March 10, 2023

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The Island Regulatory and Appeals Commission

Island Regulatory and Appeals Commission
PO Box 577
Charlottetown PE C1A 7L1

Dear Commissioners:

Response to London Economics' Review of 2023 General Rate Application (Docket UE20946)

On May 20, 2022, Maritime Electric Company, Limited ("Maritime Electric" or the "Company") filed an application with the Island Regulatory and Appeals Commission ("Commission") seeking approval of a three-year General Rate Application ("2023 GRA"). The Commission subsequently engaged London Economics International LLC ("LEI") to prepare an expert report following the review of Maritime Electric's GRA. On February 10, 2023, LEI issued its resulting report.

Maritime Electric welcomes the opportunity to provide comments on LEI's conclusions and recommendations. Maritime Electric also engaged its own expert, Concentric Energy Advisors ("Concentric") to review and comment on LEI's report, which is provided as Attachment 1.

Recommended Return on Equity ("ROE") and Capital Structure
Both Maritime Electric and Concentric agree that LEI's recommended ROE of 9.70 per cent on a common equity of 40 per cent is within a range of reasonable returns. On an overall basis, both Maritime Electric and Concentric generally agree with LEI's approach in reaching this recommendation, with a few exceptions discussed below.

Determination of the Recommended ROE
Although Concentric generally agrees that LEI's recommended ROE and capital structure are reasonable, they disagree with certain aspects of how LEI arrived at its recommended ROE. These aspects are discussed in Attachment 1.

Lack of Storm Deferral
LEI does not believe that the absence of an approved storm deferral is a major source of risk for Maritime Electric.[1] Maritime Electric does not agree with this assessment.

In fact, in its most recent credit rating report, which is provided as Attachment 2, Standard & Poors ("S&P") revised downward their assessment of Maritime Electric's business risk to reflect an increased risk. S&P believes that as the pace of climate change intensifies that Maritime Electric's storm risk marginally increases, and that a severe storm would likely affect the entire service territory and recovering such costs would likely be more challenging.

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1 Exhibit C-5, Report prepared by London Economics International LLC, page 19.

LEI points to the fact that the Commission approved the recovery of costs related to Hurricane Dorian and granted interim approval to defer the costs related to Hurricane Fiona. While this interim approval for Hurricane Fiona is positive, it should not be construed as indicative that the ultimate collection of those costs from customers will be approved by the Commission, and the approved recovery of costs related to a single storm (i.e., Hurricane Dorian) is not indicative of a predictive pattern.

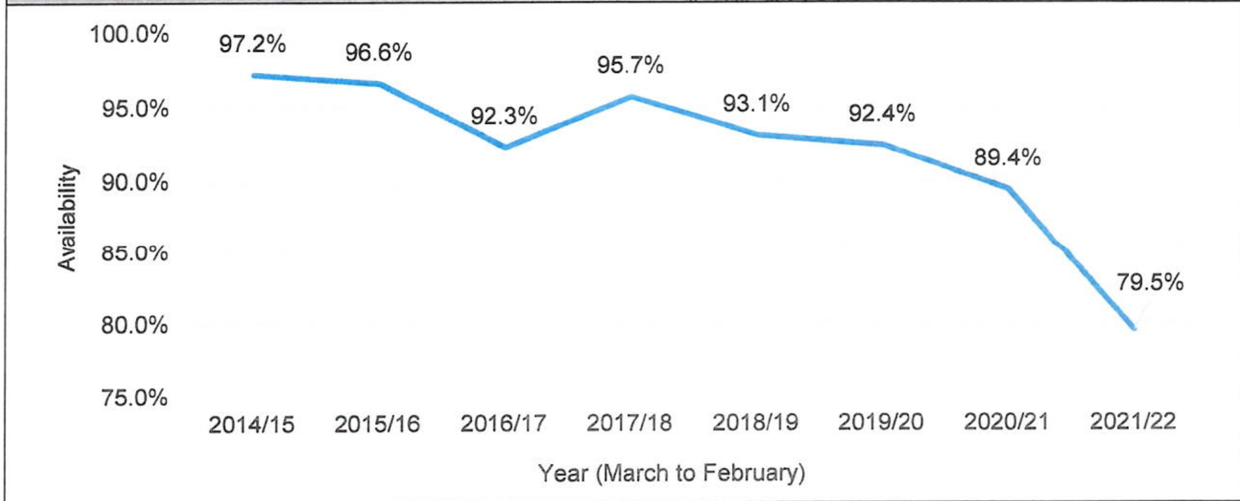
In addition, the interim approval to defer costs related to Hurricane Fiona stipulated that the balance must be excluded from the determination of the Company's rate base. The exclusion of deferred costs of $34.6 million from the determination of the Company rate base resulted in an average common equity in 2022 of 37.8 per cent, down from the approved 40 per cent, thereby preventing the Company from earning the maximum approved return.[2]

Operation of Wind Units

LEI disagrees with Concentric's view that Maritime Electric's wind generation arrangements are a source of business risk. LEI takes the position that even though Maritime Electric is not in direct control of the assets, the reliability of the assets will not suffer.[3] Maritime Electric disagrees with this assessment.

Of the six wind generation agreements, the output of the Hermanville units has steadily decreased since they were commissioned in 2014, as shown in Chart 1.[4,5]

CHART 1
Hermanville Performance



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2 The Company's capital structure was set at a maximum return of 9.35 per cent based on 40 per cent average common equity in Order UE19-08.

3 Exhibit C-5, Report prepared by London Economics International LLC, page 21.

4 The six wind generation agreements are Hermanville (30 MW), East Point (30 MW), North Cape (10.5 MW), Norway – Engie (9 MW), Norway – Aeolus (3 MW), and Norway – WEICAN (10 MW).

5 Hermanville information is from the Prince Edward Island Energy Corporation's Annual Report for the year ended March 31, 2022.

Maritime Electric believes that the observed decrease in unit availability is directly attributable to its lack of control over the maintenance of these wind generation units. The decreasing availability is the precise source of business risk to which Concentric referred.

The reduced output of the Hermanville wind farm, which is one of the two 30 MW wind farms, requires Maritime Electric to secure an alternative energy supply.

Government Involvement

LEI views the business risks associated with government involvement as not significant.[6] Maritime Electric does not agree with this assessment.

In S&P's most recent credit rating report, they reiterate their assessment that the PEI Government's history of playing an active role in establishing energy policy and setting rates exposes Maritime Electric to potential political interference, which S&P views as generally less favourable.

The recent involvement of the Nova Scotia Government to limit the rate increase allowed for Nova Scotia Power Inc. ("NSPI") is a clear example of how government involvement is a real and significant business risk for utilities.[7]

Locally, the PEI Government has demonstrated a willingness to interfere in regulatory matters with the passing of Bill 80 in December 2022, which legislated a zero per cent rent increase for residential rental units after the Commission had approved maximum allowable rent increases of 5.2 or 10.8 per cent. Furthermore, specifically related to utility matters, the Minister of Environment, Energy and Climate Action indicated he would "step in" to prevent Maritime Electric from investing in fossil fueled generation.[8] This actual and perceived government interference in regulatory matters on PEI continues to be a business risk for Maritime Electric.

Weather Normalization Mechanism and Reserve Account ("WNR")

LEI indicated that the WNR does not have a material impact on Maritime Electric's returns.[9] Both Maritime Electric and Concentric strongly disagree with this assessment. Concentric's comments on this matter are provided in Attachment 1.

WNR Benefits Customers, the Utility and the Regulatory Process

Maritime Electric's WNR benefits customers by providing rate stability and predictability; it benefits the utility by providing a fair and reasonable opportunity to recover its full cost of service; and it benefits the regulatory process by avoiding unplanned rate applications.

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6 Exhibit C-5, Report prepared by London Economics International LLC, page 28.

7 In this particular example, NSPI's rating agency downgraded both their long- and short-term debt ratings, resulting in a material increase in the utility's financing costs.

8 https://www.saltwire.com/atlantic-canada/news/pei-environment-minister-says-hed-step-in-if-maritime-electric-builds-new-fossil-fuel-generator-100799241/

9 Exhibit C-5, Report prepared by London Economics International LLC, page 46.

The WNR supports one of the fundamental principles of cost of service regulation, that the utility be provided a fair and reasonable opportunity to recover its cost of service. A utility's cost of service is recovered from customers by designing rates to recover the approved revenue requirement, which requires a forecast of customers' future energy consumption (i.e., energy sales).[10] As actual energy sales vary from forecast, the utility's recovery of its cost of service is impacted. When weather causes energy sales to be lower than forecast, the utility recovers less than its full cost of service. The weather impact on energy sales is a risk that cannot be controlled by the utility. A weather normalization deferral serves to mitigate this risk by providing the utility a fair and reasonable opportunity to recover its full cost of service. Likewise, a weather normalization deferral serves to protect the customer when weather causes energy sales to be higher than forecast, which would otherwise result in the utility recovering more than its full cost of service.

Furthermore, if the utility recovers materially less than its full cost of service, due to a weather-related decrease in energy sales, then it would be required to submit an unplanned rate application seeking recovery of this material revenue shortfall. The impact on customers would be an unexpected and potentially material rate increase, which is contrary to the principle of rate stability and predictability.

Conversely, when weather causes energy sales to materially increase, any resulting excess earnings would be deferred to Maritime Electric's Rate of Return Adjustment ("RORA") account, and a material RORA balance would also require an unplanned rate application to return the balance to customers. Given the volatility of weather impacts on energy sales, as demonstrated in Chart 2 below, it is reasonable to expect such unplanned rate applications would become frequent in the absence of the WNR.

Energy Sales Volatility

On Prince Edward Island, the transition to electric space heating has caused volatility in Maritime Electric's energy sales as they are more heavily impacted by weather and, as that transition continues, the impact and volatility will increase.[11] Therefore, in the absence of the WNR, Maritime Electric's business risk will increase, which is supported by Concentric's position as discussed in Attachment 1.

Chart 2 shows the monthly WNR balance for January 2016 to December 2021, which reflects the ending WNR balance addressed in the 2023 GRA and an additional year of data as compared to Figure 23 in LEI's report.

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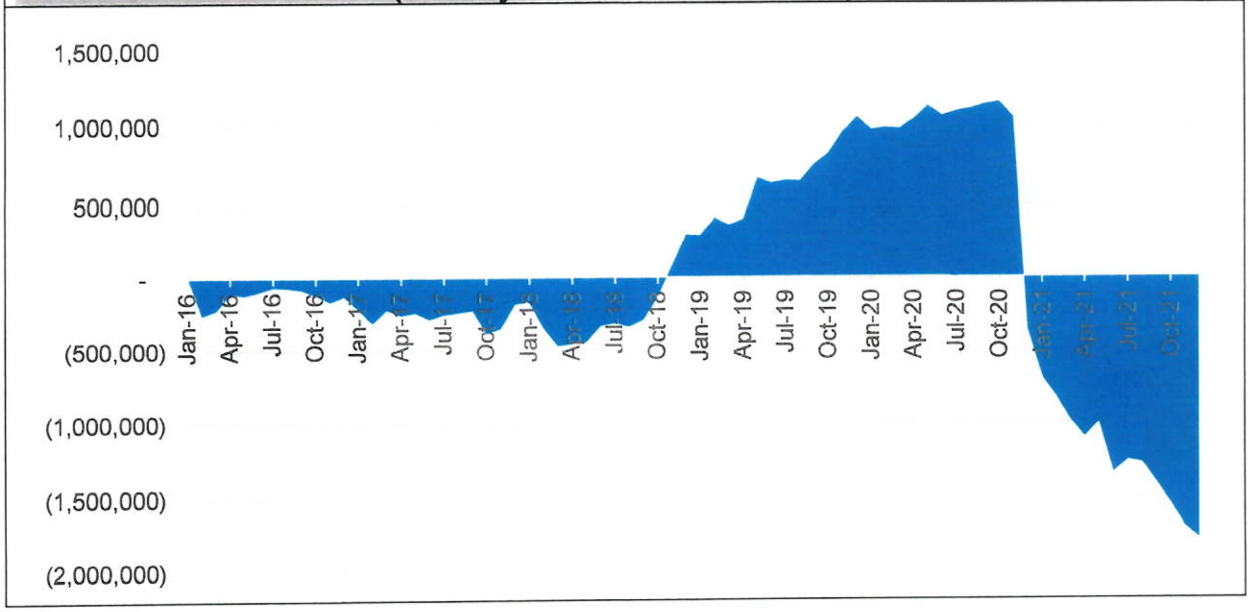
10 Simplistically, dollars (i.e., revenue requirement) divided by units (i.e., annual kWh consumption) equals a rate.

11 The use of electric space heating, as measured by heating degree days, results in higher energy consumption during periods of cold winter weather. Likewise, the use of electric air conditioning, as measured by cooling degree days, results in higher energy consumption during periods of hot summer weather. Currently, Maritime Electric's energy sales is materially impacted by heating degree days only.

CHART 2
WNR Balance
(January 2016 to December 2021)



During the period of January 2016 to October 2018, the WNR was in a deficit balance (i.e., balance owing from customers), peaking at $470,000 in April 2018. The WNR flipped to a surplus balance (i.e., balance owing to customers) for the period of November 2018 to November 2020, peaking at $1.2 million in October 2020. Then it flipped back to a deficit balance in December 2020, with a new deficit peak of $1.8 million in December 2021. This illustrates that there is real volatility in Maritime Electric's energy sales due to the impact of weather. It also illustrates that the WNR functions as designed to protect both customers and the utility from this volatility.

Material Impact of the WNR

LEI's conclusion that the WNR does not have a material impact on Maritime Electric's returns did not consider that the WNR could reach a material deficit balance (i.e., balance owing from customers) such as the deficit balance of $1.8 million in December 2021. This WNR deficit of $1.8 million is approximately 9 per cent of Maritime Electric's projected net income for 2023 to 2025, which is very material to the Company's financial health.[12] Similarly, the Company believes that the surplus peak (i.e., balance owing to customers) of $1.2 million in October 2020 was material to its customers, and the WNR appropriately allowed this revenue surplus to be deferred for the benefit of customers. This supports Maritime Electric's position that the WNR continue to approved by the Commission.

.../6

12 In comparison to the approximate 2.25 per cent indicated in LEI's report.

Accepted Utility Practice
The purpose of Maritime Electric's WNR is accepted in the utility industry as a form of revenue decoupling.[13] A recent review of regulatory adjustment clauses indicated that 56 per cent of utilities in the United States have a decoupling mechanism.[14] Such a review of Canadian utilities has not been completed. However, within the Fortis Inc. group of companies, FortisBC Energy Inc. (i.e., a gas utility), FortisBC Inc. (i.e., an electric utility), and Newfoundland Power Inc. have revenue decoupling mechanisms that specifically capture revenue variances caused by weather. FortisOntario Inc. has revenue decoupling mechanisms that protect the utility from all energy sales variances.

WNR Conclusion
Maritime Electric's position, which is supported by Concentric's assessment, is that the WNR is a critical deferral that benefits customers and the utility, and should continue to be approved. If the evidence presented herein is deemed to be insufficient by the Commission in order to support its approval of the WNR on a permanent basis, Maritime Electric respectfully requests an opportunity to provide more comprehensive evidence upon which the Commission can make a fully informed decision and that the Commission grant interim approval of the WNR as part of the 2023 GRA.[15,16]

Yours truly,

MARITIME ELECTRIC

Michelle Francis
Vice President, Finance &
Chief Financial Officer

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Attachments

13 Revenue decoupling is generally defined as a ratemaking mechanism that is designed to eliminate or reduce the dependence of a utility's revenues on system throughput (i.e., sales).

14 Regulatory Focus Topical Special Report, Adjustment clauses: A state by state overview, S&P Global, July 18, 2022.

15 The interim approval of the WNR as part of the 2023 GRA would be in alignment with the ROE evidence presented, as Maritime Electric and Concentric asserts that the absence of the WNR increases Maritime Electric's risk, and that increased risk must be reflected in the approved ROE.

16 The submission of more comprehensive evidence on the WNR would be similar to the comprehensive review of the Energy Cost Adjustment Mechanism submitted by Maritime Electric in June 2020.

Concentric Energy Advisors' Response to London Economics' Opinion on Return on Equity

Introduction and Purpose

Concentric Energy Advisors, Inc. ("Concentric" or "we") have been asked to prepare a response to the report filed by London Economics, Inc. ("LEI") on February 10, 2023. LEI's report was prepared for Counsel of the Island Regulatory and Appeals Commission (the "Commission") regarding the appropriate return on equity ("ROE") for Maritime Electric Company Ltd. ("Maritime Electric" or the "Company"). Concentric filed its cost of capital report on behalf of Maritime Electric in June 2022 in which we described our analysis of a reasonable cost of equity and deemed equity ratio for the Company.

Summary of Response

LEI recommends an authorized ROE of 9.70% and a deemed equity ratio of 40% for Maritime Electric. Concentric generally agrees that LEI's recommended ROE is within the range of reasonable equity returns for Maritime Electric, although LEI's recommended return is 25 basis points lower than our recommendation of 9.95%. LEI and Concentric agree with respect to the deemed equity ratio for Maritime Electric.

Areas of Agreement

Concentric agrees with several important aspects of LEI's report and analysis:

- Inflation and higher yields on government and corporate bonds pose more of a risk today for investors than when the analysis in our report was performed in February 2022.
- Use of a North American proxy group to estimate the cost of equity capital for Maritime Electric.

- Use of a risk-free rate of 3.75% in the Capital Asset Pricing Model ("CAPM") analysis, based on a forecast 10-year government bond yield from Consensus Economics plus the average historical spread between 10- and 30-year government bonds.
- The authorized ROE should reflect the small size of Maritime Electric. LEI makes a 40 basis point adjustment to the results of the CAPM to account for small size, pointing to the differential for FortisBC Electric over FortisBC Energy Inc. in British Columbia as support for this adjustment. Concentric did not make a specific size adjustment but recognizes this is a differentiating risk factor for Maritime Electric in relation to its peers.

Areas of Disagreement

Although Concentric generally agrees that LEI's recommended ROE and capital structure for Maritime Electric are reasonable, we disagree with certain aspects of how LEI arrived at its recommended ROE, including:

- Sole reliance on the CAPM model instead of also considering the results of other methodologies such as the Discounted Cash Flow ("DCF") and Risk Premium models.
- Use of raw betas, although LEI does adjust the betas for differences in financial leverage between the proxy group companies and Maritime Electric.
- Sole reliance on a historical market risk premium, rather than also considering a forward-looking market risk premium. LEI also rejects the inverse relationship between interest rates and the market risk premium, which Concentric believes is an important aspect of the risk premium in today's capital markets.
- LEI's assertion that Concentric's total projected growth rates and resulting returns for the TSX and S&P 500 Indexes are overstated. Concentric uses a Constant Growth DCF model to compute the forward market risk premium. This approach is consistent with

the method used by Federal Energy Regulatory Commission ("FERC"),[1] as well as staff at the Maine and Minnesota commissions, and incorporates the expertise of analysts who cover these companies.

- Excluding an adjustment for flotation costs and financial flexibility. The vast majority of Canadian jurisdictions allow an upward adjustment of 50 bps, and excluding it would create a significant departure from Canadian practice.
- The idea that earnings growth rates are overly optimistic and upwardly biased, and therefore raises concerns with the use of the DCF model. Concentric showed in its June report that Gross Domestic Product ("GDP") growth has not served as a cap on Earnings Per Share ("EPS") growth for the companies in our proxy groups.

Concentric will elaborate on each of these points of disagreement in the section that follows.

LEI's Sole Reliance on the CAPM

LEI has relied solely on the CAPM model to estimate the cost of equity for Maritime Electric. While Concentric agrees that the CAPM is one of several models used by utility regulators and analysts for purposes of estimating the cost of equity for regulated public utilities, we believe it is important to consider the results of multiple methodologies. The cost of equity cannot be directly observed in the same way as the cost of debt or preferred stock. Various financial models have been developed to estimate the cost of equity, including the DCF model, CAPM, and the Risk Premium model. Each model has strengths and limitations, depending on market conditions, and no one model always produces reliable or "accurate" results. In his financial textbook, Financial Management Theory and Practice, Dr. Eugene F. Brigham writes:

> In practical work, *it is often best to use all three methods* – CAPM, bond yield plus risk premium, and DCF – and then apply judgment when the methods produce different results. People experienced in estimating equity capital

[1] FERC Opinion No. 531-B, Order on Rehearing, issued March 3, 2015.

> costs recognize that both careful analysis and some very fine judgments are required.[2]

The important conclusion to be drawn is that these financial models provide estimates of the cost of equity. They cannot be mechanically applied to produce a precise or "correct" authorized ROE for a regulated utility such as Maritime Electric. It is incumbent upon the analyst and the regulatory commission to interpret relevant market data and use informed judgment in setting a just and reasonable ROE.

Use of the Discounted Cash Flow ("DCF") Model

LEI did not use the DCF model to estimate the cost of equity for Maritime Electric due to concerns that the EPS growth rates are overly optimistic and upwardly biased. The Constant Growth DCF model was developed by Professor Myron Gordon of the University of Toronto for the purpose of estimating the cost of equity for dividend paying companies that operate in mature, stable industries. As such, use of the DCF model is appropriate for electric utilities such as Maritime Electric. In addition, Concentric cites a 2010 article indicating that analyst bias, if it ever existed, went away after financial regulators in Canada and the U.S. imposed rules to prevent conflicts of interest and to promote the dissemination of information to all investors at the same time. Further, we have also provided the results of the Multi-Stage DCF model, which tempers the short-term rate (i.e., EPS growth) with a long-term growth rate (i.e., GDP growth). Figure 22 of Concentric's report shows that the historical EPS and DPS growth rates for the companies in our proxy groups exceeded GDP growth in Canada and the U.S. over the period 2005-2019. This is evidence that GDP growth has not served as a cap on EPS or DPS growth for the companies in our proxy groups.

[2] Dr. Eugene F. Brigham, Financial Management Theory and Practice, Fourth Edition, copyright 1985, at 256.

LEI's Use of Raw Betas

LEI has used raw betas, adjusted for differences in financial leverage between Maritime Electric and the proxy group companies. Beta is used in the CAPM model as a measure of non-diversifiable risk. While Beta is calculated based on historical stock prices, it should reflect the forward-looking differences in risk between utility stocks and the broad market. Concentric has found that adjusted betas using weekly data on stock returns calculated over five years are better indicators of future stock performance than raw or unadjusted betas. Our research is consistent with the work of Dr. Marshall Blume, who first observed the tendency of beta to revert to the market average of 1.0 over time. Concentric agrees with LEI that it is appropriate to adjust Beta for differences in financial leverage between Maritime Electric and the proxy group companies, but that adjustment, alone, is insufficient.

LEI's Sole Reliance on a Historical Market Risk Premium.

LEI has relied solely on a historical market risk premium in the CAPM analysis. There is an inverse relationship between interest rates and the market risk premium, as shown in Concentric's Risk Premium analysis. That is, when interest rates are below the historical average, the market risk premium would be expected to exceed the historical average, and vice versa. Historical market risk premiums tend to understate the market risk premium during periods when interest rates are low. Concentric has used an average of forward-looking and historical market risk premiums in its CAPM analysis. FERC relies solely on a forward-looking market risk premium, while we have averaged the historical and forward market risk premium to temper the results. Concentric's approach tends to produce a lower average market risk premium than if we had only relied on a forward market risk premium, as FERC does. LEI's approach, however, understates the market risk premium (and therefore the resulting cost of equity).

LEI's Concern with Concentric's Estimate of the Total Market Return.

LEI expresses concern that Concentric's estimate of the total market return is too high. We have used the Constant Growth DCF model to estimate the total market return for companies in the TSX and S&P 500 Indexes that pay dividends and have a projected earnings growth rate. This is the same methodology used by FERC in developing the total market return estimate in the CAPM analysis. As discussed above, Concentric does not share LEI's view that analysts' projected EPS growth rates are overly optimistic or upwardly biased. Notwithstanding our other differences, this change in the equity risk premium (Concentric's 7.86% vs. LEI's 7.25%) would abrogate the 25 basis point difference in our recommendations.

Adjustment for Flotation Costs and Financial Flexibility

LEI has not included an adjustment to the authorized ROE for flotation costs and financial flexibility. There is longstanding Canadian precedent for an adjustment of 50 basis points to the authorized ROE to account for flotation costs and financial flexibility. Every province in Canada (except Manitoba and Saskatchewan for which no information is available) has accepted an adjustment for flotation costs and financing flexibility.[3] The vast majority of these adjustments are 50 basis points, with only Quebec being somewhat lower at 30-40 basis points.

Furthermore, there is academic support for an adjustment for flotation costs. For example, Dr. Shannon Pratt explains the basis for recovering flotation costs through an adjustment to the authorized ROE as follows:

> Flotation costs occur when new issues of stock or debt are sold to the public. The firm usually incurs several kinds of flotation or transaction costs, which reduce the actual proceeds received by the firm. Some of these are direct out-of-pocket outlays, such as fees paid to underwriters, legal expenses, and prospectus preparation costs. Because of this reduction in proceeds, the firm's required returns on these proceeds equate to a higher return to compensate for the additional costs. Flotation costs can be accounted for

[3] Concentric Report, January 2022, at 69-72.

> either by amortizing the cost, thus reducing the cash flow to discount, or by incorporating the cost into the cost of capital. Because flotation costs are not typically applied to operating cash flow, one must incorporate them into the cost of capital.[4]

In addition to flotation costs, Canadian regulators have accounted for financial flexibility, which recognizes the need for utilities to have access to capital on reasonable terms under a variety of economic and financial market conditions.

Conclusions Regarding LEI's ROE Recommendation.

Despite these areas of disagreement with the methodology and model's inputs used by LEI to derive its recommended ROE, Concentric agrees that the end result of LEI's analysis is generally within the range of reasonableness, consistent with the U.S. Supreme Court's *Hope* decision in which the Court determined that it is the end result, not the methodology employed, that determines whether a return is just and reasonable.

Comments on LEI's Discussion of Business Risk and the Equity Ratio for Maritime Electric.

On the issue of equity ratio and business risk, Concentric has the following comments in response to LEI's report:

- We agree with LEI that Maritime Electric has similar business risk as in 2019.
- We do not agree that generation risk is not a consideration. As discussed in our report, the Commission has previously found that Maritime Electric has more generation risk than utilities in Ontario and Alberta that are not responsible for the generation function.
- We do not agree with LEI regarding the weather normalization account ("WNA"). If the WNA expires and is not renewed for Maritime Electric, it increases the Company's risk relative to the proxy group and supports a higher ROE. Concentric's report indicates that 54% (21 out of 39) of the operating companies held by the U.S. Electric proxy group have

[4] Shannon P. Pratt, Cost of Capital Estimation and Applications, Second Edition, at 220-221.

either full or partial revenue decoupling that protects against volumetric risk. This is especially a consideration as more Maritime Electric customers use electricity for space heating purposes, which causes demand to fluctuate more with weather.

- LEI's report does not acknowledge the wide disparity between authorized equity ratios in the U.S. as compared to Canada, although LEI does adjust the raw beta for differences in financial leverage between Maritime Electric and LEI's proxy group.
- The equity ratio for Maritime Electric is capped at 40% by legislation. Thus, any differences in risk between Maritime Electric and the proxy group must be accounted for through the authorized ROE. LEI has added 40 basis points for small size risk, which we believe is the minimum appropriate, especially given LEI's exclusion of the flotation and financial flexibility adjustment.

Summary and Conclusions

Concentric continues to support its ROE recommendation of 9.95% for Maritime Electric, based on the results of our ROE analysis and the increases in interest rates and inflation noted by LEI. Notwithstanding our methodological differences as discussed herein, Concentric agrees that LEI's recommended ROE for Maritime Electric of 9.70% is also within the range of reasonable returns, albeit on the low end. LEI and Concentric agree with respect to the deemed common equity ratio for Maritime Electric being maintained at 40.0%.

S&P Global
Ratings

RatingsDirect®

Research Update:

Maritime Electric Co. Ltd. 'BBB+' Rating Affirmed; Outlook Stable

June 17, 2022

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Rating Action Overview

- We expect that Prince Edward Island - based Maritime Electric Co. Ltd (MECL), will continue operating as a lower-risk integrated utility that is planning to proactively harden its electric system, and operates under a generally credit supportive regulatory framework, despite increasing physical risks across North America.
- Because of climate change, we modestly increased our assessment of the company's business risk to reflect our view of the company's increasing susceptibility to hurricanes or severe storms that have already increased and affected many areas across North America. As such, we revised downward our assessment of the company's business risk profile to the higher end of the strong category from the lower end of the excellent category. This modest downward revision does not affect the ratings on the company.
- We affirmed our ratings on Maritime Electric Co. Ltd., including our 'BBB+' issuer credit rating, and our 'A' issue-level rating on the company's secured bonds, with '1+' recovery rating.
- The stable outlook reflects our expectations that the company will maintain constructive relationship with its regulator, continue to harden its system over time, and generate stable and predictable financial measures. Over the next two years, we expect MECL's stand-alone funds from operations (FFO) to debt to reflect 16%-19%.

Rating Action Rationale

We affirmed our ratings on MECL and the outlook remains stable despite increasing risks from climate change. Despite increasing risks from climate change, we believe MECL will continue achieving generally constructive regulatory outcomes, while managing its susceptibility to physical risk, and maintaining stable stand-alone financial measures that support its credit quality. We expect MECL's stand-alone funds from operations (FFO) to debt to reflect 16%-19% over the next two years.

We revised downward our assessment of MECL's business risk profile to the higher end of the strong category from the lower end of the excellent category. Our revision reflects climate change and our view of the island's increasing susceptibility to physical risks even though the company is planning on hardening many portions of its system incrementally over time. Over many years, MECL is proactively invested in the hardening and replacement of portions of its electric system to minimize customer service outages. Despite these improvements, the region remains susceptible to physical risks from the increasing prevalence of storm systems and winter ice and sleet activity in the region. Also affecting the company's business risk profile is its very small customer base of only about 86,000 customers, its lack of geographic diversity, and that its service territory is limited to a single island. Should the company experience a severe storm, it would likely affect its entire service territory and recovering such costs would likely be more challenging than most other larger and more diversified utilities.

The utility has not experienced a devastating storm since 2003, but hurricane storm systems have come close over the past 24 months. As the pace of climate change intensifies, we believe the storm risk for MECL marginally increases. We also believe MECL's business risk profile is now more in line with its other island peers such as Caribbean Utilities Co. and Hawaiian Electric Co. Inc.

Our assessment of MECL's business risk also reflects the Island Regulatory and Appeals Commission (IRAC) and the provincial government of Prince Edward Island (PEI) that both have a history of playing an active role in establishing energy policy and setting rates for the island's customers, which exposes the utility to potential political interference. We view this as generally less favorable than an independent regulator with a clear, consistent mandate and an established track record of credit-supportive policies. As such, we expect the company to maintain constructive relationships with its regulator in a manner that continues to support its credit quality.

Additionally, we believe MECL has somewhat higher emission risks because the utility relies on diesel as its primary fuel for their on-island backup energy generators. Overall, MECL purchases most of its power supply, about 75%, from neighboring province New Brunswick, including about 15% from the Point LePreau nuclear generation station, and 25% from on-island wind assets.

Offsetting much of the aforementioned risks is our assessment of MECL that it is a monopolistic lower-risk, rate-regulated vertically integrated electric utility that has a track record of constructive regulatory outcomes and stable profit measures. MECL has generally managed regulatory risk effectively relying on credit supportive mechanisms allowed within its regulatory construct. These include energy cost adjustments and weather normalization in its rates, which provide stability to their cash flow, minimizing profit volatility. Overall, we assess the company at the higher end of its business risk profile. To account for this, we assess the comparable rating analysis modifier as positive.

We assess MECL's financial risk profile as significant using our medial-volatility financial benchmark table which reflects the company's lower-risk regulated utility operations and effective management of regulatory risk. Our analysis also incorporates the most recent energy cost adjustment made in February 2022 to recover approximately $5.6 million in energy supply costs due to unforeseen outages at Point LePreau, a nuclear generation station located in New Brunswick. MECL plans to file its next general rate application in the second quarter of this year proposing new rates effective March 1, 2023. Under our base-case assumptions that include the most recent rate case outcomes, capital spending of about C$60 million-C$70 million per year in 2022 and 2023, and dividends of about C$8.5 million per year, we forecast the company will maintain FFO to debt of about 16%-19% during our two-year outlook period.

We assess MECL as a moderately strategic subsidiary of Fortis Inc. We believe MECL is unlikely to be sold in the near term, is important to Fortis' long-term strategy in regulated utilities, and would likely receive support from the parent should it fall into financial difficulty. Based on this assessment, we continue to rate MECL one notch below the group credit profile.

Outlook

The stable outlook reflects our expectations that the company will maintain constructive relationship with its regulator, continue to harden its system over time, and generate stable and predictable financial measures. Over the next two years, we expect MECL's stand-alone FFO to debt to reflect 16%-19%.

Downside scenario

We could downgrade MECL over the next 12 months if:

- MECL experiences adverse regulatory rulings, severe storms, volatile profit measures, or operational setbacks that results in a higher business risk; or
- Its financial measures weaken, including FFO to debt of consistently below 16%.

Upside scenario

We could raise our ratings on MECL over a similar period if its financial measures improve, including FFO to debt consistently above 25%, without a weakening of business risk.

Company Description

MECL is an integrated electricity generation, transmission, and distribution utility with operations throughout PEI. It provides services to more than 86,300 customers and is regulated by IRAC. MECL is an indirect wholly owned subsidiary of Fortis Inc.

Liquidity

We assess MECL's liquidity as adequate. We expect the company's liquidity sources to be more than 1.1x its uses over the next 12 months and anticipate that its net sources will remain positive even if its EBITDA declines by 10%. In our view, MECL has sound relationships with its banks and a generally satisfactory standing in the credit markets. In the unlikely event of liquidity distress, we expect that MECL would scale back its capital spending and dividend payments to preserve its liquidity.

Principal liquidity sources

- Available committed credit facilities of about C$47 million as of Dec. 31, 2021; and
- Cash FFO of about C$55 million over the next 12 months.

Principal liquidity uses

- Capital expenditure of about C$65 million over the next 12 months; and

- Dividend payments of about C$8.5 million over the next 12 months

Environmental, Social, And Governance

ESG credit indicators: E-3, S-2, G-2

Environmental factors are a moderately negative consideration in our credit rating analysis of Maritime Electric Co. Ltd. Maritime Electric serves Prince Edward Island, which is a region that's becoming increasingly prone to physical risks related to Atlantic hurricane and tropical storm systems. We view MECL's small customer base and lack of geographic diversity as factors that add to the susceptibility of physical risks associated with storm conditions.

Issue Ratings - Subordination Risk Analysis

Capital structure

As of Dec. 31, 2021, MECL's capital structure comprised about C$3.7 million of short-term borrowings and C$258 million of first-mortgage bonds (FMB).

Analytical conclusions

MECL's FMBs benefit from a first-priority lien on the majority of the utility's real property owned or subsequently acquired. In addition, the collateral coverage on these FMBs is more than 1.5x, which supports a recovery rating of '1+' and an issue-level rating of 'A' (two notches above our 'BBB+' issuer credit rating on MECL).

Ratings Score Snapshot

Issuer Credit Rating: BBB+/Stable/--

Business risk: Strong

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

Financial risk: Significant

- Cash flow/leverage: Significant

Anchor: bbb

Modifiers

- Diversification/portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)

- Liquidity: Adequate (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Positive (+1 notch)

Stand-alone credit profile : bbb+

- Group credit profile: a-
- Entity status within group: Moderately strategic (no impact)

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- General Criteria: Hybrid Capital: Methodology And Assumptions, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- 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
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- Criteria | Corporates | Utilities: Collateral Coverage And Issue Notching Rules For '1+' And '1' Recovery Ratings On Senior Bonds Secured By Utility Real Property, Feb. 14, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Ratings List

Ratings Affirmed

Maritime Electric Co. Ltd.	
Issuer Credit Rating	BBB+/Stable/--
Senior Secured	A
Recovery Rating	1+