FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Alectra's IDR at 'A-'; Outlook Stable

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Fitch Ratings - Toronto - 23 Jul 2024: Fitch Ratings has affirmed Alectra Inc.'s Long-Term Issuer Default Rating (IDR) at 'A-'. The Rating Outlook is Stable. Fitch has also affirmed the company's senior unsecured debt at 'A'.

The affirmation reflects Fitch's continued expectation that a constructive rebasing outcome in 2027 would lead to improvement of Alectra's elevated FFO leverage to 5.4x in 2028. The company's rating are also supported by its large-scale regulated electric distribution operations under a highly constructive regulator in high growth areas of Ontario. Fitch rates Alectra based on its standalone credit profile with no direct uplift related to municipal ownership.

KEY RATING DRIVERS

Regulated Business Remains Predominant: Fitch expects Alectra's predominantly low-risk, regulated business mix to continue with 87%-90% of EBITDA from regulated activities through 2028. Fitch expects Alectra to dedicate over 90% of its $1.7 billion capex through 2028 to regulated operations. Recent unregulated projects and investments include gas generation facilities, energy storage facilities, and the acquisition of a power restoration business. No single segment contributes more than 2% to Alectra's total EBITDA per Fitch estimates.

Fitch expects Alectra's non-regulated businesses will maintain low capital intensity with minimal debt requirements and support its consolidated cash flows. Any material changes in business mix or debt-funded acquisitions resulting in a sustained leverage increase could lead to negative rating actions.

Continued Expectation of Deleveraging: Alectra's 'A-' IDR continues to be premised upon a constructive outcome in the 2027 rebasing and the resulting subsequent improvement in credit metrics. Fitch anticipates that Alectra's FFO leverage would remain elevated during the ongoing 10-year rebasing deferral period and then improve to 5.4x in 2028, which would be within Fitch's thresholds.

Fitch expects disposition of over-collected regulatory assets in 2027 will push the expected deleveraging by a year. In the interim, Fitch anticipates Alectra's leverage to remain elevated as earned ROEs continue to lag due to higher capex, the expiry of the Incremental Capital Module recovery mechanism in 2024, and higher operational costs. Nevertheless, constructive rebasing, customer growth, and continuing synergies should improve leverage post-rebasing. Fitch believes the regulatory support and lack of sectoral bankruptcies in Canada offset higher leverage relative to U.S. peers due to lower allowed equity thickness.

Constructive Regulatory Environment: Fitch expects the regulatory environment for Alectra under the Ontario Energy Board (OEB) to remain constructive. Alectra currently operates under the Price Cap performance-based rate-setting option and benefits from forward-looking test years in base rate cases, multi-year formulaic rate plans, revenue decoupling, and annual tariff adjustments tracking inflation and productivity savings.

Fitch believes the various annual rate riders, like those for power cost recoveries, allowed under OEB are also a credit positive. The OEB's 2023 acceleration of rate application parameters for some of the riders ahead of normal timelines has helped reduce regulatory lag and demonstrates OEB's credit-supportive stature. Alectra's allowed ROE of 8.95% and equity capitalization of 40% are lower than U.S. averages. However, Fitch believes these are sufficiently offset by the OEB's track record of predictable regulatory support.

Continuing Service Territory Growth: Alectra services over one million customers in the Greater Golden Horseshoe Area of Ontario, which has historically experienced high population and economic growth. Fitch expects customer growth of around 0.7% annually during the forecast period, supported by a strong regional economy and federal immigration targets.

Ontario Favorably Positioned for Decarbonization: Ontario derived only 13% of its electricity from fossil fuels in 2023, significantly lower than the U.S. and most Canadian provinces. The province has demonstrated support for nuclear generation, which is a zero-carbon electricity source, with plant refurbishments and investments in small modular reactors. Fitch views the cost pressures from energy transition to be more manageable for Ontario.

Shareholder Relationship: Alectra is a private corporation owned by seven municipalities of Ontario: Mississauga (26.6%), Hamilton (17.3%), Vaughan (20.5%), Markham (15%), Barrie (8.4%), Guelph (4.6%), and St. Catharines (4.6%) and by the Ontario Municipal Employees' Retirement System (OMERS) (3%). Fitch considers Alectra a Government-Related Entity (GRE). The shareholders elect Alectra's board of directors, allowing them to collectively exercise legal control over the company. However, no single shareholder has explicit control or special voting rights and, as such, is not involved in general decision-making or oversight.

After an initial investment at the time of the amalgamation in 2017, shareholders have no precedence of support to Alectra. Fitch believes a default by Alectra would have a limited impact on the continued provision of a key public service and the preservation of its government policy role. Fitch also believes Alectra's small relative contribution to the cities' operating budgets and a lack of guarantees limits contagion risk from a default by the company. Fitch has virtually no expectations of support for Alectra and rates the company based on its standalone credit profile with no direct uplift related to the municipal ownership.

Financing Structure: There are no limitations on debt issuance at the subsidiaries in the lender agreements or regulatory orders. However, Alectra's instrument rating benefits from the standard one-notch uplift applicable to the utilities sector, given management's express policy of raising debt solely at the parent. The uplift assumes that Alectra's business mix will remain predominantly regulated. Material changes to 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 (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. (A-/Stable).

Fitch views the regulatory environment in Maine (just over 20% of the forecasted EBITDA for Enmax) as restrictive compared to Ontario while the regulatory construct in Ontario is comparable to Alberta (roughly 45% of forecasted EBITDA for Enmax and 80%-85% for ATCO). Both employ a performance-based rate setting approach for distributors, but Enmax has slightly higher allowed ROE and equity thickness. 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 remain elevated in the near term and improve to below its 5.5x sensitivity threshold in 2028 post the rate rebasing. Enmax's leverage is forecast to remain lower in the 4.6x-5.0x range through 2026 while ATCO's leverage is also expected to be in the 5.1x to 5.5x range over the period.

However, Alectra's proportion of consolidated EBITDA from regulated utility operations is forecast to remain in the 87%-90% range, higher than Enmax's 60%-70% and comparable to ATCO's 80%-85%. This offers more predictability in cash flows for Alectra 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 owns commodity exposed segments like generation and retail in higher risk geographies such as Latin America. Compared to these peers, Alectra's non-regulated businesses are mainly Ontario-based energy services, which are lower risk due to low capital intensity and higher margins.

KEY ASSUMPTIONS

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

--Constructive rebasing outcomes in 2027 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 2028;

--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 $1.7 billion through 2028 with over 90% towards utility operations;

--Annual customer growth of around 0.7%

RATING SENSITIVITIES

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

-- FFO leverage below 4.8x for the period 2023-2027 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 2028 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 expected to exceed 5.8x on a sustained basis till 2027 and 5.5x following 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 debt 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

LIQUIDITY AND DEBT STRUCTURE

Fitch considers Alectra's liquidity adequate. It 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 (overdraft facility) and another $200 million credit facility to support its LCs.

At March 31, 2024, the company had $410 million of CP issued. Including a March 31, 2024 cash balance of around $14 million and excluding availability under the company's uncommitted facilities, total Alectra liquidity was approximately $304 million.

Alectra's debt maturities are manageable with the near-term maturities being private debentures of $150 million in late 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. Fitch also expects the company to manage its debt in accordance with the regulated capital structure.

ISSUER PROFILE

Alectra Inc. was formed in 2017 by amalgamation of three Ontario, Canada electric distributor utilities: PowerStream, Inc., Enersource Hydro Mississauga, Inc., and Horizon Utilities Corporation. Alectra subsequently acquired Hydro One Brampton Networks, Inc. in 2017 and amalgamated with Guelph Hydro Electric System, Inc. in 2019.

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	PRIOR

Alectra Inc.	LT IDR	A- Rating Outlook Stable Affirmed	A- Rating Outlook Stable
senior unsecured	LT	A Affirmed	A

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Corporates Recovery Ratings and Instrument Ratings Criteria (pub. 13 Oct 2023) (including rating assumption sensitivity)

Corporate Rating Criteria (pub. 03 Nov 2023) (including rating assumption sensitivity)

Sector Navigators – Addendum to the Corporate Rating Criteria (pub. 21 Jun 2024)

Government-Related Entities Rating Criteria (pub. 09 Jul 2024)

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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Endorsement Policy

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The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Fitch also provides information on best-case rating upgrade scenarios and worst-case rating downgrade scenarios (defined as the 99th percentile of rating transitions, measured in each direction) for international credit ratings, based on historical performance. A simple average across asset classes presents best-case upgrades of 4 notches and worst-case downgrades of 8 notches at the 99th percentile. For more details on sector-specific best- and worst-case scenario credit ratings, please see Best- and Worst-Case Measures under the Rating Performance page on Fitch's website.

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