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Ratings

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Research Update:

Ontario Power Generation Inc. Outlook Revised To Stable From Negative; 'BBB+' Rating Affirmed

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Rating Action Overview

- Toronto-based utility company Ontario Power Generation Inc. (OPG) recently completed the refurbishment of the Darlington Nuclear Generating Station Unit 2, on time and on budget. Unit 2's refurbishment is the first of four units S&P Global Ratings expects the company will complete by 2026. The company's on-time and on-budget record increases our confidence that the other three units will also be completed without incurring project delays or materially higher costs.
- Earlier this year, OPG completed the acquisition of several contracted gas-generation assets. We believe that the company will pause on its significant acquisition strategy for at least the next one to two years, leading to more certain and less volatile cash flows.
- We are revising our outlook on OPG to stable from negative and affirming our ratings on OPG, including the 'BBB+' issuer credit rating, the 'BBB+' senior unsecured debt rating, commercial paper rating of A-2, and the 'A-1(Low)' Canada National Scale commercial paper rating. We are also revising upwards our business risk profile on OPG to strong from satisfactory.
- The stable outlook incorporates OPG's recently improved operating performance and our view for more stable volatile cash flows, reflecting our expectations that the company will pause on its acquisition strategy, continue to effectively manage regulatory risk, and our increased confidence that future nuclear refurbishments will be completed on time and on budget. We also expect that funds from operations (FFO) to debt will reflect 14%-15%.

Rating Action Rationale

We revised the outlook to stable from negative. The company's recent refurbishment of the Darlington Nuclear Generating Station Unit 2 and our expectations that the company will temporarily pause its significant acquisition strategy increase our confidence that future cash flows will be less volatile. Also, for 2019 the company's financial measures exceeded our expectations, reflecting operational improvements and effective cost management. We expect these improvements will be sustained and lead to consistently improved financial performance. We previously expected FFO to debt of about 13% and our revised base case expects FFO to debt

of 14%-15%.

We revised the business risk profile upwards to strong from satisfactory. Our revised business risk profile reflects our expectations for more stable and predictable cash flows. The business risk profile is supported by the company's regulated operation that constitutes about 70% of consolidated EBITDA and is regulated by the Ontario Energy Board (OEB). The company benefits from the generally supportive regulatory environment that includes using an incentive ratemaking methodology for hydroelectric and a custom incentive regulation framework for nuclear. In addition, the company uses various regulatory mechanisms, which smooth cash flow and we view as supportive of credit quality.

The business risk profile is hurt by the company's growing contracted unregulated power exposure, which will contribute about 30% of consolidated EBITDA. The contracted unregulated power business increases the company's volumetric, operational, and commodity risks. These risks are partially offset by the business' long-term contracts with creditworthy counterparties. Because of OPG's unregulated power exposure, we assess the company at the lower end of the range for its business risk profile category, compared to peers. We assess the comparable rating analysis modifier as negative to reflect these higher risks.

The company's financial measures are modestly improving but still at the lower end of the range for the significant financial risk profile category. We revised our financial expectations for the company upwards, reflecting operational improvements, effective cost management, and reduced capital spending. Specifically, we expect FFO to debt of 14%-15% compared to our previous expectations of 13%. The improvement primarily reflects our expectations for increased generation availability and electricity output. We also expect operation and maintenance costs will be generally flat reflecting some cost increases that are offset by enhanced productivity. In addition, we expect 2020 capital spending will be about C$100 million lower.

We continue to 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. Under our base-case forecast that includes fewer planned outage days for nuclear plants in 2020, average annual capital expenditure of about C$2 billion, approved rate case for 2017-2021, and no significant acquisitions for the next one to two years, we forecast FFO to debt around 14%-15% for 2020-2022, consistent with the lower end of the range for its financial risk profile category. We assess the comparable rating analysis modifier as negative to account for these relatively weak financial measures for its financial risk profile category.

We assess the financial policy modifier and the comparable ratings analysis modifier as negative, lowering the company's standalone credit profile by two notches. We continue to assess the financial policy modifier as negative to account for the company's longer-term strategy of generally growing through acquisitions that can result in significantly weaker financial measures than in our base case. Despite our near-term expectation that the company will pause on acquisitions, we expect that after this pause the company will likely resume with acquisitions. Because the company does not rely on equity contributions from its parent such acquisitions could result in significantly weaker financial measures.

We assess the comparable rating analysis modifier as negative to reflect our expectations that the company's business and financial risk profiles are at the lower-end of the range for their respective categories.

We assess the government of Ontario as highly likely to provide extraordinary support for OPG. Our ratings on OPG incorporates a high likelihood that OPG's provincial owner, the Government of Ontario, will provide extraordinary support to the utility during periods of financial distress. OPG plays an important role to Ontario because it supplies about half of the province's electricity and the utility plays a vital role to Ontario's energy/environmental policies. In addition, the province has a track record of providing support, both directly and indirectly, to the utility. Our assessment of high likelihood of extraordinary government provides three-notch rating enhancement for OPG.

Outlook

The stable outlook incorporates our view for more stable cash flows, reflecting our expectations that the company will pause on its acquisition strategy, continue to effectively manage regulatory risk, and our increased confidence that future nuclear refurbishments will be completed on time and on budget. We also expect funds from operations (FFO) to debt of 14%-15%.

Downside scenario

We could take a negative rating action on OPG over the next 12-18 months if the company's financial measures weaken, reflecting FFO to debt consistently below 13%. This could happen if the company experiences delays and cost overruns at its Darlington refurbishment program, adverse regulatory decisions, or significant debt-funded acquisitions. Alternatively, a downgrade to the Province of Ontario or an unexpected deterioration in the relationship between OPG and Ontario could also result in a negative rating action.

Upside scenario

Although highly unlikely, we could take a positive rating action on OPG over the next 24 months if there is no change to the company's relationship with the Province of Ontario, the company's nonutility businesses do not grow through additional acquisitions, and the company's financial measures materially improve, reflecting FFO to debt consistently greater than 20%.

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 significant portion of the company's long-term debt. The company is the largest clean energy generator in Ontario, with an in-service capacity of about 18,000 megawatts.

Our Base-Case Scenario

- OPG continues to focus on regulated electricity generation with regulated and nonregulated cash flow mix at about 70% and 30%, respectively.
- OEB, 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 billion per year, including the Darlington refurbishment project, which we expect will not incur material cost overruns or delays.
- No significant acquisitions during our outlook period.

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:

- Estimated cash and liquid investments available of about C$500 million;
- Forecasted cash FFO of about C$2.36 billion; and
- Available credit facilities of about C$1.7 billion.

Principal Liquidity Uses:

- Debt maturities, including commercial paper outstanding of about C$1.1 billion;
- Capital expenditures of about C$2 billion over the next 12 months;
- Working capital requirements of about C$50 million; and
- Payments of dividends to non-controlling interests of about C$20 million.

Issue Ratings - Subordination Risk Analysis

Capital structure

OPG's capital structure consists of about C$8.8 billion in long- and short-term debt, of which about C$2.87 billion is secured project debt with the remaining C$5.9 billion unsecured as of March 31, 2020.

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: Strong

- Country risk: Very low
- Industry risk: Low
- Competitive position: Strong

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: Negative (-1 notch)
- Stand-alone credit profile: bb+

Related government rating: A+

Likelihood of government support: High (+3 notches from SACP)

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- 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
- Criteria | Corporates | Industrials: Key Credit Factors For The Unregulated Power And Gas Industry, March 28, 2014
- General Criteria: Methodology: Industry Risk, 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, Nov. 13, 2012

- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Ratings Affirmed; Outlook Action

	To	From
Ontario Power Generation Inc.		
Issuer Credit Rating	BBB+/Stable/--	BBB+/Negative/--
Ratings Affirmed		
Ontario Power Generation Inc.		
Senior Unsecured	BBB+	
Commercial Paper	A-1(LOW)	
Commercial Paper	A-2	

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