K10.1

Society - Panel 6

Filed:2013-09-27
EB-2013-0321
Exhibit A2-3-1
Attachment 1

Ontario Power Generation Inc.

Major Rating Factors

Corporate Credit Rating

A-/Negative/--

Strengths:

- Government ownership and financial support
- Dominant position in a strong market with a diversified economy
- Regulatory support for nuclear and the bulk of hydroelectric assets
- Diversified portfolio of generating assets
- Low-cost hydroelectric assets with river system diversity

Weaknesses:

- Significant financial risk profile, given low allowed returns on regulated operations, substantial debt-financed projects, and exposure to merchant electricity prices
- Uncertain profitability due to variability in assets' operating performance, river flows, and weather
- Nuclear technology that exposes the company to significant operating risk and potential for unexpected large capital expenditures

Rationale

The ratings on Ontario Power Generation Inc. (OPG), which the Province of Ontario owns, reflect Standard & Poor's Ratings Services' opinion of the regulatory oversight of the utility's baseload nuclear and hydroelectric assets; a diverse generation portfolio; and dominant market position in Ontario. Weak cash flow metrics and exposure to regulatory delay and cost overruns related to new construction and refurbishment of existing facilities offset the company's credit strengths, in our view. Exposure to merchant electricity prices and volume related to OPG's unregulated business further constrain the stand-alone credit profile (SACP). The company borrowed about 80% of its C$4.9 billion reported consolidated debt as of Sept. 30, 2012, from the government shareholder, through Ontario Electricity Financial Corp. (OEFC).

We base the 'A-' rating on OPG's SACP, which we assess at 'bbb-', and our opinion that the ratings on OPG and Ontario are linked. We assess that there is a "high" likelihood that the government shareholder would provide timely and sufficient extraordinary support in the event of financial distress. This reflects our views that OPG's role is "important" to Ontario, that the utility plays a major role in the government's energy policy; and that the link between the utility and the province is "very strong", reflecting ownership relationship, ongoing financial support from OEFC, and the province's strong influence in the company's investment decisions.

In our view, OPG's business risk profile benefits from having about 77% of its EBITDA in 2011 supported by regulated sources. These sources include nuclear and baseload hydroelectric assets that the Ontario Energy Board (OEB) regulates, as well as regulated nuclear waste management. Assurance of cost recovery and a predictable, albeit moderate, return for these assets is a positive credit factor. Historically, although the OEB decisions have led to more moderate returns for OPG, given the discretion that the company has with respect to its capital expenditure and the resultant level of debt, it has been able to mitigate the impact of lower revenues. However, the company has reached stable, regulated return (compared with that of DONG Energy AS, Vattenfall, and Statkraft), large postretirement debt adjustments, and poor returns from its aging thermal assets. The company's relatively weak cash flow measures largely contribute to its significant financial risk profile, along with EDF (which is more highly geared) and Statkraft (which is more exposed to price volatility, with only relatively small regulated EBITDA).

Table 3

Ontario Power Generation Inc.--Peer Comparison

Industry Sector: Electric Utility

	Ontario Power Generation Inc.	EDF Energy PLC	DONG Energy A/S	Vattenfall AB	Statkraft AS
Rating as of Feb. 1, 2013	A-/Negative/A-1	A/Negative/A-1	BBB+/Negative/A-2	A-/Stable/A-2	A-/Stable/A-2
	--Average of past three fiscal years--				
Currency (mil.)	C$	£	Dkr	kr	NOK
Revenues	5,349.7	5,557.2	53,573.3	200,006.3	25,766.3
Operating income	920.3	131.7	5,022.7	33,237.8	10,343.2
Net income from continuing operations	562.7	(26.8)	3,285.3	12,325.3	4,800.7
Funds from operations (FFO)	753.7	175.5	10,049.1	36,709.1	10,715.8
Capital expenditures	911.1	317.3	16,296.9	40,123.7	4,268.5
Free operating cash flow	(146.1)	82.8	(4,723.5)	(1,453.3)	6,601.6
Cash and short-term investments	331.0	1,351.9	1,037.3	3,473.3	9,668.3
Debt	7,518.9	2,280.6	38,715.9	192,037.2	41,301.5
Preferred stock	0.0	0.0	(4,285.7)	4,677.0	0.0
Equity	5,852.0	2,626.0	46,999.7	141,331.6	68,618.2
Debt and equity	13,371.0	4,906.6	85,715.6	333,368.8	109,919.7
Adjusted ratios					
EBIT interest coverage (x)	2.6	1.2	2.4	3.6	6.8
EBITDA interest coverage (x)	4.6	2.1	4.7	5.3	6.8
FFO interest coverage (X)	2.8	2.2	6.4	4.3	6.5
FFO/debt (%)	10.0	7.7	26.0	19.1	25.9
Free operating cash flow/debt (%)	(1.9)	3.6	(12.2)	(0.8)	16.0
Discretionary cash flow/debt (%)	(1.9)	(0.3)	(16.8)	(4.2)	(6.3)

Significant Financial Risk Profile

Financial policy

OPG does not have a publicly stated capital structure target and its reported debt-to-capital was 37% as of Sept. 30, 2012. With large capital expenditure in the next five years, we expect leverage to increase substantially. The company has a moderate dividend policy but has not paid any dividend since 2007 and we do not expect any in the next few years.

SEP Interrogatory #001

Ref: Exh C-1-1-1

Issue Number: 3.1
Issue: What is the appropriate capital structure and rate of return on equity for the currently regulated facilities and newly regulated facilities?

Interrogatory

(a) The application at page 4, lines 28-31, indicates that there have been no changes to the, 'risks faced by OPG's regulated asset portfolio that are not otherwise addressed by proposals to establish new variance and/or deferral accounts.' Please describe the specific risks that require a high percentage of equity, given that OPG is owned by the government of Ontario. Does OPG consider a change in the governing party for Ontario to be a risk?

(b) Please calculate the change in the revenue requirement for OPG's regulated asset portfolio from the current debt-equity ratio (53:47) to 70:30 (i.e. 70% debt) and 90:10, all other financial parameters kept the same.

Response

a) The OEB determined OPG's deemed capital structure in EB-2007-0905 based on its assessment of the risks facing OPG. The OEB's approach and assessment of risk is discussed at pages 135 - 150 of that decision. In summary, the OEB concluded that "OPG is of higher risk than electricity LDCs, gas utilities and electricity transmission utilities and of lower risk than merchant generation ... an equity ratio of 47%, is appropriate in the circumstances. This ratio is higher than the equity ratio of any other regulated Ontario energy utility, thereby recognizing the higher risk of OPG (pp. 149 - 150). In reaching this conclusion, the OEB addressed a number of risks including those raised in the question:

> "The Board concludes that if OPG is operated at arm's length, then it should be examined in the same way as Hydro One, another energy utility owned by the Province. In other words, Provincial ownership will not be a factor to be considered by the Board in establishing capital structure." (page 142)

> "OPG suggests that its regulated assets are subject to greater political risk than other energy utilities in the province. The Board does not agree that this is a risk that should be reflected in OPG's cost of capital." (page 142).

Witness Panel: Finance, D&V Accounts, Nuclear Liabilities

b) Attachment 1, Table 1 (2015) and Table 2 (2014) shows the change in the cost of capital using a 70:30 debt/equity ratio. The impact on revenue requirement is provided below:

Impact on revenue requirement of 70:30 debt/equity ratio

(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)	(j)
$M		Pre-filed	Pre-filed	Pre-filed	IR Request	IR Request	IR Request	Change	Change
Line	Descrip-tion	Reference	2015 ($M)	2014 ($M)	Reference	2015 ($M)	2014 ($M)	2015 ($M)	2014 ($M)
1	Interest Expense	C1-1-1 Table 1 and Table 2 line 4, col d)	256.2	253.6	Attachment 1 Table 1 and Table 2 line 4, col d)	338.5	335.7	82.3	82.1
2	ROE	C1-1-1 Table 1 and Table 2 line 5, col d)	420.5	420.2	Attachment 1 Table 1 and Table 2 line 5, col d)	268.4	268.2	-152.1	-152.0
3	Income tax	(line 2 / (1-25%) – line 2	140.2	140.1	(line 2 / (1-25%) – line 2	89.5	89.4	-50.7	-50.7
4	Revenue Require-ment Impact	Line 1 + 2 + 3	816.9	813.9	Line 1 + 2 + 3	694.6	693.4	-120.4	-120.5

Attachment 1, Table 3 (2015) and Table 4 (2014) shows the change in the cost of capital using a 90:10 debt/equity ratio. The impact on revenue requirement is provided below:

Impact on revenue requirement of 90:10 debt/equity ratio

(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)	(j)
$M		Pre-filed	Pre-filed	Pre-filed	IR Request	IR Request	IR Request	Change	Change
Line	Descrip-tion	Reference	2015 ($M)	2014 ($M)	Reference	2015 ($M)	2014 ($M)	2015 ($M)	2014 ($M)
1	Interest Expense	C1-1-1 Table 1 and Table 2 line 4, col d)	256.2	253.6	Attachment 1 Table 3 and Table 4 line 4, col d)	435.4	432.3	179.2	178.7
2	ROE	C1-1-1 Table 1 and Table 2 line 5, col d)	420.5	420.2	Attachment 1 Table 3 and Table 4 line 5, col d)	89.5	89.4	-331.0	-330.8
3	Income tax	(line 2 / (1-25%) – line 2	140.2	140.1	(line 2 / (1-25%) – line 2	29.8	29.8	-110.3	-110.3
4	Revenue Require-ment Impact	Line 1 + 2 + 3	816.9	813.9	Line 1 + 2 + 3	554.7	551.5	-262.2	-262.4

Witness Panel: Finance, D&V Accounts, Nuclear Liabilities

SEP Interrogatory #002

Ref: Exh C-1-1-1,

Issue Number: 3.2
Issue: Are OPG's proposed costs for its long-term and short-term debt components of its capital structure appropriate?

Interrogatory

Please calculate, using *ceteris paribus* assumptions, the change in the revenue requirement for OPG's regulated asset portfolio for ROEs of 8% and 7%. Please calculate the corresponding changes in the revenue requirement for these ROEs under the debt-equity ratios in 3.1-SEP-1b (i.e. 70:30 and 90:10).

Response

Attachment 1, Table 1 (2015) and Table 2 (2014) show the change in the cost of capital using a 70:30 debt/equity ratio and an ROE of 8 per cent. The impact on revenue requirement is provided below:

Impact on revenue requirement of 70:30 debt/equity ratio and 8% ROE

(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)	(j)
		Pre-filed	Pre-filed	Pre-filed	IR Request	IR Request 2015	IR Request 2014	Change 2015	Change 2014
Line	Descrip-tion	Reference	2015 ($M)	2014 ($M)	Reference	($M)	($M)	($M)	($M)
1	Interest Expense	C1-1-1 Table 1 and Table 2 line 4, col d)	256.2	253.6	Attachment 1 Table 1 and Table 2 line 4, col d)	338.5	335.7	82.3	82.1
2	ROE	C1-1-1 Table 1 and Table 2 line 5, col d)	420.5	420.2	Attachment 1 Table 1 and Table 2 line 5, col d)	239.1	239.0	-181.4	-181.2
3	Income tax	(line 2 / (1-25%) – line 2	140.2	140.1	(line 2 / (1-25%) – line 2	79.7	79.7	-60.5	-60.4
4	Revenue Require-ment Impact	Line 1 + 2 + 3	816.9	813.9	Line 1 + 2 + 3	657.4	654.3	-159.5	-159.5

Witness Panel: Finance, D&V Accounts, Nuclear Liabilities

Attachment 1, Table 3 (2015) and Table 4 (2014) show the change in the cost of capital using a 70:30 debt/equity ratio and an ROE of 7 per cent. The impact on revenue requirement is provided below:

Impact on revenue requirement of 70:30 debt/equity ratio and 7% ROE

(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)	(j)
$M		Pre-filed	Pre-filed	Pre-filed	IR Request	IR Request	IR Request	Change	Change
Line	Description	Reference	2015 ($M)	2014 ($M)	Reference	2015 ($M)	2014 ($M)	2015 ($M)	2014 ($M)
1	Interest Expense	C1-1-1 Table 1 and Table 2 line 4, col d)	256.2	253.6	Attachment 1 Table 3 and Table 4 line 4, col d)	338.5	335.7	82.3	82.1
2	ROE	C1-1-1 Table 1 and Table 2 line 5, col d)	420.5	420.2	Attachment 1 Table 3 and Table 4 line 5, col d)	209.2	209.1	-211.3	-211.1
3	Income tax	(line 2 / (1-25%) – line 2	140.2	140.1	(line 2 / (1-25%) – line 2	69.7	69.7	-70.4	-70.4
4	Revenue Requirement Impact	Line 1 + 2 + 3	816.9	813.9	Line 1 + 2 + 3	617.5	614.5	**-199.4**	**-199.4**

Attachment 1 Table 5 (2015) and Table 6 (2014) show the change in the cost of capital using a 90:10 debt/equity ratio and an ROE of 8 per cent. The impact on revenue requirement is provided below:

Impact on revenue requirement of 90:10 debt/equity ratio and 8% ROE

(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)	(j)
$M		**Pre-filed**	**Pre-filed**	**Pre-filed**	**IR Request**	**IR Request**	**IR Request**	**Change**	**Change**
Line	**Descrip-tion**	**Reference**	**2015 ($M)**	**2014 ($M)**	**Reference**	**2015 ($M)**	**2014 ($M)**	**2015 ($M)**	**2014 ($M)**
1	Interest Expense	C1-1-1 Table 1 and Table 2 line 4, col d)	256.2	253.6	Attachment 1 Table 5 and Table 6 line 4, col d)	435.4	432.3	179.2	178.7
2	ROE	C1-1-1 Table 1 and Table 2 line 5, col d)	420.5	420.2	Attachment 1 Table 5 and Table 6 line 5, col d)	79.7	79.7	-340.8	-340.5
3	Income tax	(line 2 / (1-25%) – line 2	140.2	140.1	(line 2 / (1-25%) – line 2	26.6	26.6	-113.6	-113.5
4	Revenue Require-ment Impact	Line 1 + 2 + 3	816.9	813.9	Line 1 + 2 + 3	541.7	538.5	**-275.2**	**-275.4**

Attachment 1, Table 7 (2015) and Table 8 (2014) show the change in the cost of capital using a 90:10 debt/equity ratio and an ROE of 7 per cent. The impact on revenue requirement is provided below:

Impact on revenue requirement of 90:10 debt/equity ratio and 7% ROE

(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)	(j)
$M		**Pre-filed**	**Pre-filed**	**Pre-filed**	**IR Request**	**IR Request**	**IR Request**	**Change**	**Change**
Line	**Descrip-tion**	**Reference**	**2015 ($M)**	**2014 ($M)**	**Reference**	**2015 ($M)**	**2014 ($M)**	**2015 ($M)**	**2014 ($M)**
1	Interest Expense	C1-1-1 Table 1 and Table 2 line 4, col d)	256.2	253.6	Attachment 1 Table 7 and Table 8 line 4, col d)	435.4	432.3	179.2	178.7
2	ROE	C1-1-1 Table 1 and Table 2 line 5, col d)	420.5	420.2	Attachment 1 Table 7 and Table 8 line 5, col d)	69.7	69.7	-350.8	-350.5
3	Income tax	(line 2 / (1-25%) – line 2	140.2	140.1	(line 2 / (1-25%) – line 2	23.2	23.2	-116.9	-116.8
4	Revenue Require-ment Impact	Line 1 + 2 + 3	816.9	813.9	Line 1 + 2 + 3	528.4	525.2	**-288.5**	**-288.6**