2022 and 2023, which is driving the downgrade of VGT to 'BBB+'. While not all parameters for the new regulatory period have been published, we don't expect them to significantly affect our forecast credit ratios. VGT's metrics are influenced by regulatory account 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, but we forecast FFO to debt both with and without regulatory effects to be sustainably below the previous 12% rating trigger. With expected return on equity (RoE) to be reduced according to Bundesnetzagentur

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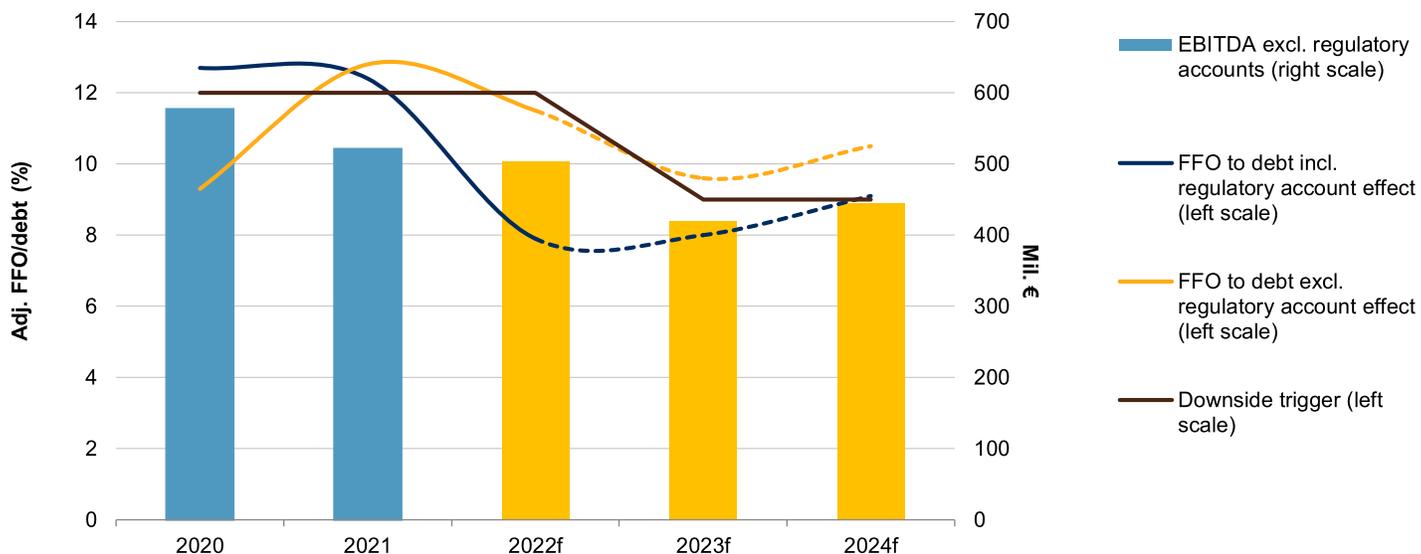
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(BNetzA) to 5.07% for the fourth regulatory period (compared with 6.9% in the third), and 3.5% (compared with 5.1%), we see clear evidence of increased pressure on VGT's profitability.

Chart 1

**We Forecast Credit Metrics Will Soften And Have Therefore Downgraded VGT One Notch To 'BBB+'**



f--Forecast. Source: S&P Global Ratings.

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**Declining investment opportunities limit EBITDA growth potential over the medium to long term.**

We expect VGT will report lower investments over the medium-to-long term, given that its business is slowly reaching maturity. We forecast adjusted capital expenditure (capex) of about €230 million-€270 million over the next two years, down from about €420 million in 2020 and €280 million in 2021. From 2024, we expect a slight further decline as a result of decreasing Network Development Plan investments. While lower investment implies positive discretionary cash flow, it also implies lower generated return EBITDA going forward. Despite Germany's favorable regulatory framework, we see limited capacity for VGT to counterbalance less favorable developments in the regulatory framework by expanding its regulatory asset base (RAB). We believe this could change if and when more investments are directed toward hydrogen assets, but that is likely more over the medium term. We also acknowledge the potential for near-term additional investment in traditional gas infrastructure, in the context of Germany achieving energy independence from Russia.

**Lower gas volume effect flow from Russia should not affect VGT.** VGT's revenue is based upon its RAB, with limited volume risk. The operating model should therefore not be affected by the lower gas flow from Russia, effective from June 16, 2022.

## **Outlook**

The stable outlook reflects our view that VGT will continue to benefit from stable fully regulated activities under one of the most supportive regulatory frameworks for gas infrastructure in Europe, and that it will be able to sustain FFO to debt between 9% and 11% over the next two years.

## **Downside scenario**

We could downgrade VGT if the company were to post FFO to debt below 9% on average. We see this scenario as unlikely, but it could happen if regulatory returns over the 2023-2027 regulatory period are set substantially below our expectations.

## **Upside scenario**

We would upgrade VGT if the group were to post 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 2021, almost all of VGT Group's revenue comes from its gas transportation business, with services to pipeline companies and third parties accounting for only a small part of the remainder.

OGE transmits gas through its 12,000-kilometer network, making it the largest supra regional 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 the 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**

- RoE I on new assets at 5.07% and 3.5% RoE I on old assets over the 2023-2027 regulatory period. We also assume an Xgen factor of 0.49% and individual efficiency factor of 100%.
- In the fourth regulatory framework, we assume operating expenditure lump sum for investment

measure (IMA) in line with the third regulatory period.

- EBITDA margins declining to 37% in 2022 and 40% in 2023, mostly due to regulatory effects. We also expect EBITDA to decrease, excluding regulatory effects from this year.
- Capex of about €230 million-€270 million over the next two years, slightly declining thereafter as a result of decreasing Network Development Plan investments.
- Dividend distributions of about €70 million in 2022 and about €100 million in 2023.
- Lower profitability and relative capex intensity, coupled with sustained shareholder remuneration, expected to result in negative discretionary cash flow in 2023.

## Key metrics

### Vier Gas Transport GmbH -- Key Metrics\*

(Mil. €)	2020a	2021a	2022f	2023f
EBITDA	577.2	521.2	380-400	370-390
Funds from operations (FFO)	418.3	407.9	250-280	270-290
Capex	419.9	280	230-270	250-280
Debt to EBITDA (x)	5.7	6.3	8.5-9.0	8.7-9.4
FFO to debt (%)	12.7	12.4	7.7-8.0	7.9-8.1

a--Actual. F--Forecast. Source: S&P Global Ratings.

## Liquidity

We assess VGT's liquidity as strong because we forecast sources to uses over 2.0x in the 12 months following March 31, 2022, and above 1.0x in the following 12 months. 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. The next major refinancing is a €750 million bond, which is due after second-quarter 2023 and is a sizable part of the capital structure. We expect VGT to refinance the bond well ahead of maturity.

Principal liquidity sources:

- Reported access to unrestricted cash and short-term marketable securities of about €96 million.
- Positive operating cash flow generation of above €270 million annually over the next 12 months.
- Access to unused revolving credit facilities totaling about €600 million, which mature in August 2024.
- Working capital inflows of about €60 million.

Principal liquidity uses:

- No debt maturities in the next 12 months, however €750 million in the 24-month timeframe.
- Capex of about €230 million-€270 million per year.

- Cash dividend payments of about €70 million in 2022.

## **Environmental, Social, And Governance**

### **ESG credit indicators: E-3, S-2, G-2**

Environmental and social aspects are relevant to VGT Group's business. Although not yet a relevant component of the company's earnings, we see the efforts in green hydrogen pioneering as relevant. On one hand, this contributes to sparking the discussion on the adoption of clean energies and decarbonizing the German economy as well as updating the framework that supports it. On the other hand, these are the first steps toward ensuring the long-term sustainability of VGT Group's business, because gas infrastructure relevance will decline as the energy mix moves toward zero carbon emissions.

Notwithstanding this, for now, the German energy transition creates opportunities for gas infrastructure companies, such as OGE. In our opinion, gas will remain a crucial component for the transition to the medium and long-term energy mix, particularly in light of plans to shut down coal generation by 2038 and the nuclear shutdown in Germany scheduled for 2022.

The majority of VGT Group's capex is related to the Network Development Plan, which represents gas infrastructure that will be key for the energy transition in Germany and is fully aligned with country's long-term climate policy.

We believe that the company's technical and operational standards will continue to ensure a high degree of network security and reliability, thereby mitigating environmental risks over the coming years, which is key to managing regulatory risk and public opinion.

In our view, VGT Group's management and governance framework meets industry standards and is particularly driven to align stakeholder interests toward long-term sustainability goals.

## **Issue Ratings - Subordination Risk Analysis**

### **Capital structure**

As of Dec. 31, 2021, the group's capital structure consists of:

- €3 billion of 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	BBB+/Stable/A-2
Business risk:	Excellent
Country risk	Very low
Industry risk	Very low
Competitive position	Strong
Financial risk:	Aggressive
Cash flow/leverage	Aggressive
Anchor	bbb
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	Positive (+1 notch)

## Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- 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: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- 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: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010

## Related Research

- Vier Gas Transport Outlook Revised To Negative On Weaker Expected Financial Performance; 'A-/A-2' Ratings Affirmed, April 29, 2021

## Ratings List

### Downgraded; Outlook Action; Ratings Affirmed

	To	From
<b>Vier Gas Transport GmbH</b>		
Issuer Credit Rating	BBB+/Stable/A-2	A-/Negative/A-2
Senior Unsecured	BBB+	A-

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