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Research Update:

London Hydro Inc. Ratings Affirmed, Outlook Stable

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PRIMARY CREDIT ANALYST

Ruchi Agrawal
Toronto
+14372252983
ruchi.agrawal
@spglobal.com

SECONDARY CONTACT

Obioma Ugboaja
New York
+ 1 (212) 438 7406
obioma.ugboaja
@spglobal.com

Rating Action Overview

- Ontario-based London Hydro Inc.'s (LHI) financial measures have more recently underperformed our expectations because of rising leverage and regulatory lag associated with the recovery of energy costs and COVID-19-related expenses.
- We expect the company's financial measures to reflect funds from operations (FFO) to debt averaging about 19%-22% over our forecast period, and as such, we revised downward our assessment of the company's financial risk profile to intermediate from modest.
- That said, LHI has been gradually increasing leverage, progressing closer to its authorized debt-to-capital ratio of 60%. Currently, LHI's debt to capital is at about 51%, or significantly higher than the 44% in 2017. We expect leverage will continue to gradually increase until the company's debt to capital is in line with its authorized capital structure. However, even with higher leverage, we expect that the company's financial measures will consistently remain within its revised financial risk profile category. To account for our changed expectations, reflecting an increasingly consistent financial performance, we revised our assessment of the company's financial policy modifier to neutral from negative.
- As a result, we affirmed our ratings on London Hydro Inc., including our 'A' issuer credit rating on the company. The outlook is stable.
- The stable rating outlook on the company largely reflects our expectation of consistent, predictable cash flow generation, effective regulatory risk management, and LHI's continued focus on its low-risk, regulated distribution business. Over the next two years, we expect the company's FFO to debt to remain 19%-22%.

Rating Action Rationale

We revised downward the company's financial risk profile, reflecting our expectations for consistently weaker financial performance. LHI's financial performance since 2018 has been consistently below our expectations, reflecting rising leverage and regulatory lag associated with the recovery of energy costs and COVID-19-related expenses. During this timeframe, the company's FFO to debt in the 11%-19% range, which is inconsistent with the company's previous financial risk profile category. We now expect that the company's financial measures will consistently reflect its revised financial risk profile category, with FFO to debt at 19%-22%. Our base case assumes full recovery of energy and COVID-19-related costs that will modestly improve financial performance compared with previous years.

We revised the financial policy modifier to neutral from negative. We expect that the company's financial measures will consistently remain within the range of its revised financial risk profile category, despite expectations for increasing leverage to the balance sheet. LHI has been gradually increasing leverage, progressing closer to its authorized debt to capital of 60%. Currently, LHI's debt to capital is at about 51%, or significantly higher than the 44% in 2017. We expect leverage will continue to gradually increase until the company's debt to capital is in line with its authorized capital structure. However, even with higher leverage, we expect that the company's financial measures will consistently remain within the range of its revised financial risk profile category.

We continue to assess LHI's business risk profile as excellent. The company's operations primarily reflect low-risk regulated transmission and distribution operations, under the credit supportive regulatory regime of Ontario, which allows LHI to recover prudently incurred operating and capital expenses generally in a timely manner, consistent with peers. Partially offsetting these key credit strengths are the company's small size and lack of geographic diversity.

Outlook

The stable outlook reflects our expectation of consistent, predictable cash flow generation, effective regulatory risk management, and LHI's continued focus on its low-risk, regulated distribution business. During our outlook period, we expect funds from operations (FFO) to debt to be in the 19%-22% range.

Downside scenario

We could lower our ratings on LHI over the next 12-24 months if the company's financial performance weakened, such that FFO to debt were consistently below 13%. This could occur if there were a material adverse regulatory ruling or a significant increase in leverage beyond our base case.

Upside scenario

We could upgrade the company over a similar period if the FFO to debt consistently improved to greater than 21% without a reduction in its debt-to-capital ratio.

Company Description

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

Liquidity

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 of about C$20 million as of March 31, 2022; and
- Estimated cash FFO of about C$41 million.

Principal liquidity uses:

- Capital spending of about C$42 million, and
- Dividends of about C$5 million.

Covenants

LHI's debt-to-capitalization ratio cannot exceed 60%. As of March 31, 2022, the company is in compliance with this covenant, and we expect it to remain compliant with this covenant with sufficient headroom in the forecast period.

Environmental, Social, And Governance

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

ESG factors have no material influence on our credit rating analysis of London Hydro Inc.

Ratings Score Snapshot

Issuer Credit Rating: A/Stable/--

Business risk: Excellent

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

Financial risk: Intermediate

- Cash flow/leverage: Intermediate

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

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
- 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 | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, 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	
London Hydro Inc.	
Issuer Credit Rating	A/Stable/--