

RatingsDirect®

Research Update:

Hydro One Ltd. And Subsidiary Downgraded To 'A-' On Lower Governance Assessment; Ratings Remain On CreditWatch

Primary Credit Analyst:

Andrew Ng, Toronto + 1 (416) 507 2545; andrew.ng@spglobal.com

Secondary Contacts:

Vinod Makkar, CFA, Toronto + 1 (416) 507 3271; vinod.makkar@spglobal.com

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

Table Of Contents

Overview

Rating Action

Rationale

CreditWatch

Ratings Score Snapshot(Hydro One Ltd.)

Ratings Score Snapshot(Hydro One Inc.)

Issue Ratings--Subordination Risk Analysis

Related Criteria

Ratings List

Research Update:

Hydro One Ltd. And Subsidiary Downgraded To 'A-' On Lower Governance Assessment; Ratings Remain On CreditWatch

Overview

- The Government of Ontario recently implemented legislation, requiring Hydro One's board of directors to establish a new executive compensation framework for the board, CEO, and other executives. The legislation also amends the current Ontario Energy Board Act, requiring the Ontario Energy Board to exclude any compensation paid to the CEO and other executives from consumer rates.
- We consider such action as a governance deficiency related to Hydro One's ownership structure and are lowering our management and governance (M&G) assessment on Hydro One Ltd. (HOL) and Hydro One Inc. (HOI) to fair from satisfactory.
- At the same time, we are lowering the issuer credit ratings on both HOL and HOI by one notch to 'A-' from 'A', reflecting the change in our M&G assessment.
- We are also lowering the issue-level rating on HOI's senior unsecured debt to 'A-', the rating on its commercial paper program to 'A-2', and the global short-term and Canadian National Scale ratings to 'A-1 (Low)'.
'A-1 (Low)'
- All ratings remain on CreditWatch with negative implications.

Rating Action

On Sept. 13, 2018, S&P Global Ratings lowered its issuer credit ratings on Hydro One Ltd. (HOL) and subsidiary Hydro One Inc. (HOI) to 'A-' from 'A'. At the same time, we lowered the short-term issuer credit rating on HOI to 'A-2' from 'A-1'.

We also lowered the issue-level rating on HOI's senior unsecured debt by one notch to 'A-' from 'A' and lowered the rating on HOI's commercial paper program by one notch to 'A-2' from 'A-1' on the global scale and to 'A-1(Low)' from 'A-1(MID)' on the Canadian National Scale.

All ratings remain on CreditWatch where we placed them with negative implications on June 15, 2018.

Rationale

The one-notch downgrade reflects our reassessment of HOL's management and governance structure, which has weakened following the government of Ontario's decision to exert its influence on the utility's compensation structure through legislation, potentially promoting the interests and priorities of one owner above those of other stakeholders.

Ontario recently passed the Hydro One Accountability Act that allows the government to issue directives governing HOL's compensation of the board, CEO, and other executives. In addition, Ontario also amended the Ontario Energy Board Act (OEBA) to exclude any amount in respect of compensation paid to HOL's CEO and executives from consumer rates. Although the financial impact of the compensation disallowance is minimal, we think the legislative actions taken reflect a governance deficiency related to HOL's ownership structure because Ontario is exercising its legislative authority to lower electricity rates, consistent with the government's election campaign promises. In our view, the use of this legislative authority to influence HOL's compensation structure for some executives undermines the effectiveness of the company's governance structure, and potentially promotes the interests and priorities of the Ontario government above those of other stakeholders. We also note that these events followed the recent resignation of the entire previous board of Hydro One.

Our view of HOL's business and financial risks is unchanged. The business risk profile continues to reflect the utility's large electricity distribution and transmission operations that serves about 1.3 million electric customers covering approximately 75% of the geographic area of Ontario. The company historically benefited from supportive regulation in Ontario that has enabled utilities to earn close to their authorized return on equity through the use of a forward-looking test year, multiyear rate-setting that adjusts to keep costs and rates aligned, decoupling, and various variance accounts that foster full cost recovery. Furthermore, we expect HOL's consolidated business risk profile will not be affected because of the Avista Corp. acquisition. We believe the jurisdictions in which Avista operates benefit from reasonably supportive regulation. In addition, the purchase gives HOL some geographic diversity and entry into low-risk natural gas distribution operations.

From a financial risk perspective, we expect credit metrics to remain weak for 2018 due to timing of the closing of the Avista transaction. Under our base case scenario, which includes the current financing plan of Avista that comprises about C\$1.54 billion of equity and C\$3.4 billion (US\$2.6 billion) of new debt, capital spending of about C\$2 billion, and dividend payments of about C\$530 million, we forecast adjusted funds from operations (AFFO) to total debt for HOL, to consistently reflect about 10% for the 2019-2020 period, after the transaction closes. In addition, we do not expect the compensation disallowance to have any significant impact on HOL's cash flow. Our base case scenario also reflects the acquisition of Peterborough Distribution Inc. for about C\$105 million, incremental executive compensation

costs of about C\$20 million, and capital spending of about C\$2.5 billion each year.

Liquidity

We assess HOL's liquidity as adequate. We expect liquidity sources to exceed uses more than 1.1x over the next 12 months. In the event of a 10% drop in the company's EBITDA, we also expect liquidity sources will cover uses. In our view, the company has sound relationships with banks and generally satisfactory standing in the credit markets. In the unlikely event of liquidity distress, we expect HOL to scale back its capital spending to preserve credit metrics.

Principal liquidity sources include:

- Cash of about C\$1.25 billion as of June 30, 2018.
- Committed credit facilities availability of about C\$7.43 billion as of June 30, 2018, including that of Avista and the committed bridge facilities for the Avista transaction.
- Cash FFO of about C\$1.9 billion over the next 12 months.

Principal liquidity uses include:

- Debt maturities of about C\$981 million over the next 12 months.
- Maintenance capital spending of about C\$1.3 billion over the next 12 months.
- Dividend payments of about C\$600 million over the next 12 months.
- Acquisitions of about C\$5 billion, including Avista and PDI.

CreditWatch

We will resolve the CreditWatch placements of the ratings on HOL and HOI as we get closer to the transaction's closing, including final regulatory approvals from key states, including Washington, Avista's largest regulatory jurisdiction. In addition, the resolution of our CreditWatch placement will depend on our confirmation of the company's forward strategy after the board appoints a new permanent CEO for HOL.

Ratings Score Snapshot(Hydro One Ltd.)

Issuer Credit Rating: A-/Watch Neg/--

Business risk: Excellent

- Country risk: Very low
- Industry risk: Very low

- Competitive position: Excellent

Financial risk: Significant

Cash flow/Leverage: Significant

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: Fair (-1 notch)
- Comparable rating analysis: Positive (+1 notch)

Stand-alone credit profile: a-

Group credit profile: a-

Status within group: Parent

Ratings Score Snapshot(Hydro One Inc.)

Issuer Credit Rating: A-/Watch Neg/A-2

Business risk: Excellent

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

Financial risk: Significant

•Cash flow/Leverage: Significant

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: Fair (-1 notch)
- Comparable rating analysis: Positive (+1 notch)

Stand-alone credit profile: a-

Group credit profile: a-

Status within group: core (no impact)

Issue Ratings--Subordination Risk Analysis

Capital structure

HOL's capital structure consists of about \$10.5 billion of senior unsecured long-term debt, all of which are issued by subsidiary HOI. There is currently no debt at the HOL level.

Analytical conclusions

We consider HOI as a qualifying utility in accordance with our criteria. As such we rate the senior unsecured debt at HOI the same as our issuer credit rating on HOI.

Related Criteria

- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- 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: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Corporates - Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Downgraded

	To	From
Hydro One Limited Issuer Credit Rating	A-/Watch Neg/--	A/Watch Neg/--
Hydro One Inc. Issuer Credit Rating	A-/Watch Neg/A-2	A/Watch Neg/A-1
Hydro One Inc. Senior Unsecured Commercial Paper	A-/Watch Neg A-2/Watch Neg	A/Watch Neg A-1/Watch Neg
Commercial Paper	A-1(LOW)/Watch Neg	A-1(MID)/Watch Neg

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.

Copyright © 2018 by Standard & Poor's Financial Services LLC. All rights reserved.

No content (including ratings, credit-related analyses and data, valuations, model, software or other application or output therefrom) or any part thereof (Content) may be modified, reverse engineered, reproduced or distributed in any form by any means, or stored in a database or retrieval system, without the prior written permission of Standard & Poor's Financial Services LLC or its affiliates (collectively, S&P). The Content shall not be used for any unlawful or unauthorized purposes. S&P and any third-party providers, as well as their directors, officers, shareholders, employees or agents (collectively S&P Parties) do not guarantee the accuracy, completeness, timeliness or availability of the Content. S&P Parties are not responsible for any errors or omissions (negligent or otherwise), regardless of the cause, for the results obtained from the use of the Content, or for the security or maintenance of any data input by the user. The Content is provided on an "as is" basis. S&P PARTIES DISCLAIM ANY AND ALL EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE, FREEDOM FROM BUGS, SOFTWARE ERRORS OR DEFECTS, THAT THE CONTENT'S FUNCTIONING WILL BE UNINTERRUPTED OR THAT THE CONTENT WILL OPERATE WITH ANY SOFTWARE OR HARDWARE CONFIGURATION. In no event shall S&P Parties be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs or losses caused by negligence) in connection with any use of the Content even if advised of the possibility of such damages.

Credit-related and other analyses, including ratings, and statements in the Content are statements of opinion as of the date they are expressed and not statements of fact. S&P's opinions, analyses and rating acknowledgment decisions (described below) are not recommendations to purchase, hold, or sell any securities or to make any investment decisions, and do not address the suitability of any security. S&P assumes no obligation to update the Content following publication in any form or format. The Content should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. S&P does not act as a fiduciary or an investment advisor except where registered as such. While S&P has obtained information from sources it believes to be reliable, S&P does not perform an audit and undertakes no duty of due diligence or independent verification of any information it receives. Rating-related publications may be published for a variety of reasons that are not necessarily dependent on action by rating committees, including, but not limited to, the publication of a periodic update on a credit rating and related analyses.

To the extent that regulatory authorities allow a rating agency to acknowledge in one jurisdiction a rating issued in another jurisdiction for certain regulatory purposes, S&P reserves the right to assign, withdraw or suspend such acknowledgment at any time and in its sole discretion. S&P Parties disclaim any duty whatsoever arising out of the assignment, withdrawal or suspension of an acknowledgment as well as any liability for any damage alleged to have been suffered on account thereof.

S&P keeps certain activities of its business units separate from each other in order to preserve the independence and objectivity of their respective activities. As a result, certain business units of S&P may have information that is not available to other S&P business units. S&P has established policies and procedures to maintain the confidentiality of certain non-public information received in connection with each analytical process.

S&P may receive compensation for its ratings and certain analyses, normally from issuers or underwriters of securities or from obligors. S&P reserves the right to disseminate its opinions and analyses. S&P's public ratings and analyses are made available on its Web sites, www.standardandpoors.com (free of charge), and www.ratingsdirect.com and www.globalcreditportal.com (subscription), and may be distributed through other means, including via S&P publications and third-party redistributors. Additional information about our ratings fees is available at www.standardandpoors.com/usratingsfees.

STANDARD & POOR'S, S&P and RATINGSDIRECT are registered trademarks of Standard & Poor's Financial Services LLC.