Research Update:

London Hydro Inc. Outlook Revised To Stable From Negative; Ratings Affirmed

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Rating Action Overview

- We concluded our review of Ontario's regulatory construct and maintained our assessment as a most credit supportive regulatory jurisdiction.
- Our assessment reflects that the Ontario Energy Board (OEB) has proactively addressed regulatory lag, and we now believe that its utilities, including London Hydro Inc. (LHI), will maintain consistent financial measures sufficient for the current ratings.
- We therefore revised the outlook to stable from negative and affirmed our 'A' issuer credit rating on LHI.
- The stable outlook reflects our expectation that LHI's financial measures will remain consistent, such that funds from operations (FFO) to debt reflects 13%-15% over our outlook period.

Rating Action Rationale

Our assessment of Ontario's regulatory environment is unchanged at most credit supportive. During 2023, the OEB proactively addressed regulatory lag, particularly related to the timely recovery of rising transmission-related costs. Previously, the local distribution companies (LDCs) in Ontario experienced regulatory lag of about 24 months in recovering transmission costs increases. Regulatory lag is the timing difference between when costs are incurred by the LDCs and when they ultimately recover such costs from ratepayers. Because of inflation and rising transmission capital spending, transmission costs were significantly increasing, and the regulatory lag was materially weakening the financial measures of most of Ontario's LDCs. However, beginning in 2024, the OEB allowed the LDCs to implement new preliminary transmission rates at about the same time that the OEB authorizes such rates for the transmission companies, materially reducing the regulatory lag. Overall, we view the OEB's proactiveness to quickly address this regulatory lag as constructive and consistent with our view of Ontario's regulatory jurisdiction as most credit supportive. As such, we expect LHI's financial measures will be more consistent and reflect FFO to debt of 13%-15% through 2026.

We continue to assess LHI's business risk profile as excellent. This mostly reflects the company's position as a monopolistic, low-risk regulated LDC. The company is regulated by Ontario's constructive regulatory framework, which generally allows LHI to recover prudently incurred operating and capital expenses in a timely manner, supporting credit quality. Our assessment also incorporates LHI's use of revenue decoupling and fixed-rate distribution tariffs, which we view as key credit strengths. Partially offsetting LHI's key credit strengths are the company's below-average size, serving about 167,000 customers, and lack of geographic diversity, resulting in our assessment of the company as being in the lower-half of the range for its business risk profile category, compared to peers.

We assess LHI's financial risk profile as intermediate using our low-volatility financial benchmark table. Use of our low-volatility financial benchmark table reflects the company's low-risk regulated electric distribution operations and effective regulatory risk management. Under our base case, which assumes annual capital expenditures of $55 million, annual dividend payments to the City of London of about $5 million, and timely cost recovery under the OEB's credit-supportive construct, we expect LHI to maintain FFO to debt of 13%-15% throughout our forecast period, with a steady cash flow generation profile, consistent with the intermediate financial risk profile.

Outlook

The stable rating outlook on LHI reflects our expectation that financial measures will remain consistent such that FFO to debt consistently reflects 13%-15%, with no weakening in business risk.

Downside scenario

We could lower our ratings on LHI over the next 12-24 months if financial measures weakened, such that FFO to debt approaches 13%, or if LHI's business risk increases, including a weakening of its effective regulatory risk management.

Upside scenario

We could raise our rating on LHI if financial measures improved such that FFO to debt were consistently above 20%, without any increase in business risk.

Company Description

London Hydro Inc. (LHI) is a midsize Ontario LDC located in Southwestern Ontario. Almost all cash flows come from its regulated electricity distribution business. LHI delivers electricity to 167,000 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 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 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 its about C$40 million of committed loan facilities through 2026 and our belief it can lower its capital spending (averaging about C$55 million annually through 2026) 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. 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$42 million, and
- Committed loan facility availability of C$20 million.

Principal liquidity uses:

- Short-term borrowings of C$9.4 million,
- Assumed maintenance capital expenditure of about C$39.5 million, and
- Dividend payments of about C$5 million.

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: Neutral (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: a

Group credit profile: a

Related Criteria

- Criteria | Corporates | General: Sector-Specific Corporate Methodology, April 4, 2024
- Criteria | Corporates | General: Corporate Methodology, Jan. 7, 2024
- Criteria | Corporates | General: Methodology: Management And Governance Credit Factors For Corporate Entities, Jan. 7, 2024
- 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
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Ratings List

Ratings Affirmed; Outlook Action

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