S&P Global
Ratings

Research

Research Update:

Ontario Power Generation Inc. Outlook Revised To Negative From Stable, Ratings Affirmed On Gas Asset Acquisitions

July 30, 2019

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Rating Action Overview

- On July 30, 2019, Toronto-based utility company Ontario Power Generation Inc. (OPG) announced the acquisition of several gas-generation assets from affiliates of TC Energy for about C$2.87 billion
- OPG also announced the acquisition of the remaining 50% interest in Brighton Beach, a combined-cycle natural gas-fired generation station, from Canadian Utilities Ltd., an ATCO subsidiary.
- The acquisitions continue OPG's strategy to expand into additional nonregulated power operations, which we view as higher risk than its regulated utility operations. Given our view of OPG's higher business risk, we are revising our ratings downside threshold to 13%, resulting in limited cushion for the current ratings on OPG.
- We are revising our outlook on OPG to negative from stable.
- We are also affirming 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 negative outlook reflects the potential for limited cushion in OPG's credit metrics upon closing of the transaction, additional acquisitions over our outlook horizon that could further stress credit metrics and execution and integration risks associated with recent transactions.

Rating Action Rationale

The negative outlook follows OPG's announced acquisitions of several gas-generation assets from affiliates of TC Energy and Canadian Utilities Ltd. In June 2019, OPG also announced the acquisition of Cube Hydro for about $1.12 billion. We view these as indicative of OPG's strategy to expand its higher risk nonregulated footprint. In addition, the timing of the transactions raises both execution and integration risks. As such, we revised our ratings downside threshold to 13%,

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potentially resulting in limited cushion for current ratings on OPG.

We expect these transactions could increase OPG's total debt position by up to about C$4.6 billion over the next 12 months, more than half of its current outstanding long- and short-term debt of about C$8 billion as of March 31, 2019. Although this is offset by cash flow generated by the assets, the large quantum of debt increases over a short period will stress credit metrics in the short term and leaves little room for any operational underperformance or integration issues.

Our business risk assessment continues to reflect OPG's stable regulated electricity generation operation under a generally supportive regulatory framework and effective management of regulatory risk. We expect regulated operation will continue to provide about 70% of OPG's cash flow. Although the transaction will increase the utility's unregulated power exposure, contributing about 30% of overall cash flow, this is offset by long-term contracts with more than five years remaining, favorable rate constructs, investment-grade counterparties, and minimal exposure to electricity commodity risks.

From a financial perspective, 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. Although our revised Ratios and Adjustments criteria provide some benefits to OPG's credit metrics, including funds from operation (FFO) to debt, this is offset by the company's large capital plan that includes the Darlington refurbishment program and acquisitions. Our base-case assumptions include capital expenditure (capex) of about C$2 billion per year, the acquisition of Cube Hydro and gas-generation assets total about C$4.6 billion, approved rate case for 2017-2021, and recovery of deferral and variance accounts of C$535 million in 2019-2021. We forecast FFO to debt of about 13% in 2019-2021. As part of our cash flow analysis, we continue to 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).

In addition, our ratings on OPG also reflect the potential for further acquisitions over our outlook horizon that could pressure credit metrics. Thus, we continue to apply a negative financial policy modifier.

Our view of the relationship between OPG and its provincial owner, the Government of Ontario, is unchanged. We continue to believe there is a high likelihood that the province will provide timely extraordinary support during financial distress. We base this on our view that OPG plays an important role to Ontario by supplying about half of Ontario's electricity. The utility also plays a vital role in 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 stand-alone credit profile (SACP).

Outlook

The negative outlook reflects the potential for limited cushion in OPG's credit metrics and weak financial measures as a result of recent acquisitions. Furthermore, the negative outlook also reflects the potential for additional acquisitions during our outlook period that could further stress credit metrics and the execution and integration risks associated with the transaction. During our two-year outlook period, we expect FFO to debt of about 13% from 2019-2020.

Downside scenario

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We could downgrade OPG over the next 12-18 months if its financial measures deteriorate, with FFO to debt consistently below 13%. This could happen with material delays and cost overruns in its Darlington refurbishment program, material adverse regulatory decisions, or significant debt-funded acquisitions. Alternatively, any downgrade of Ontario or unexpected deterioration in the relationship between OPG and Ontario could also result in a downgrade.

Upside scenario

We could revise the outlook on OPG to stable if it improves its financial measures upon close of the transaction with FFO to debt consistently above 15%. Alternatively, we could also revise the outlook if OPG shows financial discipline in its acquisition strategy.

Company Description

OPG is an Ontario-based electricity generation company whose principal business is the generation and sale of electricity. 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 OPG's long-term debt. OPG 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 cash flow of 70% and nonregulated 30%.
- The Ontario Energy Board, the provincial regulator, continues 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.
- Acquisition of Cube Hydro and gas-generation assets total for about C$4.6 billion.

Liquidity

We assess OPG's liquidity as adequate because we believe its 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, well-established and solid relationships with banks, and satisfactory standing in the credit markets. In the event of unexpected financial stress, we expect the utility would scale back capex to preserve credit metrics.

Principal liquidity sources:

- About C$511 million cash and liquid investments available as of the first quarter of 2019;
- Cash FFO of about C$1.7 billion over the next 12 months; and
- Committed credit facilities availability of about C$1.91 billion.

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Principal liquidity uses:

- Debt maturities of about C$642 million, including short-term borrowings;
- Maintenance capex of about C$700 million; and
- Acquisition of Cube Hydro and gas-generation assets for about C$1.7 billion, closing in 2019.

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 and the remaining C$4.8 billion is 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 'A-1(Low)' on the Canadian National Scale.

Ratings Score Snapshot

Issuer Credit Rating	BBB+/Negative/--
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)

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

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