S&P Global
Ratings

# Research

## Summary:
# Energir Inc. And Energir L.P.

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## Summary:

# Energir Inc. And Energir L.P.

**Business Risk:** EXCELLENT

Vulnerable — Excellent

**Financial Risk:** INTERMEDIATE

Highly leveraged — Minimal

| Anchor | Modifiers | Group/Gov't |
| --- | --- | --- |
| a | a | a |

CORPORATE CREDIT RATING

**A/Stable/--**

## Rationale

| Business Risk: Excellent | Financial Risk: Intermediate |
| --- | --- |
| • A supportive regulatory environment in Quebec<br>• Dependence on industrial consumption in the province, which introduces higher volume variability than with that of predominantly residential distributors<br>• Regulatory diversity with operations in Vermont<br>• Commodity and carbon tax costs that are passed through to ratepayers | • Stable regulated cash flow<br>• Financial metrics in line with the intermediate financial risk profile during the two-year outlook period; however, Energir Inc. -- formerly known as Gaz Metro Inc. -- has limited cushion against rating triggers |





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## Outlook: Stable

The stable outlook reflects S&P Global Ratings' expectation that Energir will continue generating stable and predictable consolidated cash flow from its low-risk regulated operations in Quebec and Vermont during our two-year 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.

### Downside scenario

We could take a negative rating action on Energir if the company's credit metrics deteriorate, with adjusted funds from operations (AFFO)-to-debt falling to and staying below 13% with no prospect for improvement. This could happen because of an adverse regulatory decision, a material debt-financed acquisition, or the company encountering significant operating challenges.

Alternatively, any material increase in unregulated or generation operations and cash flow to the extent that it affects the overall business risk profile could result in a negative rating action.

### Upside scenario

We could take a positive rating action if Energir demonstrates long-term commitment to improving its credit metrics, resulting in sustained AFFO-to-debt of 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 regulator sets the allowed return for Energir, with earnings-sharing mechanisms to split excessive over-earnings with ratepayers. This can limit the company's ability to reach the upside threshold.

## Our Base-Case Scenario

**Assumptions**

- Energir will continue to focus on regulated utility operations with unregulated energy-related activities and non-energy-related activities at 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 remain stable and transparent
- Energir will recuperate fiscal 2017's gas distribution shortfall from customers in the next rate case filing in fiscal 2019
- The population will increase about 1% in 2018 and 2019 in Quebec
- Real GDP growth will be about 1.6% in 2018 and 2019 for the province

**Key Metrics**

| | 2016A | 2017E | 2018E |
|---|---|---|---|
| AFFO-to-debt | 13.8% | About 13% | About 14% |
| FFO cash interest coverage ratio | 4.4x | ~5.0x | ~5.0x |

Note: Fully S&P Global Ratings-adjusted.

AFFO—Adjusted funds from operations. A--Actual.

E--Estimated.

## Company Description

Energir, formerly known as Gaz Metro Inc., is a Quebec-based diversified energy company with more than C$7 billion in assets. It is the largest natural gas distribution company in Quebec, where its network of over 10,000 kilometers of underground pipelines serves 300 municipalities and more than 205,000 customers.

Energir is also present in Vermont, producing electricity and distributing electricity and natural gas to meet the needs of more than 315,000 customers. As well, the company is involved in the transportation of natural gas and other businesses like energy services and storage. These form a small portion of Energir's consolidated cash flow.

## Business Risk: Excellent

Our assessment of the company's business risk profile (BRP) is unchanged. Energir 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 stable cash flows.

Moreover, the company's exposure to commodity input prices is limited because electricity and natural gas input costs remain a pass-through to ratepayers, which we view as a key credit strength.

In Quebec, where distribution activities accounts for about 65% of net income, Energir can recover revenue shortfalls from weather-related events in subsequent years, which reduces its volume risk exposure. Furthermore, key rate-base parameters such as return on equity and equity thickness that Regie de l'energie, regulator for Quebec, has approved are credit-supportive and in line with those of other jurisdictions.

Energir also operates in multiple service territories primarily in Quebec and Vermont, through subsidiaries Green

Mountain Power Corp. and Vermont Gas Systems Inc., providing some degree of regulatory, geographic, and market diversification.

Further supporting the business risk profile is Energir's overall diverse customer base, primarily consisting of residential and small-to-medium commercial customers that are less sensitive to economic cycles. In Quebec, Energir has a relatively large industrial user base that contributes a material portion of the company's cash flow; however, these 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 credit risk.

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

Overall, we assess Energir's BRP at the lower half of the category compared to other regulated utilities; reflecting the utility has some generation assets and unregulated operations with higher business risk. Furthermore, the company has an obligation to supply natural gas, creating sourcing and operation risk.

## Financial Risk: Intermediate

Our view of Energir's financial risk is unchanged. We continue to assess the company's financial measures against our most permissive leverage benchmarks because the majority of the utility's cash flow comes from the low end of the utility risk spectrum in gas distribution and electricity transmission and distribution under a supportive regulatory framework. In 2017, credit metrics are slightly below our expectation, with AFFO-to-debt at about 13%. This is due to decreased gas distribution margin following warmer-than-normal weather. However, we expect the utility to recover any shortfall in its next rate application. Furthermore, the acquisition of Standard Solar Inc. and the remainder interest of the Climatisation et Chauffage Urbains de Montreal S.E.C. joint venture resulted in larger capital spending compared with that in our previous forecast.

During our outlook period, we forecast AFFO-to-debt of about 14%. Energir has about C$892 million of subordinated debentures due to its parent company, Noverco Inc., which we have excluded from our leverage and coverage calculations because we consider these debts as a form of equity financing, consistent with our Non-Common Equity Financing criteria. Specifically, these notes are subordinated and have maturity dates beyond those of all debt at the Energir level. This would prevent the noncommon equity financing from becoming due and payable until any senior debt has been fully repaid. In addition, these notes have more than 10 years of remaining life, and we believe that Energir 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 the company intends to extend the maturity, we might include the notes in our leverage and coverage calculations.

## Liquidity: Adequate

Our view on Energir's liquidity is adequate. We expect liquidity sources will be adequate to cover uses more than 1.1x in the next 12 months. We expect that in the event of a 10% EBITDA decline, the company's sources of funds would still exceed its uses and Energir would not breach its covenant limits.

In our view, the company has sound relationships with its banks and generally prudent financial risk management. In the unlikely event of an unexpected financial stress situation, we believe Energir would scale back its capital expenditures and has the flexibility to suspend dividend payments to preserve credit metrics.

| Principal Liquidity Sources | Principal Liquidity Uses |
| --- | --- |
| • Cash and liquid investments of about C$105 million as of Sept 30, 2017<br>• Committed credit facility availability of about C$700 million, maturing in 2022<br>• Cash FFO of about C$570 million over the next 12 months | • Debt maturities of about C$120 million, including both long-term and short-term debt<br>• Capital expenditures of approximately C$550 million over the next 12 months<br>• Cash distribution (including dividends) of about C$170 million over the next 12 months |

## 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)

## Issue Ratings

### Subordination risk analysis

Capital structure

Energir has secured utility bonds (SUB), including first mortgage bonds (FMBs), secured notes and secured term loans, with maturities of 2019-2048. These SUBs are secured under trust deeds that contain a hypothec on Energir's assets. A first immovable hypothec on Energir L.P.'s pipelines and gas distribution system also covers creditors.

Analytical conclusions

We estimate that the current regulated capital value at Energir is greater than 1.5x the SUBs outstanding. This results in a '1+' recovery rating, and an 'A+' rating on the FMBs, one notch above Energir's corporate credit rating.

## Related Criteria

- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, Sept. 21, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- 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
- 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

**Business And Financial Risk Matrix**

| | Financial Risk Profile | | | | | |
|---|---|---|---|---|---|---|
| **Business Risk Profile** | Minimal | Modest | **Intermediate** | Significant | Aggressive | Highly leveraged |
| **Excellent** | aaa/aa+ | aa | **a+/a** | a- | bbb | bbb-/bb+ |
| Strong | aa/aa- | a+/a | a-/bbb+ | bbb | bb+ | bb |
| Satisfactory | a/a- | bbb+ | bbb/bbb- | bbb-/bb+ | bb | b+ |
| Fair | bbb/bbb- | bbb- | bb+ | bb | bb- | b |
| Weak | bb+ | bb+ | bb | bb- | b+ | b/b- |
| Vulnerable | bb- | bb- | bb-/b+ | b+ | b | b- |