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Ratings

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London Hydro Inc.

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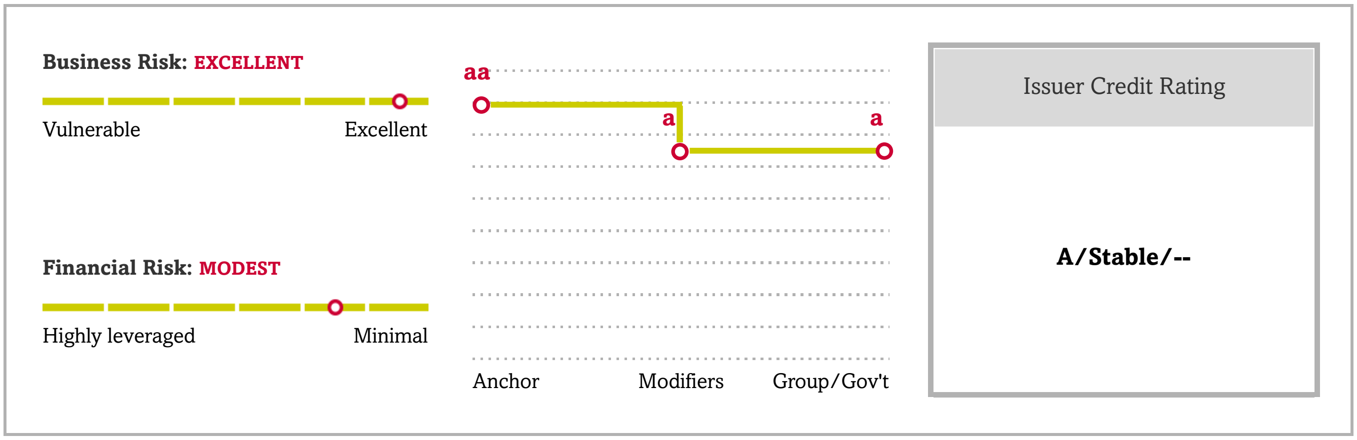

Credit Highlights

Overview

Key strengths	Key risk
Low-risk regulated electricity distribution utility in Ontario.	Lack of geographic and regulatory diversity with limited likelihood of government support.
Regulatory environment is stable, transparent, and predictable.	Deferral of COVID-19 costs recovery could modestly increase cash flow volatility.
Ability to recover all prudently incurred costs in a timely manner.	Continued negative discretionary cash flow indicates external funding needs.

The Ontario Energy Board (OEB) has established deferral accounts to record the costs and losses stemming from the COVID-19 pandemic. The OEB, Ontario's regulator, has acknowledged that utility distributors, including London Hydro Inc. (LHI), may incur incremental costs related to the ongoing coronavirus pandemic. Therefore, it established deferral accounts for utilities to track incremental costs and lost revenue related to the pandemic. This will allow LHI to recover potential lost revenue, incremental expenses, or costs related to bad debt expenses, subject to the OEB's approval. The pandemic could increase LHI's cash flow volatility over the short term and lead to some regulatory lag, though the expected recovery of its COVID-19-related costs through the deferral accounts partly mitigates potential lost revenue.

The utility's lack of geographic and regulatory diversity is marginally offset by its favorable customer mix and credit-supportive regulatory environment. LHI serves about 160,000 customers, all in Ontario, making the company reliant on its sole regulator, OEB, to sustain its credit quality. While LHI has a small customer base, it is composed mostly of residential customers that are less sensitive to macroeconomic factors. We consider Ontario a relatively strong regulatory jurisdiction that is stable, transparent, and predictable, supporting LHI's excellent business risk. However, compared with other utilities, LHI has a small customer base and lacks geographic and regulatory diversity.

Outlook: Stable

The stable outlook reflects what S&P Global Ratings considers to be consistent, predictable cash-flow generation, which LHI's low-risk, regulated distribution business supports. During our outlook period, we expect funds from operations (FFO) to debt to be in the 23%-26% range.

Downside scenario

We believe a downgrade during the next two years is highly unlikely. However, a material, adverse regulatory ruling or a significant increase in leverage leading to a sustained deterioration in forecast adjusted FFO to debt of less than 13% could lead to a downgrade.

Upside scenario

We believe an upgrade during the next two years is highly unlikely. However, if the company implemented a well-articulated financial and dividend policy aligned with a shareholder agreement that enshrined the current modest balance-sheet leverage, and we became satisfied that there was negligible potential for future alignment with a more highly leveraged deemed capital structure used by the Ontario regulator for setting rates, we could reduce the impact of the financial policy modifier and raise the ratings.

Our Base-Case Scenario

Assumptions

- OEB will continue to operate in a transparent, stable, and predictable manner. We expect no adverse regulatory decisions in the forecast period.
- EBITDA margin of about 9% per year through 2022.
- Capital spending of C$45 million-C$50 million per year through 2022.
- Dividends of C$5 million per year through 2022.
- All debt maturities refinanced.

Key metrics

	2020e	2021e	2022e
FFO to debt (%)	22-24	24-26	22-24
Debt to EBITDA (x)	3.8-4.2	3.4-3.8	3.6-3.9

e--Estimate. FFO--Funds from operations.

Company Description

LHI is a City of London-owned electricity distributor utility serving about 160,000 customers in southwestern Ontario, Canada.

Business Risk: Excellent

Our assessment of the company's business risk profile reflects the utility's regulated low-risk electricity-distribution operations in Ontario. Also, it reflects our view of the OEB's regulatory framework, which supports the utility's steady cash flow. In our view, the regulatory process is transparent, consistent, and predictable. These factors substantiate timely recovery of capital spending and operating costs. Exposure to commodity-related expenses is limited since the utility can pass through costs to rate payers. Additionally, there is revenue decoupling for distribution operators and fixed-rate distribution tariffs. We view these as key credit strengths.

LHI's business risk profile also takes into account a concentrated geographic footprint and limited size. We consider LHI a small utility because it provides electricity service to only about 160,000 customers. We expect the customer profile to remain stable, with about two-thirds of electricity demand from residential customers that are less sensitive to macroeconomic stresses and business cycles.

Financial Risk: Modest

Our base-case scenario includes adjusted FFO to debt in the 23%-26% range. Furthermore, we expect annual capital spending for the next few years to be higher than depreciation, at about C$45million-C$50 million for 2021, which will result in negative discretionary cash flows for the forecast period. We expect the company will require external funding sources to fund this capital spending.

We base our assessment on our low-volatility financial benchmarks, which are the most relaxed compared with those for a typical corporate issuer. This reflects the company's focus on low-risk regulated electricity distribution operations and strong management of regulatory risk.

Our ratings on LHI include a three-notch downward adjustment to account for the impact of its financial policy because we believe that debt leverage could be significantly higher than our base-case forecast. The utility has a relatively conservative capital structure with a forecast debt-to-capital ratio of about 47%, well below the authorized debt-to-capital ratio of 60%. Additional special dividend payments and an absence of any incentive to maintain the existing capital ratio within the financial policy could result in incremental debt leverage and financial measures weaker than those in our base case.

Liquidity: Adequate

We assess the company'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. The assessment also reflects the company's generally prudent risk management, sound relationship with banks, and generally satisfactory standing in credit markets.

Principal liquidity sources

- Cash on hand of about C$28 million as of Dec. 31, 2020;
- Credit facility availability of C$45 million; and
- Estimated cash FFO of about C$45 million.

Principal liquidity uses

- Capital spending of about C$50 million; and
- Dividends of about C$5 million.

Environmental, Social, And Governance

LHI's exposure to environmental risk is limited given its operations are entirely in lower-risk electric distribution operations without commodity exposure. LHI is better positioned than its counterparts, with generation assets across North America. Social or governance factors have not had a material impact on the rating and are generally in line with those of peers.

Government Influence

We believe there is a low likelihood that LHI's owner, the City of London, would provide timely and sufficient extraordinary support in the event of financial distress. We base this on our assessment that there is a limited link and limited importance role to its government owner. The low likelihood of extraordinary government support means no rating enhancement to the 'a' stand-alone credit profile.

Ratings Score Snapshot

Issuer Credit Rating

A/Stable/--

Business risk: Excellent

- **Country risk:** Very low
- **Industry risk:** Very low
- **Competitive position:** Excellent

Financial risk: Modest

- **Cash flow/leverage:** Intermediate

Anchor: aa

Modifiers

- **Diversification/portfolio effect:** Neutral (no impact)
- **Capital structure:** Neutral (no impact)
- **Financial policy:** Negative (-3 notches)
- **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)

Related Criteria

- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, Sept. 21, 2017
- 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: Methodology: Industry Risk, Nov. 19, 2013
- ARCHIVED - General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Corporates - Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- ARCHIVED Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, 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 And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Business And Financial Risk Matrix

Business Risk Profile	Financial 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-

Ratings Detail (As Of May 7, 2021)*

London Hydro Inc.	
Issuer Credit Rating	A/Stable/--
Issuer Credit Ratings History	
10-Jun-2009	A/Stable/--
03-Jun-2008	A/Positive/--
26-Mar-2007	A-/Positive/--

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.