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Research Update:

Hydro One Inc. Ratings Raised To 'A+'; Outlook Stable

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Rationale

On June 3, 2008, Standard & Poor's Ratings Services raised its long-term corporate credit and senior unsecured debt ratings on Hydro One Inc. to 'A+' from 'A'. At the same time, Standard & Poor's affirmed the 'A-1' short-term rating on the company. We also affirmed the 'A-1' global scale and 'A-1(Mid)' Canada scale commercial paper ratings. The outlook is stable.

Hydro One is a large, regulated transmission and local electricity distribution company (LDC) in the Province of Ontario (AA/Positive/A-1+). The rating action reflects a stable energy policy in Ontario and consistent, independent regulation. (For more details on the credit-positive trends influencing the sector, please refer to "Key Contributors To Rating Actions On Ontario Electricity Distributors," to be published on RatingsDirect following this research update.)

The ratings on Hydro One reflect the company's low-risk monopoly electricity transmission and distribution networks, secure and relatively predictable regulated cash flows, and the support of its owner, Ontario. Offsetting its excellent business risk profile is an intermediate financial risk profile that will face challenges from a large capital expenditure program in the next several years. Hydro One had C$6.2 billion in debt outstanding as of March 31, 2007.

Hydro One's monopoly position, the business' asset-intensive nature, and regulatory oversight limit competitive risk. It owns and operates more than 96% of the province's transmission network as measured by revenue, and its distribution network service territory covers about 75% of the province. Both the electricity transmission and distribution business carry relatively low operating risk, and exhibit average operational efficiency and reliability. We view transmission as lower risk than distribution.

Supporting transmission and distribution cash flow stability is the Ontario Energy Board's regulatory framework, which allows for the recovery of prudent costs and the opportunity to earn a modest return. Regulatory cost recovery is generally predictable and timeliness is improving. The current environment limits the LDC's exposure to commodity risk. Although the LDC must bill electricity customers for the commodity delivered, the cost is a flow through. The company has no obligation to ensure an adequate supply of electricity and is not burdened with the procurement process or power purchase agreements. Net distribution revenues are subject to modest volumetric risk due to weather. There is no near-term expectation of energy policy or electricity market framework initiatives that would affect the regulatory environment and LDC credit quality.

Hydro One has an intermediate financial risk profile that could weaken in the next few years. AFFO-to-total debt should remain at about 12% compared with its 2007 level of 14%. Sustainable AFFO interest coverage of 3.7x as of

Dec. 31, 2007 could fall below 3.0x in 2008. The extent of the decline in the utility's cash flow strength will depend on regulatory approvals and execution of planned capital expenditures, the impact of weather on revenue net of commodity costs, and the company's ability to find operating efficiencies sufficient to offset the OEB's performance-based regulatory pressures on rates.

During the upcoming period of higher than average construction, Hydro One's leverage, as measured by adjusted total debt-to-total capital, is likely to creep back up to the historical level of about 64%, compared with 58% in 2007. Although predominantly funded from internal sources (about 80%), capital spending during the next few years will be a drain on the company's cash flow, reducing financial flexibility and pressuring cash flow coverage. The utility has budgeted C$1.4 billion in capital expenditure for 2008, higher than the C$1 billion spent in 2007 and a historical average of about C$700 in the period 2002 to 2006. Upgrades and expansion of the transmission system are required to accommodate: new generation, increased imports and exports, and modest growth in domestic demand. The 2008 capital program also includes part of the estimated remaining C$670 million investment that Hydro One will make in smart meters for all distribution customers under a provincial directive by 2010.

The province's ownership of Hydro One enhances the utility's credit quality. Although Ontario does not formally guarantee the company's debt obligations, Hydro One's strategic nature within the provincial economy and the government's demonstrated willingness to assist the business (with liquidity support) under extraordinary circumstances in the past bode well for similar future support.

Short-term credit factors

The short-term rating on Hydro One is 'A-1'. Unused and committed bank lines, together with strong cash flow from operations and access to the debt capital markets, provide Hydro One with sufficient liquidity and the financial flexibility to meet the company's estimated capital expenditure of C$1.4 billion, annual dividend payments of C$250 million-C$290 million, and C$540 million of debt maturing in 2008. Furthermore, the company remains well within its banking covenant of total debt-to-total capital of 75% and has no material adverse change clauses that could trigger a default.

To support liquidity, the company can draw on:

- A committed C$1 billion bank line (maturing August 2010) that remained largely available as of March 31. The bank line is used for general corporate purposes and to support Hydro One's C$1 billion Canadian commercial paper program. The line was increased to C$1 billion from C$750 million as of Jan. 28, 2008.
- Annual regulated cash flows, as represented by unadjusted FFO, estimated at about C$900 million in 2008;
- A medium-term note shelf program, maturing in July 2009, that had C$1.65 billion remaining capacity as of March 31; and
- Discretionary capital expenditure estimated at more than C$200 million in 2008.

Outlook

The stable outlook reflects Hydro One's excellent business risk profile, which mitigates financial pressures of a larger-than-normal capital spending program. An adverse regulatory ruling or market restructuring (such as the assumption of the obligation to supply) could lead to a negative rating action. An upgrade is unlikely without the assurance of a much stronger balance sheet, and deeper cash flow-interest and -debt coverage. A significant change in the relationship with the government shareholder could move the rating up or down, but likely not more than a notch given the company's underlying credit strength.

Ratings List

Hydro One Inc.

Ratings Raised

	To	From
Corporate credit rating	A+/Stable/A-1	A/Positive/A-1
Senior unsecured debt	A+	A

Ratings Affirmed

Commercial paper	
Global scale	A-1
Canada scale	A-1(Mid)

Complete ratings information is available to subscribers of RatingsDirect, the real-time Web-based source for Standard & Poor's credit ratings, research, and risk analysis, at www.ratingsdirect.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com; select your preferred country or region, then Ratings in the left navigation bar, followed by Credit Ratings Search.