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## H.TO - Q4 2015 Hydro One Ltd Earnings Call

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## CORPORATE PARTICIPANTS

**Bruce Mann** *Hydro One Limited - VP of IR*

**Mayo Schmidt** *Hydro One Limited - President & CEO*

**Michael Vels** *Hydro One Limited - CFO*

## CONFERENCE CALL PARTICIPANTS

**Linda Ezergailis** *TD Securities - Analyst*

**Paul Lechem** *CIBC World Markets - Analyst*

**Robert Kwan** *RBC Capital Markets - Analyst*

**Andrew Kuske** *Credit Suisse - Analyst*

**Ben Pham** *BMO Capital Markets - Analyst*

**Jeremy Rosenfield** *Industrial Alliance - Analyst*

## PRESENTATION

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**Operator**

Good morning, ladies and gentlemen, and welcome to the Hydro One Limited fourth-quarter results investment community teleconference.

(Operator Instructions)

As a reminder, this call may be recorded. I would now like to turn the call over to Bruce Mann, with the Hydro One management team. Please go ahead.

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**Bruce Mann** - ***Hydro One Limited - VP of IR***

Good morning, everybody, and thank you for joining us. I'm here in Toronto with Hydro One's President and CEO, Mayo Schmidt; and our Chief Financial Officer, Michael Vels.

We'll provide some brief comments and background on the fourth quarter and the full-year results. Then we're going to spend the majority of the call answering as many of your questions as time permits. There's also several slides that illustrate or support some of the points we'll go over. They should be up on the webcast now, but if you are dialed into the teleconference, you can find them on our investor relations site, HydroOne.com, and it will say events and presentations.

You will note that the results we reported today are for the first time those of Hydro One Limited. This is the entity of which the common shares of the November IPO were issued. We separately also filed the results of Hydro One Inc., our fully owned operating subsidiary, which holds all the regulated utility assets and the outstanding borrowings of the Company, which represents 99% of the consolidated business. But going forward and effective today, both entities are now reporting issuers. For the full year reported results, 2015 consisted of Hydro One Inc. up until October 31, and then the results of the consolidated Hydro One Limited and Hydro One Inc. from November 1 to the end of year. The comparative periods in 2014 are those of Hydro One Inc.

Lastly, as the discussion this morning will undoubtedly touch on estimates and other forward-looking information, please review the cautionary language in this morning's release, also in our full year MD&A that was filed this morning and in our recent IPO prospectus with respect to the various factors, assumptions, and risks that could cause our actual results to differ, all of which apply equally to our dialogue on the call this morning.

With that, I will turn it over to Mayo.

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**Mayo Schmidt** - ***Hydro One Limited - President & CEO***

Thank you, Bruce. Good morning, everyone.

Overall, we closed out the year with a fourth quarter that was in line with expectations, and reflected a number of items we had discussed previously. Those include the effect of more normalized operational spending compared to unusually lower spending in the 2014 fourth quarter, the divestiture of Hydro One Brampton at the end of the August, insurance settlement proceeds received in quarter four of last year that didn't recur in quarter four of this year. Other items that affected the quarter include the revenue impact of reduced peak demand levels due to the unseasonably warm weather in quarter four, and the costs associated with two windstorms during the quarter. These impacts were partially offset by a one-time tax benefit related to the IPO. Also during the quarter we closed the previously announced CAD46 million acquisition of Woodstock Hydro and their 15,800 local power distribution customers.

The full-year 2015 net income for Hydro One of CAD690 million is approximately in line with our expectations for the year. In addition to our earnings, we also announced earlier this morning that our Board declared the Company's first quarterly common share dividend since the November initial public offering.

Recently, we announced the definitive agreement to acquire Great Lakes power electric transmission business located in northern Ontario and based in Sault Saint Marie. This is an Ontario-regulated electricity transmission asset that is directly contiguous on both ends with Hydro One's own transmission network. Upon completion of the transaction, following approval by the Ontario Energy Board, Hydro One will own and operate approximately 98% of Ontario's transmission capability. This transaction aligns with our objective of growing within Ontario in our existing electrical transmission distribution businesses, and was a unique opportunity to add a high-quality asset and management team and continue to expand in Canada's most populated province.

Following the completion of the November IPO, new leadership is assessing future opportunities to transform Hydro One into a performance-focused commercial organization that will generate consistent growth and value for our customers and shareholders. We have a great deal of work to do, and I expect we should be able to provide shareholders with more details at or around the time of our annual shareholder meeting in late May.

Although early to have formulated specific action plans, Management is focused on four key themes. First, we will become much more focused on customer needs and ensure that customer feedback drives our business decisions in a more direct manner. Second, we will adapt to the emerging technology landscape and position our business appropriately to win. Thirdly, we will focus continuously on increased efficiency and productivity while accelerating the effectiveness of our capital deployment to more quickly execute the multi-year infrastructure upgrades we have in front of us. At the same time, we will make Hydro One a rewarding and safe place to work for our employees. Fourth, we will build a world-class competency and strive for delivering best-in-class operating metrics to position Hydro One for accelerating growth well into the future.

Over the long term, we will look to go beyond our core, leveraging our strong asset base and expertise we will have built throughout this process. As you can imagine, we are currently in an intense process to carefully examine in detail every aspect of our business, sharpening the focus on core capabilities, strengths, gaps, and identifying where we must move the needle to become best-in-class with operational excellence. I can assure you that we are focused on becoming a leading globally admired utility.

Finally, I would like to recognize the hard work and heroic efforts of thousands of Hydro One employees who rose to the challenge during two very intense windstorms that rolled across the province during the fourth quarter, and resulted in many of our employees working through the holidays on the front lines to restore power to our customers. Both of these storms took down lines, disrupting service to many tens of thousands of customers across Ontario. These employees worked around the clock in challenging and frigid conditions, putting the restoration of power to our customers first. They did so safely and expertly across hundreds of the communities that we serve. We couldn't be more proud of our people. They exemplify the values of unwavering commitment to service and reliability for our customers, and are continuing and contributing to the communities in which we operate.

So with that, I will turn this over to Mike to discuss the financials. Then we would be happy to take your questions. Mike?

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**Michael Vels** - ***Hydro One Limited - CFO***

Thanks, Mayo. Good morning, everyone.

This is the first full quarter of reporting after the initial public offering. And as you can imagine, there are several impacts related to IPO accounting, and also some operating items that have made comparisons for this quarter difficult compared to last year. We've outlined these items in our press release and related MD&As and I will highlight several of those items today.

On slide 4, we have provided a year-over-year comparison of components of the income statement. First off, full-year earnings were in line with our expectations. The fourth quarter is affected by several unusual impacts and timing differences. Although revenue benefited from rate increases that were effective from the beginning of

2015, these positive effects on revenue were more than offset in the fourth quarter by unseasonably warm weather in Ontario during November and December that reduced peak load in consumption, and also affected by the divestiture of our Brampton business on August 31, 2015.

The most significant variance for the quarter is an increase in OM&A costs. This is a reflection primarily of unusually low OM&A spending in the fourth quarter of last year, as costs in 2015 were more evenly incurred across all four quarters. In addition to these timing differences, we also had higher expenses in the quarter as we restored damage from the two large windstorms in November and December that Mayo referred to. These effects more than offset ongoing cost reductions and improvements in the areas of customer service, information technology, and bad debt expense, as billing and back office systems are now stable and operating to specification. We also incurred some local distribution company acquisition integration costs during the quarter, and, as Mayo said, there was insurance settlement benefit last year that further made the year-over-year comparisons difficult.

Tax expense for the quarter is unusually low, at CAD1 million. In fact, the underlying effective tax rate is approximately 14% compared to a lower tax rate of 7% last year. Included in the tax expense for this quarter is a one-time tax benefit of approximately CAD19 million associated with truing up adjustments to deferred tax assets that were created upon the exit of the Company from the PILs regime post the IPO.

This morning, we announced the Company's first dividend, post-IPO. When calculating the payout ratio of the dividend, it is important to note that the 2015 earnings still include the Brampton numbers, and also do not reflect higher interest costs from the IPO recapitalization. Adjusting for these items, the dividend payout ratio compared to 2015 earnings is towards the higher end of the 70% to 80% target dividend payout range. However, we continue to expect that the 2016 ratio will be towards the lower end of that range.

On slide 5, we've reflected our decision to include an adjusted earnings per share amount in our financial statements that adjusts the share count included in the earnings per share calculation. Generally Accepted Accounting Practices requires that we use the average number of shares outstanding for Hydro One Inc. and Hydro One Limited prior to the IPO, which, as you can imagine, yields an EPS number that's not representative of the new public Company's share count. To normalize this, we've used the share count post-IPO of 595 million shares to calculate adjusted EPS, which we consider to be a more meaningful measure.

Slide 6 outlines capital expenditures and estimated rate base for the transmission and distribution businesses. Capital expenditure increased by 9% for the full year 2015 to CAD1.66 billion, as we continue to invest in infrastructure renewal associated with both businesses. We continue to expect that this level of investment will be maintained, and we expect that our capital expenditures for each of the next five years will approximate CAD1.6 billion per annum. As a result of this investment in the province's aging electrical infrastructure, assets placed in service for 2015 were CAD1.5 billion, and the Company's estimated rate base increased by approximately CAD565 million, or 3.5%, compared to 2014.

On slide 7, you can see that we ended the year with a very strong balance sheet and significant available liquidity. During the fourth quarter, we renewed the Company's CAD3.5 billion medium-term note shelf prospectus, which at this point is fully undrawn. We have strong investment-grade A credit ratings from all three rating agencies. We have an excellent balance sheet as we look forward to the transformation of the Company and the continued renewal of Ontario's electrical grid. We do expect that during 2016 we will issue long-term debt under the Company's MTN program.

As we both mentioned, today we announced the first post-IPO dividend. This first dividend includes CAD0.21 for the first quarter for an annualized rate of CAD0.84. It also includes a pro-rated amount of CAD0.13 for the seven-week portion in the 2015 fourth quarter following the IPO. The total dividend of CAD0.34 will be paid on March 31 to shareholders of record on March 17. In addition, we've also outlined on the slide the expected dividend declaration record and payment dates for the next four quarters, all subject to future Board approvals. The Company's dividend payout ratio target is 70% to 80% of net income, and, as I mentioned previously, we currently expect that the annualized dividend of CAD0.84 per share should be towards the lower level of this range for 2016.

With that, we'd be pleased to take your questions.

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**Bruce Mann** *- Hydro One Limited - VP of IR*

Thanks, Mike and Mayo.

Quickly, Operator, before you go ahead and explain to the participants how you would like to organize the polling for the Q&A, we want to quickly request that participants who do wish to ask questions try to keep them to a single topic, so that as many people as possible have an opportunity to ask questions. And to the extent we have time, we will circle back and take more. So if you would please go ahead and explain how you would like to conduct this, we are ready to go.

## QUESTION AND ANSWER

**Operator**

(Operator Instructions)

Linda Ezergailis, TD Securities.

**Linda Ezergailis** *- TD Securities - Analyst*

Thank you. Congratulations on getting your first quarter report out.

**Mayo Schmidt** *- Hydro One Limited - President & CEO*

Thank you.

**Linda Ezergailis** *- TD Securities - Analyst*

So, your five-year CapEx plan has inched up slightly to CAD1.6 billion a year, versus CAD1.5 billion. I realize that could be considered rounding or noise, but can you give us a sense if there's anything driving that? Is that FX? Is it scope? Is it just refining your estimates, or a bit of all of the above?

And then my two-pronged question would be: Other than that slight shift in outlook, is there anything else that has changed since the IPO, in your outlook?

**Michael Vels** *- Hydro One Limited - CFO*

I will answer that in two parts. Firstly, you're 100% correct; the numbers really just reflect rounding and minor timing differences. So, as we go forward and submit our transmission rate filing, for example, in May, and as we further fine-tune our business plans, we will provide revised estimates.

But at this point, the changes that you are seeing are primarily timing and rounding. So, there's nothing new, or nothing that I'd point to that is particularly material. Also, the key number that we also track, which is in-service assets, was right on our expectations.

In terms of going forward, as Mayo said, we do have an intense period, or an intense amount of scrutiny that we are putting to the Business right now. And we are looking at all corners of the Business and understanding a number of things.

Part of that is assessing the appropriate level of capital expenditures and the amount of investment required for the electrical grid. We are at the early stages of assessing that, and as Mayo said, probably around the May time frame we will have more definitive perspective on those future expenditures.

**Linda Ezergailis** *- TD Securities - Analyst*

Thank you.

**Operator**

Paul Lechem, CIBC World Markets.

**Paul Lechem** *- CIBC World Markets - Analyst*

Good morning -- just a question on M&A. You announced the Great Lakes Power acquisition recently. Just wondering what your internal M&A capabilities -- how advanced they are at this point?

We've seen a couple of large utility transactions announced the past week in the US. Is it too early for Hydro One to have looked at those kind of opportunities, or how should we expect your M&A capabilities (inaudible) over the course of the year? Thanks.

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**Mayo Schmidt** *- Hydro One Limited - President & CEO*

Thanks, Paul. First of all, the history is, as we illustrated on the road show, is that the Company's executed on a consolidation of [ADA] to LDCs historically. We've got three under way at this time.

The Great Lakes was an opportunistic event that arose recently that we, being connected on both ends, and having a high degree of competency, and I would say in our backyard, executed well on acquiring that asset, subject to regulatory approval. So, that was more their timing than ours.

I would say that my view is that the former LDC acquisitions and the Great Lakes will allow us to hone our skills on the integration of businesses, which takes us to your other question. As we look south of the border, I think that the interesting thing of activity is that the recent announcement by others' interest south of the border demonstrates the ability of Canadian companies to look at opportunities and seek opportunities south of the border. We are watching with keen interest, and will be noting the learnings from those experiences.

We are working very hard right now and going through a number of -- as Mike illustrated, a few changes in the Organization structurally reporting. We're impressed with some of the new leadership that's emerging in the Organization, and empowerment, responsibility and accountability are becoming themes of the day.

So, there's a lot of work streams and processes under way. We would not interrupt those to effectively attempt a large transaction in the near future. And that's, again, as stated on the road show.

So, we're going to be consistent with that thinking. But certainly down the road, if you think about 24 months out, plus or minus, we do expect this Organization to be -- the competencies and capabilities to be extremely high, and capable of finding, pursuing and executing on opportunities.

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**Paul Lechem** *- CIBC World Markets - Analyst*

Thanks, Mayo. That's extremely helpful. Thank you.

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**Mayo Schmidt** *- Hydro One Limited - President & CEO*

Thank you, Paul.

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**Operator**

Robert Kwan, RBC Capital Markets.

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**Robert Kwan** *- RBC Capital Markets - Analyst*

Morning, just wondering if you could comment on a couple things that have come out from the OEB and then the Auditor General's report? Just on the OEB, any comments on the ROE paper, or I guess call it almost lack thereof of a review, and then anything just on that Auditor General's report?

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**Michael Vels** *- Hydro One Limited - CFO*

Thanks, Robert.

First of all, in terms of the paper related to ROE, we saw that as marginally positive. The OEB clearly appears to be comfortable with the ROEs at their current levels, and has indicated that they have no intention, at this time, to reopen any type of review. So, from our perspective, that's pretty well what we anticipated anyway. That's confirmation of our view.

Secondly, related to the Auditor General report, as Mayo mentioned, we are looking at our processes and controls, and ensuring that any items that were highlighted in that report are adequately and appropriately addressed. And we don't anticipate or expect any issue, going forward, in terms of either explaining that from a regulatory perspective or ensuring that our processes are in good shape in the future.

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**Operator**

Andrew Kuske, Credit Suisse.

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**Andrew Kuske** *- Credit Suisse - Analyst*

Thank you, good morning. Just what are your thoughts on the recent OEB decision as it relates to Toronto Hydro, and effectively their PBR application, and how that may translate into Hydro One in the future?

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**Michael Vels** *- Hydro One Limited - CFO*

Every time there's a rate application that's rendered -- or rate decision, rather -- it provides great insight for us. So, we certainly looked very positively that there was a material rate decision rendered in advance of the ones that we have coming up. So, that's always good insight, and always good learning.

The thing that we took from it that was very positive is some more certainty on how the OEB is going to look at incentive-based regulation. Also, the point of view that they will take on supporting evidence for capital divestments and additions to rate base.

So, all of those we actually saw as positive from our perspective, because they'll just inform us, and we'll have a higher quality set of applications in evidence. We didn't see anything there that was particularly problematic or would run counter to our points of view within Hydro.

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**Andrew Kuske** *- Credit Suisse - Analyst*

More specifically on the earnings sharing mechanism that was accepted, you feel very comfortable on the 100-basis-point dead band, and then the sharing mechanism around that, or beyond that?

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**Michael Vels** *- Hydro One Limited - CFO*

That was what they put forward, and that was what the OEB accepted. That doesn't mean that we would do that. We have a different business to them -- different drivers.

And whilst that might be a mechanism that we would consider to be appropriate, we will consider it carefully, and ensure that whatever we put in place works for us and for our rate payers. Toronto Hydro is a different business; but as I said, it certainly informs our thinking, and we wouldn't rule it out.

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**Andrew Kuske** *- Credit Suisse - Analyst*

Okay, that's very helpful. Thank you.

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**Operator**

Ben Pham, BMO Capital Markets.

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**Ben Pham** *- BMO Capital Markets - Analyst*

Thanks, and good morning, everybody. I wanted to ask on one of the four themes you've highlighted in your commentary, can you expand on the topic of adapting to emerging technologies?

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**Mayo Schmidt** *- Hydro One Limited - President & CEO*

Sure, I would be happy to. Currently, we have under way a move to mobile, which we think is going to be very effective for the Organization. We've been very much historically a paper-based organization, relating to our work orders and our methodologies in the countryside with thousands of workers. And we've got under way a technology program that's going to allow us recording, dispatch and tracking of assets at a much higher level.

So, there's a number of things that we are pursuing in that regard and the ability to communicate through our metering system -- better tracking and early warning notice relating to asset difficulties. As you can imagine, with tens of thousands of kilometers of lines, when a power outage that doesn't have an address as to where the line broke or the power pole had a problem, so we go hunting.

So, we think our innovation, both from our very sophisticated call center in Barrie, which also tracks and has all of the technology for noting power outages, along with our move to mobile, are going to be good moves for us. And then there's other things that will be under development that we will talk about probably later in the year.

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**Ben Pham** *- BMO Capital Markets - Analyst*

Okay. And if I may, there was commentary around -- in transmission -- on revising your asset replacements strategies. Can you expand on what's going on there? Is that something you guys do every year as part of that process? Was that externally driven? Did that drive the CapEx numbers a little bit around?

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**Michael Vels** *- Hydro One Limited - CFO*

Ben, I'm not sure I fully understood the question. What reference are you referring to?

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**Ben Pham** *- BMO Capital Markets - Analyst*

Yes, sorry. It is in your transmission segment commentary. You talked about some write-offs occurring in the quarter; and those related to revisions and asset replacement. I'm just wondering is that just a regular thing that you guys look at each year, or is that externally driven that causes you to do that?

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**Michael Vels** *- Hydro One Limited - CFO*

Yes, it is. I'm sorry. Now I know what you are referring to.

Yes, it is a fairly consistent process. There are always engineering or costs incurred or inventory that's purchased that, for one reason or another, cannot be used or deployed. In this quarter, we are slightly higher, as we did have some engineering related to a significant station that we will be shortly refurbishing, and some of the engineering costs related to a different solution that we wrote off. So, nothing -- really nothing to see there, just slightly higher than it has been in prior quarters.

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**Ben Pham** *- BMO Capital Markets - Analyst*

Okay. Thanks, everybody.

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**Operator**

Jeremy Rosenfield, Industrial Alliance.

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**Jeremy Rosenfield** *- Industrial Alliance - Analyst*

Thanks, and good morning. Just in relation to some of the severe weather events that occurred during the fourth quarter, I'm curious to know if you anticipate being able to recover some of the costs associated with the work that had to be done, and if that may be something that you could look to try to break out under the incentive based rate making, as you move forward?

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**Michael Vels** - ***Hydro One Limited - CFO***

The short answer on the storms in November and December is that none of those costs are recoverable. Generally, storm costs that are recoverable -- or should I say are capitalized -- would be storms that lasted for a longer duration. These were very short, quite vicious storms that took out a material number of poles in our distribution system, most of them up sort of northern, cottage country area. And we had -- as Mayo said, our people worked around the clock. We had the damage restored quickly, and as a result, those costs would all be expensed.

Going forward, I would not want to speculate on the sort of things we include in our rate filings, but this is a fairly well-established methodology. I think our view is that it is evenly balanced between Company taking some risk and rate payers being protected, but equally the Company being compensated for things that are of longer duration and potentially debilitating. So, we've operated on that basis for some time, and pretty comfortable with it.

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**Jeremy Rosenfield** - ***Industrial Alliance - Analyst***

Okay. And if you will permit me, perhaps, a follow-up question? Just on integration costs that you had mentioned during the quarter, I'm curious if there was any materiality to it? If you have the number associated with that?

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**Michael Vels** - ***Hydro One Limited - CFO***

It would be one of the lesser impacts. We're talking about maybe CAD1 or CAD2 million. It is not that much.

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**Jeremy Rosenfield** - ***Industrial Alliance - Analyst***

Great. Okay, thanks a lot.

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**Operator**

Thank you. That does conclude our Q&A session for today. I would now like to turn the call back to Bruce Mann for any further remarks.

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**Bruce Mann** - ***Hydro One Limited - VP of IR***

Thank you very much, operator.

And the management team here at Hydro One would like to thank everybody for investing some of your time with us this morning, during what we know is a busy period and in unusually crazy markets of late. So, we appreciate your interest and your support. And to the extent you have questions that weren't answered on the call, please feel free to reach out. Our contact information is at the end of this morning's release.

And that concludes today's call. Thank you.

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**Operator**

Ladies and gentlemen, thank you for your participation in today's conference. This does conclude today's program. You may all disconnect. Everyone, have a great day.

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