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Research Update:

Ontario Power Generation Inc. Ratings Affirmed On Acquistion Of Cube Hydro; Taken Off UCO; Outlook Stable

June 25, 2019

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Rating Action Overview

- On June 25, 2019, Ontario Power Generation Inc. (OPG) announced the acquisition of Cube Hydro for about $1.12 billion.
- The acquisition signals the company's strategy to expand into the nonregulated power business, which we view as higher risk relative to its regulated utility operations. As a result, we revised the company's overall business risk to satisfactory from strong reflecting the increased exposure to unregulated business and cash flow.
- At the same time, we reviewed our ratings on OPG that we labeled as "under criteria observation" (UCO) after publishing our revised Ratios and Adjustments criteria on April 1, 2019.
- Following our review, we revised OPG's financial risk profile to significant from aggressive and comparable rating analysis modifier to neutral.
- Furthermore, we revised our financial policy modifier on OPG to negative, reflecting the potential for further debt-funded acquisitions over our outlook period that could materially increase the company's leverage.
- We affirmed our ratings on OPG, including the 'BBB+' issuer credit rating, the 'BBB+' senior unsecured debt rating, and the A-1(Low) Canada National Scale Commercial Paper rating.
- The stable outlook reflects our view of the steady relationship between the utility and the Government of Ontario and that OPG will continue to generate majority of its cash flow from its low-risk regulated generation operations.

Rating Action Rationale

The affirmation reflects an improvement to the utility's financial position as a result of our revised Ratios and Adjustments criteria that was published on April 1, 2019. However, this improvement is offset by the company's new growth strategy to pursue higher risk nonregulated power generation

businesses through debt-funded acquisitions.

On June 25, 2019, OPG announced the acquisition of Cube Hydro for about $1.12 billion. OPG has steadily increased its cash flow contribution from nonregulated power generation sources over the past years. This is evident with the acquisition of Eagle Creek Renewable Energy LLC in August 2018. While we continue to expect the majority of OPG's cash flow will be backed by its stable regulated generation operations, the utility's nonregulated power operations has become a sizable part of OPG's overall cash flow profile, with about 20% of its EBITDA from nonregulated power generation. As a result, our decision to revise OPG's business risk to satisfactory from strong largely reflects the company's increased exposure and risk to nonregulated power.

Our business risk assessment on OPG continues to reflect the company's stable regulated electricity generation under a generally supportive regulatory framework and effective management of regulatory risk. OPG has a strong market position in Ontario, accounting for about half of the province's total electricity production in 2018. Moreover, Ontario has a strong and diverse economy with modest population growth that provides stable demand to electricity. Further supporting our business risk is OPG's diverse portfolio of generation assets in Ontario comprising two nuclear stations, 66 hydroelectric stations, one biomass station, one solar facility, one oil and gas-fired station, and two co-owned combined cycle gas-fired stations. Although the company's hydroelectric assets are exposed to hydrology risk, its multiple river systems partially mitigate this.

On its nonregulated power operations, the majority of cash flow is backed by long-term contracts with more than five years remaining, favorable rate constructs, investment-grade counterparties, and minimal exposure to electricity commodity risks. Furthermore, OPG's merchant power participates in the NYISO, PJM, and SERC power markets, which are well-established with predictable market rules.

From a financial perspective, we assess OPG's financial risk profile using our medial-volatility financial benchmark table, reflecting the company's lower-risk regulated electric generation operation and effective management of regulatory risk. The company's credit metrics, including funds from operation (FFO) to debt, improve modestly under the revised Ratios and Adjustments criteria. However, this is offset by the company's large capital plan that includes the Darlington refurbishment program and debt-funded acquisition growth strategy. Our base-case assumptions include capital expenditure of about C$2.0 billion per year, acquisition of Cube Hydro, approved rate case for 2017-2021, and recovery of deferral and variance accounts of C$535 million in 2019-2021. We forecast OPG's FFO to debt of about 13%-15% in 2019-2021. As part of our cash flow analysis, we exclude all cash flow and debt related to the Fair Hydro Plan, including about C$900 million of senior debt at Fair Hydro Trust (FHT).

We expect OPG's growth strategy to be primarily debt-funded over our outlook horizon. Due to the timing, quantum, and uncertain nature of acquisitions, leverage could become materially higher than our base-case forecast over time and depresses credit metrics. For this reason, we also revised our financial policy modifier to negative to capture these event risks.

Collectively, these revisions result in a stand-alone credit profile (SACP) of 'bb+' for OPG. In our view, there is a high likelihood that OPG's provincial owner, the Government of Ontario, will provide timely extraordinary support to the utility during periods of financial distress. We base this on our view that OPG plays an important role to Ontario because it supplies about half of the province's electricity. In addition, the utility also plays a vital role to Ontario's energy and environmental policies. Furthermore, the province has a track record of providing support, both directly and indirectly, to the utility. As a result, OPG's relationship with the government provides a three-notch rating enhancement to its SACP.

Outlook

The stable outlook reflects S&P Global Ratings' expectation that OPG will continue to generate the vast majority of its revenues from regulated generation operations, which provides stable and predictable cash flows, and that the company will not experience any adverse regulatory decisions, material delays, or cost overruns associated with the Darlington refurbishment plan. Furthermore, our outlook reflects a stable relationship between OPG and its owner, the Province of Ontario. During our two-year outlook period, we expect FFO to debt to be about 13%-15% in 2019 to 2020.

Downside scenario

We could take a negative rating action on OPG over the next 12 to 18 months if the company's financial measures show material deterioration with FFO to debt consistently below 11%. This could happen if the company experiences material delays and cost overruns in its Darlington refurbishment program, material adverse regulatory decisions, or significant debt-funded acquisitions. Alternatively, any downgrade to Ontario or unexpected deterioration in the relationship between OPG and Ontario could also result in a negative rating action.

Upside scenario

We could take a positive rating action on OPG if the utility's SACP improves by two notches. All else being equal with the relationship with the province, this would result in a one-notch upgrade to the utility. This could happen if the company improves its business risk by not pursuing nonregulated power operation, which has a higher industry risk, and improves its financial position with FFO to debt consistently above 25%. However, we view this as unlikely during our outlook period given OPG has a large capital plan to execute on the Darlington refurbishment project and the company's growth strategy to pursue unregulated power operation.

Company Description

OPG is an Ontario-based electricity generation company whose principal business is the generation and sale of electricity in Ontario. The utility supplies about half of the electricity in the province and is wholly owned by the Province of Ontario, which also holds a majority of the company's long-term debt. The company is the largest clean energy generator in Ontario, with an in-service capacity of about 16,344 megawatts.

Our Base-Case Scenario

- OPG continues to focus on regulated electricity generation with regulated and nonregulated cash flow mix at about 80% and 20%, respectively.
- The Ontario Energy Board, the provincial regulator, will continue to operate in a transparent, stable, and predictable manner.
- The utility will not experience any adverse regulatory decisions.
- Capital spending will average about C$2.0 billion per year, including the Darlington refurbishment project, which we expect will not incur material cost overruns or delays.

- Acquisition of Cube Hydro for about $1.12 billion.

Liquidity

We assess OPG's liquidity as adequate because we believe its liquidity sources are likely to cover uses by more than 1.1x over the next 12 months and meet cash outflows even with a 10% decline in EBITDA. Moreover, liquidity should benefit from the company's likely ability to absorb high-impact, low-probability events without the need for refinancing, its well-established and solid relationships with banks, and its satisfactory standing in the credit markets. In the event of unexpected financial stress, we expect the utility would scale back on its capital expenditures to preserve the credit metrics.

Principal Liquidity Sources:

- Cash and liquid investments available of about C$511 million as of first quarter of 2019;
- Cash FFO of about C$1.6 billion over the next 12 months; and
- Committed credit facilities availability of about C$1.11 billion.

Principal Liquidity Uses:

- Debt maturities of about C$642 million including short-term borrowings;
- Maintenance capital expenditures of about C$702 million over the next 12 months; and
- Acquisition of Cube Hydro for about $1.12 billion (C$1.5 billion).

Issue Ratings - Subordination Risk Analysis

Capital structure

OPG's capital structure consists of about C$7.2 billion in long- and short-term debt, excluding the FHT senior secured debt, of which about C$2.4 billion is secured project debt with the remaining C$4.8 billion unsecured as of March 31, 2019.

Analytical conclusions

We rate the senior unsecured debt 'BBB+', the same as the issuer credit rating on the utility, because priority debt is less than 50% of total consolidated debt. We also rate OPG's commercial paper at A-1(Low) on the Canadian National Scale.

Ratings Score Snapshot

Issuer Credit Rating: BBB+/Stable/--

Business risk: Satisfactory

- Country risk: Very low
- Industry risk: Low

- Competitive position: Satisfactory

Financial risk: Significant

- Cash flow/Leverage: Significant

Anchor: bbb-

Modifiers

- Diversification/Portfolio effect: Neutral
- Capital structure: Neutral
- Financial policy: Negative (-1 notch)
- Liquidity: Adequate
- Management and governance: Satisfactory
- Comparable rating analysis: Neutral

Stand-alone credit profile: bb+

- Related government rating: A+
- Likelihood of government support: High (+3 notches from SACP)

Related Criteria

- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Key Credit Factors For The Unregulated Power And Gas Industry, March 28, 2014
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria | Corporates | Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 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

Ratings List

Ratings Affirmed	
Ontario Power Generation Inc.	
Issuer Credit Rating	BBB+/Stable/--
Ontario Power Generation Inc.	
Senior Unsecured	BBB+
Commercial Paper	A-1(LOW)

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