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Research Update:

Portuguese Gas Network Operator Galp Gas Natural Distribuicao S.A. Assigned Preliminary 'BBB-' Rating; Outlook Stable

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Overview

- We are assigning our preliminary 'BBB-' corporate credit rating to Portuguese gas distribution network operator Galp Gas Natural Distribuicao S.A. (GGND). We assess GGND's regulated gas distribution business risk profile as excellent and its financial risk profile as aggressive.
- The rating is constrained by our view of the consolidated creditworthiness of GGND and its parent, oil and gas company Galp Energia. However, based on the material the company has provided, we believe that GGND is sufficiently insulated from its parent to be rated one notch above the group credit profile.
- The stable outlook reflects GGND's long-term franchise agreement, supportive operating and regulatory environment, and management's track record of meeting regulatory expectations.

Rating Action

On Aug. 25, 2016, S&P Global Ratings assigned its preliminary 'BBB-' long-term corporate credit rating to Portuguese gas distribution network operator Galp Gas Natural Distribuicao S.A. (GGND). The outlook on GGND is stable.

The preliminary rating is subject to GGND's successful placement of the proposed debt refinancing and our receipt and review of the final documentation and the implementation of the shareholders' agreement. If we do not receive the final documentation within a reasonable time frame, or if the final documentation or implementation departs from the materials we have already reviewed, we reserve the right to withdraw or revise our rating.

Rationale

The preliminary rating reflects management's announced agreement to sell a minority position (22.5%) to a consortium led by Marubeni Corp., expected to close within the next few months. The preliminary rating is also subject to a significant reduction in GGND's financing costs via a successful bond issuance, our receipt and review of the final documentation, and the implementation of the signed shareholder's agreement.

GGND owns nine of the 11 distribution networks operating in Portugal and is a wholly owned intermediate holding company of Galp Energia SGPS S.A. (Galp), an integrated oil and gas company engaged in refining and exploration and production. The preliminary rating reflects our assessment of GGND's excellent business risk and aggressive financial risk profiles, as well as its relationship with its owner Galp and our view of the consolidated creditworthiness of Galp. The preliminary rating also reflects management's plans to sell a minority position (22.5%) to a long-term infrastructure investor within the next month. We understand Galp will share control over GGND's board with the minority shareholder and that the board will have one independent director, as defined by U.K. governance standards. We anticipate that GGND will no longer be fully consolidated by Galp in future reporting.

The preliminary rating and outlook are contingent upon GGND making a significant reduction in its financing costs via a successful bond issuance. We expect GGND to establish a €1 billion medium-term note program, issue up to €600 million senior unsecured notes under the program, and obtain a committed €50 million senior unsecured revolving credit facility. We expect the proceeds of the notes will be used to repay the existing shareholder loan and for general corporate purposes.

The excellent business risk profile is supported by a transparent and predictable regulatory environment, which provides a capacity-based tariff determined through a cost-of-service-based revenue allowance with a three-year cycle. There is a well-established track record (since 2008) of utilities recovering their operating and capital costs as well as debt service obligations under Portugal's Energy Services Regulatory Authority (ERSE) regulatory framework. ERSE has also demonstrated its independence within the legal framework under a period of financial duress in Portugal. Operating and capital expenses are approved in advance, with the difference between allowed and realized costs recoverable over the next two years of the regulatory cycle. The return on rate base (RoR) is updated annually based on the 10-year Portuguese government bonds. To stabilize returns within the cycle in the event of large movements in yields, the regulator sets a cap and a floor for each three-year period. We believe this approach enhances regulatory predictability and consistency. The regulator tracks operating performance but there are no related monetary incentives or penalties, or any requirement to share efficiencies with customers. Offsetting these strengths are a declining rate base and related revenue allowance, relatively low allowed returns compared with peers, and an inability to fully recover cash taxes through the tariff.

The excellent business risk profile is also supported by GGND's reliability and safety record, in line with its peers, and the ERSE's customer service expectations. Further, the utility's asset profile is relatively young--the bulk of its assets are less than 20 years old. Management has a track record of keeping costs aligned with the expenses allowed by the regulator. Offsetting these strengths is a customer base that is largely industrial, which we view as less stable than residential. Furthermore, in our view, the franchise has negligible growth prospects in the near term, given the economic environment and population density of the region.

Our base case assumes:

- Steady economic recovery in Portugal, supported by improving labor market conditions, underpinning our forecast of 1.8% average GDP growth in 2016 and 2017. This has little impact on GGND's revenues as they are based on approved tariffs that allow for the recovery of approved costs.
- Slightly lower EBITDA at GGND, reflecting lower yield from Portuguese government 10-year treasury notes, which are used to determine the utility's allowed RoR of 6.2% for July 2016-July 2017.
- A fairly stable EBITDA margin, thanks to the company's ongoing efficiency efforts and the supportive regulatory framework.
- A significant decline in the average cost of debt in 2016, reflecting the planned bond issuance that will be used to repay a similar-sized shareholder loan that currently attracts higher interest.
- Minimal maintenance capital expenditure of about €22 million per year resulting in a declining revenue allowance and regulatory asset base over the next few years.
- Dividends of about €40 million from 2017 onward.

Based on these assumptions, we arrive at the following credit measures for 2016-2019:

- Adjusted funds from operations (FFO) to debt of 11%-12%.
- FFO cash interest coverage averaging about 8x.
- Positive discretionary cash flow given minimal capital spending.

Allowed RoR for the period July 2016-July 2017 was recently announced at 6.2% for 2016, with a floor of 5.7% and a cap of 9.2% within the regulatory period of 2016 to 2019. Although this will have a modest negative impact on credit metrics, we still expect metrics to stay within our medial volatility benchmark range for an aggressive financial risk profile during the 2016-2019 regulatory cycle.

We arrive at a stand-alone credit profile (SACP) of 'bbb-' for GGND after applying a negative adjustment under our comparable ratings analysis. This reflects our view of pressures on GGND's business risk profile due to continuing economic constraints and fiscal pressures on energy companies in Portugal.

The preliminary rating outcome reflects the application of our group rating methodology. Our consolidated view of Galp's creditworthiness is weaker than GGND on a stand-alone basis, but we consider that GGND is sufficiently insulated from the parent to be rated one notch above the group credit profile (GCP). In our view, there is a less compelling economic incentive for Galp to preserve GGND's creditworthiness than exists for peers that enjoy insulation under our group rating methodology. However, the proposed structural protections (dividend lockup, financial covenants, step-up margin on the bond, ratings test for acquisitions and disposals, and governance), combined with what we view as modest reputational risk to Galp if GGND's creditworthiness were to suffer, are just sufficient to offset these concerns.

Although GGND does not have a funding track record in the capital markets, we expect its debt funding prospects to be independent from those of the group going forward as it plans to raise debt at the GGND level, replacing an existing shareholder loan. We believe the subsidiary's financial performance is independent from the parent's, given they are engaged in very different business activities and there is a strong track record of regulatory support for the utility subsidiary. Although GGND has service level agreements for most services with Galp, we believe the subsidiary is severable from the group and would be able to subcontract functions previously provided by the parent if the latter were in financial distress. Based on the information provided to us, we believe that the subsidiary holds itself as a separate entity at arm's length from its affiliates, and is unlikely to be drawn into bankruptcy proceedings at the group level that would lead to a default on its obligations.

The final rating will be subject to our review of the final debt documentation and implementation of the shareholders' agreement. All else being equal, any deterioration in the agreement's structural or governance protections could result in no insulation and a lowering of the rating to the GCP level of 'bb+'. We expect GGND to implement the shareholders' agreement with structural and governance provisions that we believe should preserve GGND's creditworthiness should the parent encounter severe setbacks. As part of the shareholder agreement, we also understand that GGND will have an independent board member, as defined by U.K. governance standards, with veto power to stop dividends subject to a ratings test and financial covenants; additionally, executive board members will not be employees of the shareholders. We expect similar structural protections to be included in all the proposed debt documentation as well as a meaningful step-up margin on the debt, subject to a rating trigger.

Based on our stress-test of the long-term rating on GGND, we conclude that there is a measureable likelihood that the issuer would withstand a sovereign default. We therefore believe the utility's ability to service and repay debt is superior to that of the sovereign.

Liquidity

We anticipate liquidity sources for GGND in the 12 months from Dec. 31, 2015, to be:

- FFO of about €74 million; and
- Cash position of €28 million.

We estimate that GGND's uses of liquidity over the same period will be:

- Short-term debt maturity of about €12 million;
- Capital spending of €24 million; and
- Dividend distributions of about €17 million in 2016.

We view GGND's liquidity as adequate based on quantitative and qualitative factors. We believe the company is likely to be able to absorb a high-impact, low-probability event without refinancing, given strong regulatory support. We expect management to take necessary actions to ensure continued adequate liquidity and believe GGND enjoys a sound relationship with banks. In addition, we calculate that sources of liquidity would still be positive even if EBITDA declined by 15% relative to our forecast.

Outlook

The stable outlook reflects our expectation that the regulatory environment will continue to support stable cash flow, GGND's operating environment remains relatively low risk, and management will continue to manage costs and meet regulatory expectations. We anticipate stable credit metrics with an adjusted FFO-to-debt ratio of 11%-12% over the next three years--within the 9%-13% benchmark range for an aggressive financial risk profile on our medial volatility table.

Upside scenario

Even if the SACP of GGND were to improve, which we do not anticipate within our two-year outlook horizon, a positive rating action is highly unlikely because the rating on GGND is constrained by our view of group creditworthiness. We don't anticipate an improvement in the group credit profile over our outlook period given a significant upstream development phase at the parent.

Downside scenario

Although we do not anticipate it during our outlook period, deterioration in the group credit profile would likely result in a commensurate action on GGND. We could also lower the rating following an unexpected and sustained deterioration in GGND's SACP, for example, if we expect FFO-to-debt to remain below 9% on a sustained basis due to a material change in financial policy, which we do not anticipate within our outlook period.

All else being equal, we could lower the rating by one notch if there is a change in governance, the signed shareholders' agreement, or the proposed debt documentation that we believe would weaken the factors insulating GGND from Galp.

Ratings Score Snapshot

Corporate Credit Rating: BBB- (prelim)/Stable/--

Business risk: Excellent
- Country risk: Intermediate
- Industry risk: Very low
- Competitive position: Strong

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: Fair (no impact)
- Comparable rating analysis: Negative (-1 notch)

Stand-alone credit profile: bbb-
- Group credit profile: bb+
- Entity status within group: Nonstrategic, one notch of insulation (no impact on SACP)
- Related government rating: BB+

Related Criteria And Research

Related Criteria

- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Corporate Methodology, Nov. 19, 2013
- Methodology: Industry Risk, Nov. 19, 2013
- Group Rating Methodology, Nov. 19, 2013
- Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Galp Gas Natural Distribuição, S.A.	
Corporate Credit Rating	BBB- (prelim)/Stable

Additional Contact:
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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.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at spcapitaliq.com. All ratings affected by this rating action can be found on the S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.