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Research Update:

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

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Overview

- We are assigning our 'BBB-' corporate credit rating to Portuguese gas distribution network operator Galp Gas Natural Distribuicao S.A. (GGND).
- The rating reflects our review of management's signed agreement to sell a minority position (22.5%) to a consortium led by Marubeni Corp. and its successful €600 million euro medium term note (EMTN) issuance.
- The rating is also linked to our views on the consolidated creditworthiness of GGND and its parent, oil and gas company Galp Energia SGPS S.A., as well as our 'BB+' sovereign credit rating on Portugal.
- 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 Oct. 5, 2016, S&P Global Ratings assigned its 'BBB-' long-term corporate credit and issue ratings to Portuguese gas distribution network operator Galp Gas Natural Distribuicao S.A. (GGND). The outlook on GGND is stable.

These ratings are in line with the preliminary ratings we assigned on Aug. 25, 2016.

Rationale

The rating reflects our review of management's signed agreement to sell a minority position (22.5%) to a consortium led by Marubeni Corp., expected to close in a month or so, and its successful €600 million bond issuance last month. Galp Energia SGPS S.A. (Galp; not rated) will share control over GGND's board with the minority shareholder and the board will have one independent director, as defined by U.K. governance standards.

Stable cash flows are 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. Management has a track record of keeping costs aligned with the expenses allowed by the regulator. 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 (5.7% and 9.3% for the current cycle). 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. GGND's reliability and safety record are in line with its peers as well as ERSE's customer service expectations.

At the same time, we believe GGND's credit profile is exposed to continuing economic and fiscal constraints for energy companies in Portugal, the company's declining rate base--which drives regulated revenue allocation--and its lumpy capital structure (seven-year bullet maturity). We believe the franchise has negligible growth prospects in the near term, given the region's economic environment and population density. Furthermore, the utility's customer base is largely industrial, which we view as less stable than residential.

Our base-case assumptions for GGND have not changed materially since we assigned the preliminary rating on Aug. 25, 2016 (see "Portuguese Gas Network Operator Galp Gas Natural Distribuicao S.A. Assigned Preliminary 'BBB-' Rating; Outlook Stable," published on RatingsDirect). Our base case assumes:

- Portugal's economic recovery will decelerate in 2016, primarily due to a slowdown in exports and investment activity. In September 2016, we revised our forecast of GDP growth downward to 1.2% and 1.3% in 2016 and 2017, respectively;
- Allowed RoR of 6.2% in 2016-2017. We have assumed it will remain at this level in 2017-2018;
- Fairly stable EBITDA margin of 48%, thanks to the company's ongoing efficiency efforts and the supportive regulatory framework;
- A significant decline in the average cost of debt in the fourth quarter of 2016, reflecting a €600 million bond issuance that will repay a €567 million shareholder loan at a higher coupon;
- Minimal maintenance capital expenditure (capex) of about €22 million per year, given its asset base is relatively young (about 20 years); and
- Dividends of about €40 million from 2017 onward.

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

- Weighted-average forward-looking S&P Global Ratings-adjusted funds from operations (FFO) to debt of 11%-12%; and
- Positive discretionary cash flow given minimal capex.

The current shareholders' agreement has structural and governance provisions that we believe should preserve GGND's creditworthiness one notch above the parent. These include a dividend lockup, financial covenants, a step-up margin on the bond, and a ratings test for acquisitions and disposals. We also view Galp's reputational risk as modest if GGND's creditworthiness were to suffer. As part of the shareholder agreement, GGND will have an independent board member, as defined by U.K. governance standards, with veto powers to stop dividends--subject to a ratings test and financial covenants. Additionally, executive board members will not be employees of the shareholders. Structural protections are also in the debt documentation and there is 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 current ability to service and repay debt is one notch superior to that on the sovereign.

Liquidity

We anticipate liquidity sources for GGND in the 12 months from June 30, 2016, to be:

- FFO of about €76 million;
- Cash position of €34 million; and
- New public debt of €600 million.

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

- Repayment of a €567 million shareholder loan;
- Short-term debt maturity of about €12 million;
- Capex of €23 million; and
- Dividend distributions increasing to about €30 million.

Outlook

The stable outlook reflects our expectation that the regulatory environment will continue to support stable cash flow, GGND's operating environment will remain relatively low risk, and management will continue to manage its costs and meet regulatory expectations. We therefore anticipate stable credit metrics with adjusted FFO to debt of 11%-12% over the next three years.

Upside scenario

We view an upgrade of GGND over our two-year outlook horizon as highly improbable because it would likely require a material change in the utility's financial policy (with an FFO-to-debt ratio of about 13% on a sustained basis), an improvement in the credit quality of the parent, and an upgrade of the sovereign.

Downside scenario

Although we do not anticipate a downgrade during our outlook horizon, a deterioration in the parent's credit profile or the sovereign credit rating on

Portugal would likely result in a similar action on GGND. We could also lower the rating following an unexpected and sustained deterioration in GGND's stand-alone credit profile due, for example, to a change in financial policy, leading to an FFO-to-debt ratio sustained below 9%. All else being equal, we could also lower the rating by one notch if there was a change in governance or the signed shareholders' agreement, which could weaken the factors insulating GGND from its parent, Galp.

Ratings Score Snapshot

Corporate Credit Rating: BBB-/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
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Group Rating Methodology, Nov. 19, 2013
- Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- Methodology: Industry Risk, Nov. 19, 2013
- Ratings Above The Sovereign--Corporate And Government Ratings:

Methodology And Assumptions, 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
- 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

Related Research

- Ratings On Portugal Affirmed At 'BB+/B'; Outlook Stable, Sept. 16, 2016
- Portuguese Gas Network Operator Galp Gas Natural Distribuicao S.A. Assigned Preliminary 'BBB-' Rating; Outlook Stable, Aug. 25, 2016

Ratings List

New Rating

Galp Gas Natural Distribuição, S.A.	
Corporate Credit Rating	BBB-/Stable/--
Senior Unsecured	BBB-

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.