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Ratings

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Research Update:

Alectra Inc. Outlook Revised To Negative On Heightened Regulatory Lag; 'A-' Ratings Affirmed

May 11, 2023

Rating Action Overview

- The financial performance of the Ontario local distribution companies (LDC), regulated by the Ontario Energy Board (OEB), has gradually weakened, primarily reflecting regulatory lag. We view this development as negative for the credit quality of these companies, which could lead to our reassessing Ontario's regulatory framework.
- We therefore affirmed our ratings on Alectra Inc. (Alectra), including the 'A-' issuer credit rating, and revised the outlook to negative from stable.
- The negative outlook reflects the possibility that we could reassess our view of the Ontario regulatory framework because of regulatory lag that has weakened financial performance, increased cash flow volatility, and weakened financial predictability for Alectra.

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Rating Action Rationale

We have historically assessed the Ontario regulatory framework as one of the most credit-supportive regulatory jurisdictions for utilities. Despite the OEB only authorizing its LDCs an average return on equity (ROE) and a significantly below average capital structure, reflecting a 40% equity ratio, we have consistently assessed the Ontario regulatory framework as one of the most credit-supportive regulatory jurisdictions for LDCs because they have consistently been able to earn at or close to their authorized ROE. However, this has gradually weakened because of rising regulatory lag, which is the timing difference between when costs are incurred and when regulators allow those costs to be fully recovered from ratepayers. During the past two years, transmission costs and wholesale market charges have significantly increased. Although we expect the LDCs to entirely recover these costs from ratepayers, it has taken them as long as 24 months to fully recover these costs, which has eroded financial performance. In general, regulatory jurisdictions that we assess as most credit supportive have a regulatory construct in place that consistently minimizes regulatory lag.

Alectra's financial measures have weakened. Alectra's financial performance materially weakened in 2022, reflecting regulatory lag. In 2022, funds from operations (FFO) to debt was 8.8%, significantly below our downgrade threshold of 13%. As a company based in Canada, Alectra's financial statements are prepared in accordance with International Financial Reporting Standards. Under our base case of annual capital expenditures of C$400 million, annual dividend payments to its municipal owners, and the recovery of previously incurred costs, we expect financial measures will improve over the next three years. Specifically, we expect FFO to debt to reflect 12%-14% over that period.

We assess Alectra's business risk profile as excellent. We base this on the company's lower-risk regulated electric LDC business that reflects around 90% of consolidated EBITDA, partially constrained by its non-utility businesses. We assess Alectra's non-utility business (about 10% of EBITDA) as higher risk than the regulated utility business because its heavy dependence on storm activity and restoration work, which increases the volatility of Alectra's financial performance. Our assessment of Alectra's business risk profile also reflects its large customer base (about 1.1 million customers), consisting of mostly residential customers that provide a degree of cash flow stability, and our assessment of the Ontario regulatory construct as highly supportive. However, should we reassess Ontario's regulatory construct downward, we would likely reconsider our assessment of Alectra's business risk profile within its excellent business risk profile category.

Outlook

The negative outlook on Alectra reflects our view that we could downgrade the company over the next 12 months, pending our review of the Ontario regulatory jurisdiction. Our outlook also incorporates our expectations that financial measures will improve, with FFO to debt of 12%-14% through 2025.

Downside scenario

We could lower our ratings on Alectra over the next 12 months if we revise downward our assessment of Ontario's regulatory jurisdiction and Alectra's FFO to debt is consistently below 14%. We could also downgrade Alectra if we maintain our assessment of Ontario's regulatory jurisdiction and Alectra's FFO to debt is consistently below 13%. We could also lower the rating if the company expands its riskier unregulated operations further.

Upside scenario

We could revise our outlook to stable and affirm the ratings on Alectra over the next 12 months if we revise downward our assessment of Ontario's regulatory jurisdiction and Alectra's FFO to debt is consistently greater than 14%. We could also revise the outlook to stable if our assessment of Ontario's regulatory jurisdiction is unchanged and Alectra's FFO to debt is consistently greater than 13%.

Company Description

Alectra is an investment holding company that owns Alectra Utilities Corp. (about 90% of EBITDA), and Alectra Energy Solutions Inc. (about 10% of EBITDA).

Our Base-Case Scenario

- Continued rate increases in conjunction with annual rate increases, recovery of energy costs.
- Recovery of large energy cost variances of 2021 and 2022 in 2023 and 2024.
- We forecast that that energy sales variance would be between C$60 million to C$80 million in 2023.
- Capital spending averaging about C$400 million per year through 2025.
- Minimal discretionary cash flow deficits through 2025.
- No material disallowance of costs.
- All debt maturities are refinanced, and discretionary cash flow deficits funded by debt.

Liquidity

As of Dec. 31, 2022, we assess Alectra's liquidity as adequate, which reflects our expectation that sources will cover uses by 1.1x over the coming 12 months. Additionally, we anticipate its net sources will remain positive even if consolidated EBITDA declines 10%. We believe the predictable regulatory framework for Alectra provides cash flow stability even in times of economic stress. This supports our use of slightly lower thresholds than for a typical corporate issuer to assess the company's liquidity. In addition, Alectra has the ability to absorb high-impact, low-probability events, given that it maintains about C$700 million in committed credit facilities that mature beyond 12 months. We also believe the company can significantly lower its robust capital spending during stress, which would reduce the need for refinancing under such conditions.

Our assessment also reflects the company's prudent risk management, sound relationships with its banks, and satisfactory standing in the credit markets. Overall, we believe the company could withstand adverse market circumstances over the next 12 months with sufficient liquidity to meet its obligations. The company has its next big long-term debt maturities in 2024, totaling about C$315 million coming due, and we expect the company to proactively address these maturities well in advance of their scheduled due date.

Principal liquidity sources

- Committed credit facilities availability of C$700 million;
- Cash FFO of about C$440 million; and
- Cash balance of about C$50 million.

Principal liquidity uses

- Debt maturities of about C$290 million;
- Capital expenditure of about C$430 million; and
- Dividend payments of about C$75 million.

Ratings Score Snapshot

Issuer credit rating: A-/Negative/--

Business risk: Excellent

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

Financial risk: Significant

- Cash flow/leverage: Significant

Anchor: a-

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: Neutral (no impact)

Stand-alone credit profile: a-

- Group credit profile: a-
- Entity status within group: Core (no impact)
- Government-related entity: Low (no impact)

ESG credit indicators: E-2, S-2, G-2

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- 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: 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 | Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Ratings List

Ratings Affirmed; Outlook Action

	To	From
Alectra Inc.		
Issuer Credit Rating	A-/Negative/--	A-/Stable/--
Issue-Level Ratings Affirmed		
Alectra Inc.		
Senior Unsecured	A-	

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.