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Research Update:

Scotland Gas Networks PLC And Southern Gas Networks PLC Downgraded To 'BBB' On Ofgem Final Determination; Outlook Stable

May 13, 2021

Rating Action Overview

- We expect the 2021-2026 regulatory period for U.K. gas distribution networks (RIIO-GD2) to be challenging for U.K.-based gas distribution network operators Scotland Gas Networks PLC and Southern Gas Networks PLC (together Scotia Gas Networks or Scotia), because of a significant cut in remuneration and more limited scope for outperformance against regulatory allowances.
- We anticipate that Scotia's financial metrics will weaken due to reduced profitability combined with the sustained capital expenditure (capex) plan. While the group has lodged appeals against Ofgem's final price determinations with the Competition and Markets Authority (CMA), we do not believe that the potential upside of these appeals could sufficiently offset the impact of the new regulatory period.
- We lowered our long-term issuer credit ratings on Scotland Gas Networks PLC and Southern Gas Networks PLC to 'BBB' from 'BBB+'.
- The stable outlook indicates that the group will demonstrate good operating performance and maintain funds from operations (FFO) to debt at about 7.5%-8%; above the 6% downside trigger for the current rating.

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Rating Action Rationale

Ofgem's final determination for the 2021-2026 regulatory period (RIIO-GD2) has negative regulatory implications for Scotia. Under the U.K. regulator's final determination, which was published in December 2020 and applies from April 1, 2021, Scotia is subject to lower overall regulatory returns, greater pressure on operating performance, and limited scope for outperformance in terms of total expenditure (totex). Scotia's networks will see a material reduction in their return on capital. The weighted average cost of capital in RIIO-GD2 will be about 2.82%, excluding consumer price index (CPI) inflation (measured as CPIH; CPI including owner occupiers' housing costs), compared with about 3.77%, excluding retail price index (RPI) inflation), in the previous period. This will reduce EBITDA from Scotia's regulated networks by about £50 million-£60 million per year.

From the start of RIIO-GD2 we expect to see free operating cash flow (FOCF) becoming negative due to the continued intensive capex and replacement expenditure (repex) program while EBITDA reduces. However, this high capex allows the group to build its regulatory asset value (RAV), in contrast with most regulated gas networks across Europe. We expect dividends to be distributed to the target 73% gearing (measured by net debt to RAV) level of the operating company (opco), which is a slight increase from the current 71% level. As a result, we project Scotia's FFO to debt will average 7.5%-8% over RIIO-GD2, from 9.5%-10.5% over RIIO-GD1 and below the 9% target for the previous ratings.

Even if Scotia's CMA appeal is successful, we do not expect the group's metrics to improve enough to support a higher rating. Scotia has appealed the GD2 final determination in a number of areas, focusing on: allowed return; the outperformance wedge; ongoing efficiency; and the efficiency benchmark. The appeal on the allowed return is technical in scope and reflects Scotia's view that there are technical arguments to support a higher allowed return on equity for the networks. The outcome of the appeal is expected to be published by Oct. 30, 2021, and will supersede Ofgem's final determination if successful. However, even if the CMA agrees to increase the allowed return and modify the outperformance wedge as Scotia has argued, FFO to debt will rise by only about 40-50 bps (the lower end of Scotia's proposal), which we do not consider sufficient to maintain the previous 'BBB+' rating.

Scotia's strong operational performance should continue to support its credit metrics, albeit to a more limited extent than under RIIO-GD1 . During RIIO-GD2, gas networks will be required to maintain high levels of efficiency. We expect it will be harder to achieve extra earnings from outperformance given the efficiency challenge Scotia will face in light of the level of allowed totex against its submitted business plans. This is in contrast with RIIO-GD1, during which gas networks have been able to achieve material outperformance, significantly enhancing their returns on regulated equity (RoRE). Over RIIO-GD1, it is anticipated that Southern Gas Networks and Scotland Gas Networks' combined totex outperformance will be 15% (£800 million), on a cumulative basis, significantly weighted toward efficiencies in operating expenditure and repex. Scotia is also on track to meet most of its regulatory performance indicators. When excluding the impact of its financing and tax performance from its RoRE, Scotia has forecast a RoRE of 10.6% at Southern Gas Networks and 11.7% at Scotland Gas Networks for RIIO-GD1.

Outlook

The stable outlook reflects our view that Scotia will maintain FFO to debt of about 7.5% to 8%, which is above our 6% trigger for the ratings. The outlook also indicates that the group will be able to operate in line with its business plan for RIIO-GD2 and maintain good operating performance.

Upside scenario

We could upgrade Scotia over the medium term if we saw a track record of maintaining FFO to debt metrics sustainably above 9% coupled with excellent operational performance. This would likely require a significant improvement in operating conditions resulting from the outcome of the CMA appeal, or significant mitigating action implemented by the management team. We would also expect to see FOCF (operating cash flow after capex) to debt at a broadly neutral level.

Downside scenario

We could lower the rating if Scotia demonstrated weaker operating performance or reduced profitability, causing credit metrics to fall below the triggers for the current rating level; that is, FFO to debt falling below 6%.

Company Description

Scotia Gas Networks supplies natural gas to 5.9 million customers (about 28% of U.K. gas users) through 75,000 kilometers of gas mains and services. Scotia comprises a holding company, SGN Gas Networks Ltd., a consolidated MidCo group, which includes SGN MidCo Ltd., and the two operating companies (Southern Gas Networks and Scotland Gas Networks). Scotia is privately owned by a consortium comprising SSE PLC and three financial investors: Borealis Infrastructure Europe (UK) Ltd., wholly owned by OMERS Administration Corp.; Apple Newco Ltd., wholly owned by Ontario Teachers' Pension Plan Board; and Blue Spyder B 2016, wholly owned by the Abu Dhabi Investment Authority. A small part of Scotia's operating profit comes from the nonregulated activities of its contracting, connections, commercial services, and smart operations. Scotia's networks in southern England stretch from Milton Keynes in south-central England, to Dover in the southeast, and Lyme Regis in the southwest, and includes London boroughs to the south of the River Thames. The Scottish network covers all of Scotland.

Our Base-Case Scenario

In our base case, we assume over RIIO-GD2:

- EBITDA of about £630 million annually;
- A neutral performance in terms of Scotia's totex allowance (£536 million per year [2018/2019 prices]) as well as on its operational targets.
- Capex and replacement expenditure of about £380 million-£420 million annually;
- Adjusted EBITDA margin falling to 52%-56% from an average of about 60% over RIIO-GD1; and
- Shareholder distributions targeting a 73% gearing level.

Based on these assumptions, we arrive at the following credit measures:

- Adjusted FFO to debt of 10.7% for fiscal year (FY) ending March 31, 2021, and 7.5%-8% over RIIO-GD2.
- Debt to RAV gradually rising to approximately 73% over RIIO-GD2 from the current 71%.

Liquidity

We assess Scotia's liquidity as adequate, reflecting our forecast that the ratio of liquidity sources to liquidity uses will exceed 1.1x for the 12 months from March 31, 2021.

Principal liquidity sources:

- Access to unrestricted short-term cash of about £100 million as of March 31, 2021;

- An undrawn £360 million of revolving credit facilities maturing in 2025; and
- Our forecast that Scotia will generate almost £500 million of cash FFO.

Principal liquidity uses:

- No debt maturities in next 12 months as of March 31, 2021;
- About £380 million to £420 million of capex and repex; and
- Dividend payments to support the 73% gearing target set by Scotia.

Ratings Score Snapshot

Issuer Credit Rating: BBB/Stable/--

Business risk: Excellent

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

Financial risk: Aggressive

- Cash flow/leverage: Aggressive

Anchor: bbb

Modifiers

- Diversification/portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: bbb

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: 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
- Criteria | Corporates | Utilities: Key Credit Factors For The Regulated Utilities Industry, 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: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- U.K. Water Utilities: Was Appealing Ofwat's Determination Worth It?, Oct. 1, 2020
- Various Rating Actions Taken On U.K. Gas Networks Amid Upcoming Regulatory Review And Tougher Operating Conditions, April 30, 2020

Ratings List

Downgraded; Outlook Action

	To	From
Scotland Gas Networks PLC		
Southern Gas Networks PLC		
Issuer Credit Rating	BBB/Stable/--	BBB+/Negative/--
Scotland Gas Networks PLC		
Senior Unsecured	BBB/Stable	BBB+/Negative
Southern Gas Networks PLC		
Senior Unsecured	BBB/Stable	BBB+/Negative