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Q3 2023 Hydro One Ltd Earnings Call

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PRESENTATION

Operator

Good morning, ladies and gentlemen, and welcome to Hydro One Limited's Third Quarter 2023 Analyst Teleconference. As a reminder the call is being recorded.

I would now like to introduce your host for today's conference, Mr. Omar Javed, Vice President, Communications, Marketing and Investor Relations at Hydro One. Please go ahead.

Omar Javed ***Hydro One Limited - Vice President, Communications, Marketing & Investor Relations***

Good morning, and thank you for joining us in Hydro One's quarterly earnings call. Joining us today are our President and CEO, David Lebeter, and our Chief Financial and Regulatory Officer, Chris Lopez.

In the call today, we will go over our quarterly results and then spend most of the call answering as many of your questions as time permits. There are also several slides that illustrate some of our points that we will address in a moment. This should be up on the webcast now, or if you're dialled into the call, you can also find them on Hydro One's website in the Investor Relations section under Events and Presentations.

Today's discussions will likely touch on estimates and other forward-looking information. You should review the cautionary language in today's earnings release and our MD&A, which we filed this morning regarding the various factors, assumptions and risks that could cause our actual results to differ as they all apply to this call.

With that, I'll turn the call over to our President and CEO, David Lebeter.

David Lebeter ***Hydro One Limited - President, CEO & Director***

Thank you, Omar, and good morning, and thank you for joining us on our third quarter earnings call. I would like to begin by acknowledging that today's National Indigenous Veterans Day in Canada, a day to acknowledge and commemorate the contributions and sacrifices made by the First Nation, Inuit and Metis soldiers who served our country. In addition, Remembrance Day is only a few days away. It is a day for us to collectively remember and honour those who died in military service or served and continue to serve our country during times of war, conflict and peace. It's easy to take the freedom we enjoy for granted, so we acknowledge the sacrifice that allow us to have a better and brighter future.

I also want to take a moment to reflect on the current global conflicts. As events unfold across the world, they can have a deep and profound impact on all of us. The news of innocent lives lost can be overwhelming. I want to extend my support and sympathy to those affected by these global events. In times such as these, it's important that we stand together and are there for each other.

Turning to the quarter. This morning, I will provide an update on our recent activities, and then Chris will take you through the third quarter financial results.

First, on safety, which is a focal point for Hydro One. I'm pleased to report that we are on track to improve on last year's outstanding safety results. Our recordable injury and high-energy serious injury rates continue to be below our annual targets, in large part due to the relentless pursuit of zero safety incidents by our employees. However, ensuring every employee returns home safely at the end of the day is a journey with no end. We must work to continue to adhere to our safety absolutes, carefully plan all work and look out for each other with continued focus, eliminating all serious injuries is achievable.

Turning to our assets. Hydro One continues to invest in the critical infrastructure to energize life and accelerate the adoption of sustainable electricity solutions that will contribute to Ontario's economic growth. Our investments in modernizing and expanding the grid are playing a pivotal role in Ontario's economic future. At the same time, we continue to advance our economic reconciliation efforts with Indigenous communities, ensuring they also benefit from our transmission investments. As an example of what Team Hydro can accomplish, the Chatham by Lakeshore transmission line will enter service in 2024, a full year ahead of schedule. By completing the project early, the company expects to reduce the cost of the project by approximately $15 million.

As a reminder, we broke ground on the line last quarter. This achievement is a result of the hard work and dedication put forth by our teams, working in collaboration with our partners, communities and with regulators. This result underscores Hydro's ability to deliver large, complex projects safely, on time and on budget.

Once complete, the line will provide clean electricity to support the growth in agri-food and manufacturing industries in Southwestern Ontario. The line will add approximately 400 megawatts of clean electricity in the region. Enough power to supply a city the size of Windsor. I am pleased with the efforts our teams put forth and the hard work that went into getting us to this point, ahead of schedule and under budget. Superior execution is a critical aspect of why Hydro One continues to be a transmitter of choice for the development, construction and operation of priority projects in Ontario.

As discussed in our second quarter conference call, the government of Ontario proposed the prioritization of the regulatory approval process for three transmission lines in Northeastern and Eastern Ontario to support the growing electricity demand. I'm very pleased to report that the government has declared three new line projects as priorities and has designated Hydro One as a transmitter responsible for their development. The new lines include the Mississagi to Third Line, an approximate 75 kilometre, 230-kilovolt transmission line between Mississagi Transformer station (in Wharncliffe)and the Third Line transformer station (in Sault Ste Marie).

The Hanmer to Mississagi Line an approximate 205 kilometere, 500-kilovolt transmission line between Hanmer Transformer Station (in the Greater Sudbury area) and Mississagi Transformer Station (in Wharncliffe) and the Greater Toronto Area East Line, an approximate 50-kilometre 230-kilovolt transmission line between either Cherrywood Transformer Station (near Pickering) or Clarington Transformer Station (near Oshawa) and Dobbin Transformer Station (in Peterborough).

The three new transmission lines will support the continued growth in our northern communities and will help facilitate the growing electricity demand in transportation, mining, steel and manufacturing industries in the northeastern and eastern parts of the province. We will further support the production of clean steel at Algoma Steel, furthering our efforts to help industries decarbonize and at the same time, contribute to Ontario's long-term economic growth.

As a reminder, First Nations have the opportunity to invest in a 50% equity stake in the transmission line components of the projects through Hydro One's Equity Partnership model. We are already collaborating on advancing the planning, development and construction phase of the projects.

On the distribution side, we continue to engage with local distribution companies to facilitate the consolidation within the sector. Consolidation isn't just about growth. For Hydro One, it's about energizing life in Ontario by helping communities achieve their goals, improving the value customers get from the distribution grid and lending to hand when others need it.

I am pleased to report that on November 7th, Hydro One announced an agreement with the Township of Chapleau, for the acquisition of Chapleau Hydro, a local electric distribution company, which serves approximately 1,200 customers. While small, the transaction is meaningful for those 1,200 customers in the township of Chapleau who will continue to have dependable electricity. Hydro One started assisting Chapleau Hydro this summer as it experienced challenges in continuing operations. We were happy to help. As the service territory is embedded within Hydro One's, we already have a local presence, and we already serve Indigenous communities and businesses on the outskirts of township.

With this transaction, Hydro One will leverage its deep local knowledge and its scale to ensure the residents and businesses of Chapleau have an electric system which meets their needs today and is ready for the future. Given these synergies, we believe the transaction will be socially and financially accretive. This transaction exemplifies Hydro One's willingness and capacity to step in and provide support across Ontario.

These successful outcomes are not possible without the dedication and coordinated efforts of our Hydro One family. Our employees are the heartbeat of our organization, and we recognize their invaluable contributions to our shared success. Along those lines, I'm pleased to report that the two collective agreements we reached with the Power Workers Union and one with the Society of United Professionals were ratified in the quarter. The conclusion of bargaining provides us the certainty in our labour costs over the next two years as we execute our strategic objectives. These agreements expire on September 30, 2025. I want to thank our respective teams for negotiating in good faith in search of solutions that meet the needs of employees, customers and Hydro One.

In other updates, we continue working with the telcos to advance the delivery of high-speed Internet to approximately 700,000 Ontario. We remain concerned that work packages are not being brought forward by the proponents as quickly as anticipated to meet the December 2025 completion deadline. Hydro One is prepared and has been for some time. We've made investments in labour and training, strengthened our supply chains, streamlined our joint use processes, relaxed standards, onboarded contractors and purchased materials in preparation of this initiative. We understand the importance of connectivity to everyday life for families and businesses, many of whom are our customers.

The spirit of helping is deeply rooted in our corporate culture and is a value our employees live every day. This past September was our annual Power to Give month. I'm thrilled to share that Hydro One employees raised over $2 million dollars in donations for more than 800 registered charities in Canada. This is a remarkable achievement and a record for Hydro One that will go a long way in helping those in need. While the giving in September is remarkable, it is typical of Hydro One employees who demonstrate their community spirit and generosity through donations and volunteer work throughout the year.

Recently, Hydro One joined an exclusive club of Canadian companies. In recognition of our commitment to reconciliation, we were awarded the Gold Level Progressive Aboriginal Relations certification by the Canadian Council for Aboriginal Business. Hydro One was recognized for its commitment to building lasting strong and mutually beneficial relationship with Indigenous communities. This is an advancement from the silver level certification we earned in 2020.

Our emphasis on economic reconciliation through programs like the 50-50 equity partnership model and building lasting partnerships with Indigenous communities has been instrumental in this award. At Hydro One, we are focused on building partnerships based on an understanding, respect, trust and sharing.

Finally, we are pleased to be recognized by Newsweek in its inaugural listing of the world's most trustworthy companies. The list was compiled after gathering 269,000 evaluations through interviews with 70,000 participants that consisted of customers, investors and employees across 21 countries and 23 industries.

With that, I will turn it over to Chris to discuss our financial results this quarter. Over to you, Chris.

Christopher Felix Lopez ***Hydro One Limited - Executive VP, Chief Financial & Regulatory Officer***

Good morning and thank you for joining us today.

I want to acknowledge and thank our teams for their hard work and dedication, allowing us to deliver on our promise to all stakeholders. It is this effort and the outcomes achieved by the whole team that enable us to be the builder of choice for transmission projects in our province. We're extremely proud to have been awarded the three priority transmission projects that David mentioned earlier. With these three lines, we continue to build a better and brighter future for all Ontarians.

In terms of our financial results for the third quarter, basic earnings per share was $0.60 compared to $0.51 in 2022. The key drivers for the change in earnings this quarter were: higher transmission revenues resulting from adjustments to Ontario Energy Board or (OEB) approved rates following the approval of the joint rate application or JRAP as well as higher monthly average peak demand. And lower income tax expenses primarily attributable to higher deductible timing differences compared to the prior year. These were partially offset by higher financing charges attributable to higher weighted average interest rates on the long-term and short-term debt and higher depreciation, amortization and asset removal costs primarily due to growth in capital assets.

Our third quarter revenue, net of purchase power was higher year-over-year by 1.1%. Transmission revenues increased 5.7%, primarily due to higher revenues resulting from OEB approved rates, coupled with higher average monthly peak demand, which increased 4.5%. The higher revenues were partially offset by net income neutral items, including cessation of the deferred tax asset (or DTA) recovery and normal course regulatory adjustments. Distribution revenues net of purchased power decreased by 4%, mainly due to the same net income-neutral items associated with the cessation of the DTA recovery and normal course regulatory adjustments. After adjusting for the net income-neutral items, the distribution revenues were essentially unchanged from last year.

On the cost front, operating maintenance and administration expenses decreased year-over-year by approximately 1%. The decrease was mainly driven by items that are either going to be offset later in the year or are net income neutral. On transmission, costs were higher by 4.7% due to the OEB approved recovery of historical cost deferrals, which are offset in revenue and therefore, net income neutral.

Distribution costs were lower by 6.4% due to higher storm restoration costs last year that were also net income neutral as they were recovered from third parties, as well as lower work program expenditures, including vegetation management. These reductions were partially offset by higher costs associated with the OEB approved recovery of historical cost deferrals, which are net income neutral as they are fully recovered in revenues.

Depreciation expense was higher year-over-year by 3.3%, primarily due to the growth in capital assets, which is consistent with our stated capital investment program as well as higher asset removal costs.

On financing, we saw a 17.2% increase in financing charges year-over-year due to a higher weighted average interest rate on our long-term debt and short-term notes. This was a result of long-term debt issuance executed in 2023 as well as increased rates on short-term notes.

During the quarter, Hydro One issued $425 million of floating rate medium-term notes due in 2026. This was yet another first, the first corporate issuance of green floating rate notes in Canada. Subsequent to the quarter, Hydro One issued an additional $400 million of medium-term notes due in 2025. Concurrent with the offering, the company executed a $400 million fixed to floating interest rate swap agreement. Both offerings were done under our sustainable financing framework.

In total, Hydro One has raised over $1.8 billion proceeds in 2023 to retire maturing debt and to support our capital investment requirements. We continue to be pleased with the stability of our balance sheet and robust investment-grade credit ratings that have allowed us to execute these financings. We are also happy to report that as part of their review process conducted in August, S&P Global Ratings revised its outlook on Hydro One Limited and Hydro One Inc. to positive from stable. S&P also affirmed the existing issuer and issue-level ratings on both entities.

Income tax expense in the quarter was $36 million compared to $100 million in the same quarter last year. The decrease in income tax expense was primarily due to a lower tax expense resulting from the cessation of the DTA recovery at the end of June, coupled with normal course regulatory adjustments, which as described previously, are net income neutral, as well as higher deductible timing differences compared to the prior year. These were partially offset by higher earnings adjusted for net income neutral items.

The effective tax rate this quarter was 9.1% versus the effective tax rate last year of 24.4%. It is important to note the higher deductible timing differences this quarter driven by the timing and class of assets in-serviced, which resulted in a lower effective tax rate are temporary. As such, we expect the deductible timing differences to revert in the fourth quarter and the annual effective tax rate to be consistent with our previous tax rate guidance of 13% to 16%.

Moving to investing activities. In the third quarter, we placed $699 million of assets in service, which is a 74.3% increase compared to the prior year. The increase in the Transmission segment was primarily related to timing of investments placed in-service for station equipment refurbishments and replacements, as well as timing of assets placed in-service relating to information technology, partially offset by major development projects put in service in the prior year.

In the Distribution segment, the increase was primarily related to the timing of asset placed in-service pertaining to the information technology initiatives, a higher volume of storm-related asset replacements, customer connections and line refurbishments and wood pole replacements, partially offset by a lower volume of station refurbishment and replacements. Assets placed in service also increased to the other segment, primarily due to the replacement of Acronym's information technology equipment.

Capital investments for the third quarter were $638 million, which is a 27.3% increase from the third quarter in 2022. Transmission capital investments increased 23.5% year-over-year primarily due to a higher volume of station refurbishments and equipment replacements. Distribution capital investments increased by 34.6% due a higher volume of storm-related asset replacements, higher volume online refurbishments and wood pole replacements, investments in the advanced metering infrastructure system 2.0 project as well as higher volumes of work on customer connections.

With the announcement regarding the revision of timing for Chatham by Lakeshore line, we have updated the future capital investment table to reflect the acceleration of timing and decrease in capital costs. The table does not include any future investments associated with the three Northeastern and Eastern Line that David discussed earlier today. Consistent with past practices, those lines and others that do not have estimates will be updated in the table once a Section 92 or Leave to Construct application has been filed.

As David mentioned, Hydro One reached an agreement with the Chapleau Public Utilities Corporation to acquire substantially all the business and distribution assets. The township of Chapleau is located around 200 kilometres from our Timmins operations centre. The acquisition equates to a purchase multiple of approximately 1.2x enterprise value to rate base on a current rate base of $1.9 million. The acquisition is conditional upon the satisfactory of customary closing conditions and approval by the OEB. We believe this transaction provides excellent value to both Hydro One and the customers of Chapleau Hydro. We are very pleased to join the Chapleau community.

We intend to file an application with the OEB for approval of the acquisition by the end of 2023 and expect to close the transaction in the second half of 2024 with integration completed by the end of 2024. We continue to engage with other local distribution companies and look for additional opportunities to facilitate further consolidation within the sector.

On guidance, we reaffirm our previous target of 5% to 7% earnings per share growth through 2027 on the normalized 2022 EPS of $1.61. As a reminder, the EPS growth range does not factor in growth from broadband, LDC consolidation, all the transmission lines that have been previously awarded but only have preliminary estimates or are pending approval, such as the Waasigan Transmission Line as well as any amounts from externally driven variance accounts. Finally, I am pleased to report that we declared a dividend to common shareholders of $29.64 cents per share.

I'll stop there, and we'll be pleased to take your questions.

QUESTIONS AND ANSWERS

Omar Javed ***Hydro One Limited - Vice President, Communications, Marketing & Investor Relations***

Thank you, David and Chris. We ask the operator to explain how they'd like to organize the Q&A polling process. In case we can't address your questions today, my team and I are always available to respond to follow-up questions. We ask that you limit your questions to one question and one follow-up. If you have any additional questions, we request you to rejoin the queue. Please go ahead.

Operator

(Operator Instructions) Our first question comes from the line of Robert Hope with Scotiabank.

Robert Hope ***Scotiabank Global Banking and Markets, Research Division - Analyst***

Good to see the recent transmission line enter service ahead of schedule and under budget. Can you just speak to what you're seeing with the supply chain, a bunch of third parties are still noting some tightness there and some inflation there. And then can you just maybe compare contrast that with your recent experiences and successes on the recent lines?

David Lebeter ***Hydro One Limited - President, CEO & Director***

Thanks, Robert. Supply chain is definitely tightening up. And what we find is we're ordering critical components further out. Now this is an advantage that Hydro One has perhaps over other utility companies in that we saw this starting at the beginning of the pandemic. So our procurement team reached out to our suppliers, diversified the supplier base, standardize the product mix, among other things, but also started securing manufacturing space further out. We've continued that as we've seen the increase in the electrification. So far, we haven't had any challenges reaching -- getting the critical equipment on site for any of the projects we're working on.

Robert Hope ***Scotiabank Global Banking and Markets, Research Division - Analyst***

And then just in terms of the three new projects that were awarded to you, any visibility on any incremental projects there? And when do you think you could see a Section 92 to better kind of scope out the timing and cost?

David Lebeter ***Hydro One Limited - President, CEO & Director***

You sound like me asking my team those same questions. They're working hard to get the detailed engineering finished to do the engagements that are necessary at the local communities, the Indigenous groups, partners and landowners so as soon as we can have the materials pulled together we can share that.

Operator

Our next question comes from the line of Dariusz Lozny with Bank of America.

Dariusz Lozny ***BofA Securities, Research Division - Research Analyst***

Maybe just starting on the distribution capital opportunity related to the build-out of broadband. Certainly, it sounds like you guys have done quite a bit of work and perhaps some investment ahead of time to be prepared. Can you comment on any impact on OM&A or capital associated with that?

And as part B to that question, certainly appreciate the 2025 timeframe that you're managing to. Just wondering if there's been any talk at all of that possibly getting pushed back, whether by amending the legislation or otherwise?

David Lebeter ***Hydro One Limited - President, CEO & Director***

Thanks, Dariusz. I'll start with the last question. First, no talk about amending that timeframe. It's critically important to people who live in rural Ontario that they have access to high-speed internet and all the parties are working to make sure we still meet that December 2025 deadline. Recently, I've been having meetings with the executives of some of the different telcos that have purchased that have participated and they're starting to ramp up and getting excited about this. So starting to feel a bit more positive on how this is moving forward.

In terms of your first question, no impact on our OM&A and capital programs at this point in time from the work -- the pre-work we've done to get ready. It's just set us all up for success over the next 2 years.

Dariusz Lozny ***BofA Securities, Research Division - Research Analyst***

One more, if I can. Just on the prospective LDC opportunity. We are and have been in a higher rate environment. Are you seeing perhaps an uptick in smaller LDCs that might be in sort of more difficult financial condition that would therefore open them up for a potential transaction? Or are you seeing more or less kind of the regular cadence.

Christopher Felix Lopez ***Hydro One Limited - Executive VP, Chief Financial & Regulatory Officer***

Dariusz, it's Chris here. As the higher interest rates for longer, coupled with the theme of energy transition and higher demand on capital, those 2 coming together, and they've both been increasing and have been now around for 12 months or more, we have seen an increase in activity. And Chapleau is a good example of that. There are others. Certainly, the pressure at the smaller end is higher. And then as you get to the larger LDCs, they have a few more options, but we're starting to see a lot more activity.

Dariusz Lozny ***BofA Securities, Research Division - Research Analyst***

Appreciate it and looking forward to catching up at EEI.

Operator

(Operator Instructions) Our last question comes from the line of Maurice Choy with RBC Capital Markets.

Maurice Choy ***RBC Capital Markets, Research Division - MD & Analyst***

If I could just start with the financing bit. And Chris, could you discuss your upcoming maturities to 2026. The rate at which the maturing debt are at and what you tend to borrow today? And maybe bigger picture to, seeing that your cost of capital is fixed for a duration that JRAP period, thoughts on how this might feed into your guidance and what tools you have in your financing tool box to offset any drag?

Christopher Felix Lopez ***Hydro One Limited - Executive VP, Chief Financial & Regulatory Officer***

Maurice, thanks for the question. Look, in the short term, not a concern. We've completed our borrowing for this year. As you'll know, that through JRAP, they factor in forecast borrowing rates for the first year. So it's all covered and we've met our requirements there. We've retained some flexibility because the last 2 were floating reissuances, which allows us to fix those as interest rates normalize over time as we believe will occur. In fact, in the last couple of weeks, interest rates in the long end, have dropped 50 to 60 basis points. So that was a fortuitous decision for us.

In the longer term, we don't see a big concern here, Maurice. The question we get a lot is what if interest rates stay at the current level throughout the entire period, it would still keep us within our current guidance. It would not take us outside of that. So we're quite comfortable that we have the ability to flex the way we finance, either short or long term. We can change the timing of that. We can go with any duration 2, 5, 10 or 30. So there are many options available to us to do that. In short, it's not going to change our guidance at this point.

Maurice Choy ***RBC Capital Markets, Research Division - MD & Analyst***

And just to be clear, you're able to stay within the 5% to 7% range without the potential bump up in Waasigan as well as the high-speed internet?

Christopher Felix Lopez ***Hydro One Limited - Executive VP, Chief Financial & Regulatory Officer***

Sorry, can you repeat that, Maurice, I didn't get that.

Maurice Choy ***RBC Capital Markets, Research Division - MD & Analyst***

You mentioned that you were able to stay within the 5% to 7% range if rates stay where they are. But you're seeing that without having to have any offsets from the Waasigan as well as high speed Internet. Is that correct?

Christopher Felix Lopez ***Hydro One Limited - Executive VP, Chief Financial & Regulatory Officer***

Correct. So we haven't updated our range. I think last time I said, Maurice said Waasigan got a Section 92, I think the question came and my response was that if Waasigan was approved at its rate and in service as planned, it would put us at the upper end of the 5% to 7% range. Any impact from interest rates or financing those projects would not take this outside that range.

Operator

Thank you. And that does conclude our Q&A session for today. I'd like to turn the call back over to Omar Javed for any further remarks.

Omar Javed ***Hydro One Limited - Vice President, Communications, Marketing & Investor Relations***

Thanks, Shannon. The management team at Hydro One thanks everyone for their time with us this morning during what is a busy period. We appreciate your interest and your ownership. If you feel you have any questions that weren't addressed on the call, please feel free to reach out, and we'll get them answered for you.

Thank you again, and enjoy the rest of your day.

Operator

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