FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Scotland Gas and Southern Gas IDR at 'BBB'; Outlooks Stable

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Fitch Ratings - London - 08 Dec 2023: Fitch Ratings has affirmed Scotland Gas Networks plc's (Scotland GN) and Southern Gas Networks plc's (Southern GN) Long-Term Issuer Default Ratings (IDRs) at 'BBB' and senior unsecured ratings at 'BBB+'. The Outlooks on the Long-Term IDRs are Stable.

The affirmations primarily reflect the companies' financial policy that seeks to maintain the current ratings, keeping the credit metrics compliant with negative rating sensitivities. We expect the companies to reduce dividends if operational performance deteriorates. Otherwise, rating headroom could be reduced under post-maintenance interest cover ratios (PMICR) and net debt-to-regulatory asset value (RAV).

The affirmation also reflects adequate gearing and nominal PMICR during the price control period GD2 (regulatory period of 1 April 2022 to 31 March 2026) for both Scotland GN and Southern GN. However the average cash PMICRs are at the negative sensitivity for GD2, due to materially higher refinancing costs.

KEY RATING DRIVERS

Exhausted Cash PMICR Headroom: We forecast average cash PMICRs to be at our negative rating sensitivity of 1.5x over GD2. Pressure on cash PMICR are adequately offset by a strong nominal PMICR, which we estimate at 2.2x and 2.4x for Scotland GN and Southern GN respectively over GD2, against our negative sensitivity of 1.8x.

Adequate Gearing Headroom: Fitch expects Scotland GN and Southern GN to maintain an adequate net debt/RAV, at about 67% and 70%, respectively, over GD2, against their negative rating sensitivity of 73%. Scotland GN and Southern GN closing net debt/RAV of about 64% at financial year-end 31 March 2023 (FYE23) reflects high inflation benefit and the companies' decision to not increase dividend distribution, however we expect gearing to rise in the second part of GD2.

Inflation Beneficial for Credit Metrics: Higher inflation leads to higher indexation on inflation-linked debt but the inflation-driven increase in RAV is greater, ultimately leading to lower net debt/RAV. Scotland GN and Southern GN debt structure has about 32% and 38% of inflation-linked debt, respectively at FYE23, but RAV indexation supports decreasing net debt/RAV and strong nominal PMICRs. However, we expect a weakening trend in cash PMICR towards the end of GD2, due to higher borrowing costs.

Flexible Financial Policy: Fitch views Scotland GN's and Southern GN's financial and dividend policies as conservative. We understand from management that the companies' financial policy targets preserving the current ratings and would adjust dividends and consider other mitigating measures if net debt/RAV or PMICR headroom becomes tight.

Mixed Regulatory Performance: During the first two years of GD2, Scotland GN and Southern GN generated an operational return on regulated equity (RoRE) of 8.1% and 6.2% respectively, compared to the allowed equity return of 5.7%, supported by total expenditure (totex) outperformance contributing 2.5% and 0.5% respectively. In addition, financing outperformance further improved total RoRE by 3.8% and 5.5%.

Fitch forecasts 7% underspend at Scotland GN and 7% overspend at Southern GN over GD2, largely due to the different re-profiling of the workload across the second half of GD2, combined with higher inflation pressures on totex, which penalised Southern GN. Fitch estimates GBP15 million of combined penalties in FY24.

Assessment Under PSL: In assessing the credit linkage between Scotland GN and Southern GN and SGN Midco Limited (Midco), we determine the strength of the legal ring-fencing as 'porous', reflecting the Scotland GN and Southern GN cash lock-up at 77.5% net debt to/RAV, which is above our negative rating sensitivity. At the same time, SGN Midco would go into cash lock-up if consolidated licenced opco group, net debt/RAV exceeds 75%. Access and control is also 'porous' as Scotland GN and Southern GN operate in a well-defined regulatory framework.

DERIVATION SUMMARY

Scotland GN and Southern GN benefit from a stable and transparent regulatory framework for UK gas distribution networks. The closest rated peers are Cadent Gas Limited (BBB+/Stable) and Wales & West Utilities Limited (WWU, BBB/Stable).

Cadent benefits from a stronger financial profile, hence the higher rating. WWU has the same IDR of Scotland GN and Southern GN, but its class A senior secured debt is rated 'A-', higher compared with Scotland GN and Southern GN senior unsecured debt rating of 'BBB+'. This is due to the benefits deriving from contractual and structural enhancements.

Scotland GN and Southern GN have a lower debt capacity compared to electricity distribution peers, reflecting lower long-term sector visibility. Fitch would consider revising the debt capacity if we believe that the energy transition would result in tougher regulatory decisions, ultimately increasing gas companies' business risk.

KEY ASSUMPTIONS

Fitch Assumptions for Scotland GN and Southern GN:

- Allowed WACC as reported in the regulatory price control financial model of July 2023

- Totex underperformance of 7% at Southern GN, outperformance of 7% at Scotland GN in GD2

- Average CPIH and RPI at 3.6% and 5.1% respectively in FY24-26

- Average cost of new debt of 5.8%

- No incentive income; GBP15 million of combined penalties in FY24

- Average combined annual dividend of GBP230 million for FY24-FY26

RATING SENSITIVITIES

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

-Net debt/RAV comfortably and consistently below 68% combined with cash PMICR above 1.7x, and nominal PMICR above 2.0x

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade

-Net debt/RAV above 73% combined with cash PMICR below 1.5x and nominal PMICR below 1.8x

-Higher-than-expected dividend distributions or weaker than expected performance

-Adverse changes to the regulatory framework could result in lower debt capacity for a given rating

LIQUIDITY AND DEBT STRUCTURE

Adequate Liquidity: At FYE23, Scotland GN had no unrestricted cash and cash equivalents, while Southern GN had GBP208 million. In addition, Scotland GN and Southern GN, both benefit from an undrawn GBP360 million revolving credit facility maturing in 2025. Fitch expects sufficient liquidity to cover negative free cash flows in FY24.

In October 2023, Southern GN repaid GBP300 million fixed-rate notes and GBP300 million of floating EIB loans early (maturing in FY26 and FY27) with GBP436 million of proceeds from debt issuance in September 2023 with the balance from available cash. Scotland GN has no significant upcoming debt maturities after its early repayment of GBP65 million floating-rate notes due FY27.

ISSUER PROFILE

Scotland GN and Southern GN are two of the eight regulated gas distributors in the UK. Their assets consist of around 49,000 km of gas pipes in southern England and around 25,000 km in Scotland as well as storage and pressure reduction stations adding up to a RAV of GBP2.2 billion for Scotland GN and GBP4.8 billion for Southern GN as of FYE23.

SUMMARY OF FINANCIAL ADJUSTMENTS

- Cash interest is adjusted to reflect cash payments related to the companies' onerous debt from 2022 and before

- Total debt excludes onerous debt from 2022 and before

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

The highest level of ESG credit relevance is a score of '3', unless otherwise disclosed in this section. A score of '3' means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. Fitch's ESG Relevance Scores are not inputs in the rating process; they are an observation on the relevance and materiality of ESG factors in the rating decision. For more information on Fitch's ESG Relevance Scores, visit https://www.fitchratings.com/topics/esg/products#esg-relevance-scores.

RATING ACTIONS

ENTITY / DEBT	RATING			PRIOR
Southern Gas Networks plc	LT IDR	BBB Rating Outlook Stable	Affirmed	BBB Rating Outlook Stable
senior unsecured	LT	BBB+	Affirmed	BBB+
Scotland Gas Networks plc	LT IDR	BBB Rating Outlook Stable	Affirmed	BBB Rating Outlook Stable
senior unsecured	LT	BBB+	Affirmed	BBB+

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Parent and Subsidiary Linkage Rating Criteria (pub. 16 Jun 2023)

Corporates Recovery Ratings and Instrument Ratings Criteria (pub. 13 Oct 2023) (including rating assumption sensitivity)

Corporate Rating Criteria (pub. 03 Nov 2023) (including rating assumption sensitivity)

Sector Navigators – Addendum to the Corporate Rating Criteria (pub. 03 Nov 2023)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Corporate Monitoring & Forecasting Model (COMFORT Model), v8.1.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Scotland Gas Networks plc	UK Issued, EU Endorsed
Southern Gas Networks plc	UK Issued, EU Endorsed

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