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Research Update:

Vier Gas Transport GmbH (Open Grid Europe Group) Outlook Revised To Negative; Affirmed At 'A-/A-2'

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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, faces increasing investments and lower allowed returns during the next regulatory period starting 2018.
- We believe this will result in OGE's credit metrics weakening in the near to medium term, although we recognize that the investments should support a growing regulatory asset base and provide stable cash flows.
- We are therefore revising our outlook on OGE to negative from stable and affirming our 'A-/A-2' ratings.
- The negative outlook reflects the risk of credit metrics falling below our expectations for the current ratings for a prolonged period.

Rating Action

On April 27, 2017, S&P Global Ratings revised its outlook on Germany-based gas transmission system operator Open Grid Europe Group (OGE), which comprises Vier Gas Transport GmbH and its subsidiary Open Grid Europe GmbH, to negative from stable. At the same time, we affirmed our 'A-/A-2' long- and short-term corporate credit ratings on the company.

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

Rationale

The outlook revision reflects the increasing investments the group will have to undertake as part of its revised network development plan, as well as the lower allowed return on equity during next five-year regulatory period starting 2018. Although all parameters for the next regulatory period are not yet set, including efficiency factors and a revenue cap, we believe that there is a risk that OGE's credit metrics will weaken below our expectations for the current ratings, including adjusted funds from operations (FFO) to debt falling further below 12%. We recognize that the investments should be earnings accretive and support a growing regulatory asset base. At the same time, we believe there is execution risk attached to the material capital expenditure (capex) plan, and we are also uncertain as to the extent the group and its shareholders are able and willing to mitigate declining credit metrics, for example by cutting shareholder returns.

The affirmation incorporates our view that OGE will maintain its excellent business risk profile, which benefits from the very low risk environment in the regulated utilities industry, including our view of the regulatory framework for the group's gas transmission network being very stable and predictable (see "Why We See Germany's Electricity And Gas Regulatory Framework As Supportive," published Nov. 21, 2016, on RatingsDirect). OGE, which comprises the holding company Vier Gas Transport GmbH and gas transmission system operator Open Grid Europe GmbH, 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.

We expect that OGE will maintain its focus on its core business as the leading gas transmission operator in its service area, as well as its high level of operating efficiency, and high-quality network in terms of safety and reliability.

We continue to assess OGE's financial risk profile as significant, reflecting our base-case forecast of OGE's ratio of adjusted FFO to debt of about 12% on a weighted average basis between 2015-2019. In our ratio calculation, we weigh each of the five years equally to capture volatility over the period, for example triggered by the regulatory account mechanism. However, over a regulatory period, we view OGE's earnings as very stable, resulting in low volatility of cash flows, which we take into account when benchmarking OGE's credit metrics and assessing its financial risk profile.

In our base-case scenario we assume:
- An efficiency factor of 100% for both the second and third regulatory periods, 2013-2017 and 2018-2022, respectively.
- An average productivity factor of 1.5% for both the second and third regulatory periods.
- An imputed return on equity new assets of 9.05% for the second regulatory period and 6.91% for the third.
- An imputed return on equity old assets (max 40%) of 7.14% for the second regulatory period and 5.12% for the third.
- A return on excess equity of 4.19% for the second regulatory period and 3.03% for the third.
- Total capex of €1.4 billion for 2017-2019.
- Cash dividends of about €50 million annually.
- No material impact from economic development in Germany or other countries, given the regulated nature of its operations.

Based on these assumptions, we arrive at the following credit measures:
- Adjusted FFO to debt of about 10%-12% per year; and
- Debt to EBITDA of approximately 5.5x-6.5x.

Liquidity

We view liquidity position assessment on OGE as adequate and project that the group's ratio of liquidity sources to uses is at about 1.3x for the 12 months from March 31, 2017.

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 company is currently in the process of increasing its revolving credit facility (RCF) within the coming months, which could improve our liquidity assessment.

We calculate the following principal liquidity sources for the 12 month from March 31, 2017:

- Reported access to unrestricted cash and short-term marketable securities of about €260 million.
- Positive operating cash flow generation of above €300 million over the next 12 months.
- Access to an unused RCF totaling about €210 million, of which about €200 million matures at end-2018.

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

- Debt maturities of about €40 million (maturing July 2017).
- Capex of about €500 million.
- Working capital outflows of about €50 million.
- Cash dividend payments of €44 million in 2017.

Outlook

The negative outlook reflects that OGE faces increased investments and lower allowed return on equity for the regulatory period starting 2018, which could result in its credit metrics falling below our expectations for the ratings for a prolonged period, unless mitigated by proactive countermeasures by the group and its shareholders.

Downside scenario

We could consider a downgrade in the next 6-24 months if we believe that OGE's credit metrics will fall below our expectations for the ratings for a prolonged period, and that adequate countermeasures are not being taken by the group or its shareholders. This would include adjusted FFO to debt moving toward 11% on an equally weighted-average basis.

This could occur if OGE were subject to any of the following or a combination thereof: weaker operating performance, for instance driven by adverse regulatory decisions on efficiency scores and the revenue cap; less dividends received from equity accounted investees; higher-than-expected refinancing costs; poor execution of investments; or a further increase in debt-financed investments.

We could also lower the ratings if OGE's business risk profile deteriorated below our current excellent assessment due to materially adverse regulatory changes or a shift in the business mix toward what we regard as riskier industries and countries, although we view such a scenario as unlikely.

Upside scenario

We would revise the outlook to stable if we are confident that credit metrics will remain in line with our expectations for the ratings, including FFO to debt at about 12% on a weighted-average basis, along with improved visibility on a supportive and flexible dividend policy.

Ratings Score Snapshot

Corporate 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: Adequate (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable ratings analysis: Neutral (no impact)

Related Criteria

- 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 - 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: Group Rating Methodology, 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
- Criteria - Corporates - General: 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

Ratings List

Outlook Action; Ratings Affirmed

	To	From
Open Grid Europe Group		
Corporate Credit Rating	A-/Negative/A-2	A-/Stable/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.globalcreditportal.com and at spcapitaliq.com. All ratings affected by this rating action can be found on the 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.