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EDITED TRANSCRIPT

H.TO - Q4 2019 Hydro One Ltd Earnings Call

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PRESENTATION

Operator

Good morning, ladies and gentlemen, and welcome to the Hydro One Limited's Fourth Quarter 2019 Analyst Teleconference. (Operator Instructions] 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, Investor Relations at Hydro One. Please go ahead.

Omar Javed *- Hydro One Limited - VP of IR*

Thank you, Shannon. Good morning, everyone, and thank you for joining us. I am here in Toronto with our President and CEO, Mark Poweska; and our Chief Financial Officer, Chris Lopez. We'll provide some comments on our fourth quarter results and then spend the majority of the call answering as many of your questions as time permits. There are also several slides that illustrate some of our points we'll go over in a moment. They should be up on the webcast now, or if you're dialed into the call, you can also find them on Hydro One's website in the Investor Relations section under Events & 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 have 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 turn the call over to our CEO, Mark Poweska.

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Mark Poweska - *Hydro One Limited - President & CEO*

Thank you, Omar, and thank you to everyone for joining us today and for dedicating your time to review our year-end results. A reminder that if you don't get a chance to ask a question near the end of this call, please keep in mind that Omar and his team remain available to you. So after I review the highlights of the quarter, we will turn to Chris to review the financial results.

So I'm pleased to say that we closed the last quarter of 2019 on a high note. Our corporate strategy, which I outlined on our last call, was very well received by our many stakeholders, and we've already made concrete steps to implement our plan. Last year, we dug even deeper to find OM&A savings. Our operating costs, after we adjust for investor-related expenditures, decreased by approximately $50 million year-over-year. At this level, we've achieved, in nominal terms, a reduction in OM&A of nearly $92 million or approximately 8% since the IPO in 2015.

In 2019, we realized productivity savings of $202 million, representing 49.3% increase year-over-year. This now means that since 2015, our total productivity savings amount close to $0 5 billion. Given this strong operational performance and higher demand for electricity, I'm pleased to report that we will be sharing the fruits of our efforts with our customers. We will be returning approximately $20 million under the earnings sharing mechanism, which was envisioned within the incentive rate making regulatory construct. This sharing also highlights why we believe the regulatory environment is constructive, in line with both our and our customers' interest.

On the regulatory front, we received the decision on the motion to review and vary the ruling on the pension costs within the distribution rate application. Within the decision, the Ontario Energy Board clarified that the rationale of the cut was on account of overall higher OM&A cost. This overall reduction to OM&A is within the purview of the OEB, and we respect that mandate and our regulator. As such, we are not pursuing the appeal that is currently being held in advance with the divisional court. We will endeavor to offset this headwind in future years through our efforts to further productivity gains.

On that note, I welcome the announcement made by Minister of Energy of their intention to propose Mr. Richard Dicerni as the new Chair of the OEB Board of Directors. Mr. Dicerni chaired the OEB modernization review panel whose recommendations we and the electricity industry supported. Under his leadership, we hope for a period of continued constructive rate regulation in Ontario that helps our efforts to support Ontario's growth and our customers.

Consistent with our promises, strong project execution also led to annual capital investments of $1.67 billion in 2019, which is an increase of 5.8% from last year and in line with the plans that we put forward to the Ontario Energy Board. Our focus on customer has delivered positive results with our residential and small business customer satisfaction scores in our distribution business reaching 86% in 2019. This represents a 10-year high and an increase of 9.3% year-over-year. Our commercial and industrial customer satisfaction was also at an all-time high. In addition, we continue to see strong satisfaction scores with our transmission customers. While we saw a minor decrease in 2019 from 90% to 87%, we are confident that our strategy to become a trusted energy adviser to our customers will drive this score higher.

In 2019, we made a renewed commitment to build stronger relationships with the communities we serve through community investment, partnership and local customer engagement. Last year, our community investment program reached over 190 communities and provided safety training to over 200,000 youth across the province. Our work to support the indigenous economy through progressive procurement was recognized as an award from the Canadian Energy Association in the first -- in the fourth quarter.

We also continue to support the booming economy in the Leamington area with new electricity infrastructure. In the last quarter, we brought another transmission station online in that area, reflecting our commitment to the economic development of Ontario. These are just some of the ways we are becoming a trusted partner for our customers and communities we serve. We've also been building the grid of the future by using smart technologies to enhance and bolster the infrastructure. By the close of 2019, we had installed about 1,200 smart switches and fault indicators across our grid to reduce the number and length of power outages.

When in the last quarter of the year we did experience several large storms, we used our storm prediction tools to position our crews in the areas projected to be hit hardest. Our crews demonstrated their expertise and restored power safely and efficiently in the harsh conditions. This performance is evidenced by our 9.7% year-over-year improvement in Customer Average Interruption Duration index, also known as CADI.

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In October of 2019, we were once again recognized for our industry-leading expertise after sending crews to support Manitoba Hydro following a severe storm that caused record pot -- power outages in that province. At the end of last year, we were informed that the Edison Electric Institute would present us with our 10th award for emergency assistance and response. For the 5th consecutive year, Hydro One was recognized by Forbes in its list of Canada's Best Employers for 2020. We moved up in the rankings this year to become the top-ranked utility in Ontario and the third utility across Canada. This recognition underscores our commitment to creating an engaged workforce.

I would also like to welcome Susan Wolburgh Jenah to the Hydro One Board of Directors. We all will benefit from her exceptional experience, and I look forward to working with her. With her appointment, our Nonexecutive Board is now up -- made up of 50% women and 50% men, which is a testament to our values of diversity and inclusion, even at the highest levels of this company. We also ended the year with a strengthened executive team. We welcome David Lebeter as our new Chief Operating Officer. His extensive experience in both the utility and forestry sectors will prove to be invaluable as we execute on our strategy. Darlene Bradley is now serving in our newly created role of Chief Safety Officer reporting directly to me. The creation of this position on our executive team underscores our dedication to improving our safety culture at Hydro One.

We have set a clear direction and put in place the right leadership team to drive our plan forward in 2020. Investors will get a chance to meet the leadership team as well as their team members at our Investor Day on March 5 in Toronto. The event will showcase our progress on several fronts as well as give investors an opportunity to interact with the bench strength of the organization. I would like to thank our employees for the hard work and dedication that delivered the impressive results we achieved in 2019. Our annual report was released today and is available on our website. I encourage everyone to review it as it showcases the great effort that was made in 2019.

I would like to end my portion of this call on our dedication to safety. Earlier this year, we tragically lost one of our colleagues who passed away from injuries sustained on the job while doing forestry work. This is unacceptable to me. I am deeply committed to enhancing our safety culture and eliminating serious injuries at Hydro One. In Q4, Darlene Bradley, our Chief Safety Officer, launched a new frontline-led safety improvement team, which will combine employee feedback and industry best practices to determine the actions we need to take to ensure every employee goes home at the end of each and every day. I am very confident in the leadership team that we have in place and the entire team at Hydro One.

With that, I would like to pass it over to Chris.

Christopher Felix Lopez - *Hydro One Limited - CFO*

Thank you, Mark, and good morning, everyone. Before I get into the financial results, I, too, would like to welcome our newest team members to Hydro One at this exciting time for the company and our stakeholders. While 2019 was a year in which we refreshed our strategy and confirmed our commitment to Ontario, the one aspect that did not change was the fundamental model of this great business we operate. The business continues to be strong. We are pleased with the work our teams, which our staff and our partners have done to achieve the efficiency and productivity outcomes that you see in today's results.

As Mark mentioned, we ended the year on a strong note. In terms of the financial details, earnings per share and adjusted earnings per share in the fourth quarter increased to $0.35 compared to a loss per share of $1.18 and adjusted earnings per share of $0.30. For the full year, earnings per share was $1.30 and adjusted earnings per share was $1.54 compared to a loss of $0.15 per share and an adjusted EPS of $1.35 last year.

While our results are good, the comparability of the fourth quarter and even our full year results to the prior year require some adjustment. A significant driver of the year-over-year increase in earnings was the decision we received on the deferred tax asset, which resulted in a net income charge of $867 million in Q4 of 2018. In addition, we incurred a cost of approximately $140 million to terminate the Avista transaction in Q1 of 2019. So while the headline number of a year-over-year increase of $867 million in net income for the full year is significant, it does not accurately convey the whole story and reflect the operational performance of the business.

To evaluate the operational performance of the company, we will compare the adjusted numbers as presented in the financial statements. For the fourth quarter of 2019, net income was $211 million compared to $176 million in 2018. For the full year, net income was $918 million compared to $807 million in 2018. When we look at full year results, there were 3 main drivers of this performance. The first, with the decision we received on the distribution rate case that allowed us to book revenues for 2018 and 2019 under the new incentive rate based regulatory construct. The

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catch up revenue for 2018 alone, which was booked in the first quarter of this year, was approximately $85 million or $0.10 per share. The second was higher electricity demand in the distribution segment, partially offset by the lower transmission peak demand that combined drove total revenues net of purchase power up 3.6%. The third and final driver was a reduction in OM&A costs that Mark referenced earlier. We have reduced OM&A by approximately $50 million year-over-year on account of lower corporate support costs, receipt of insurance proceeds in relation to losses at the Finch, Longwood and Merivale stations and the repatriation of our call center that resulted in operational improvement. The higher electricity demand, coupled with an effective and disciplined cost control, has allowed us to share approximately $20 million with our customers in the distribution segment.

As Mark referenced earlier, we strongly believe the constructive incentive-based regulatory model aligns all stakeholders' interests to the benefit of our customers. And we are pleased to have our customers participate in our journey to become a leading utility in efficiency and productivity.

In terms of productivity, we continued our path to do more with less. We achieved over $200 million in productivity savings in 2019, an increase of approximately 49%, which puts our cumulative productivity gains, since the initial public offering, to over $450 million. This year, the increase was driven by further improvements in procurement and supply chain, reductions in our fleet and optimization of our corporate expenditures. Overall, 60% of productivity came from capital expenditures, while the remaining 40% was from OM&A.

Focusing on the fourth quarter itself, we saw a few key themes that help shape the full year results. In the Transmission segment, unlike the previous 3 quarters of 2019, average monthly 60 minutes peak demand for electricity was approximately 1.2% higher than the same period last year, which, you may recall, was in itself favorable. This, together with reduced OM&A on account of timing of work in stations and line maintenance as well as our vegetation management program, the receipt of insurance proceeds and lower corporate support costs, resulted in strong performance for this segment.

In the Distribution segment, weather, which included storm activity, was again similar to last year's fourth quarter. This resulted in similar levels of energy consumption. However, after accounting for earnings sharing with our customers and clarity on the pension decision in the fourth quarter, the resulting revenues net of purchased power cost were lower. On OM&A, lower corporate support costs and operational improvements due to the repatriation of our call center resulted in a slight reduction year-over-year.

Turning to the balance sheet. Our balance sheet remains strong, and the resulting savings from low interest costs continues to be a key factor in the provision of cost-effective services for our customers. In the fourth quarter, financing costs were lower by 5 7% year-over-year, as we did not incur the interest charges related to the convertible debentures that have been issued in conjunction with the Avista transaction. For the year, our interest costs were higher by $55 million as we issued additional loan and short-term debt at favorable rates and incurred higher merger-related financing costs compared to the prior year.

In November, we received 2 rating agency actions that highlight our continued balance sheet strength. First, S&P affirmed Hydro One Issuer and Hydro One Inc.'s Issuer and Issued Level credit rating at A minus and changed its rating outlook from negative to stable, citing a stabilized operating environment and our Ontario-focused strategy. Second, Moody's upgraded Hydro One Inc.'s long-term debt rating from Baa1 to A3 with a stable outlook, citing similar drivers.

Taxes in the fourth quarter declined versus last year due to the deferred tax asset ruling mentioned earlier and the enactment of the accelerated tax depreciation measures related to the federal and provincial budgets. Our effective tax rate for the quarter was 0.9%, which resulted in a 2019 effective tax rate for the year of negative 0.8%. While we have previously guided on a 2% effective tax rate for the year, the accelerated CCA, or capital cost allowance, values for the mix of assets placed in service was higher, resulting in a lower effective tax rate. Lower taxes are passed through to the customer in the form of lower rates with no impact to net income or our after-tax return on equity. Our effective tax rate over the next 5 years is expected to remain in the 6% to 13% range.

On the capital investment side, we had a modest increase in capital investment for the year of 5.8%, which was in line with our expectations and consistent with the capital forecast put forward to our regulator. You'll notice that the future capital investment profile for both segments has changed marginally. This is due to timing differences on our project planning and does not impact our projected rate base growth. The year-over-year comparison on assets placed in services is challenging due to the lumpy nature of the in-servicing of assets in 2018. In addition, storm activity was

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muted in 2019, which led to lower asset capitalization. Despite these minor fluctuations, rate base increased by approximately 5% year-over-year, which again was in line with our expectations.

While we are pleased with the financial performance this year, given the number of onetime items and demand impacts, we will be providing a normalized view of 2019 earnings at our Investor Day on March 5. We continue to be confident in our projections of 5% rate base growth translating to 5% earnings growth and 5% dividend per share growth.

On the regulatory front, as Mark mentioned, we received clarity on our motion to review and vary the pension decision. In this decision, the OEB clarified that the cut was made for the category of overall expenditures. The impact of this decision was a reduction of OM&A with a net income impact of approximately $0.03 per share. In 2019, this impact was offset by a 1% -- $0.01 per share reduction due to earnings sharing for a net impact of $0.01 per share on overall results. For the next 3 years, and until our next distribution rate application, we expect there will be a per year headwind of approximately $0.01 to $0.02 per share on account of this decision. Whilst challenging, we aim to manage the reduction in OM&A and capital expenditures through our productivity programs.

For the transmission rate application, we made our final submissions in January 2020 and expect the decision from the regulator in the first half of this year. As a reminder, this application will take our transmission business into incentive-based rate regulation through 2022. This is consistent with our distribution business. We also made our final submissions for the acquisition of Orillia and Peterborough in January 2020 and expect the decision sometime in the first half of this year.

Finally, even though we have reflected the impact of the OEB's decision with respect to the deferred tax asset in our financials, we filed an appeal with the divisional court which was heard on November 21, 2019. We made a strong case to the court and now await the decision.

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

Omar Javed - *Hydro One Limited - VP of IR*

Thank you, Mark and Chris. Shannon, could you please explain how you'd like to organize the Q&A polling process. Please go ahead.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Robert Kwan with RBC Capital Markets.

Robert Michael Kwan - *RBC Capital Markets, Research Division - MD & Energy Infrastructure Analyst*

Chris, I guess, you alluded a little bit that you're going to give, it sounds like a specific kind of normalized 2019 number, but I'm just wondering if you can walk through some of the puts and takes for '19 as we head into '20. You did talk about the $0.10 on the Dx true-up. Other things, can you just talk about what the insurance proceeds were in the fourth quarter of this -- Q4 '19 as well as heading forward on the pension side of things, is that going to be a year-over-year headwind? Or did you actually take the 2019 into the Q4 results as well?

Christopher Felix Lopez - *Hydro One Limited - CFO*

Yes. So the single largest one, as you mentioned, Robert, we reported $1.54. The single largest one is the distribution rate decision relating to 2018, which was $0.10, and there are a couple of other one-offs. Insurance this year was slightly higher, but we have insurance proceeds every year. So it's an ongoing result, and really that's compensating for losses that we booked in prior years. So that one is -- yes, it's one-off, and this year was

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slightly larger, and we'll give more guidance on that at Investor Day as to how to look at that. And there are 2 or 3 items like that, but nothing that is substantial.

Robert Michael Kwan - *RBC Capital Markets, Research Division - MD & Energy Infrastructure Analyst*

Okay. And how much was the insurance that was specifically in the quarter?

Christopher Felix Lopez - *Hydro One Limited - CFO*

Yes. In the quarter, insurance -- so over the year, so if I looked at year-over-year, we're in the $10 million to $15 million range different.

Robert Michael Kwan - *RBC Capital Markets, Research Division - MD & Energy Infrastructure Analyst*

$10 million to $15 million plus Q4 '19 versus Q4 '18?

Christopher Felix Lopez - *Hydro One Limited - CFO*

So in Q4, it was timed differently. So we've received all proceeds this year in Q4. So in Q4, it was closer to $19 million. But across the year, it was in the $10 million to $15 million range. So like I said, we do get recurring proceeds. This happens every year across our whole fleet. This time, it was timed to Q4.

Robert Michael Kwan - *RBC Capital Markets, Research Division - MD & Energy Infrastructure Analyst*

And then directionally heading into '20, other things to think about then, I think weather was a benefit net for 2019. Is that correct? And then you have an ROE headwind on Tx?

Christopher Felix Lopez - *Hydro One Limited - CFO*

Correct. So overall, we did very well. So as a reminder, on transmission this year, we did an inflationary application. So it wasn't an incentive-based application, so it doesn't have an ROE attached to it. But on our distribution application, you can see that we are sharing benefits with customers. So what that implies is that we have done very well this year. So a part of that is weather and a part of that is the cost control that we've highlighted.

Robert Michael Kwan - *RBC Capital Markets, Research Division - MD & Energy Infrastructure Analyst*

Got it. Okay. And if I can just finish on just the pension cost decision. You've set out why you decided to discontinue to appeal. Just wondering, is there a potential impact then of this being brought into the transmission proceeding or you're just not concerned that by not appealing it in the courts that and -- effectively accepting it for Dx, that it still wouldn't find its way into the Tx proceeding?

Mark Poweska - *Hydro One Limited - President & CEO*

Yes. It's Mark here, Robert. So the ruling from the motion review and very, really, what it did was it clarified the intention of the original decision, which was directly reducing our overall OM&A costs. So based on that we decided not to appeal. During the transmission rate hearings in that, this issue didn't get a lot of airtime during that process. So we don't expect any different outcome from the transmission filing.

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Robert Michael Kwan - *RBC Capital Markets, Research Division - MD & Energy Infrastructure Analyst*

And so have there been actually very specific behind-the-scenes kind of discussions with the OEB that kind of was just about the OM&A envelope and not -- it's not going to find it's way to Tx?

Mark Poweska - *Hydro One Limited - President & CEO*

No, we haven't had those behind-the-scenes discussions with the OEB. Our discussions with the OEB are all in the public forum.

Operator

Our next question comes from Andrew Kuske with Crédit Suisse.

Andrew M. Kuske - *Crédit Suisse AG, Research Division - MD, Head of Canadian Equity Research, and Global Co-ordinator for Infrastructure Research*

Maybe just following up on some of the OM&A-related questions. And, I think, Chris, you gave a bit more clarity on just the timing of some of the issues in the Q4. But maybe the broader question, when we think about the OM&A on transmission, just on a year-on-year basis, there's a pretty big step function downwards from the $409 million to the $355 million. Distribution, you've had a bit of a movement downwards in Q4 of '19 versus '18, a little bit drifting upwards on the year. When should we expect a step function downwards in just the distribution OM&A?

Christopher Felix Lopez - *Hydro One Limited - CFO*

Yes. So taking the distribution OM&A specifically, we manage our work program across the duration of the rate application, which is the 5 years. So what you're seeing in the distribution spend there is that we have -- due to mild weather from a maintenance perspective, we've been able to do more maintenance this year than we had planned. So we've gotten ahead of that program. So you can see some benefit of that coming through in future years on the Distribution segment. In relation to the Transmission segment, we pointed out quite a large gap there. Really, that was a function of -- we did the inflationary filing. So OM&A was reduced in this year in our filing that we put forward to the regulator, that program will go back to a more normal level in 2020, but that would also be recovered through rates, so -- with no net income impact. The benefits of insurance proceeds also flow to the Transmission segment.

Andrew M. Kuske - *Crédit Suisse AG, Research Division - MD, Head of Canadian Equity Research, and Global Co-ordinator for Infrastructure Research*

Okay, that's helpful. And then maybe just the broader question although this is -- given the improvements in OM&A and just productivity across the whole business, really since the IPO, does this wind up being a much more helpful calling card in the policy direction within the province for potential further consolidation or just other efficiency initiatives or incentive earnings in the future?

Christopher Felix Lopez - *Hydro One Limited - CFO*

Yes. I agree, Andrew. So it's just -- it's a further progression, an evidence of Hydro One continuing to transform to being an efficient and a productive utility. So when you compare our cost structure in the future and going forward, you can expect that structure to continue to improve. One of the items that have been highlighted in the past is, in some cases, compared to small regional utilities, our cost structure could be slightly higher. That gap is closing quickly. And we also, as you know, when we do our MAD applications for acquisitions, we can demonstrate approximately a 50% reduction in OM&A.

Operator

Our next question comes from Ben Pham with BMO.

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Benjamin Pham - *BMO Capital Markets Equity Research - Analyst*

Okay. Just with some of your productivity expectations the next few years, could you comment on where that's coming from? I know you've looked at IT, optimizing staff and whatnot. Can you talk about the main sources? And is it in transmission or distribution or both? And do you expect that to more than offset that $0.01 or $0.02 drag you've mentioned?

Mark Poweska - *Hydro One Limited - President & CEO*

Yes. It's Mark here. So the main areas that the productivity has come from, and we will continue to build on that going forward, are from supply chain sold through strategic sourcing, through maximizing repayment volumes, those types of things that you do in supply chain. And we've looked at certain categories so far and we've driven cost savings through those categories, and we'll continue to look at other categories of our spend and continue to drive similar savings going forward. We talked about the fleet optimization. So by putting telematics and technology on our vehicles, we've optimized the use of our vehicles as well as the size of our fleet. And then corporate costs, overall, we've had a reduction in overall corporate costs over the years. And our customer service this year, because we insource the call center, we had significant savings in the call center costs as well as we improved our customer service, and you can see that in our customer service stats. So we see, going forward, our ability within those segments to continue to drive these productivity savings as well as an increase in productivity of our field crews through better planning and execution of our work. So we do see a pretty good runway of our ability to continue the path that we've been on since we IPO'ed in 2015 of driving out this level of cost savings incrementally each year.

Benjamin Pham - *BMO Capital Markets Equity Research - Analyst*

Okay. And maybe can I ask a more detailed question. Can you comment on your realized ROE in both transmission and distribution, recognize there's some onetime items to factor in?

Christopher Felix Lopez - *Hydro One Limited - CFO*

Yes. So overall, in distribution, and we report this in April. So what I'll caveat with right now is that the actual calculation will be based on separate and distinct financial statements for distribution and transmission. So -- but the high level calculation that we have today is that the Distribution segment performed at approximately 10.9%, and really what that said is we share 50% of the benefit above 10% with ratepayers. That's why we can give back $20 million to $21 million to ratepayers next year. That's when it will go back to ratepayers. So a very good news story that incentive rate making is working and the company is performing as expected. On the transmission side, as I said, there was no calculation for ROE this year. But if you did a back calculation, it would be north of 9% ROE, which is consistent with the approved ROE that would have been sought if we had gone for a custom IR.

Benjamin Pham - *BMO Capital Markets Equity Research - Analyst*

Okay, that's great. And maybe just one last cleanup question. On the tax rate that's -- it is below what you've been guiding all year. So is it your -- if we take the adjustment on deferred tax asset sharing in CCA rate, we take that out of the equation, does that get to that 2% tax rate you guys been mentioning? Or is -- are you guys are coming a little bit lower than that?

Christopher Felix Lopez - *Hydro One Limited - CFO*

Yes. So we actually came in -- we recorded negative 0.8%. And there are 3 drivers of that. One was the deferred tax asset. The second one was the accelerated CCA. But remember, this year, we also had -- this year being 2019, we also had the tax shelter from the Avista costs. So that's what drove it to be negative. But going forward, we're guiding to a 6% to 13% range. So why did it go below 2% that we had originally thought, it's because when we actually did the year-end tax returns, which are just being done, we actually had a higher benefit from accelerated CCA. So that

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just made the tax here that was being provided from the government incentive was more than originally first calculated. Again, there is no impact to net income for us. It doesn't drive that bottom line. It doesn't change our return on equity. Any benefit from that gets deferred and returned to customers.

Operator

Our next question comes from Linda Ezergailis from TD Securities.

Linda Ezergailis - *TD Securities Equity Research - Research Analyst*

With respect to your 5-year outlook on the income tax rate, that's very helpful. But I'm wondering if you can give us some thoughts on what might drive a given year being at the bottom or the top of the range? Can we assume that it might be increasing over 5 years as you work through certain pools, so we might start at 6% and grow to 13% or might it be quite variable year-over-year?

Christopher Felix Lopez - *Hydro One Limited - CFO*

You're correct, Linda. It is going to go back to 13% over the long term. And the reason for that is in the early part of this accelerated CCA program, capital cost allowance, you get 3x the deduction on the capital expenditure and then it drops to 2 and then it disappears. So over time, the benefit from that program will disappear. So it will go from 6% to 13%. The other driver would be in years where we have higher net income. For example, we end up exposing higher variable income to higher tax rate, the 26.5%. So that could be another driver. But I'd expect it to start at the low end over the next 2 to 3 years and then go up towards the 13%.

Linda Ezergailis - *TD Securities Equity Research - Research Analyst*

Okay. And your transmission application, I'm wondering if you could give us some more color on the focus areas of interveners, yourselves and the OEB. Was there anything that was particularly contentious or surprising as you work through the hearing process?

Mark Poweska - *Hydro One Limited - President & CEO*

Yes. It's Mark here. So I would say that as we went through the hearing process that there was nothing unusual that we haven't heard in previous cases. In general, the transmission hearings are made up of quite sophisticated customers because of the source of where those customers come from on the transmission business. So I don't expect any outcomes different than what we've seen in the past because there was nothing really raised in that. Obviously, the form is there for us to justify the expenditures we need to make on the system, and we had good support from many of our interveners on the needs for those investments. They are focused on reliability of the system for their businesses and their needs. So we had quite a bit of support from interveners throughout. And I think we put a very good case together for the rationale behind the investments we need to make.

Linda Ezergailis - *TD Securities Equity Research - Research Analyst*

Okay. And I realize your unregulated business is not necessarily the focus and the largest part of your business. But I'm wondering if you could just help us understand some of the practical milestones and time lines related to growing it now that you've had a little bit of time to start thinking of implementing your strategy?

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Mark Poweska - *Hydro One Limited - President & CEO*

Yes. I'll start, and then I'll pass it over to Chris because Chris is actually managing that part of the business right now. But the unregulated areas that we talked about in our deck as well as in previous calls were around our telecom business, and we've already kicked off starting some new services in that business. It's through the LDC consolidation. And as you know, we're in front of the OEB for Peterborough and Orillia, and we're assessing where there may be some other opportunities and working with other communities on the possibility of consolidation there. And then the final one is in our Energy Management Services business, which we are working with some specific customers right now and some third parties to join them up to provide those types of services, in particular, trying to offset their peaks so that we can bring some of the cost of the services down for those people. And so I'll let Chris build on that.

Christopher Felix Lopez - *Hydro One Limited - CFO*

Yes. I think as you said quite rightly at the outset, Linda, it's a very small part of our strategy when we talk about growth in the business, 99% of it is going to come from our regulated business. So generic rate based reinvestment in the grid, transmission and distribution and LDC consolidation, are classified as the same. And then the other part that you're talking about, the unregulated piece, the -- that's not included in our guidance on 5% growth in earnings. So that would be in addition to that. And really, that's us optimizing our telecom business and then providing energy services to complex, large complex industrial and commercial customers, not to the residential sector. In terms of what you could expect there is no more than 1% in any 1 year. That's what I would see. In the first year, it's about building that business. And then thereafter, the objective there is to try and get an additional 1% growth for the next few years out of that business. We will provide more clarity and exactly how that might be done at Investor Day.

Operator

Our next question comes from Rob Hope with Scotiabank.

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

I was hoping you could add a little bit of color on kind of the tone or any incremental conversations you're having with local LDCs, just given the kind of the new vision of Hydro One as well as the cost containment? Are they more willing to engage in M&A discussions there?

Mark Poweska - *Hydro One Limited - President & CEO*

Yes. So it's Mark here. The -- we've reengaged with a bunch of the forms in Ontario, including the Ontario Electricity Association, but also one of them is the Electricity Distributors Association which we're now on the board there and we're at the table. And what I would say is, yes, people are recognizing the improvements that the Hydro One has made and the productivity and the things that we bring to the table that some of the local distribution companies can't bring on their own, and they see the value in things like our leverage buy and things like that, that we can bring to the table and drive out costs. And so I would say that there is an openness in that form to be looking at consolidation. I think everybody in the sector recognizes that we have to work together in the sector to drive out costs overall, and there is a lot of inefficiencies in the overall sector driven by the fragmentation. And so that is a driver overall for all of us. And in those forms, like I said, like the Electricity Distributors Association, there is quite an openness at that table to be discussing this.

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

All right. That's great. And then just a clarify question, clarification. The 10.9% achieved ROE that you mentioned for distribution, does that include the catch-up benefit of 2018 into 2019? Or is that more of a -- we'll call that a strong 2019, just given the weather and OM&A?

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Christopher Felix Lopez - *Hydro One Limited - CFO*

I would call that a healthy 2019. It does not include the catch-up revenue for 2018. That would be adjusted back to the 2018 calculation, and is a very small sharing in 2018 as a result. So we go slightly above 10% there, and we're going to share that benefit with ratepayers as well. That's included in the total amount being shared, it's about $21 million. So 10.9% does not include the 2018 catch-up revenue.

Operator

(Operator Instructions) Our next question comes from Mona Nazir with Laurentian Bank.

Mona Nazir - *Laurentian Bank Securities, Inc., Research Division - Director of Research and Transportation & Infrastructure Analyst*

My first question is just in regard to the team. With management additions and even a recent board member, I believe that you're now at full capacity. Is that true? Are there any other areas that need to be filled?

Mark Poweska - *Hydro One Limited - President & CEO*

Yes, Mona, there is one additional executive position that I'm in the process of recruiting for right now and that is the leader of our Planning, Strategy and Growth team. And really, they're the front end of our operating model, which is responsible for the asset management portion of our business as well as identifying where we have growth opportunities. Right now, Chris is looking after the growth portfolio, the intent is long-term to put it over to that executive once we hire. We are in the process of recruiting right now, and I'm optimistic that we have some really good candidates to choose from.

Mona Nazir - *Laurentian Bank Securities, Inc., Research Division - Director of Research and Transportation & Infrastructure Analyst*

Okay. All right. Perfect. So pretty stable, though?

Mark Poweska - *Hydro One Limited - President & CEO*

Yes.

Mona Nazir - *Laurentian Bank Securities, Inc., Research Division - Director of Research and Transportation & Infrastructure Analyst*

Okay. And my second question. I know that you touched on kind of the transmission OM&A and some of the one-offs and even going forward. But I'm just -- perhaps a different way to try to ask it is, in regard to the sustainability of OM&A levels, and you mentioned that it's down 8% from the IPO, what kind of annual reduction have you targeted?

Christopher Felix Lopez - *Hydro One Limited - CFO*

Yes. So I think generally speaking, we look to try and offset inflation. So that's -- it's not necessarily a reduction. It's offsetting inflation. We've gone ahead of that in some respects. What I will remind you all, though, in regards to the transmission application, that was a 1-year inflationary filing. So the costs in that were lowered. As a result, that is not sustainable. So those costs will go back up a little, I expect in the $15 million to $20 million range, but that will be recovered in rates. So there's no impact on net income. It was just a bridge year, if you like.

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Mona Nazir - *Laurentian Bank Securities, Inc., Research Division - Director of Research and Transportation & Infrastructure Analyst*

Okay. And then lastly, and this is just a clarification. I understand you're not pursuing an appeal with OEB related to the deferred tax asset. But did you say that you presented to the divisional courts at the end of November and you are awaiting that decision?

Mark Poweska - *Hydro One Limited - President & CEO*

Yes. Just to clarify, we are appealing the deferred tax asset decision, and it is in front of the divisional courts right now, and we're awaiting the decision from that. That's separate from the motion to review and vary of the OEB pension cost, which we decided not to appeal. So we are moving forward with the DTA process, and it is in front of the courts right now.

Operator

Our next question comes from Mark Jarvi with CIBC Capital Markets.

Mark Thomas Jarvi - *CIBC Capital Markets, Research Division - Director of Institutional Equity Research*

Maybe I'll just start with financing. Maybe this is for Chris, but you said you have commercial paper here. You've kind of taken up over $1 billion here. Just thoughts on that versus where the debt markets are and looking to term out over the next year?

Christopher Felix Lopez - *Hydro One Limited - CFO*

Yes. So Mark, each year, we look at somewhere between $1 billion and $1.5 billion depending on when debt sort of needs to be rolled over, and we'll be doing that same process this year. We don't have to come to market. We have fairly large credit lines. That said, we do see the market being quite accommodative at the moment. So I would anticipate that we would be doing something this year in that range.

Mark Thomas Jarvi - *CIBC Capital Markets, Research Division - Director of Institutional Equity Research*

Okay. And then kind of coming back, you guys talked a bit about the transmission in the last question here. But on the distribution utility, you have sort of offset inflation to sort of 1-ish, 1 5% sort of increase in OM&A a year. Do you guys think you can get to a level where you can actually get an absolute reduction as you look into 2020 or 2021? And views on that in terms of being able to sort of hit the upper end of the range of maybe 10% again on achieved ROE in 2020.

Christopher Felix Lopez - *Hydro One Limited - CFO*

Yes. I think -- so Mark, the drivers on achieved ROE, cost is one, the other is also demand. So those 2 things can drive the outcome. We look at our cost structure over the entire duration of the rate case, which is 5 years. So you will see it go up and down a little between years. This year, we did say we've accelerated some maintenance work from future periods. That's just a timing decision that we have, and that's because we could take advantage of good weather and the workforce being more productive. Over time, I would expect that we would continue to be able to offset inflation.

Operator

Our last question is from Jeremy Rosenfield with Industrial Alliance Securities.

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Jeremy Rosenfield - *Industrial Alliance Securities Inc., Research Division - Equity Research Analyst*

Just a little bit of a cleanup question. The sale of the Niagara line was recorded in the fourth quarter. I think it was mentioned as $12 million or something like that. Is that an after-tax number, Chris?

Christopher Felix Lopez - *Hydro One Limited - CFO*

The sale would have been a cost. So there was no profit on the sale of the Niagara line. So we finished it and we transferred ownership of it to First Nations at the cost of the line going in service. So there's no net income as a result of that transaction.

Operator

And our next question comes from Patrick Kenny with National Bank.

Patrick Kenny - *National Bank Financial, Inc., Research Division - MD*

Just with respect to the capital plan for transmission since filing the application last spring, wondering if there's been any incremental demand for investments from either the Leamington region from greenhouses or perhaps reinforcing some lines into the nuclear plants that now may be online for a little bit longer? Just curious if there could be any upside to the capital plan for Tx over the next few years, given the political support for these demand pockets?

Mark Poweska - *Hydro One Limited - President & CEO*

Yes. So the Leamington line actually didn't meet the full asks of the energy for that area. So that's a growing area, the growing area down in Leamington. So the new line that we'll build will provide about 600 to 700 megawatts. We do have a request for up to 1,500 megawatts of additional load in that area. So that may lead to additional investments there. That is the purview of the IESO, not of us, but we will continue to advocate for our customers in that area. In addition, the IESO released their planning outlook document in January, which is a 20-year forecast look at the province and growth. And it does show a slow and steady incremental demand in areas like transportation, agriculture and modest residential and commercial growth. So there is a growth of energy in these -- in the province as well as there is a capacity shortfall in the mid-2020s as a result primarily of the shutting down of some of the nuclear plants. So there is some draws and some needs on the system. The next step in that is for the IESO to do the regional planning, then we'll get more visibility into where they're seeing those growth and what those needs are, and we'll have a much better idea on whether there's incremental transmission required for those.

Patrick Kenny - *National Bank Financial, Inc., Research Division - MD*

That's great color. And then just on the balance sheet front here now with the rating agencies moving to stable outlook. Maybe just a quick refresh on target leverage metrics, FFO to debt, whatnot. And I guess, there's some puts and takes out there, but to the extent that you do have a little bit of excess cash to put to work, just wanted to confirm if that will be going towards accelerating the telecom initiatives or perhaps allocating elsewhere across the business lines?

Christopher Felix Lopez - *Hydro One Limited - CFO*

Yes. I think, Pat, what you're highlighting there, just to clarify, we don't necessarily target a specific credit rating. We target the capital structure that the OEB has approved for us, which is really 60% debt and 40% equity. So we stated that by chance has seen a very low volatility part of the rating agencies schedule, which says that we'll have an FFO of somewhere in the 10% to 12% range, and we're at the upper end of that right now, FFO to debt. So you do have some capacity. In terms of our discipline in where that capital goes, number one, it should go to regulated assets, transmission or distribution. If there is some excess capacity on our balance sheet, we can look at the opportunities in our telecom and other

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business. Again, that is more constrained by -- we still want our business to be no less than 90% regulated T&D. So it's always going to be the major part of our business, and you will not be seeing growth anything more than 1% per year from any other segment. Therefore, there is no real need for capital in those businesses.

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 - VP of IR*

Thank you, 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 have any questions that weren't addressed in the call, please feel free to reach out, and we'll get them answered for you. Thank you, again, and enjoy the rest of the 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.

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