

<b>STANDARD &amp; POOR'S</b>	<b>RATINGS DIRECT</b>
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## Research: Gaz Métropolitain Inc.

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### Corporate Credit Rating

A-/Stable/--

### Outstanding Rating(s)

#### Gaz Métropolitain Inc.

Sr secd debt

Local currency

A

CP

Local currency

A-2

### Corporate Credit Rating History

Apr. 23, 2001

A-

### Company Contact

Steve Pilon, (1) 514-598-3324

### ■ Business profile:

Above average

### ■ Financial policy:

Above average

### ■ Debt maturities:

2002 C\$3 mil.

2003 C\$132 mil.

2004 C\$21 mil.

2005 C\$71 mil.

2006 C\$75 mil.

#### ■ **Collateralization:**

C\$85 million accounts receivable securitization program

#### ■ **Bank lines:**

Gaz Metropolitan Inc. has C\$223 million in unsecured credit lines, including C\$30 million for its 50%-owned subsidiary Trans Quebec & Maritimes Pipeline Inc. Vermont Gas Systems (100% owned) also has a US\$15 million unsecured credit line. Gaz Metropolitan has a C\$300 million commercial paper program, and a C\$300 million syndicated term loan due April 2005, which is used to backup the commercial paper program.

#### ■ **Major Rating Factors**

##### **Strengths:**

- Strong core gas distribution and transportation businesses
- Stable financial performance

##### **Weaknesses:**

- Low residential customer penetration rate and reliance on industrial customers
- Increasing competitive market

#### ■ **Rationale**

The ratings on Gaz Metropolitan Inc. reflect the strength of the company's core gas distribution and transportation businesses, and its stable financial performance. The company, through its 77%-owned subsidiary, Gaz Metropolitan and Co. L.P. (GMCLP), transports and distributes natural gas in Quebec and the northeastern U.S. The ratings also reflect the diversification benefits of the company's 50% stake in Trans Quebec & Maritime Pipeline Inc. and its 21% interest in Portland Natural Gas Transmission System (PNGTS), as well as its nonregulated energy services and other businesses. Standard & Poor's expects Gaz Metropolitan's growth strategy will focus primarily on increasing the low market penetration of natural gas in Quebec (currently about one-half the national average), diversifying its gas supply sources away from the Canadian western basin (Sable Island, the U.S. Midwest, and the Gulf of Mexico), increasing earnings through performance-based regulation, diversifying the utility's sources of regulated revenues, and generating growth through nonregulated activities.

Gaz Metropolitan's above-average business risk profile reflects its strong gas distribution franchises in Quebec and Vermont, and the stable regulatory environment. In Quebec, the company accounts for 97% of natural gas consumed while its wholly owned subsidiary, Vermont Gas Systems, is the sole gas distributor in Vermont. The Quebec distribution assets are subject to performance-based regulation

where the downside risk is limited to the cost of service and rate of return method. Current regulation protects Gaz Metropolitain from commodity risk, which is a direct flow through to the distribution customers. The company has a strong ownership group, with its largest stakeholders consisting of Hydro-Quebec (41%), Enbridge Inc. (32%), and Gaz de France (18%).

The ratings are partially offset by the company's low residential penetration rate and reliance on industrial customers, which exposes Gaz Metropolitain to economic slowdowns. As well, the volatile energy prices in combination with the fuel-switching capabilities of large load customers have increased the competitiveness of the market. In 2001, industrial customers accounted for 43% of revenues, commercial customers 40%, and residential 17%. The company, however, does continue to enjoy a 30% price advantage over electricity in the important commercial market segment.

Gaz Metropolitain's above-average financial risk profile reflects its strong profitability and cash flow protection measures and a stable, regulated capital structure. The company's total debt to capital of 62%, funds from operations (FFO) interest cover ratio of 3.9 times, and FFO to total debt of 23% continue to measure within the parameters of the current rating category. Standard & Poor's expects Gaz Metropolitain's cash flow protection measures will remain relatively stable in the near to medium term, and the company's strong cash flow generation will be sufficient to fund projected capital expenditures.

## ■ Outlook

The outlook reflects the expectation of a stable regulatory regime and steady earnings. Furthermore, Standard & Poor's expects Gaz Metropolitain's financial risk profile will remain relatively unchanged between 2002 and 2004, as the company's cash flow protection measures will be largely determined by its deemed capital structure and regulated returns.

Table 1 Gaz Metropolitain Financial Summary					
	--Year ended Sept. 30--				
(Mil. C\$)	2001	2000	1999	1998	1997
Gross revenues	2,063.3	1,628.7	1,327.7	1,249.4	1,203.7
Net income from cont. operations	141.2	143.7	135.8	140.7	138.7
Funds from operations (FFO)	297.5	265.9	234.1	229.9	257.9
Net cash flow (NCF)	157.2	128.9	99.3	91.4	115.7
Capital expenditures	(80.8)	(86.0)	(176.8)	(229.5)	(69.4)
Total capital	2,120.6	2,032.7	1,936.3	1,830.8	1,623.8
Pretax interest coverage (x)	2.3	2.5	2.4	2.6	2.5
Total debt (incl. STD)/capital (%)	62.8	61.2	59.7	60.5	56.1
FFO/interest coverage (x)	3.8	3.8	3.5	3.8	3.9
FFO/avg. total debt (%)	22.5	21.7	20.2	22.2	27.7

NCF/capital expenditures (%)	194.4	149.8	56.2	39.8	166.7
STD--Short-term debt.					

## ■ Business Description

Gaz Metropolitain's core business is the regulated distribution and transportation of natural gas in Quebec and Vermont. The company is involved in the transportation of natural gas through its 50% interest in Trans Quebec & Maritimes Pipeline Inc. and a 21% interest in PNGTS.

Overall, GMCLP has more than 184,000 customers and operates 11,000 kilometers of pipelines. Ninety-five percent of GMCLP's revenues and 86% of EBITDA are derived from gas distribution. In 2001, gas transportation accounted for more than 51% of gas deliveries and 13% of EBITDA.

GMCLP also has interests in nonregulated businesses, which include heating and air-conditioning products, a 12% interest in Cable VDN (local fiber optic network), and two small water infrastructure management companies. Overall, nonregulated businesses account for only 3% of assets and 2% of revenues.

## ■ Business Profile

### Regulation.

The Canadian operations are regulated by the Regie de l'Energie (Quebec) and the National Energy Board. The regulation for the Quebec distribution assets is quite favorable. Performance-based regulation limits any downside risk to a cost of service and rate of return method, which is currently set at a 9.67% ROE. Although the downside is limited, productivity gains allow Gaz Metropolitain to potentially earn up to 400 basis points above the base rate of return (productivity gains are shared with consumers by formula), and the company does not have any commodity risk, as these costs are a direct flow through to distribution customers. The Quebec regulation also allows for a weather-normalization deferral account. Rates are calculated on normal weather (30-year average); any variation is deferred through a normalized account and collected through rate adjustments over a five-year period. Interest rate risk is also not a concern because any variation in floating interest rates also can be deferred through a normalization account.

The U.S. operations are subject to the FERC and the Vermont Public Service Board. The regulatory framework for gas distribution in Vermont is not as favorable as that of Quebec. It provides a single rate that includes commodity, transportation, balancing, and distribution, but the company must apply for each rate increase. Rate decisions are not retroactive, and there is no automatic rate adjustment mechanism to reflect the cost of gas. Thus, the company must use derivative instruments to fix the price of gas.

### Markets.

Quebec is the second-largest province in Canada by size and population (7.4 million). During the past three years, Quebec's per capita income has been below the national average, unemployment

has been higher than the national average, and real GDP growth has been a bit slower than the national average. Although Vermont is small (population 600,000), its economy has been healthy and stable.

Industrial customers are well diversified. The highest concentrations of total volume are in the metallurgical (11%), and pulp and paper (10%) sectors. The three largest industrial customers account for only 7% of total volume. About 300 industrial customers account for 50% of total deliveries. The top 10 industrial customers account for 31% of industrial volume, which is around 15% of the total volume. Reliance on the industrial customers exposes Gaz Metropolitain to economic slowdowns and cyclical commodity prices. Thus, revenues can be more volatile.

In 2001, 43% of revenues came from industrial companies, of which 14% have dual-fuel capabilities, 39% from commercial customers, and 18% from residential customers. GMCLP has partially mitigated its heavy exposure to the industrial sector by engaging the customers to long-term take-or-pay contracts. With volatile energy prices, however, customers have become more reluctant to sign such long-term contracts. Standard & Poor's expects the customer base composition will remain stable in the near to medium term.

#### **Operations.**

Most operating risks are mitigated by regulation. Commodity prices are not a risk because regulation allows the flow through of these costs (and there is an automatic monthly adjustment mechanism). The Quebec distribution assets are fairly new and efficient, and abundant natural gas reserves assure the security of short- to medium-term supply.

Gaz Metropolitain's operating statistics do not compare favorably with those of other Canadian gas distributors such as Enbridge Consumers Gas, Union Gas Ltd., or BC Gas Utility Ltd.. This is explained mostly by the fact that GMCLP has such a low penetration rate on high-margin residential customers, which prevents increased economies of scale. Thus, on operating cost per customer, customer per employee, and EBITDA margin bases, GMCLP trails the other large distributors.

GMCLP would like to diversify its supply sources with the Cartier Pipeline project, which would access the natural gas produced in the Atlantic coast basin. Two problems have appeared. First, the producers have not been as successful as hoped in the development of the reserves and secondly, the transporter of natural gas produced in the region appears to prefer moving the gas to the larger U.S. first Petroleum Administration for Defense District (PADD I) market rather than central Canada. Thus, an extension of the system from New Brunswick to Quebec (where it would attach to Cartier) might not be constructed. Regardless of the Cartier project, the short- to medium-term supply of gas is stable, and the long-term outlook is quite strong.

GMCLP also owns a 50% interest in the 220 kilometer Trans Quebec & Maritime Pipeline. The other 50% is owned by TransCanada PipeLines Ltd. The gas pipeline connects upstream with that of TransCanada PipeLines and downstream with that of PNGTS.

PNGTS is a 350 kilometer pipeline that originates at the Quebec border and extends to the suburbs of Boston, Mass. GMCLP is a minority owner (21%). The other partners are TransCanada PipeLines (33%), El Paso Energy (30%), and MCN East Coast Pipeline (16%).

Table 2 Operating Efficiencies of Canadian Gas Distributors*								
--At Dec. 31, 2001--								
	Operating costs per customer (C\$)	Rank	Customers per employee	Rank	Operating margin (%)	Rank	Number of Customers	Rank
BC Gas Utility Ltd.	183	3	524	3	24.7	3	767,000	3
Consumers Gas Co. Ltd. (The)¶	179	2	989	1	23.6	4	1,546,255	1
Gaz Metropolitan Inc.¶	933	8	134	8	17.9	6	184,489	6
Pacific Northern Gas Ltd.	515	7	446	4	25.3	2	39,230	8
Union Gas Ltd.	241	5	526	2	28.3	1	1,147,000	2
AltaGas Services Inc.	235	4	364	6	11.1	8	57,542	7
Centra Gas Manitoba§	177	1	389	5	15.1	7	248,074	5
SaskEnergy	341	6	322	7	20.0	5	321,504	4

\*Operating, maintenance, and administrative costs only. ¶ For the fiscal year ended Sept 30, 2001. §For the fiscal year ended March 31, 2001.

### Competitive position.

GMCLP delivers about 97% of the natural gas consumed in Quebec; however, the residential penetration rate in Quebec is quite low because, for years, the Quebec government promoted cheap electricity through provincially owned Hydro-Quebec. Natural gas market penetration for the residential market is just 4% versus 71% in neighboring Ontario, and 51% for the national average. This low penetration rate is now seen as a large opportunity for GMCLP (although Hydro-Quebec owns 41% of Gaz Metropolitan, competition is intense). Although the company has around 185,000 customers, it will be difficult to convince nongas consumers to switch, given the upfront conversion costs. Furthermore, high natural gas prices can narrow the price advantage natural gas has traditionally enjoyed over electricity. Price volatility in energy markets combined with the flexibility of large customers to switch energy sources highlights how quickly the competitive conditions can change. In addition, Quebec is a very competitive market unlike any other Canadian province because of the artificially low electricity prices.

Despite high natural gas prices, 2,200 new residential customers were added in Quebec and another 1,000 customers were added in Vermont. The majority of new customers are the result of new housing construction. Vermont Gas Systems is the sole gas distributor in Vermont, and natural gas continues to enjoy a price advantage over electricity. Standard & Poor's expects additional customer growth will continue at the historical rate in the near to medium term.

## ■ Financial Profile

Balance-sheet leverage is largely dictated by regulatory guidelines, which currently stipulate a 38.5% deemed common equity capital component. There is no incentive to diverge from these directives as "excess" equity generates a lower return than the approved ROE, while successfully operating with less than the deemed equity might signal that the allowed equity cushion is too thick. Involvement in nonregulated activities is limited to 10% of assets, and GMCLP may not issue, assume, or guarantee long-term debt if the total long-term debt exceeds 65% of the company's total capitalization.

### Profitability and cash flow protection.

The utility's profitability and cash flow protection measures adequately reflect the current credit ratings. Although revenues will fluctuate with gas prices, Gaz Metropolitan has demonstrated consistent profitability and strong cash flow generation. The company has the opportunity to modestly increase earnings through productivity improvements and the nonregulated activities. The majority of Gaz Metropolitan's revenues, however, are subject to regulation that limits the downside risk to a cost-of-service basis. Thus, Standard & Poor's expects the company will continue to be profitable and generate healthy cash flows.

### Capital structure and financial flexibility.

Standard & Poor's expects Gaz Metropolitan's capital structure will remain stable over the long term given the regulatory directives. Earnings are paid out as distributions, and there is little incentive to diverge from the approved regulatory structure. The existing equity owners are expected to maintain their current proportionate ownership interests in the company. Internally generated cash should be sufficient to fund capital expenditures, which are fairly predictable and average C\$150 million annually. Gaz Metropolitan also possesses ample liquidity, including a C\$300 million commercial paper program, which is fully supported by bank lines of credit and a term loan facility. Commercial paper borrowings are primarily used for working capital purposes and are highly seasonal. In addition, the company's debt maturity schedule is balanced.

Table 3 Gaz Metropolitan Historical Profitability					
	--Year ended Sept. 30--				
	2001	2000	1999	1998	1997
<i>Income statement (mil. C\$)</i>					
Gross revenues	2,063.3	1,628.7	1,327.7	1,249.4	1,203.7
Operating expenses (excl. DD&A)	1,698.8	1,276.4	1,005.9	933.2	888.1
Depreciation and amortization	127.1	120.8	106.8	100.8	92.4
EBIT	237.4	231.5	215.0	215.4	223.3
Gross interest expense	98.1	90.3	88.4	80.1	86.3
AFUDC and other income/expense	1.9	2.5	9.2	5.5	1.7

Pretax income	141.2	143.7	135.8	140.7	138.7
Income taxes	0.0	0.0	0.0	0.0	0.0
Net income from continuing ops	141.2	143.7	135.8	140.7	138.7
<b>Earnings protection</b>					
EBIT interest coverage (x)	2.4	2.5	2.4	2.7	2.6
Adjusted EBIT interest coverage (x)	2.3	2.5	2.4	2.6	2.5
EBITDA interest coverage (x)	3.6	3.8	3.6	3.9	3.7
AFUDC and other income/earnings (%)	0.0	0.0	0.1	0.0	0.0
Return on avg. common equity (%)	17.1	17.6	16.4	18.4	18.7
Common dividend payout (%)	99.4	95.3	99.2	98.4	102.5
Annual expense growth (excl DD&A) (%)	33.1	26.9	7.8	5.1	8.3
Operating expenses (excl DD&A)/revenues (%)	82.3	78.4	75.8	74.7	73.8
DD&A--Depreciation, depletion, and amortization. EBIT--Earnings before interest and taxes. AFUDC--Allowance for funds used during construction. EBITDA--Earnings before interest, taxes, depreciation, and amortization.					

<b>Table 4 Gaz Metropolitan Capital Structure</b>					
	<b>--Year ended Sept. 30--</b>				
	<b>2001</b>	<b>2000</b>	<b>1999</b>	<b>1998</b>	<b>1997</b>
<b>Balance sheet (mil. C\$)</b>					
Cash	3.7	4.1	9.2	28.2	2.3
Gross plant	2,556.2	2,477.5	2,396.5	2,235.5	1,965.3
Net plant	1,750.7	1,740.6	1,727.5	1,628.5	1,425.6
Total assets	2,349.7	2,262.9	2,138.0	2,017.3	1,775.3
Short-term debt	41.5	36.9	57.1	55.1	71.8
Long-term debt	1,267.2	1,189.8	1,082.4	1,034.8	819.8
Common equity	811.8	806.0	796.8	740.9	732.1
Total capitalization	2,120.6	2,032.7	1,936.3	1,830.8	1,623.8
Total off-balance-sheet obligations	63.0	43.0	43.0	43.0	43.0
<b>Balance-sheet ratios</b>					
Short-term debt/total capital (%)	2.0	1.8	2.9	3.0	4.4
Long-term debt/total capital (%)	59.8	58.5	55.9	56.5	50.5
Total debt/total capital (%)	61.7	60.3	58.8	59.5	54.9
Common equity/total capital (%)	38.3	39.7	41.2	40.5	45.1
Adjusted total debt/total capital (%)	61.7	60.3	58.8	59.5	54.9

Table 5 Gaz Metropolitan Cash Flow Protection					
	--Year ended Sept. 30--				
	2001	2000	1999	1998	1997
<b>Cash flow (mil. C\$)</b>					
Net income	141.2	143.7	135.8	140.7	138.7
Depreciation and amortization	127.1	121.7	106.8	100.8	93.4
Other noncash items	29.2	0.4	(8.5)	(11.6)	25.9
Funds from operations (FFO)	297.5	265.9	234.1	229.9	257.9
Common dividends	(140.3)	(137.0)	(134.7)	(138.5)	(142.2)
Net cash flow (NCF)	157.2	128.9	99.3	91.4	115.7
Working capital changes	25.6	(75.8)	12.5	1.9	(10.3)
Capital expenditures	(80.8)	(86.0)	(176.8)	(229.5)	(69.4)
Discretionary cash flow	101.9	(33.0)	(65.0)	(136.1)	36.0
<b>Cash flow adequacy</b>					
FFO interest coverage (x)	3.8	3.9	3.6	3.9	4.0
Adjusted FFO interest coverage (x)	3.8	3.8	3.5	3.8	3.9
FFO/avg. total debt (%)	23.5	22.5	21.0	23.2	29.2
Adjusted FFO /avg. total debt (%)	22.5	21.7	20.2	22.2	27.7
NCF/capital expenditures (%)	194.4	149.8	56.2	39.8	166.7

Table 6 Comparative Statistics: Canadian Gas Distribution Companies					
	--Year ended Dec 31, 2001--				
(Mil. C\$)	BC Gas Utility Ltd.	Consumers Gas Co. Ltd. (The)*	Gaz Metropolitan Inc.*	Pacific Northern Gas Ltd.	Union Gas Ltd.
Corporate credit rating (as of June 27, 2002)	BBB+/Stable/--	A-/Negative/--	A-/Stable/--	BB-/Watch Pos/--	A+/Stable/--
Gross revenues	1,423.2	2,514.9	2,063.3	138.6	1,926.0
Net income	67.2	174.1	141.2	5.7	121.0
Funds from operations (FFO)	142.4	368.8	297.5	15.8	338.0
Net cash flow	82.4	260.8	157.2	15.5	268.0
Capital expenditures	(146.0)	(267.1)	(80.8)	(3.8)	(218.0)
Total capital	2,431.0	3,825.3	2,120.6	165.2	3,738.0
Return on capital (%)	9.8	10.7	11.5	10.7	8.9
NCF/capital expenditures	56.4	97.6	194.4	412.3	122.9

Pretax interest coverage (x)	1.8	2.8	2.3	2.3	1.9
FFO interest coverage (x)	2.0	3.4	3.8	2.9	2.9
FFO/avg total debt	8.7	16.6	22.5	15.8	14.2
Total debt (incl. STD+PFD)/capital	69.5	58.4	62.8	55.0	68.1
*For the fiscal year ended Sept. 30, 2001. STD--Short-term debt. PFD--Preferred shares.					

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