

Tear Sheet:

Scotland Gas Networks PLC and Southern Gas Networks PLC

June 26, 2023

High inflationary pressure in the U.K. will lead to short-term pressure on Scotland Gas Networks PLC and Southern Gas Networks PLC's (together known as SGN) credit metrics.

With lags in tariff setting and revenues indexation as part of the current regulatory framework, we expect temporary pressure for the financial year ended in March 2023 (FY 2023) as inflationary pressures feed through the group's cost base on top of much higher accretion amounts (with index-linked debt and derivatives accounting for about 35% of SGN's consolidated reported debt).

That said, we believe SGN's credit metrics will remain in line with the current 'BBB' rating during the current five-year regulatory period (RIIO-GD2). Our base case assumes inflation levels will gradually ease, leading to a recovery in credit metrics as short-term pressures fade, while the benefits of revenues indexation to higher inflation will gradually accrue from FY 2024 onwards. Our forecast is for S&P Global Ratings-adjusted FFO to debt of 5.0%-6.0% in 2023, rising to 7%-8% for the rest of RIIO-GD2, ending in FY 2026.

High inflationary pressure adds to an already challenging financial package for gas distribution networks over RIIO-GD2. RIIO-GD2, which has completed its second year, is marked by a reduced allowed return compared with the previous regulatory period. The average cost of capital was projected to average about 3.2% for both networks as of January 2023 in real CPIH (a measure of real consumer price inflation that includes owner-occupiers' housing costs) terms, compared with 3.76% in retail price index over RIIO-GD1.

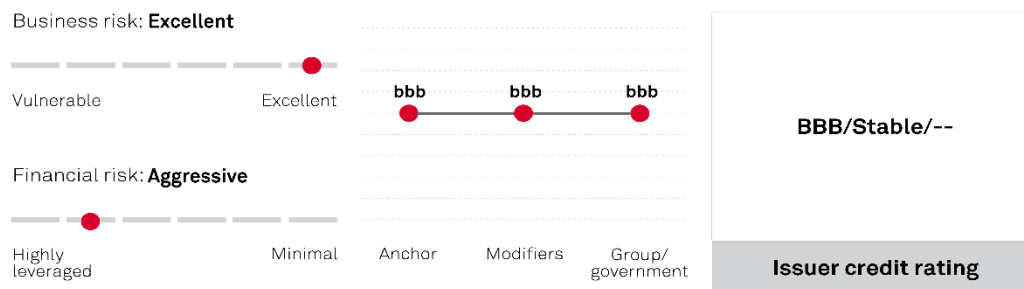
Primary contact

Julien Bernu
London
442071767137
Julien.Bernu
@spglobal.com

Secondary contact

Gustav B Rydevik
London
44-20-7176-1282
gustav.rydevik
@spglobal.com

Ratings Score Snapshot



Recent Research

- EMEA Utilities Outlook 2023: United Kingdom: Tailwinds For Energy, Cross-Currents For Water, Jan. 24, 2023
- Industry Top Trends 2023: EMEA Utilities, Jan. 23, 2023
- Western Europe Regulated Gas Utilities Handbook 2022, Nov. 4, 2022

Company Description

SGN supplies natural gas to 5.9 million customers (about 28% of U.K. gas users) through 75,000 kilometers of gas mains and services. SGN comprises a holding company, Scotia Gas Networks Ltd., a consolidated MidCo group that includes SGN MidCo Ltd., and the two operating companies Southern Gas Networks and Scotland Gas Networks, which have a combined regulatory asset value of £7 billion as of the end of March 2023. SGN is privately owned by a consortium comprising the Ontario Teachers' Pension Plan Board (37.5%), Brookfield (37.5%), and Global Infrastructure Partners (25%).

A small part of SGN's operating profit comes from the nonregulated activities of its contracting, connections, commercial services, and property operations. SGN'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 include London boroughs to the south of the River Thames. The Scottish network covers all of Scotland.

Outlook

The stable outlook reflects our view that SGN will maintain FFO to debt of 6%-8% over 2023-2026, which is above our 6% trigger for our ratings on the group. The outlook also indicates that the group will operate in line with its business plan during RIIO-GD2 and maintain good operating performance.

Downside scenario

We could lower the rating if SGN demonstrates weaker operating performance or reduces profitability, causing credit metrics to fall below the triggers for the current rating level (i.e., FFO to debt falling consistently below 6%).

Upside scenario

We could upgrade SGN over the medium term if we see a track record of maintaining FFO to debt sustainably above 9%, coupled with excellent operational performance. This would likely require significant mitigating action implemented by the management team. We would also expect to see FOCF to debt at a broadly neutral level.

Key Metrics

Scotland Gas Networks PLC--Forecast summary

Period ending	Mar-30-2019	Mar-31-2020	Mar-31-2021	Mar-31-2022	Mar-31-2023	Mar-31-2024	Mar-31-2025	Mar-31-2026
(Mil. GBP)	2019a	2020a	2021a	2022a	2023e	2024f	2025f	2026f
Revenue	1,235	1,262	1,217	1,105	1,200-1,250	1,300-1,350	1,250-1,300	1,325-1,375
EBITDA	717	795	723	569	600-650	700-750	625-675	750-800
Funds from operations (FFO)	459	493	488	304	275-325	400-450	375-425	450-500
Debt	4,704	4,764	4,625	4,791	5,100-5,200	5,200-5,400	5,400-5,600	5,600-5,800
Adjusted ratios								
Debt/EBITDA (x)	6.6	6.0	6.4	8.4	8.0-9.0	7.0-8.0	8.0-9.0	7.0-8.0
FFO/debt (%)	9.8	10.3	10.6	6.3	5.0-6.0	7.5-8.5	6.5-8.0	7.5-9.0

All figures are adjusted by S&P Global Ratings, unless stated as reported. a--Actual. e--Estimate. f--Forecast. .

Financial Summary

Scotland Gas Networks PLC--Financial Summary

Period ending	Mar-31-2017	Mar-31-2018	Mar-30-2019	Mar-31-2020	Mar-31-2021	Mar-31-2022
Reporting period	2016a	2017a	2018a	2019a	2020a	2021a
Display currency (mil.)	GBP	GBP	GBP	GBP	GBP	GBP
Revenues	1,125	1,156	1,235	1,262	1,217	1,105
EBITDA	721	661	717	795	723	569
Funds from operations (FFO)	444	407	459	493	488	304
Interest expense	209	175	196	189	166	185
Cash interest paid	194	155	160	160	156	133
Operating cash flow (OCF)	406	357	343	458	610	349
Capital expenditure	381	398	429	408	346	318
Free operating cash flow (FOCF)	25	(41)	(86)	50	264	31
Discretionary cash flow (DCF)	(175)	(378)	(319)	(28)	149	(83)

Scotland Gas Networks PLC--Financial Summary

Cash and short-term investments	20	381	30	124	289	123
Gross available cash	20	381	30	124	289	123
Debt	4,362	4,379	4,704	4,764	4,625	4,791
Common equity	643	1,024	1,046	1,332	1,456	1,238
Adjusted ratios						
EBITDA margin (%)	64.1	57.2	58.0	63.0	59.4	51.5
Return on capital (%)	11.1	9.2	9.4	10.1	8.8	6.1
EBITDA interest coverage (x)	3.5	3.8	3.7	4.2	4.3	3.1
FFO cash interest coverage (x)	3.3	3.6	3.9	4.1	4.1	3.3
Debt/EBITDA (x)	6.1	6.6	6.6	6.0	6.4	8.4
FFO/debt (%)	10.2	9.3	9.8	10.3	10.6	6.3
OCF/debt (%)	9.3	8.1	7.3	9.6	13.2	7.3
FOCF/debt (%)	0.6	(0.9)	(1.8)	1.0	5.7	0.7
DCF/debt (%)	(4.0)	(8.6)	(6.8)	(0.6)	3.2	(1.7)

Peer Comparison

Scotland Gas Networks PLC--Peer Comparisons

	Scotland Gas Networks PLC	Cadent Gas Ltd.	Northern Gas Networks Finance PLC	Wales & West Utilities Finance PLC
Foreign currency issuer credit rating	BBB/Stable/--	BBB+/Stable/--	BBB+/Stable/--	--
Local currency issuer credit rating	BBB/Stable/--	BBB+/Stable/--	BBB+/Stable/--	--
Period	Annual	Annual	Annual	Annual
Period ending	2022-03-31	2022-03-31	2022-03-31	2022-03-31
Mil.	GBP	GBP	GBP	GBP
Revenue	1,105	1,984	421	452
EBITDA	569	1,089	236	228
Funds from operations (FFO)	304	647	160	79
Interest	185	273	53	72
Cash interest paid	133	188	34	81
Operating cash flow (OCF)	349	770	133	94
Capital expenditure	318	861	165	144
Free operating cash flow (FOCF)	31	(91)	(31)	(50)
Discretionary cash flow (DCF)	(83)	(286)	(123)	(110)
Cash and short-term investments	123	91	7	283
Gross available cash	123	91	7	283
Debt	4,791	8,956	1,649	1,682

Scotland Gas Networks PLC--Peer Comparisons

Equity	1,238	3,862	561	(128)
EBITDA margin (%)	51.5	54.9	56.1	50.5
Return on capital (%)	6.1	5.0	6.7	9.0
EBITDA interest coverage (x)	3.1	4.0	4.5	3.2
FFO cash interest coverage (x)	3.3	4.4	5.7	2.0
Debt/EBITDA (x)	8.4	8.2	7.0	7.4
FFO/debt (%)	6.3	7.2	9.7	4.7
OCF/debt (%)	7.3	8.6	8.1	5.6
FOCF/debt (%)	0.7	(1.0)	(1.9)	(3.0)
DCF/debt (%)	(1.7)	(3.2)	(7.5)	(6.5)

Environmental, Social, And Governance

ESG Credit Indicators

E-1	E-2	E-3	E-4	E-5	S-1	S-2	S-3	S-4	S-5	G-1	G-2	G-3	G-4	G-5
- Climate transition risks					- N/A					- N/A				

N/A--Not applicable. ESG credit indicators provide additional disclosure and transparency at the entity level and reflect S&P Global Ratings' opinion of the influence that environmental, social, and governance factors have on our credit rating analysis. They are not a sustainability rating or an S&P Global Ratings ESG Evaluation. The extent of the influence of these factors is reflected on an alphanumeric 1-5 scale where 1 = positive, 2 = neutral, 3 = moderately negative, 4 = negative, and 5 = very negative. For more information, see our commentary "ESG Credit Indicators: Definition And Applications," published Oct. 13, 2021.

Environmental factors are a moderately negative consideration in our credit rating analysis of SGN, as is the case for other regulated gas networks in Europe. This reflects long-term uncertainty about the prospects for gas networks. SGN is working on a range of projects that seek to demonstrate the viability of hydrogen networks in the U.K., including H100 in Fife, which will deliver green hydrogen to about 300 households when completed. These projects will support the U.K. government's aims to have 10 gigawatts of hydrogen production capacity by 2030. SGN's environmental strategy, announced in April 2021, includes a target for all its business operations to be net-zero by 2045.

Rating Component Scores

Foreign currency issuer credit rating	BBB/Stable/--
Local currency 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
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	Neutral (no impact)
Stand-alone credit profile	bbb

Related Criteria

- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: Guarantee Criteria, Oct. 21, 2016
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- 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: Country Risk Assessment Methodology And Assumptions, 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
- Criteria | Corporates | General: Corporate Methodology, 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

Copyright © 2023 by Standard & Poor's Financial Services LLC. All rights reserved.

No content (including ratings, credit-related analyses and data, valuations, model, software or other application or output therefrom) or any part thereof (Content) may be modified, reverse engineered, reproduced or distributed in any form by any means, or stored in a database or retrieval system, without the prior written permission of Standard & Poor's Financial Services LLC or its affiliates (collectively, S&P). The Content shall not be used for any unlawful or unauthorized purposes. S&P and any third-party providers, as well as their directors, officers, shareholders, employees or agents (collectively S&P Parties) do not guarantee the accuracy, completeness, timeliness or availability of the Content. S&P Parties are not responsible for any errors or omissions (negligent or otherwise), regardless of the cause, for the results obtained from the use of the Content, or for the security or maintenance of any data input by the user. The Content is provided on an "as is" basis. S&P PARTIES DISCLAIM ANY AND ALL EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE, FREEDOM FROM BUGS, SOFTWARE ERRORS OR DEFECTS, THAT THE CONTENT'S FUNCTIONING WILL BE UNINTERRUPTED OR THAT THE CONTENT WILL OPERATE WITH ANY SOFTWARE OR HARDWARE CONFIGURATION. In no event shall S&P Parties be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs or losses caused by negligence) in connection with any use of the Content even if advised of the possibility of such damages.

Credit-related and other analyses, including ratings, and statements in the Content are statements of opinion as of the date they are expressed and not statements of fact. S&P's opinions, analyses and rating acknowledgment decisions (described below) are not recommendations to purchase, hold, or sell any securities or to make any investment decisions, and do not address the suitability of any security. S&P assumes no obligation to update the Content following publication in any form or format. The Content should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. S&P does not act as a fiduciary or an investment advisor except where registered as such. While S&P has obtained information from sources it believes to be reliable, S&P does not perform an audit and undertakes no duty of due diligence or independent verification of any information it receives. Rating-related publications may be published for a variety of reasons that are not necessarily dependent on action by rating committees, including, but not limited to, the publication of a periodic update on a credit rating and related analyses.

To the extent that regulatory authorities allow a rating agency to acknowledge in one jurisdiction a rating issued in another jurisdiction for certain regulatory purposes, S&P reserves the right to assign, withdraw or suspend such acknowledgment at any time and in its sole discretion. S&P Parties disclaim any duty whatsoever arising out of the assignment, withdrawal or suspension of an acknowledgment as well as any liability for any damage alleged to have been suffered on account thereof.

S&P keeps certain activities of its business units separate from each other in order to preserve the independence and objectivity of their respective activities. As a result, certain business units of S&P may have information that is not available to other S&P business units. S&P has established policies and procedures to maintain the confidentiality of certain non-public information received in connection with each analytical process.

S&P may receive compensation for its ratings and certain analyses, normally from issuers or underwriters of securities or from obligors. S&P reserves the right to disseminate its opinions and analyses. S&P's public ratings and analyses are made available on its Web sites, www.standardandpoors.com (free of charge), and www.ratingsdirect.com (subscription), and may be distributed through other means, including via S&P publications and third-party redistributors. Additional information about our ratings fees is available at www.standardandpoors.com/usratingsfees.

STANDARD & POOR'S, S&P and RATINGSDIRECT are registered trademarks of Standard & Poor's Financial Services LLC.