S&P Global
Ratings

Research

Summary:

Ontario Power Generation Inc.

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Summary:

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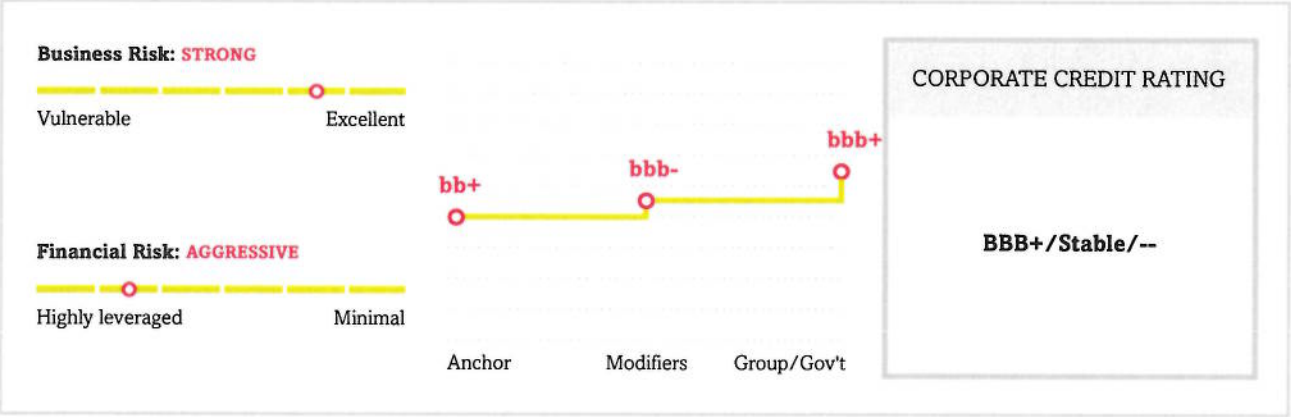

Rationale

Business Risk: Strong	Financial Risk: Aggressive
• Ontario Power Generation Inc.'s (OPG) dominant market position in a strong market with a diversified economy • Regulatory support for the utility's nuclear assets and the bulk of its hydroelectric assets • A diversified portfolio of power-generating assets • Low-cost hydroelectric assets with diversified river systems	• Stable, regulated cash flow • Weak overall cash flow metrics • Large capital programs over the next several years

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Outlook: Stable

The stable outlook reflects S&P Global Ratings' expectation that OPG will continue to generate the vast majority of its cash flow from regulated generation, which provides a steady and predictable cash flow. In addition, we do not expect any adverse regulatory decisions, including the pending rate decision in the second half of this year. The outlook also reflects no material delays and cost overruns associated with the Darlington refurbishment plan. Furthermore, the outlook reflects our view of the 'bbb-' stand-alone credit profile (SACP) on OPG and that we do not expect the relationship between the utility and its owner, the Province of Ontario, to change. A one-notch deterioration in either the SACP or our rating on the Province of Ontario would not affect our rating on the utility. During our two-year outlook period, we expect adjusted funds from operations (AFFO)-to-debt to be 7%-8% in 2017 before rising to 10%-12% in 2018-2019.

Downside scenario

We believe a negative rating action on OPG is unlikely during the outlook period, given that both the SACP of OPG and our rating on the province would have to decline one notch. An unexpected change in our view of the relationship between OPG and the province to moderately high or lower could also negatively affect the rating. However, we do not expect this to happen given our view of the relationship between OPG and the province. Alternatively, we could take a negative rating action on OPG if credit metrics deteriorate significantly with AFFO-to debt approaching 7% with no prospects of improvement. This could happen if the company experience significant operational outages with its generation fleet or adverse regulatory decisions. However, we believe this is also unlikely during our outlook period, given that OPG operates under a stable regulatory regime.

Upside scenario

We could take a positive rating action on OPG if the utility's financial position improves with AFFO-to-debt consistently above 13%. A one-notch improvement to OPG's SACP, all else being equal with the province, would result in a one-notch upgrade to the utility. However, we view this as unlikely during our outlook period, given that rates are regulated and the company has a large capital spending program to execute for the next several years, including the multi-billion-dollar Darlington nuclear plant refurbishment.

Our Base-Case Scenario

OPG is an Ontario-based electricity generation company whose principal business is in electricity generation and sale in the Province of Ontario. OPG supplies about half of the electricity in Ontario and is wholly owned by the province.

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Assumptions

- OPG will continue to focus on its regulated electricity generation business
- 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
- OPG will get most of its revenue requirements approved. The utility filed a five-year rate application for 2017-2021 with regulated nuclear rates under the custom incentive regulation, and the regulated hydroelectric rates under the incentive rate making regulation
- Ontario gross domestic growth of about 2.4% in 2017
- The Darlington refurbishment project will incur no material delays and cost overruns

Key Metrics

	2016A	2017E	2018E
AFFO/debt	15.8%	7%-8%	10%-12%

AFFO--Adjusted funds from operations. A--Actual. E--Estimated.

Business Risk: Strong

Our assessment of OPG's business risk profile has not changed. The assessment reflects our view of the utility's strong market position (which accounted for about 50% of Ontario's electricity generation in 2016) and a supportive regulatory framework. We expect OPG will continue to generate about 95% of its EBITDA from regulated sources, recover prudently incurred fixed and variable cost in a timely manner, and earn a moderate return on capital assets.

In addition, OPG has a diverse portfolio of generation assets comprising four nuclear (including Bruce), 66 hydro-electric, two biomass stations, one thermal station, and one wind turbine asset; therefore, OPG does not depend on a single or few generation assets. The hydro-electric assets are subject to hydrology risk; however, the multiple river systems mitigate this.

Further supporting the strong business risk profile is that OPG's service territory, Ontario, has a very strong and diversified economy with modest population growth supporting electricity consumption. However, the ongoing demand conservation programs offset this, resulting in ratepayers being more cautious about conserving energy and reduce electricity consumption.

Due to the nature of the business, OPG does not deal directly with ratepayers and does not have a large and diverse customer base. OPG's main counterparty is the Independent Electricity System Operator (IESO), a crown agent, which remits monthly electricity sales revenue to OPG in the subsequent month.

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Financial Risk: Aggressive

Our view of OPG's financial risk is also unchanged. We assess the utility's financial measures against our medial leverage benchmarks to reflect the supportive regulatory framework and that virtually all of OPG's cash flows come from the higher end of the utility risk spectrum in electricity generation compared with that of transmission and distribution.

The company has huge capital programs over the next several years, averaging about C$1.7 billion per year, including the Darlington nuclear refurbishment program. The large capital spending will pressure OPG's credit metrics. Over the next several years we expect the utility to generate negative free operating cash flow (FOCF) and require external financing to fund its capital programs.

We forecast the company's AFFO-to-debt at about 7%-11% during our outlook period. For fiscal 2017, we expect the utility's AFFO-to-debt to be unusually low, at about 7.5%. We attribute this to the following factors:

- We expect a pending decision on OPG's rate application for 2017-2021 in the second half of 2017. The interim rates for fiscal 2017 are based on the regulated rates set in 2014. We expect the difference between the new rates for 2017 and the base rates to be collected in the 2018 period. As a result, 2017 cash flow is lower, but only temporarily.
- As part of the government of Ontario's rate smoothing implementation to avoid rate shocks, the government has amended the legislation that will defer recovery of a portion of the revenue requirement to the post-refurbishment period. Under this plan, we expect about C$1.4 billion of deferred revenue and interest by 2019. The rate smoothing will result in lower cash flow and credit metrics during the outlook period.

The combination of the pending rate decision, rate smoothing and large capital spending result in lower AFFO-to-debt for fiscal 2017, at about 7.5%; however, we do not believe this is a major concern because it is primarily due to the timing difference of cash flow collection. We expect OPG will fully recover its operating and capital costs.

In March 2017, the government announced that the IESO and OPG will work together to refinance the global adjustment (GA) over a longer period to lower electricity cost for rate-payers; details regarding the refinancing plan are unavailable. As such, we have not included the impact, if any, of the financing plan into our forecast. We will continue to monitor this situation.

Liquidity: Adequate

We consider OPG's liquidity adequate. We expect liquidity sources to exceed uses by more than 1.1x over the next twelve months. In the event of a 10% drop in the company's EBITDA, we also expect there are sufficient liquidity sources to cover uses. In our view, the company has sound relationships with banks. In the event of unexpected financial stress, we expect the utility would scale back on its capital expenditures to preserve the credit metrics.

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Principal Liquidity Sources	Principal Liquidity Uses
• Cash and liquid investments available of about C$430 million as of March 31, 2017 • Cash FFO of about C$530 million over the next 12 months • Committed credit facilities availability of about C$1.3 billion, maturing between 2021 and 2022	• Debt maturity of about C$1.3 billion over the next 12 months • Maintenance capital expenditures of about C$570 million over the next 12 months • Partnership distributions of about C$16 million over the next 12 months

Other Modifiers

We believe other features of OPG further support the business risk profile assessment. Specifically, unlike many global power generators that have sizable unregulated operations, OPG's operations are virtually all regulated.

In addition, as a generation company, OPG does not have the obligation to ensure adequate supply of electricity, which reduces operational and procurement risks.

Furthermore, the utility has a diverse fleet of generation assets and a dominant market position in Ontario given that it provides about half of the province's power.

As a result, we applied a positive comparable rating analysis modifier to the utility. Other modifiers have no impact on the rating.

Government Influence

Our expectation is that the province (OPG's sole owner) is likely to provide extraordinary support during period of financial distress. In our view, OPG plays an important role to Ontario because it supplies about half of the province's electricity. In addition, the utility provides an essential infrastructure to Ontario and plays an important role in the implementation of the province's energy and environmental policies. Furthermore, Ontario has a track record of providing support both directly and indirectly to the utility.

The high likelihood of extraordinary government support provides two-notch rating enhancement to the 'bbb-' SACP.

Ratings Score Snapshot

Corporate Credit Rating

BBB+/Stable/--

Business risk: Strong

- **Country risk:** Very low
- **Industry risk:** Very low

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- **Competitive position:** Satisfactory

Financial risk: Aggressive

- **Cash flow/Leverage:** Aggressive

Anchor: bb+

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:** Positive (+1 notch)

Stand-alone credit profile : bbb-

- **Likelihood of government support:** High (+2 notches from SACP)

Related Criteria

- 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
- General Criteria: National And Regional Scale Credit Ratings, Sept. 22, 2014
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria - Corporates - Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Group Rating Methodology, 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
- Criteria - Corporates - General: 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

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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-

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