

**Credit Opinion: [Hydro One Inc.](#)**

**Hydro One Inc.**

Toronto, Ontario, Canada

**Ratings**

<b>Category</b>	<b>Moody's Rating</b>
Outlook	Stable
Senior Unsecured -Dom Curr	Aa3
Commercial Paper	P-1

**Contacts**

<b>Analyst</b>	<b>Phone</b>
Allan McLean/Toronto	416.214.3852
William L. Hess/New York	212.553.3837

**Key Indicators**

**Hydro One Inc.**

	<b>2008</b>	<b>2007</b>	<b>2006</b>	<b>2005</b>	<b>2004</b>
(CFO Pre-W/C + Interest) / Interest Expense (x) [1]	<b>3.6x</b>	<b>4.1x</b>	<b>3.9x</b>	<b>3.4x</b>	<b>3.4x</b>
(CFO Pre-W/C) / Debt (%) [1]	<b>14.4%</b>	<b>17.7%</b>	<b>18.1%</b>	<b>16.7%</b>	<b>15.9%</b>
(CFO Pre-W/C - Dividends) / Debt (%) [1]	<b>10.6%</b>	<b>12.2%</b>	<b>12.2%</b>	<b>12.0%</b>	<b>11.7%</b>
Debt / Book Capitalization (%)	<b>59.5%</b>	<b>55.2%</b>	<b>58.3%</b>	<b>61.1%</b>	<b>62.6%</b>

[1] CFO pre-W/C, which is also referred to as FFO in the Global Regulated Electric Utilities Rating Methodology, is equal to net cash flow from operations less net changes in working capital items

*Note: For definitions of Moody's most common ratio terms please see the accompanying [User's Guide](#).*

**Opinion**

**Rating Drivers**

Relatively large, low-risk regulated electricity T&D utility with no commodity price risk. Operates in a relatively supportive regulatory environment.

Stable and predictable cash flows but credit metrics expected to weaken further and remain significantly weaker than other A-rated, low-risk T&D utilities in the short-term.

Low allowed ROE, continuing elevated capital expenditures and under-funded pension plan have depressed credit metrics.

Sufficient liquidity has been maintained through frequent and sizeable debt capital market issuances.

Aa3 rating reflects HOI's baseline credit assessment in the 5 to 7 range, high default dependence and high probability of extraordinary support in context of the Province of Ontario's Aa1 rating.

**Corporate Profile**

Headquartered in Toronto, Ontario, Hydro One Inc. (HOI) is a commercial corporation, 100% owned by the Province of Ontario. Virtually all of HOI's revenues and cash flows are derived from its electricity T&D businesses, both of which are regulated by the Ontario Energy Board (OEB). HOI owns and operates virtually all of Ontario's

electricity transmission system, and is responsible for a substantial portion of regulated electricity distribution in Ontario.

## **SUMMARY RATING RATIONALE**

HOI's Aa3, stable senior unsecured rating reflects its baseline credit assessment (BCA) in the 5 to 7 range, high default dependence and high probability of extraordinary support in context of the Province of Ontario's Aa1 rating. HOI's A-category BCA reflects the company's low-risk business model as a cost of service-regulated electricity T&D utility with no commodity price risk exposure. HOI's financial profile is weak relative to other A-rated low risk electric utilities and is expected to weaken further due to the combination of low allowed ROEs and ongoing high levels of capital spending. The weakening of HOI's credit metrics in 2008 reflects continued high spending on capital projects. These projects generate little or no cash flow until completed and placed into service. In addition, HOI's adjusted leverage rose in 2008 because, like many other companies, HOI incurred significant losses on its pension plan assets. Moody's expects that HOI's financial profile should recover modestly in two to three years' time as major capital projects are completed and capital spending moderates and as pension funding improves with the anticipated recovery of financial asset values and ongoing pension contributions. However, HOI's BCA could come under pressure if the anticipated improvement in financial metrics fails to materialize.

## **DETAILED RATING CONSIDERATIONS**

### **RATING METHODOLOGY FOR GOVERNMENT RELATED ISSUERS**

In accordance with Moody's Government Related Issuer (GRI) rating methodology, HOI's Aa3 rating reflects the combination of the following inputs:

Baseline Credit Assessment (BCA) in the 5 to 7 range (on a scale of 1 to 21, where 1 represents the equivalent risk of a Aaa, 2 a Aa1, 3 a Aa2 and so on).

Aa1 local currency rating of the Province of Ontario.

High default dependence.

High probability of extraordinary support.

HOI's high default dependence reflects HOI's exposure to virtually all facets of the provincial economy and its operational and financial proximity to the government. HOI's high probability of extraordinary support reflects the strategic importance of HOI to the Provincial economy, the Province's history of providing support through dividend deferrals as well as the Province's role as the architect of electricity policy and regulation and its history of intervention in the electricity sector. As a 100%-owned subsidiary of the Province, HOI can be utilized as an instrument of public policy. Moody's observes that public policy goals are not always completely aligned with the interests of debt holders.

HOI's BCA reflects the following:

### **LOW-RISK REGULATED ELECTRIC UTILITY OPERATING IN A RELATIVELY STABLE LEGISLATIVE BUT EVOLVING REGULATORY ENVIRONMENT**

HOI is considered to be a low-risk utility given that its operations are almost exclusively T&D, its T&D assets are wholly regulated and all of its operations are located in Canada, a jurisdiction that Moody's generally views as being one of the more supportive regulatory environments for utilities on a global basis. Moody's considers the T&D segment to be a relatively lower risk segment of the electric utility industry since it is typically not exposed to commodity price and volume risks or the operational, financial and environmental risks that can be associated with electricity generation. Moreover, virtually all of HOI's activities are regulated with the exception of its telecommunications business, which represents less than 1% of total assets.

HOI falls under the jurisdiction of the OEB which regulates both the T&D segments of its business. The legislative environment in Ontario has been relatively stable since 2005 but the regulatory framework continues to evolve and thus experiences some regulatory lag. With the evolution of the regulatory environment, Moody's anticipates that there will be increased transparency and predictability for HOI after 2008 as distribution rates will be established pursuant to a formula driven mechanism under the OEB's 3rd Generation Incentive Regulation Model (IRM).

HOI's cash flow tends to be stable and predictable given its lack of commodity price exposure, nominal foreign exchange exposure and manageable exposure to floating interest rates. While HOI purchases power in its distribution segment, these commodity costs are a full pass-through to customers. In the transmission segment, HOI has no exposure to electricity prices. Like many cost of service utilities whose rates are established on a forward test year basis, HOI is exposed to a degree of forecast risk.

**STABLE, PREDICTABLE CASH FLOW BUT KEY FINANCIAL METRICS SIGNIFICANTLY WEAKER THAN**

## THOSE OF A-RATED PEERS IN NEAR-TERM

While HOI's low-risk regulated business model generates stable and predictable funds from operations, Moody's expects HOI's financial metrics to weaken further in 2009 and be significantly weaker than other A-rated, low-risk electric utilities. HOI's financial metrics have always tended to be weaker than those of other A-rated international peers due to the relatively low allowed ROEs and deemed equity components common to Canadian regulated utilities. Historically, Moody's has considered this relatively weak financial profile to be balanced by HOI's low-risk business model and supportive regulatory and business environments. However, HOI is currently experiencing a cyclical peak in its capital spending which is further pressuring its credit metrics as capital is being deployed on assets that are not yet generating cash flows. Moody's anticipates that HOI's metrics could improve modestly in 2012 provided that capital spending moderates as expected. However, the company points out that the Province's proposed Green Energy and Green Economy Act, 2009 (Bill 150) could cause HOI's capital spending to remain elevated beyond 2011. If beyond 2011, HOI's capital spending remains elevated and its credit metrics do not improve, for instance (CFO pre-WC + Interest)/Interest of 4x or more and CFO pre-WC/Debt of 16% or more, HOI's BCA could be downgraded.

### Liquidity Profile

#### LIQUIDITY ARRANGEMENTS SUFFICIENT BUT CONTINUE TO BE PRESSURED BY ELEVATED CAPITAL SPENDING

HOI's commercial paper (CP) program is rated Prime-1 (P-1) based on the stable cash flow generated by its regulated operations and alternative liquidity arrangements that are expected to be sufficient to meet the balance of HOI's 2009 funding requirements under Moody's liquidity stress scenario. Moody's liquidity stress scenario assumes that the company loses access to new capital, other than credit available under its committed credit agreements, for a period of 12 months.

HOI is currently experiencing a cyclical peak in its capital spending. High levels of capital spending stressed HOI's liquidity resources during the 2007 and 2008 and are expected to continue to do so at least until to the end of 2011. To date, HOI has managed this stress by regularly accessing the capital markets, including raising \$500 million in November 2008 and a further \$600 million in three offerings during in the first quarter of 2009. Given the expectation that capital spending will remain elevated through 2011, Moody's expects that HOI will continue to require regular access to the term debt markets in order to avoid curtailing its planned capital spending and dividends.

In support of the company's \$1 billion CP program, HOI maintains a syndicated committed three year bank facility that matures on August 9, 2010. The facility contains a maximum debt to total capitalization ratio covenant of 75% but does not include funding inhibiting language such as an ongoing material adverse change clause. At December 31, 2008, it is estimated that HOI had access to the full amount of the bank facility less \$111 million of outstanding letters of credit which, for analytical purposes, Moody's considers to be a use of HOI's committed credit facilities.

HOI is expected to generate approximately \$890 million of adjusted FFO in 2009. After dividends, capital expenditures and working capital changes of approximately \$1.8 billion, Moody's expects HOI to be FCF negative by approximately \$870 million in 2009. Given scheduled maturities of \$400 million in 2009, HOI's 2009 funding requirement was nearly \$1.3 billion. However, the funding requirement for the balance of 2009 was reduced to approximately \$700 million by the \$600 million of MTNs issued by HOI in the first quarter of 2009. HOI's can issue up to \$550 million under its existing MTN shelf which expires in July 2009.

### Rating Outlook

HOI's rating outlook remains stable despite the expectation that, over the next 12 to 18 months, HOI's credit metrics will continue to be significantly weaker than those of other A-rated low-risk electric utilities. Moody's currently expects that HOI's metrics will exhibit some modest improvement in two to three years' time as capital spending moderates and as pension funding improves. The stable outlook reflects Moody's belief that HOI's low-risk business model and stable and predictable cash flows can accommodate the extended period of high capital spending and weaker credit metrics provided that HOI prudently manages its liquidity resources.

### What Could Change the Rating - Up

Moody's considers an upward revision in HOI's rating to be unlikely in the near term. However, the company's BCA or published rating could be positively impacted if HOI could demonstrate a sustainable improvement in financial ratios, such as CFO pre-WC to Interest exceeding 6.0x, CFO pre-WC to Debt exceeding 30% and CFO pre-WC less Dividends to Debt exceeding 25%.

### What Could Change the Rating - Down

HOI's BCA or published ratings could be negatively impacted by one or more of the following:

A material reduction in the perceived probability of extraordinary support.

A sustained weakening of cash flow metrics such as CFO pre-WC to Interest coverage below 4.0x, CFO pre-WC to Debt below 16% and/or CFO pre-WC less Dividends to Debt below 14.5%.

Failure of the company to ensure sufficient sources of liquidity in support of its growing capital expenditure program.

Actions on the part of the shareholder that impede the company's ability to act in a commercial manner.

Material changes in the ownership, governance or management structures.

Further restructuring of the electricity sector that increases HOI's business or financial risk profiles.

**CREDIT RATINGS ARE MOODY'S INVESTORS SERVICE, INC.'S (MIS) CURRENT OPINIONS OF THE RELATIVE FUTURE CREDIT RISK OF ENTITIES, CREDIT COMMITMENTS, OR DEBT OR DEBT-LIKE SECURITIES. MIS DEFINES CREDIT RISK AS THE RISK THAT AN ENTITY MAY NOT MEET ITS CONTRACTUAL, FINANCIAL OBLIGATIONS AS THEY COME DUE AND ANY ESTIMATED FINANCIAL LOSS IN THE EVENT OF DEFAULT. CREDIT RATINGS DO NOT ADDRESS ANY OTHER RISK, INCLUDING BUT NOT LIMITED TO: LIQUIDITY RISK, MARKET VALUE RISK, OR PRICE VOLATILITY. CREDIT RATINGS ARE NOT STATEMENTS OF CURRENT OR HISTORICAL FACT. CREDIT RATINGS DO NOT CONSTITUTE INVESTMENT OR FINANCIAL ADVICE, AND CREDIT RATINGS ARE NOT RECOMMENDATIONS TO PURCHASE, SELL, OR HOLD PARTICULAR SECURITIES. CREDIT RATINGS DO NOT COMMENT ON THE SUITABILITY OF AN INVESTMENT FOR ANY PARTICULAR INVESTOR. MIS ISSUES ITS CREDIT RATINGS WITH THE EXPECTATION AND UNDERSTANDING THAT EACH INVESTOR WILL MAKE ITS OWN STUDY AND EVALUATION OF EACH SECURITY THAT IS UNDER CONSIDERATION FOR PURCHASE, HOLDING, OR SALE.**

© Copyright 2009, Moody's Investors Service, Inc. and/or its licensors including Moody's Assurance Company, Inc. (together, "MOODY'S"). All rights reserved.

ALL INFORMATION CONTAINED HEREIN IS PROTECTED BY COPYRIGHT LAW AND NONE OF SUCH INFORMATION MAY BE COPIED OR OTHERWISE REPRODUCED, REPACKAGED, FURTHER TRANSMITTED, TRANSFERRED, DISSEMINATED, REDISTRIBUTED OR RESOLD, OR STORED FOR SUBSEQUENT USE FOR ANY SUCH PURPOSE, IN WHOLE OR IN PART, IN ANY FORM OR MANNER OR BY ANY MEANS WHATSOEVER, BY ANY PERSON WITHOUT MOODY'S PRIOR WRITTEN CONSENT. All information contained herein is obtained by MOODY'S from sources believed by it to be accurate and reliable. Because of the possibility of human or mechanical error as well as other factors, however, such information is provided "as is" without warranty of any kind and MOODY'S, in particular, makes no representation or warranty, express or implied, as to the accuracy, timeliness, completeness, merchantability or fitness for any particular purpose of any such information. Under no circumstances shall MOODY'S have any liability to any person or entity for (a) any loss or damage in whole or in part caused by, resulting from, or relating to, any error (negligent or otherwise) or other circumstance or contingency within or outside the control of MOODY'S or any of its directors, officers, employees or agents in connection with the procurement, collection, compilation, analysis, interpretation, communication, publication or delivery of any such information, or (b) any direct, indirect, special, consequential, compensatory or incidental damages whatsoever (including without limitation, lost profits), even if MOODY'S is advised in advance of the possibility of such damages, resulting from the use of or inability to use, any such information. The credit ratings and financial reporting analysis observations, if any, constituting part of the information contained herein are, and must be construed solely as, statements of opinion and not statements of fact or recommendations to purchase, sell or hold any securities. NO WARRANTY, EXPRESS OR IMPLIED, AS TO THE ACCURACY, TIMELINESS, COMPLETENESS, MERCHANTABILITY OR FITNESS FOR ANY PARTICULAR PURPOSE OF ANY SUCH RATING OR OTHER OPINION OR INFORMATION IS GIVEN OR MADE BY MOODY'S IN ANY FORM OR MANNER WHATSOEVER. Each rating or other opinion must be weighed solely as one factor in any investment decision made by or on behalf of any user of the information contained herein, and each such user must accordingly make its own study and evaluation of each security and of each issuer and guarantor of, and each provider of credit support for, each security that it may consider purchasing, holding or selling.

MOODY'S hereby discloses that most issuers of debt securities (including corporate and municipal bonds, debentures, notes and commercial paper) and preferred stock rated by MOODY'S have, prior to assignment of any rating, agreed to pay to MOODY'S for appraisal and rating services rendered by it fees ranging from \$1,500 to approximately \$2,400,000. Moody's Corporation (MCO) and its wholly-owned credit rating agency subsidiary, Moody's Investors Service (MIS), also maintain policies and procedures to address the independence of MIS's ratings and rating processes. Information regarding certain affiliations that may exist between directors of MCO and rated entities, and between entities who hold ratings from MIS and have also publicly reported to the SEC an ownership interest in MCO of more than 5%, is posted annually on Moody's website at [www.moody.com](http://www.moody.com) under the heading "Shareholder Relations - Corporate Governance - Director and Shareholder Affiliation Policy."