Summary:

Scotia Gas Networks Ltd. Group

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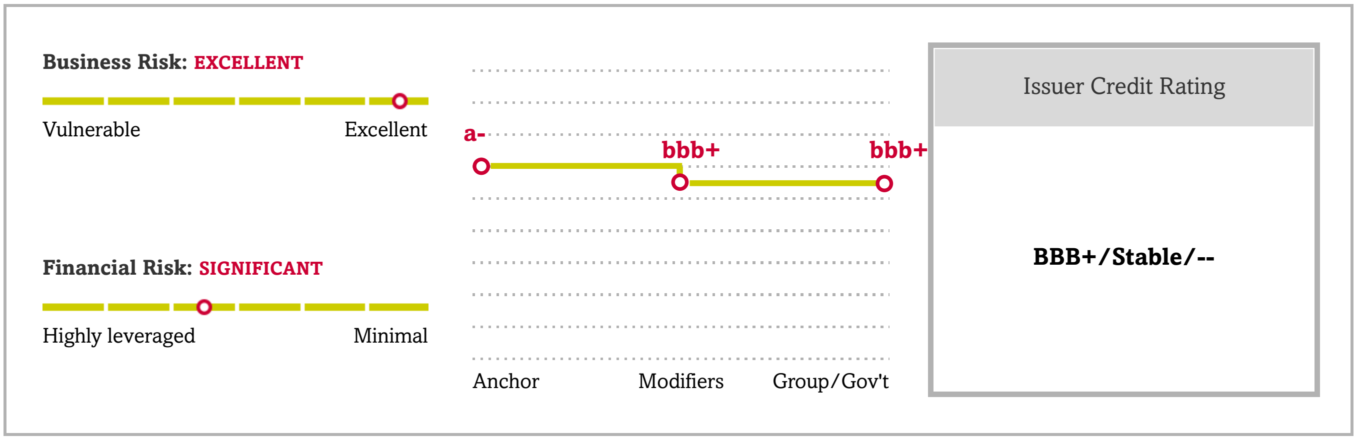

Credit Highlights

Overview

Key Strengths	Key Risks
Stable, predictable revenues and steady cash flows from the group's low-risk gas distribution network.	Increasing regulatory reset risk. Proposed RIIO-2 framework indicates lower remuneration, a change in indexation, and lower capacity to underspend on total expenditure allowances.
Good regulatory performance on key indicators aligned with the operating requirements set by the U.K. energy regulator, the Office of Gas and Electricity Markets (Ofgem).	Relatively high leverage with group's consolidated debt to regulatory asset value (RAV) at approximately 81% for the rest of the regulatory period.

Scotia Gas Networks Ltd., parent of Scotland Gas Networks PLC and Southern Gas Networks PLC, continues to demonstrate good operating performance.

At the consolidated group level, Scotia Gas Networks (SGN; the group) received total rewards of £5.3 million for performing well against the regulator's customer satisfaction indicator during fiscal 2018 (fiscal year ends March 31, 2018).

Reset risk is increasing as the 2021-2026 regulatory period nears and the next price control is considered.

Proposed framework for RIIO-2 (RIIO; revenue = incentives + innovation + output) indicates that gas and electricity networks, including SGN, would see lower remuneration, a change in indexation, and limited capacity to underspend on total expenditure allowances over the next five-year regulatory period.

The next price controls will be tougher with lower return on capital.

Although we project that RIIO-2 will see lower returns and tighter ratios, there is still a long way to go before the final price controls are established. SGN, alongside other gas companies, will submit their initial business plans to Ofgem during the summer of 2019, and their final plans in December 2019.

Outlook: Stable

The stable outlook on Scotland Gas Networks PLC and Southern Gas Networks PLC reflects S&P Global Ratings' view that SGN will maintain strong operational performance. We also assume that the consolidated group--at SGN, which is the focus of our analysis--will exhibit stable financial ratios. In particular, we anticipate that the group's adjusted funds from operations (FFO) to debt will remain sustainably above 9%.

Downside scenario

We could consider lowering the ratings if the group reports weaker operating performance or reduced profitability, which could result from cost overruns, compared with regulatory assumptions. Also, we might take a negative rating action if our forecast for the group's adjusted FFO-to-debt ratio falls below 9% over an extended period or if we observed signs of a more aggressive shareholder policy. We understand that dividend pay-outs are discretionary.

Rating pressure could also emerge if we saw a more pronounced deterioration of operations as stricter regulation is introduced in 2021, which could lead to FFO to debt declining below 9%.

Upside scenario

We consider an upgrade unlikely in the near term because of the group's relatively high leverage. That said, we could consider raising the ratings if the group's financial profile improves significantly, for example, if adjusted FFO to debt comfortably exceeds 11% and financial policies become more moderate, lowering leverage from the current levels.

Our Base-Case Scenario

Assumptions

- Revenue growth of 2%-3% in 2019-2021.
- Capital expenditure (capex) of £2.7 billion over the current eight-year regulatory period, with average yearly capital spending of about £370 million.
- Discretionary dividend payments.
- Some outperformance on total expenditure (operating expenses and capex) as a result of efficiency initiatives.
- We treat the £328 million shareholder loan as equity. SGN has amended its terms, which fully meet our criteria for equity treatment of shareholder loans.
- The group's consolidated debt to RAV at approximately 81% for the rest of the regulatory period, under the trigger covenant of 85%;
- The operating companies' (opcos') debt to RAV at 72.0% for the rest of the regulatory period, under the trigger covenant of 77.5%.

Key Metrics

	2018a*	2019e*	2020e*	2021e*
Revenues (mil. £)	1,156	1,155-1,165	1,185-1,195	1,210-1,220
EBITDA (mil. £)	661	700-705	725-730	735-740
FFO/debt (%)	9.3	9.5-10.5	9.5-10.5	9.5-10.5
Debt/EBITDA (x)	6.6	6.0-7.0	6.0-7.0	6.0-7
DCF/debt (%)	(8.6)	(3.5)-(2.5)	(3.0)-(2.0)	(1.5)-(0.5)

*Year-ending March 31. DCF--Discretionary cash flow. a--Actual. e--Estimate

Company Description

SGN, formed in 2005, supplies natural gas to 5.9 million customers (about 28% of U.K. gas users) through 74,000 kilometers of gas mains and services. SGN comprises a holding company, SGN Gas Networks Ltd, a consolidated MidCo group, which include SGN MidCo Limited, and the two operating companies (Southern and Scotland Gas Networks PLC). SGN is privately owned by a consortium comprising SSE PLC and three financial investors: Borealis Infrastructure Europe (UK) Limited, wholly owned by OMERS Administration Corporation; Ontario Teachers' Pension Plan Board, and Blue Spyder B 2016, wholly owned by the Abu Dhabi Investment Authority. A small part of SGN's operating profit comes from the nonregulated activities of its contracting, connections, commercial services, and smart operations. SGN's networks stretch from Milton Keynes in the north, to Dover in the east and Lyme Regis in the west, including London boroughs to the south of the River Thames.

Business Risk: Excellent

We take into account the low risk in the regulated utilities industry, low country risk for the U.K., and the strong regulatory advantage for the group's gas distribution network. In addition, we consider that the group's networks are very efficient, and that they are ranked first and fourth in terms of their customer satisfaction output scores in fiscal 2018, per Ofgem's RIIO GD-1 Annual Report. These supportive factors will underpin a significant part of the group's incentive income going forward.

In 2017-2018 SGN met its targets on environment, customer satisfaction, connections, safety and reliability, and availability. However, the same report shows Southern Gas Networks PLC is not on track to meet its fuel poor connections social obligations, based on an eight-year forecast.

The proposals for RIIO-2 include a reduction in the allowed return on capital that we believe may prove challenging for U.K. gas utilities. Ofgem has adjusted its guidance for the baseline allowed cost of capital to about 2.6% in terms of real consumer price inflation including house prices, or 1.63% in real RPI terms. This compares with an estimated weighted-average cost of capital ranging from 3.1% to 4.2% for RIIO-1 in real RPI terms through the period. They also propose the return adjustment mechanism alongside the total expenditure incentive mechanism, both of which are designed to limit the scope of financial outperformance for companies with total expenditure efficiencies; conversely, however, they will also limit the downside with total expenditure inefficiencies. See "Ofgem's Proposed RIIO-2 Regulatory Framework Will Test U.K. Energy Networks," published Feb. 20, 2019 on RatingsDirect.

Peer comparison

Table 1

SGN*-- Peer Comparison

Industry Sector: Gas

	SGN**	Wales & West Utilities Finance PLC	Northern Gas Networks Finance PLC
Rating as of May 15, 2019	BBB+/Stable/--	-/-/-	BBB+/Stable/--
	--Fiscal year ended March 31, 2018--		
(Mil. £)			
Revenues	1,156.3	425.2	411.0
EBITDA	661.4	246.7	263.2
FFO	407.3	120.2	183.3
Interest Expense	175.2	133.9	49.6
Cash Interest Paid	153.8	126.5	66.5
Cash flow from operations	356.7	116.0	182.8
Capital expenditures	397.7	131.1	151.3
Free operating cash flow	(41.0)	(15.1)	31.5
Dividends paid	337.3	0.0	73.4
Discretionary cash flow	(378.3)	(15.1)	(41.9)
Gross available cash	381.3	681.5	8.1
Debt	4,378.5	1,462.2	1,382.1

Table 1

SGN*-- Peer Comparison (cont.)			
Preferred stock	0.0	0.0	0.0
Equity	1,024.0	(575.0)	695.6
Debt and equity	5,402.5	887.2	2,077.7
Regulatory asset base	5,483.5	2,117.3	2,198.0
Adjusted ratios			
EBITDA margin (%)	57.2	58.0	64.0
Return on capital (%)	9.2	18.3	9.1
EBITDA interest coverage (x)	3.8	1.8	5.3
FFO cash interest coverage (x)	3.6	2.0	3.8
Debt/EBITDA (x)	6.6	5.9	5.3
FFO/debt (%)	9.3	8.2	13.3
Cash flow from operations/debt (%)	8.1	7.9	13.2
Free operating cash flow/debt (%)	(0.9)	(1.0)	2.3
Discretionary cash flow/debt (%)	(8.6)	(1.0)	(3.0)
Net Cash Flow / Capex (%)	N.A.	N.A.	N.A.
Debt/regulated asset base (%)	79.8	69.1	62.9
Return on capital (%)	9.2	18.3	9.1
Return on common equity (%)	29.0	0.1	19.7
Common dividend payout ratio (un-adj.) (%)	147.2	0.0	76.2

*All figures are S&P Global Adjusted numbers. **Figures are for the consolidated group but the rating reflects that for Scotland Gas Networks PLC and Southern Gas Networks PLC. FFO--Funds from operations.

Financial Risk: Significant

The financial risk profile is somewhat constrained by the group's policy of maintaining relatively high financial leverage at the opcos of 70%-75% net debt to RAV, and the high leverage at SGN Midco, expected to be 80%-85% net debt to RAV. That said, we anticipate that S&P Global Ratings-adjusted FFO to debt will be above 10% until the end of the regulatory period in 2021, which leaves the group with headroom under its current 9% threshold for our 'BBB+' rating. The group achieved this through continuous outperformance of the operating allowances set by Ofgem.

Financial summary

Table 2

SGN* Financial Summary--Yearly Data			
Industry Sector: Gas			
	--Fiscal year ended March 31.--		
	2018	**2017**	**2016**
(Mil. £)			
Revenues	1,156.3	1,125.0	1,079.7
EBITDA	661.4	721.0	687.5
FFO	407.3	443.8	448.4

Table 2

SGN* Financial Summary--Yearly Data (cont.)

Industry Sector: Gas

	--Fiscal year ended March 31.--		
	2018	**2017**	**2016**
(Mil. £)			
Interest Expense	175.2	209.0	200.7
Cash Interest Paid	153.8	193.0	198.3
Cash flow from operations	356.7	406.5	417.1
Capital expenditures	397.7	381.0	321.7
Free operating cash flow	(41.0)	25.5	95.4
Dividends paid	337.3	200.0	160.0
Discretionary cash flow	(378.3)	(174.5)	(64.6)
Gross available cash	381.3	19.7	263.9
Debt	4,378.5	4,361.9	4,189.7
Preferred stock	0.0	0.0	0.0
Equity	1,024.0	642.7	588.6
Regulatory asset base	5,483.5	5,247.0	5,024.0
Adjusted ratios			
EBITDA margin (%)	57.2	64.1	63.7
EBITDA interest coverage (x)	3.8	3.5	3.4
FFO cash interest coverage (x)	3.6	3.3	3.3
Debt/EBITDA (x)	6.6	6.1	6.1
FFO/debt (%)	9.3	10.2	10.7
Cash flow from operations/debt (%)	8.1	9.3	10.0
Free operating cash flow/debt (%)	(0.9)	0.6	2.3
Discretionary cash flow/debt (%)	(8.6)	(4.0)	(1.5)
Return on common equity (%)	29.0	51.1	(192.7)
Common dividend payout ratio (un-adj.) (%)	147.2	63.6	48.3

*All figures are S&P Global Adjusted numbers. FFO--Funds from operations.

Liquidity: Adequate

We assess SGN's liquidity position as adequate, supported by our view that SGN's liquidity resources will exceed its funding needs by more than 1.1x in the next 12 months.

SGN enjoys well-established, solid relationships with its banks and a generally high standing in credit markets. Furthermore, the group demonstrates generally prudent financial risk management.

Principal Liquidity Sources	Principal Liquidity Uses
• An undrawn £350 million of revolving credit facilities maturing in 2023; and • Our forecast that SGN will generate almost £502 million of cash FFO.	• £75 million of debt maturities over the 12 months started March 31, 2019; • About £400 million of annual capex; and • Shareholder distributions in line with our expectations for a 'BBB+' rating.

Other Credit Considerations

In our view, the group's financial ratios are at the lower end of our significant financial risk category over our current forecast period. This leads us to assess the group as negative under our comparable rating analysis.

Environmental, Social, And Governance
SGN operates in the U.K.--whose government published a "25 Year Environment Plan" in 2018--and the U.K. energy regulatory framework incorporates environmental efforts. Overall, the group meets most of the environmental targets set by Ofgem, which we view positively. More specifically, in 2017-2018 it met its targets on environment, customer satisfaction, connections, safety and reliability and availability. However, the same report shows Southern Gas Networks PLC is not on track to meet its fuel poor connections social obligations of the current regulatory period. SGN are a leader in the development of green gas and were the first gas distribution company to inject bio-methane into the network at Didcot in Oxfordshire in late 2011. With ambitions to have 250,000 homes and businesses supplied with green gas by 2021.

Issue Ratings - Subordination Risk Analysis

Capital structure

The group structure consists of £3.76 billion senior unsecured debt issued by the two opcos--Scotland Gas Networks and Southern Gas Networks--and about £482 million of unrated debt issued by SGN Midco.

Analytical conclusions

Scotland Gas Network's and Southern Gas Network's debt is rated 'BBB+', the same level as the issuer credit rating, because no significant elements of subordination risk are present in the capital structure.

Reconciliation

Table 3

Reconciliation Of SGN Reported Amounts With S&P Global Ratings' Adjusted Amounts (Mil. £)

	--Fiscal year ended March 31, 2018--							
SGN reported amounts								
	Debt	**Shareholders' equity**	**EBITDA**	**Operating income**	**Interest expense**	**S&P Global Ratings' adjusted EBITDA**	**Cash flow from operations**	**Dividends**
	5,039.3	696.4	653.5	471.3	217.9	661.4	547.2	286.0
S&P Global Ratings' adjustments								
Cash taxes paid	--	--	--	--	--	(66.6)	--	--
Cash taxes paid - Other	--	--	--	--	--	--	--	--
Cash interest paid	--	--	--	--	--	(153.8)	--	--
Operating leases	14.0	--	2.9	0.9	0.9	(0.9)	2.0	--
Postretirement benefit obligations/deferred compensation	--	--	0.4	0.4	--	--	--	--
Accessible cash & liquid investments	(381.3)	--	--	--	--	--	--	--
Asset retirement obligations	34.1	--	--	--	2.0	--	--	--
Nonoperating income (expense)	--	--	--	0.3	--	--	--	--
Reclassification of interest and dividend cash flows	--	--	--	--	--	--	(192.5)	--
Debt - Shareholder loans	(327.6)	--	--	--	--	--	--	--
Equity - Other	--	327.6	--	--	--	--	--	--
EBITDA - Gain/(loss) on disposals of PP&E	--	--	4.6	4.6	--	--	--	--
Interest expense - Shareholder loan	--	--	--	--	(45.6)	--	--	--
FFO - Other	--	--	--	--	--	(32.8)	--	--
Dividends - Other	--	--	--	--	--	--	--	51.3
Total adjustments	(660.8)	327.6	7.9	6.2	(42.7)	(254.1)	(190.5)	51.3
S&P Global Ratings' adjusted amounts								
	Debt	**Equity**	**EBITDA**	**EBIT**	**Interest expense**	**Funds from operations**	**Cash flow from operations**	**Dividends paid**
	4,378.5	1,024.0	661.4	477.5	175.2	407.3	356.7	337.3

Ratings Score Snapshot

Issuer Credit Rating

BBB+/Stable/--

Business risk: Excellent

- **Country risk:** Low
- **Industry risk:** Very low
- **Competitive position:** Excellent

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 rating analysis:** Negative (-1 notch)

Stand-alone credit profile : bbb+

- **Group credit profile:** bbb+
- **Entity status within group:** Core (no impact)

NB: The ratings score snapshot reflects that of Scotland Gas Networks PLC and Southern Gas Networks PLC.

Related Criteria

- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, Sept. 21, 2017
- General Criteria: Guarantee Criteria, Oct. 21, 2016
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria - Corporates - General: The Treatment Of Non-Common Equity Financing In Nonfinancial Corporate Entities, April 29, 2014
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, 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 And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Ofgem's Proposed RIIO-2 Regulatory Framework Will Test U.K. Energy Networks, Feb. 20, 2019
- How Regulatory Reset, Brexit, And Other Political Risks Weigh On U.K. Utility Ratings, Dec. 12, 2018
- Why We See The Regulatory Frameworks For U.K. Utilities As Supportive, Sept. 26, 2017

Business And Financial Risk Matrix

	Financial Risk Profile					
Business Risk Profile	Minimal	Modest	Intermediate	**Significant**	Aggressive	Highly leveraged
Excellent	aaa/aa+	aa	a+/a	**a-**	bbb	bbb-/bb+
Strong	aa/aa-	a+/a	a-/bbb+	bbb	bb+	bb
Satisfactory	a/a-	bbb+	bbb/bbb-	bbb-/bb+	bb	b+
Fair	bbb/bbb-	bbb-	bb+	bb	bb-	b
Weak	bb+	bb+	bb	bb-	b+	b/b-
Vulnerable	bb-	bb-	bb-/b+	b+	b	b-