S&P Global
Ratings

Research

Research Update:

Gaz Metro Inc. Affirmed At 'A' After Change To Downside Trigger; Outlook Stable

Primary Credit Analyst:
Andrew Ng, Toronto (416) 507-2545; andrew.ng@spglobal.com

Secondary Contact:
Stephen R Goltz, Toronto (416) 507-2592; stephen.goltz@spglobal.com

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Research Update:

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Overview

- We are affirming our 'A' long-term corporate credit rating and 'A+' senior secured first mortgage bond ratings on Quebec-based regulated utility Gaz Metro Inc. (GMI).
- We are also affirming our 'A-1' global scale and 'A-1 (Mid)' Canada scale commercial paper ratings on the company.
- We are revising our downside trigger on GMI to 13% adjusted funds from operation (AFFO)-to-debt from 16% as the company moves to U.S. generally accepted accounting principles (GAAP) reporting from Canadian GAAP.
- The stable outlook reflects our assessment of the company's predictable and stable cash flows from its low-risk, regulated gas and electricity business in Quebec and Vermont.

Rating Action

On Dec. 13, 2016, S&P Global Ratings affirmed its 'A' long-term corporate credit rating, 'A+' senior secured first mortgage bond rating, and 'A-1' global scale and 'A-1(Mid)' Canada scale commercial paper ratings on Quebec-based regulated utility Gaz Metro Inc. (GMI). The outlook is stable.

Rationale

The affirmation follows S&P Global Ratings revising its downside trigger on the company to 13% adjusted funds from operation (AFFO)-to-debt from 16% as the company moved to U.S. generally accepted accounting principles (USGAAP) reporting from Canadian generally accepted accounting principles (CGAAP). GMI made the change starting in fiscal 2016, which has resulted in lower credit metrics; however, credit metrics are still consistent with the intermediate financial risk profile (FRP). In addition, the underlying business model is unchanged, as our business risk profile (BRP) assessment reflects. Because credit metrics presented under USGAAP are lower, we have revised our downside trigger on the company. The main impact of USGAAP on credit metrics includes the following:

- Using the equity method of consolidation instead of the proportionate method for joint ventures. This reduces debt outstanding, although decreases in cash and AFFO offset this; and
- Reclassification of deferral charges, resulting in lower adjustments to AFFO related to cost of energy.

For fiscal 2016, the net resulting impact on GMI's AFFO-to-debt is about

13.8%. During our 24-month outlook period, we forecast the company's AFFO-to-debt to be 14%-15%. We continue to use the low volatility cash flow table when assessing GMI's cash flow leverage to reflect the generally supportive regulatory regime that underpins the company's stable and predictable cash flow stream and that vast majority of GMI's operating cash flows are from the low end of the utility risk spectrum.

We continue to exclude the C$892.8 million of non-common equity financing from Noverco Inc. provided to GMI from our leverage and coverage calculations as per our "Non-Common Equity Financing In Nonfinancial Corporate Entities" criteria, published April 29, 2014, on RatingsDirect. The notes have more than 10 years remaining, and we believe that the company intends to extend the maturity date to at least 30 days after all other debt matures. When the bonds have less than 10 years, or (while unlikely) should we no longer believe GMI intends to extend the maturity, we might include the notes in our leverage and coverage calculations.

Our assessment of GMI's business risk profile (BRP) is unchanged at excellent. There is no change to the company's fundamentals and underlying business model as a result of the accounting change. GMI continues to benefit from its stable, low-risk, regulated utilities operations. Tariff structures are generally supportive, allowing recovery of prudently incurred operational and capital expenses in a timely manner that supports the stable cash flow. Moreover, GMI's exposure to commodity input price is limited as electricity and natural gas input costs remain a pass-through to rate-payers, which we view as a credit strength.

In Quebec, which accounts for 65%-70% of the cash flow, the company can recover revenue shortfall from weather-related impacts in subsequent years, which reduces its volume risk exposure. Furthermore, key rate base parameters including return on equity (ROE) and equity thickness approved by the Regie de l'energie, regulator for Quebec, is supportive and in line with those of other regulated utilities across other jurisdictions. For 2017, approved ROEs are 8.90% for the Regie, 8.50% for the Alberta Utilities Commission (AUC), and 8.78% for the Ontario Energy Board (OEB). For the equity thickness in the deemed capital structure for 2017, the Regie approved 38.5%, the AUC 37%-41%, and the OEB 36%-40% for gas distribution companies.

GMI also operates in multiple service territories primarily in Quebec and Vermont, through its wholly owned subsidiary Green Mountain Power Corp., providing some degree of regulatory, geographic, and market diversification.

Further supporting the business risk profile is GMI's overall diverse customer base, primarily consisting of residential and small-to-medium commercial customers that are less sensitive to economic cycles. Although in Quebec, GMI has a relatively large industrial user base that contributes a material portion of the company's cash flow; however, these industrial users' gas consumption largely depends on the price of natural gas. Given that natural gas is relatively cheap compared with other fuel sources, we do not expect fuel switching among industrial users to be a concern at present.

GMI also owns and operates a renewable energy wind farm, an unregulated business, but its cash flow contribution to GMI is minimal and is immaterial to our rating on the company.

Our base-case scenario assumptions include the following:
- Population growth of about 0.8% in 2017 and 2018 in the Province of Quebec
- Real GDP growth of about 1.6% in 2017 and 2018 in Quebec
- GMI will continue to focus on regulated utility operations with unregulated energy-related and non-energy-related activities less than 10% of its total unconsolidated assets
- The company will not experience any adverse and material regulatory decisions, and the regulatory regimes in Quebec and Vermont will be stable and transparent

Based on these assumptions, we arrive at the following credit measures:
- AFFO-to-debt of 14%-15% in 2017 and 2018
- Debt-to-EBITDA of 5x-6x in 2017 and 2018

Liquidity

Our view on GMI's liquidity is adequate. We expect that liquidity sources will be adequate to cover uses of about 1.4x in the next 12 months. We further expect that, in the event of a 10% EBITDA decline, the company's sources of funds would still exceed its uses. In our view, GMI has sound relationships with its banks and generally prudent financial risk management. In an unexpected financial stress situation, we believe the utility would scale back on its capital expenditures and have the flexibility to suspend dividend payments to preserve credit metrics.

Principal liquidity sources include:
- Cash FFO of about C$560 million over the next 12 months
- Committed credit facilities availability of about C$530 million as of Sept. 30, 2016, maturing in 2021
- Proceeds of about C$125 million from debt issuance in October 2016

Principal liquidity uses include:
- Capital expenditure of about C$470 million over the next 12 months
- Dividends of about C$170 million over the next 12 months

Outlook

The stable outlook reflects S&P Global Ratings' expectation that, on a consolidated basis, GMI will continue generating stable and predictable cash flow from its low-risk regulated operations in Quebec and Vermont during our 24-month outlook horizon. The outlook also reflects our expectation that management will continue to focus on its core regulated business and that the company will not experience any adverse regulatory decisions during our outlook horizon.

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Downside scenario

We could take a negative rating action on GMI if the company's credit metrics deteriorate, with AFFO-to-debt falling to and staying below 13%. This could happen as a result of adverse regulatory decision, a material debt-financed acquisition, or if the company encountered significant operating challenges.

Upside scenario

We could take a positive rating action if the company demonstrates long-term commitment to improve its credit metrics resulting in sustained AFFO-to-debt about 23%. However, we do not expect this to happen during our outlook period, given the company's current capital plan and strategy. In addition, the allowed return on a regulated utility such as Gaz Metro is set by the regulator with earnings sharing mechanisms to split excessive over-earnings with ratepayers, which can limit the company's ability to reach the upside threshold.

Ratings Score Snapshot

Corporate Credit Rating: A/Stable/--

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

Financial risk: Intermediate
- Cash flow/Leverage: Intermediate

Anchor: a

Modifiers
- 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)

Recovery Analysis

GMI has secured utility bonds (first mortgage bonds [FMBs]) outstanding with maturities of 2017-2045. These FMBs are secured under trust deeds that contain a hypothec on GMI's assets. A first immovable hypothec on Gaz Metro L.P.'s pipelines and gas distribution system also covers creditors. We estimate that the regulated capital value at GMI is greater than 1.5x the secured utility bonds outstanding. This results in a '1+' recovery rating, and an 'A+' rating on the FMBs.

Related Criteria

- 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
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, 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
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 7, 2013
- Criteria - Corporates - Utilities: Collateral Coverage And Issue Notching Rules For '1+' And '1' Recovery Ratings On Senior Bonds Secured By Utility Real Property, Feb. 14, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria - Corporates - General: 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

Ratings List

Ratings Affirmed

Gaz Metro Inc.	
Gaz Metro L.P.	
Corporate credit rating	A/Stable/--

Ratings Affirmed; Recovery Rating Unchanged

Gaz Metro Inc.	
Senior secured	A+
Recovery rating	1+
Commercial paper	
Global scale	A-1
Canada scale	A-1(Mid)

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

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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 www.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.