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Ratings

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Research Update:

London Hydro Inc. Outlook Revised To Negative On Heightened Regulatory Lag; Ratings Affirmed

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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 credit quality for these companies, which could lead to us to revise our assessment of Ontario's regulatory framework.
- We affirmed our 'A' issuer credit rating on London Hydro Inc (LHI), an LDC. We 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 LHI.

Rating Action Rationale

We have historically assessed the Ontario regulatory framework as one of the most credit-supportive regulatory jurisdictions for LDCs. 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. This is because the LDCs have historically 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 recover these costs from ratepayers, it has taken them as long as 24 months to fully recover these costs, which has weakened their financial performance. In general, regulatory jurisdictions that we assess as most credit supportive have a regulatory construct in place that consistently minimizes regulatory lag.

LHI's historical financial measures have weakened. The company's financial performance materially weakened in 2022, reflecting regulatory lag. In 2022, funds from operations (FFO) to debt was 11.8%, significantly below our downgrade threshold of 13%. Under our base case of annual capital expenditures of $40 million, annual dividend payments to the City of London of about $5 million, and the recovery of previously incurred costs, we expect financial measures will improve. Specifically, we expect FFO to debt of 11%-16% over the next two years.

We continue to assess LHI's business risk profile as excellent. Our assessment of LHI's business risk profile reflects its position as a low-risk regulated LDC, operating under Ontario's regulatory framework. Partially offsetting LHI's key credit strengths are the company's below-average size, serving about 166,000 customers, and lack of geographic diversity.

Outlook

The negative outlook on LHI reflects our view that we could downgrade the company by one notch over the next 12 months, pending our review of the Ontario regulatory jurisdiction.

Downside scenario

We could lower our ratings on LHI by one notch over the next 12 months if we revise downward our assessment of Ontario's regulatory jurisdiction, assuming the company maintains FFO to debt above 15% in line with our baseline expectations. Failure to achieve this improvement to the financial profile could result in additional downside ratings pressure.

If we don't revise our assessment of Ontario's regulatory jurisdiction then we could lower our ratings on LHI if FFO to debt weakened consistently below 13%.

Upside scenario

We could affirm our ratings on LHI and revise our outlook to stable over the next 12 months if we revise downward our assessment of Ontario's regulatory jurisdiction and LHI's financial measures significantly improve such that FFO to debt is consistently greater than 20%.

We could also affirm our ratings on LHI and revise the outlook to stable over this period if we maintain our current assessment of Ontario's regulatory jurisdiction and LHI's FFO to debt consistently improves to greater than 13%.

Company Description

London Hydro Inc. (LHI) is a midsize Ontario local distribution company (LDC) located in Southwestern Ontario. Almost all cash flows come from its regulated electricity distribution business. LHI delivers electricity to 166,000 customers through a fully owned extensive network of overhead and underground lines.

Liquidity

We assess LHI's liquidity as adequate and expect its sources to be 1.1x over its uses over the next 12 months. In addition, we anticipate its net sources would remain positive even if its forecast consolidated EBITDA declines 10%. We believe the company's generally predictable regulatory framework provides manageable cash flow stability, even in times of economic stress, which supports our use of slightly lower thresholds to assess its liquidity. In addition, we believe LHI could absorb high-impact, low-probability events, reflecting about C$40 million of committed credit facilities through 2025 and our belief it can lower its capital spending (averaging about C$40 million annually through 2025) during stressful periods. This indicates that it would have a limited need for refinancing under such conditions. Furthermore, our assessment reflects LHI's generally prudent risk management practices. Overall, we believe that the company would likely be able to withstand adverse market circumstances over the next 12 months with sufficient liquidity to meet its obligations.

Principal liquidity sources

- Cash FFO of about C$32.6 million; and
- Committed credit facility availability of C$40 million.

Principal liquidity uses

- Debt maturities of C$2.2 million;
- Capital expenditures of about C$39.3 million; and
- Dividend payments of about C$5 million.

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 LHI.

Ratings Score Snapshot

Issuer credit rating: A/Negative/--

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

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
- 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: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, 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; Outlook Action

	To	From
London Hydro Inc.		
Issuer Credit Rating	A/Negative/--	A/Stable/--

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.