FitchRatings

RATING ACTION COMMENTARY

Fitch Assigns 'A-' First-Time IDR to ALECTRA INC.; Outlook Stable

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Fitch Ratings - Toronto - 14 Aug 2023: Fitch Ratings has assigned a first-time Long-Term Issuer Default Rating (IDR) of 'A-' to ALECTRA INC. (ALECTRA). The Rating Outlook is Stable. Fitch has also assigned an instrument rating of 'A' to ALECTRA's senior unsecured debt.

ALECTRA's ratings are supported by the company's large-scale regulated electric distribution operations in high growth areas of Ontario. Additionally, Fitch views the rate-setting mechanisms employed by ALECTRA's regulator, the Ontario Energy Board (OEB), to be highly constructive. While current FFO leverage is elevated, it is forecasted to improve to 5.2x with reducing regulatory lag and constructive rebasing expected in 2027. Fitch rates ALECTRA based on its standalone credit profile with no direct notching uplift related to municipal ownership.

Fitch has applied a one notch utility sector uplift from the IDR to the ratings of ALECTRA's senior unsecured debt. This assessment is based on ALECTRA's financing policy of raising debt exclusively at the parent level and the expectation that its business mix will remain predominantly regulated.

KEY RATING DRIVERS

Predominantly Regulated Utility Business: ALECTRA derived over 88% of consolidated 2022 EBITDA from Alectra Utilities Corporation, which is the largest municipally-owned electric distribution company in Canada. Fitch expects the company's predominately low-risk, regulated business mix to continue with 87%-90% of ALECTRA's EBITDA from regulated activities through 2027. Fitch expects 92% of ALECTRA's $1.5 billion five-year capex to be dedicated to regulated operations.

ALECTRA's non-utility operations remain largely limited to solar generation projects (4% of 2022 EBITDA) and other energy-based services (8% of 2022 EBITDA), which include storm restoration, consulting, metering, storage and street lighting. Fitch expects ALECTRA's nonregulated businesses to continue to be low capital intensity with minimal debt requirements and support ALECTRA's consolidated cash flows.

Favorable Service Territories: ALECTRA services over one million customers based in the Greater Golden-Horseshoe Area of Ontario, Canada, which has historically seen high population and economic growth. Fitch expects customer growth of around 0.7% annually to sustain during the forecast period, benefitting from a strong regional economy and Federal immigration targets.

Constructive Rate-Setting Mechanisms: Fitch expects the regulatory environment for ALECTRA under the OEB to remain constructive with several supportive mechanisms in place. ALECTRA currently operates under the Price Cap IR option, which is one of several performance-based rate options employed by the OEB when setting distribution rates. ALECTRA benefits from a forward-looking test years in base rate cases, multi-year formulaic rate plans, revenue decoupling and annual tariff adjustments tracking inflation and productivity savings.

Additionally, incremental capital tracker mechanisms and various annual rate riders are also a positive. ALECTRA's allowed ROE of 8.95% and equity capitalization of 40% are lower than U.S. averages though sufficiently offset, in Fitch's opinion, by the OEB's track record of predictable regulatory support.

Expected Moderation in Regulatory Lag: Despite Ontario's, favorable regulatory mechanisms, ALECTRA has experience some regulatory lag. The OEB historically authorizes recovery of pass through costs including cost-of-power in as long as 24 months. Increases in these costs have been exacerbated by macro-pressures like inflation and COVID-related deferrals leading to sizeable under recoveries and lower-than-authorized earned ROEs. However, Fitch believes that OEB's recent acceleration of rate application parameters ahead of normal timelines is a positive development that should help reduce regulatory lag and demonstrates OEB's credit supportive stature.

In conjunction with the 2017 amalgamation that formed ALECTRA, the company was allowed a 10-year rebasing deferral period that ends in 2026 for four (out of five) rate zones. The purpose of the deferral period, was to enable ALECTRA to realize post amalgamation synergies. Fitch believes that while the deferral period has allowed ALECTRA to retain amalgamation benefits, the deferred rebasing - has delayed recovery of certain regulatory costs ordinarily recovered in cost-of-service applications. Fitch expects inflationary and customer bill pressures to continue to lead to lower earned ROEs in the near term. Fitch's 'A-' IDR is based upon a constructive outcome in the 2027 rebasing. Fitch considers the recent favorable cost-of-service application outcome for a larger provincial peer to underpin this view.

Improvement Expected in Credit Metrics: Fitch forecasts FFO leverage to average 5.6x and improve to 5.2x through 2027. Fitch expects recovery of some eligible costs with a reduced lag, especially power, coupled with continued customer growth, realization of amalgamation synergies as well as a constructive rebasing in 2027. Also, Fitch believes the regulatory support and lack of sectoral bankruptcies in Canada sufficiently offsets higher leverage relative to U.S. peers that arises out of lower allowed equity thickness.

Ontario Favorably Positioned for Decarbonization: Ontario derived only 10% of its electricity from fossil fuels in 2022 - significantly lower than the U.S. and most Canadian provinces. The province continues to demonstrate its support for nuclear generation, which is a zero-carbon electricity source, with plant refurbishments and investments in small modular reactors. As such, Fitch views the cost pressures from energy transition to be more manageable for Ontario.

Shareholder Relationship: ALECTRA is a private corporation owned by 1) seven municipalities of Ontario-Mississauga (26.6%), Hamilton (17.3%), Vaughan (20.5%), Markham (15%), Barrie (8.4%), Guelph (4.6%) and St. Catharine's (4.6%) and 2) the Ontario Municipal Employees' Retirement System- OMERS (3%). As such, Fitch deems ALECTRA to be a Government-Related Entity (GRE). The shareholders elects ALECTRA's board of directors. Through its election of directors, the shareholders collectively exercise legal control over the company. However, Fitch notes that no single shareholder has explicit control or special voting rights.

Additionally, after an initial investment at the time of the amalgamation in 2017, the shareholders have not provided any financial support to ALECTRA, leading to Fitch's assessment of a moderate strength of linkage. While Fitch views the socio-political implications of an ALECTRA default on the shareholder as moderate, ALECTRA's small relative contribution to overall operating budgets of these cities and a lack of guarantees causes Fitch to deem the incentives to support as weak. Due to these support considerations, Fitch rates ALECTRA based on its standalone credit profile with no direct notching uplift related to the government ownership.

Financing Structure: Fitch notes that there is no limitation on debt issuance at the subsidiaries in the lender agreements or regulatory orders. However, ALECTRA's instrument rating has been afforded the standard one notch uplift applicable to the utilities sector given management's express policy of raising debt solely at the parent. Additionally, the uplift is based on the expectation of ALECTRA's business mix remaining predominantly regulated. Any change in the financing policy or business mix would likely result in removal of the uplift.

DERIVATION SUMMARY

ALECTRA's Long-Term IDR is well positioned relative to Canadian peer parent holding companies ENMAX Corporation (BBB/Stable) and ATCO Limited (ATCO; BBB+/Stable). While ALECTRA operates an electric distribution only in Ontario, ENMAX operates T&D utilities in Alberta and Maine and ATCO operates T&D utilities in Alberta through its purely regulated subsidiary CU, Inc. (CU; A-/Stable).

Fitch views the regulatory environment in Maine (around 20%-25% of the forecasted EBITDA for ENMAX) as restrictive compared to Ontario. However, it views regulatory construct in Ontario to be comparable to Alberta (40%-45% of EBITDA for ENMAX and 85%-90% for ATCO). Notably, both employ a performance-based rate setting approach for distributors but ALECTRA has slightly higher allowed ROE and equity thickness. Further, the construct in Ontario has been somewhat tempered by the regulatory lag in the recent past, although this is expected to improve.

Regulatory lag coupled with deferred rebasing for ALECTRA is expected to keep its leverage slightly elevated at an average 5.6x and improve to 5.2x through 2027. ENMAX's leverage is forecasted to average lower at 5.4x through 2025 supported by rate case resolutions while ATCO is also expected to average lower at 5.2x through 2026.

However, ALECTRA's proportion of consolidated EBITDA from regulated utility operations is forecasted to remain in the 87%-90% range, higher than ENMAX's 60%-70% and comparable to ATCO's 85%-90%. This offers more predictability in cash flows for ALECTRA as compared to ENMAX which has a sizeable exposure to competitive non-regulated businesses.

ATCO's non-regulated businesses include cyclical segments like infrastructure, transport and logistics. Additionally, it also owns commodity exposed segments like generation and retail in higher risk geographies like Latin America. As compared to these, ALECTRA's non-regulated businesses are Ontario based energy services and therefore viewed as lower risk given low capital intensity and higher margins.

KEY ASSUMPTIONS

--Continuation of the multi-year Incentive-Rate Setting framework for distribution rates;

--2027 to be the rebasing year for Horizon, Enersource, Brampton and PowerStream rate zones and 2029 for Guelph;

--Constructive rebasing outcomes in 2027 and 2029, in line with recent outcomes for other utilities in the province;

--Annual Adjustment Mechanisms to continue in line with the existing Price IR model;

--Regulated EBITDA to form 87%-90% of the total through 2027;

--Shareholder dividends consistent with the current policy of targeting 60% of the net income (MIFRS) excluding the Ring Fenced Solar Partnership income and targeting 80% of the solar net FCF while maintaining the regulated capital structure of 40% equity capitalization;

--Consolidated ALECTRA capex of $1.5 billion with over 90% towards utility operations;

--Annual customer growth of around 0.7% through 2026;

--Interest rates to remain elevated in 2023, moderate slightly in 2024 and remain stable in 2025-2026.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade

--FFO leverage below 4.8x for the period 2023-2026 on a sustained basis with regulated utility EBITDA continuing to form over 85% of the total on a sustained basis;

--Constructive rebasing outcome providing for an FFO leverage below 4.5x for 2027 and beyond on a sustainable basis;

--Further improvement in regulatory outcomes in Ontario providing for timely cost recoveries and earning of allowed ROE.

Factors that could, individually or collectively, lead to negative rating action/downgrade

--FFO leverage exceeding 5.8x on a sustained basis till 2026 and 5.5x post the rebasing in 2027;

--Debt financed acquisition or amalgamations with no clear path to deleveraging over the forecast period;

--Expansion into unregulated businesses leading to less than 85% EBITDA contribution on a sustained basis from regulated operations;

--Adverse regulatory outcomes especially for the next rebasing application;

--As it pertains to the instruments' ratings, any changes in ALECTRA's financial policy of raising debt solely at the parent level or introduction of any structural subordination to the debt structure or expansion into unregulated businesses leading to less than 85% EBITDA contribution on a sustained basis from regulated operations.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Non-Financial Corporate issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

LIQUIDITY AND DEBT STRUCTURE

Fitch considers the liquidity for ALECTRA to be adequate. Liquidity is primarily supported by the company's $700 million CP program backstopped by a $700 million committed unsecured revolving credit facility (RCF), maturing in 2027. Additionally, ALECTRA has a $100 million uncommitted credit facility (LC facility), $100 million overdraft facility and another $100 million expansion option subject to mutual agreement between ALECTRA and its lenders.

At Dec. 31, 2022, the company had $290 million of CP issued. Including a Dec. 31, 2022 cash balance of around $48 million and excluding availability under the company's uncommitted facilities, total ALECTRA liquidity was approximately $458 million.

ALECTRA's near-term debt maturities are manageable with around $150 million in unsecured private debentures and $166 million promissory notes due to the cities of Markham, Barrie and Vaughan due in 2024 and private debentures of $675 million in 2027. Fitch expects ALECTRA to have continued access to capital markets to refinance the private debt as it comes due and expects the company to manage its debt in accordance with the regulated capital structure. The promissory notes from three of the shareholders also have extension options- a 12-year renewal and two 10-year extensions.

ALECTRA's debt is primarily fixed rate, which mitigates the risks associated with the current high interest rate environment.

ISSUER PROFILE

Ontario, Canada based ALECTRA INC. was formed in 2017 by amalgamation of three electric distributor utilities: 1) PowerStream, Inc. 2) Enersource Hydro Mississauga, Inc. and 3) Horizon Utilities Corporation. ALECTRA subsequently acquired Hydro One Brampton Networks, Inc. in 2017 and, Guelph Hydro Electric System, Inc. in 2019.

SUMMARY OF FINANCIAL ADJUSTMENTS

Fitch has adjusted ALECTRA's historical financial statements to reflect the effects of rate regulation in Canada and, in particular, the recognition of regulatory assets and liabilities and the changes in those assets and liabilities for FYs 2019 to 2022.

DATE OF RELEVANT COMMITTEE

21 July 2023

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

The highest level of ESG credit relevance is a score of '3', unless otherwise disclosed in this section. A score of '3' means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. Fitch's ESG Relevance Scores are not inputs in the rating process; they are an observation on the relevance and materiality of ESG factors in the rating decision. For more information on Fitch's ESG Relevance Scores, visit https://www.fitchratings.com/topics/esg/products#esg-relevance-scores.

RATING ACTIONS

ENTITY / DEBT	RATING			
ALECTRA INC.	LT IDR	A- Rating Outlook Stable	New Rating	
senior unsecured	LT	A	New Rating	

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Government-Related Entities Rating Criteria (pub. 30 Sep 2020)

Corporates Recovery Ratings and Instrument Ratings Criteria (pub. 09 Apr 2021) (including rating assumption sensitivity)

Corporate Rating Criteria (pub. 28 Oct 2022) (including rating assumption sensitivity)

Sector Navigators: Addendum to the Corporate Rating Criteria (pub. 12 May 2023)

Climate Vulnerability in Corporate Ratings Criteria (pub. 21 Jul 2023) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Corporate Monitoring & Forecasting Model (COMFORT Model), v8.1.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

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ALECTRA INC.	-

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