

1    Q.    Produce the Standard & Poor's report "Canadian Regulation Reassessed as  
2           a Ratings Factor" March 5, 2003, referred to at line 7 of page 12 of the Cost  
3           of Capital Evidence.

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6    A.    Please see attached.

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## Research:

### Canadian Utility Regulation Reassessed as a Ratings Factor

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(Editor's note: The original version of this report, published yesterday, misstated the rating on Oakville Hydro Corp. in Table 2. A corrected version follows.)

For many years, Standard & Poor's Ratings Services has maintained strong investment-grade ratings on a large number of Canadian utility companies, despite balance-sheet and profitability metrics that are significantly weaker than those exhibited by highly rated utilities in other countries or jurisdictions. The justification frequently cited by Standard & Poor's was that the supportive nature of Canadian utility regulation would sustain a high level of credit quality, notwithstanding what might be considered to be aggressive financial profiles. Based on a wide-ranging reassessment of business and financial risk among Canadian utilities, Standard & Poor's is now questioning the appropriateness of placing exceptional analytical reliance on the positive influence of regulatory factors in its analysis of Canadian utilities. The purpose of this report is to impart transparency to an ongoing reassessment that affects a number of utility ratings, and to define the framework within which future ratings actions will occur.

In the past two years, there has been downward pressure on Canadian utility ratings that has culminated with multiple issuers either being downgraded, assigned negative outlooks, or placed on CreditWatch with negative implications. These ratings actions have been driven by several factors. Although the general business environment and company-specific reasons have played a large role in the ratings actions, the highly leveraged financial profiles of Canadian utilities consistently have been identified by Standard & Poor's as a material contributing factor in the downward trend of the ratings.

Why now? Is this report a reaction to specific developments that suggest regulation has become less supportive, or that utilities are taking on more business risk? In fact, the basis for this reassessment emerges from deliberations over the past year within Standard & Poor's, involving many analysts based in Canada and other countries. These discussions led to a general view that the business positions of Canadian utilities remain strong in most cases, but perhaps not exceptionally so. Nevertheless, a pattern of downward ratings pressure emerged. In the background of these discussions have been regulatory rulings, utility sector policy initiatives, and developments arising from actions by various utility companies that have triggered a closer examination of each individual utility's exposure to operational, commercial, regulatory, financial, and other risks.

For the purposes of this report, regulated utilities include natural gas and power transmission and distribution networks, and in some cases companies with power generation business units. The ratings methodology applied to regulated utilities also has direct implications for the ratings on holding companies that control both regulated and unregulated business units, because the regulated business units usually make a substantial contribution to the credit profile of the consolidated entity.

### ■ A Tradition of High Leverage

The leveraged financial profiles of Canadian utilities generally stem from regulatory directives, which essentially dictate the financial profiles for most utilities. (Admittedly, some companies have taken it upon themselves to add leverage at the unregulated parent or subsidiary company level.) The interaction of regulatory and financial risks has a critical influence on ratings in this sector.

Investor-owned Canadian utilities are among the most highly levered utilities in Standard & Poor's global ratings universe, with financial profiles that are noticeably weaker than those of their global peers. Many Canadian utilities typically have lower equity layers in their capital structures than their global peers, with total debt in some cases representing 60% to 70% of total capital. The lower equity bases are the result of regulatory directives whereby the utility is allowed to earn only a (regulated) rate of return on the deemed equity base. There is little incentive to diverge from such a directive. The rate of return on any excess equity that a utility carries on its balance sheet is limited to the cost of debt and hence is punitive for shareholders. Operating successfully with less equity than allowed might signify to regulators that the allowed equity cushion is too thick. Thus, it is not surprising that the actual capital structures conform to the deemed regulatory or jurisdictional directives.

With debt leverage at these high levels, it follows that the cash flow interest protection measures are often conversely low and generally range between 2.0x to 3.0x for many issuers. Although Standard & Poor's credit analysis is not solely based on financial ratios, the standard credit protection metrics for many Canadian utilities are below average compared with global peers. Accordingly, the question becomes whether or not other aspects of these utilities' risk profiles compensate for their more aggressive financial profiles, providing justification for high investment-grade ratings.

## ■ Standard & Poor's Global Framework for Utility Analysis

Standard & Poor's utility ratings methodology considers regulation to be one of five key factors in determining a utility's overall business risk profile. Consideration is given to other qualitative factors such as markets served, competitive position, operations, and management. Regulation is often the most important determinant of a utility's business risk profile, and can directly and indirectly affect the other four factors.

Standard & Poor's evaluates regulation on the basis of how supportive it is of credit quality. Although it is in society's interest to have financially stable and efficient utilities because they provide an essential service, it is not usually the priority of the regulator to protect utility creditors. The interests of bondholders and other creditors, and a firm's access to capital in general, are often considered secondary to ratepayer interests at best. For credit purposes, the analysis focuses on whether the regulatory system allows a utility to recover its costs and generate sufficient cash in a timely manner to meet obligations, and to what degree the system exposes the utility to the combined effects of operational and financial risks. In this regard, Canadian regulation ranks quite highly. There are extensive track records of stable performance for many companies, even those carrying high leverage.

Although Canadian regulation might rank highly as a credit factor on its general merits, the issue becomes the relative degree of comfort gained from regulatory and other factors, in light of whatever degree of financial risk might be present. Standard & Poor's is reassessing the specific features of Canadian regulatory practices that might be used to justify the continuing assertion of an overall stronger business risk profile--in comparison with regulatory mechanisms and practices in other global jurisdictions--and to what extent this should offset risks arising from the capital structures and allowed returns that have been sanctioned by Canadian regulators.

Regulation in Canada typically is based on a cost of service plus regulated rate of return methodology, although some jurisdictions are starting to introduce performance-based regulation, whereby the utilities are at risk for managing their operating and administration costs in exchange for the opportunity to generate "extra" earnings. Standard & Poor's views the cost of service methodology as being quite favorable. Nevertheless, regulatory systems in which the utility enjoys rate-setting autonomy are viewed as superior with regards to creditor protection.

Financial leverage affects credit quality because it constrains the ability of a utility (or any other kind of corporation) to weather variations in business performance. For regulated utilities, the sources of variation are considerably fewer than for many other corporations, but the business risks are far from negligible. (At the same time, more limited business risk exposure is used to justify the manageability of the regulated utilities' leverage, offsetting the benefit of their limited business risk exposure.) What kinds of business risks do utilities frequently face? Several elements can lead to year-on-year variations in financial results and can eat into the degree of cushion provided by a utility's equity layer, and also can compound risks associated with liquidity management and refinancing risk, including:

- The service quality and cost impact of aging physical assets,
- The impact on revenue of demand variation arising from the economic environment, weather, demand elasticity, substitution, declining population, etcetera,
- Variations in operating costs,
- The timing uncertainty associated with commodity cost recovery deferrals,
- Uncertainties and delays in necessary rate increases,
- Wholesale customer bypass,
- The exclusion of capital investments from the rate base,
- The disallowance of certain operating costs by regulators,
- Changes in environmental or health and safety regulations,
- Adverse commodity contracting arrangements, and
- Risks arising from unsuccessful noncore business initiatives.

There are gradations of business risk exposure for utility companies. At one end of the spectrum, utilities with virtually no business risk would have rate-setting autonomy, an inelastic service area demand profile, strong financial flexibility, and a proven ability to adjust rates to counteract adverse developments of any sort. At the other end of the spectrum would be utilities that have no regulatory assurance of recovery of either invested capital or operating expenses (including commodity costs) incurred. A typical Canadian regulated network utility lies between these two end points, and likely closer to the low-risk end of the spectrum.

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For the most part, Standard & Poor's view is that the various Canadian regulatory environments provide transparent and predictable foundations for solid utility credit quality (except perhaps in the Province of Ontario, where transparency has deteriorated substantially due to transitional circumstances). This reassessment of the link between regulation and credit quality has not been prompted by any perceived deficiencies associated with the various Canadian regulatory jurisdictions. Again, the issue is one of degree; how much bondholder protection is conferred by regulated capital structures in light of the operational risks borne by the companies?

## ■ Linking Utilities' Financial Profiles to Ratings

The table below shows key global utility benchmark ratios. These reflect the general levels for certain financial indicators and how they might link to ratings for different degrees of business risk. The ratings on certain Canadian utilities currently depend on a characterization of those utilities' respective business positions as very strong, as presented in the table. The justification for this has been the supportive regulatory environment in which those companies operate. Many other Canadian utility ratings already incorporate a more conservative view of business risk, and these ratings are not likely to be affected by this criteria review. A list of the issuers with ratings that are most likely to be affected by this review is presented at the end of this report.

Table 1 Financial Ratio Benchmarks: Rating Category Midpoints						
	FFO interest coverage (x)		FFO to total debt (%)		Debt to capital (%)	
Business risk position	A	BBB	A	BBB	A	BBB
Very strong	2.9	2	18	13.5	54	61
Strong	3.5	2.6	23	17	50	57
Moderately strong	4.1	3.3	27	21	47	53
FFO—Funds from operations.						

Referring to the table, the interactions between different degrees of business and financial risk should be apparent. For example, a utility with a very strong business position with funds from operations (FFO) interest coverage just below 3.0x (and assuming a complementary alignment of other ratios) can achieve a rating in the 'A' category. In contrast, a utility with a moderately strong business position would need FFO interest coverage around 4.0x to achieve a 'A' rating. The ratio benchmarks shown are the midpoints for the respective ratings categories; thus, by extrapolation, a very strong business position and FFO interest cover of 2.5x might be associated with ratings of either 'BBB+' or 'A-'. (The business risk gradations shown in the table are from the top tiers of a much broader scale, extending downward to encompass less strong business positions that derive little or no benefit from protective regulation.)

Clearly, many considerations influence the proper application of financial ratio benchmarks and hence the rating on an issuer, such as parental support or nonquantitative aspects of the financial profile, financing flexibility, liquidity measures, accounting policies, etcetera. The ratings process is not a simplistic application of financial benchmarks. Considerable judgment is involved at many stages of the process, including in the determination of the overall business risk profile of an issuer, and in arriving at a balanced characterization of the forward-looking financial strength of the company. The interaction of a range of cash flow, balance sheet, and profitability measures must be considered, along with considerations of capital expenditure funding, the company's access to capital markets, liquidity, maturity schedules, and bank financing. Financial ratio benchmarks should not be considered in isolation, nor without a strong element of judgment as to the observed riskiness of an issuer's credit profile. Accepting these caveats, financial ratio benchmarks have proven to be helpful to issuers, investors, and others (including regulators) to answer questions about at what point ratings might change in response to variations in an issuer's financial performance.

With specific reference to Canadian utility ratings, the premise of a supportive regulatory environment has led to some utilities' business profiles being assessed as particularly low risk. If a slightly more conservative business-position standing is determined, this would lead to lower ratings, assuming leverage and other financial indicators remain unchanged and there are no other offsetting analytical considerations.

## ■ Questions for Discussion and Next Steps

In the next few months, Standard & Poor's will seek the views of various Canadian regulators and other market participants on the current and evolving nature of business risk in the Canadian utility sector. Certain questions frame the discussions Standard & Poor's will pursue with various industry players:

- What are the perceptions of current business risks that underlie the capital structures and allowed returns embedded in recent regulatory filings and decisions?
- How and to what extent do regulatory arrangements mitigate or eliminate certain elements of utility

business risk?

- How does the perceived credit profile of a utility factor into regulatory decisions, and how might regulators respond to sustain the credit profile of a particular utility company?
- How do regulators take account of noncore activities on the part of the regulated utility's parent, and, as a practical matter, how do the regulated and unregulated parts of a utility company interact?

A possible outcome of this review may be a reduction in the degree of reliance placed on regulatory protection from business risks. Such an outcome would affect all Canadian regulated utilities. Standard & Poor's expects to have the review completed in the next few months.

## ■ Ratings That Could Be Revisited

The companies (and their subsidiaries) whose ratings are most likely to be affected negatively by this review are included in the list below. Rated utility companies not included in either list below are not expected to be affected directly by this review, because the ratings incorporate a balanced and sustainable characterization of business risks.

Although it is Standard & Poor's expectation that selected ratings downgrades will be the result of this review, some or all of the ratings listed below could end up remaining at their current levels. Standard & Poor's does not expect ratings upgrades to be prompted by this review, either for companies listed below (and their subsidiaries) or for other rated utilities or holding companies.

Table 2 Ratings on CreditWatch With Negative Implications	
Company	Corporate credit rating*
ATCO Ltd.	A+/Watch Neg/---
BC Gas Inc.	BBB+/Watch Neg/---
Borealis Infrastructure Trust (Enersource)†	A+/Watch Neg
Emera Inc.	BBB+/Watch Neg/---
Electricity Distributors Finance Corp. (EDFIN)	A-/Watch Neg/---
Foothills Pipe Lines Ltd.‡	A-1(Low)/Watch Neg
Fortis Inc.	A-/Watch Neg/---
Hamilton Utilities Corp.	A+/Watch Neg/---
Hydro Ottawa Holdings Inc.	A-/Watch Neg/---
London Hydro Inc.	A-/Watch Neg/---
Oakville Hydro Corp.	A-/Watch Neg/---
Toronto Hydro Corp.	A-/Watch Neg/---
TQM Pipeline & Co. LP	BBB+/Watch Neg/---
TransCanada Pipelines Ltd.	A-/Watch Neg/---
Veridian Corp.	A-/Watch Neg/---
*Ratings at March 5, 2003. †Senior secured debt rating. ‡Canadian national scale CP rating.	

This review also will factor into Standard & Poor's assessment of other companies, notably Enbridge Inc., Westcoast Energy Inc., and Union Gas Ltd., where regulation is a factor in the ratings on the companies, albeit to a lesser extent than those listed above. Although the regulatory review could affect these ratings, there are other more salient factors contributing to the current ratings and outlooks on these companies.