Research Update:

Vier Gas Transport GmbH 'BBB+/A-2' Ratings Affirmed; Outlook Stable

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Rating Action Overview

- We expect transmission system operator Vier Gas Transport GmbH (VGT) will report funds from operations (FFO) to debt of 10%-13% over the coming years on a regulatory accounting basis, despite higher investments.
- We anticipate VGT will benefit from stable regulated earnings from natural gas transmission operations, with the regulatory account mechanism mitigating volume and commodity risks over time.
- Even though the German government has updated the Energy Industry Act to reflect key elements for hydrogen regulations, questions remain concerning this type of infrastructure and the risks related to its successful ramp-up. We believe these are relevant to VGT's long-term business prospects.
- We therefore affirmed our 'BBB+/A-2' long- and short-term issuer credit ratings on VGT and our 'BBB+' issue rating on VGT's debt.
- The stable outlook indicates that we expect VGT's FFO to debt will remain at an average of 10%-13% over the next two years.

Rating Action Rationale

We expect VGT's EBITDA will slightly exceed €500 million over 2024-2026 and support credit ratios of about 10%-13%, which are well in line with the rating. On a regulatory accounting basis, EBITDA is about €500 million in our forecast for 2024 and slightly more than €550 million in 2025. The extraordinarily high EBITDA of €931 million in 2023 resulted from substantially lower cost for fuel energy as well as volume effects the company is exposed to under the German regulatory framework. These resulted in excess revenues and EBITDA of €461 million, which VGT must return to the system over 2026-2028, at about €157 million-€158 million per year. We believe the reported numbers overstate the underlying volatility in credit metrics. Adjusted for the regulatory accounting effects in 2023, FFO to debt remained at about 11%, which is consistent with the rating. We expect gas prices and volume effects will continue to create artificial volatility

in reported numbers but not to the same extreme extent as in 2023.

The sector is maturing and opportunities for regulated investments in natural gas decline. We believe the moderate and gradual decline for fossil gas from the residential and industrial sectors that we expect through 2030 and from the sharp decline we anticipate thereafter reflect the sector's gradual but predictable maturity. As this trend accelerates, we think gas operators will have to deleverage to preserve their credit quality. Since we expect that this will reduce opportunities for regulated investments in natural gas, we consider gas transmission system operators' (TSOs') business prospects are weaker relative to those of power TSOs. We note positively that the German government has approved the amended Energy Industry Act, providing clarity on a regulatory framework for new hydrogen grids. However, we understand operators may bear up to 16% of their unamortized investment if the ramp-up is not successful by 2039, an amount which could increase to 24% if the ramp-up is declared a failure in 2055. We therefore believe that the risks associated with hydrogen infrastructure are higher than those related to natural gas and power grids that operate under the German regulated framework as residual risk will remain over the long term.

Future investments will depend on hydrogen adoption rates and regulations. We expect capital expenditure (capex) of about €400 million-€450 million in 2024 and €550 million-€600 million in 2025, from €386 million in 2023, with most funds dedicated to growth investments. This is well above our previous expectations. Instead, we now expect investments will decline after peaking over 2025-2026. Investments in hydrogen assets could increase from 2026 but will depend fully on regulatory developments. We expect the final determination of a regulatory framework for hydrogen will influence VGT's investment decisions, with the company prudently balancing risks and rewards. Yet we believe that the development of a hydrogen economy will likely take longer than initially expected. This is exemplified by, for instance, the likely delay of the German hydrogen pipeline network to 2037 from 2032, in line with the Energy Industry Act. Overall, regulatory uncertainties--coupled with VGT's dependence on a successful ramp-up of hydrogen activities and the accelerating maturity of its natural gas pipeline business--have led us to re-assess our expectation of FFO to debt for the 'BBB+' rating to 10%-13% over 2025-2026, from 9%-12%. The hydrogen infrastructure is currently not part of regulated remuneration, meaning cash flows related to hydrogen investments are harder to predict. We note that the German regulator Bundesnetzagentur published a determination for the financing of the hydrogen core network in June 2024 that is due to come into effect in 2025. While the determination stipulates a methodology for establishing tariffs, it does not fully mitigate investment risk for hydrogen grid investments. This still depends on German legislation.

We expect VGT will operate with financial headroom under the 'BBB+' rating, based on our updated forecast for 2024-2026. We now expect EBITDA of €500 million-€600 million over 2024-2025, adjusted for regulatory accounting effects. This slightly exceeds our previous expectations and partly results from higher investments and a favorable regulatory environment. Accordingly, VGT's core credit ratios will be slightly stronger than we expected. We therefore revised our financial risk profile to significant from aggressive. However, this is not leading to any pressure on ratings upside, partly because other credit ratios, such as free operating cash flow to debt and discretionary cash flow to debt will be moderately negative. We view the company's financial policy as supportive to the 'BBB+' rating. We need clarity on hydrogen regulations before considering any positive rating action.

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 of 10%-13% over the next two years.

Downside scenario

We could downgrade VGT if the company's FFO to debt decreased below 10%. We see this scenario as unlikely over the next two years as the regulatory returns over 2024-2027 are set. Downside rating pressure could instead emerge from a change in VGT's financial policy and increased dividend payments, which we do not foresee at this stage as the company has a track record of committing to its financial policy. Over the longer term, pressure could emerge from the risks related to hydrogen investments.

Upside scenario

We see an upgrade of VGT as unlikely as it would require excellent visibility on future business prospects, including related to the hydrogen infrastructure, and FFO to debt sustainably above 13% on average. This would likely stem from investment stimulus over the medium term, including an adoption of a regulated framework for hydrogen infrastructure that was equivalent in strength to the current fossil gas regulation.

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 company designs, constructs, operates, and markets gas transmission networks. As of 2023, almost all of VGT's revenues came 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 supra-regional pipeline network in Germany. Its pipeline systems connect the border-crossing points to cities, municipalities, and industrial users in Germany 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 several 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 that includes British Columbia Investment Management (32.15%), Abu Dhabi Investment Authority through Infinity Investments (24.99%), Fluxys (24.13%), and Munich Re (18.73%).

Our Base-Case Scenario

Assumptions

- Return on equity of 5.07% on new assets and of 3.5% on old assets over the 2023-2027 regulatory period. We expect a productivity factor of 0.49% and an individual efficiency factor of 100%.
- Annual capital cost allocation adjustment under the 2023-2027 regulatory period.
- EBITDA margins declining to 33%-34% over 2024-2026, including a temporary improvement to about 40% in 2025, mostly due to regulatory accounting effects and the new regulatory period.
- Capex of about €410 million-€585 million over the next two years.
- Dividend distributions of €109 million in 2024 and about 140 million annually over 2025-2028.
- Lower profitability and relative capex intensity, coupled with sustained shareholder remuneration, to result in negative discretionary cash flow over 2024-2026.

Key metrics

Vier Gas Transport GmbH--Key metrics*

	--Fiscal year ends Dec. 31--			
(Mil. €)	**2022a**	**2023a**	**2024e**	**2025f**
EBITDA	426	931	450-550	550-650
Funds from operations (FFO)	357	774	300-400	400-500
Capital expenditure	347	387	380-450	550-650
Debt	3,364	3,090	3,100-3,300	3,300-3,500
Adjusted ratios				
Debt to EBITDA (x)	7.9	3.3	5.6-7.3	5.1-6.4
FFO to debt (%)§	14.0	11.0	10.0-12.0	11.0-13.0
FOCF to debt (%)	3.0	14.1	(5.0)-5.0	(5.0)-5.0

*All figures are adjusted by S&P Global Ratings, unless stated as reported. §Excluding the regulatory accounting effect, meaning without the temporary effect on earnings stemming from volume, price, or changes in operating costs that lead to over- or under-shooting under IFRS accounting. a--Actual. e--Estimate. f--Forecast.

Liquidity

We now assess VGT's liquidity as adequate because we forecast liquidity sources will cover uses by about 1.25x over the next 12 months, compared with our previous expectation of more than 1.5x. This unusually low ratio for VGT stems from a €750 million bond that is due in June 2025 and weighs on our A/B calculation. VGT has in the past demonstrated proven access to debt capital markets and sound relationships with banks, reflected in the company's diverse funding sources. Since VGT displays prudent risk management, we expect management will refinance the bond well in a timely manner.

VGT's main revolving credit facility (RCF) of €600 million is mostly undrawn and the company extended it last year to September 2028. Beside the €750 million bond due in 2025, there is no major debt maturity until 2027 when a €500 million bond is due.

Principal liquidity sources over the next 12 months will include:

- According to management, unrestricted cash and short-term marketable securities of about €459 million, as of the end of May 2024;
- Positive operating cash flow generation of about €350 million-€400 million;
- Access to unused RCFs totaling about €715 million; and
- Some working capital inflows.

Principal liquidity uses over the same period will include:

- €750 million bond;
- Capex of about €350 million-€400 million; and
- Cash dividend payments of about €116 million.

Environmental, Social, And Governance

ESG aspects are a neutral consideration in our credit rating analysis of VGT. Although not yet a relevant component of the company's earnings, we see VGT's green hydrogen efforts as relevant. They can contribute to the adoption of clean energies and the decarbonization of the German economy. Additionally, they represent the first steps toward ensuring the long-term sustainability of VGT because the relevance of gas will decline as the energy mix moves toward zero carbon emissions.

So far, the German energy transition has created opportunities for gas infrastructure companies. Yet we believe the country is clearly trending toward a long-term gas phase-out, which will likely accelerate gas grid operators' business maturity. As this trend accelerates, we expect gas operators will have to deleverage to preserve their credit quality. That said, we believe gas will remain crucial for Germany's energy mix, at least until the end of the decade.

Most of VGT's capex is related to the network development plan, which outlines gas infrastructure that will be key for the energy transition in Germany and is fully aligned with the country's long-term climate policy.

We believe VGT'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's management and governance framework meets industry standards and aligns stakeholder interests with long-term sustainability goals.

Issue Ratings - Subordination Risk Analysis

Capital structure

As of Dec. 31, 2023, VGT's capital structure consists of:

- €3.25 billion in bonds issued at the VGT level; and
- €395 million at the pipeline company level, which is reported at pro rata share (51%).

Analytical conclusions

We rate VGT's debt at 'BBB+', in line with the issuer credit rating, as we believe the debt sitting at pipeline companies does not represent a material disadvantage to VGT 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:	Significant
Cash flow/leverage	Significant
Anchor	a-
Modifiers:	
Diversification/portfolio effect	Neutral
Capital structure	Neutral
Financial policy	Neutral
Liquidity	Adequate
Management and governance	Neutral
Comparable rating analysis	Negative (-1 notch)
Stand-alone credit profile:	bbb+

Related Criteria

- Criteria | Corporates | General: Sector-Specific Corporate Methodology, April 4, 2024
- Criteria | Corporates | General: Corporate Methodology, Jan. 7, 2024
- Criteria | Corporates | General: Methodology: Management And Governance Credit Factors For Corporate Entities, Jan. 7, 2024
- 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
- 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: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Ratings List

Ratings Affirmed	
Vier Gas Transport GmbH	
Issuer Credit Rating	BBB+/Stable/A-2
Senior Unsecured	BBB+

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.spglobal.com/ratings for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://disclosure.spglobal.com/ratings/en/regulatory/article/-/view/sourceId/504352. Complete ratings information is available to RatingsDirect subscribers at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.spglobal.com/ratings. Alternatively, call S&P Global Ratings' Global Client Support line (44) 20-7176-7176.

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