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H.TO - Q2 2017 Hydro One Ltd Earnings Call

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PRESENTATION

Operator

Good morning, ladies and gentlemen, and welcome to the Hydro One Limited Second Quarter 2017 Results Investment Community Teleconference. (Operator Instructions) As a reminder, this call is being recorded.

I would now like to introduce your host for today's conference, Omar Javed, with the Hydro One management team. Please go ahead, sir.

Omar Javed

Good morning, everyone; and thank you for joining us. I am here in Toronto with Hydro One's President and CEO, Mayo Schmidt; our Senior Vice President of Finance, Chris Lopez; Greg Kiraly, our Chief Operating Officer; Paul Barry, our Executive Vice President of Strategy and Corporate Development; and Ferio Pugliese, our Executive Vice President of Customer Care and Corporate Affairs. We'll provide some brief comments on our second quarter results and then spend the majority of the call answering as many of your questions as time permits. There are also several slides, which illustrate some of the points we'll go over in a moment. They should be up on the webcast now; or, if you dialed into the teleconference you can also find them on Hydro One's website in the Investor Relations section under Events & Presentations. As the discussion this morning will likely touch on estimates and other forward-looking information, you should review the cautionary language in today's earnings release and our quarterly 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 will turn the call over to Mayo Schmidt.

Mayo M. Schmidt - *Hydro One Limited - CEO, President and Director*

Thank you, Omar; and good morning, everyone. As you are aware, on July 19, we announced the acquisition of Avista Corporation, a high quality strategic transaction to purchase, a market leading transmission and distribution utility headquartered in Spokane, Washington. We're very excited about the opportunities this acquisition creates to combine and leverage the strengths of 2 high performance companies to create additional value for our shareholders. I would like to talk to you more about this transaction in a moment, but first I'd like to highlight the achievements and results of the quarter. We have continued to focus our efforts on cost-saving initiatives and operational improvements as we manage our major influences in our business. The 3 most impactful factors affecting results were unseasonably mild weather and multiple storms, the time required for the Ontario Energy Board to process the decision on our transmission rate filing and a reduction in the regulatory allowed ROE associated with lower interest rates. While these factors are outside of our control, we have made good progress on a number of initiatives to effect the outcomes over which we have control. Some highlights of the quarter include our continued demonstration of our extraordinary storm response capabilities to turn the power back on. Our crews worked around the clock to restore power during multiple heavy storms in this quarter. They responded to 6 significant storms affecting over 580,000 customers in total, working through difficult conditions to keep the lights on for our communities across the vast province of Ontario. We also fully launched on a timely basis Ontario's Fair Hydro Plan, we worked hard to successfully update our backend monthly bill, meaning an average annual savings of about [CAD 600]. Hydro One's transformation to a customer-focused and commercially oriented organization continues to generate positive results and garner strong praise for our employees and customers. The strength of our senior leadership team put in place last year has significantly enhanced our executional capabilities and we are seeing positive results. We have successfully implemented innovative ideas, such as the Move-to-Mobile program launched in April that has now been fully rolled out across the province and has provided over 2,000 staff with improved processes and tools that ultimately enhance customer service and drive down per unit cost. At the same time, we are making real improvements in planning and execution around capital deployment, which enables us to meet our capital program targets with precision and accuracy. In 2016, our teams executed on our transmission capital program with precision and achieved targets that were set out and agreed to by the OEB. Over the past quarters, we have continued to see strong execution on a number of early stage initiatives, which we profiled recently that all served to improve our customer experience, while reducing our service and bad debt costs. These include continued rapid uptake by customers in the company's enhanced paperless billing service, customized usage alerts and billing arrival notifications. We now have well in excess of 50,000 residential and small business customers already enrolled and this number is growing quickly. Our teams are tracking to deliver over 150,000 customer enrollments by the end of the year, which amongst other things, serves to reduce our billing and postage costs. I'm also pleased to report to you that billing accuracy continues to surpass the Ontario Energy Board's requirements and is the highest in the company's history at 99.4%. Furthermore, our receivables are coming to trend down and are now at stable levels. We have also extended our Winter Relief program by an additional month, further enabling us to help our customers currently in difficult financial positions move on the payment programs that they can afford while helping enroll them in government support programs, for which they might qualify. This has helped us to achieve enhanced customer satisfaction and savings for the company by reducing call center and collection costs all without increasing receivable levels. These initiatives are all specific examples of our ongoing focus on creating incremental improvements in customer satisfaction, while at the same time streamlining our operations. We also continue to champion capital programs with the Ontario Energy Board to ensure we are maintaining reliability in the system through appropriate investments and are approved to do the things necessary to continue to provide additional value for our customers, while lowering our costs. The work being done to transition both transmission and distribution businesses to an incentive-based regulatory construct will benefit both customers and shareholders alike. We are well underway leading customer consultations and meeting the requirements associated with the 5-year incentive rate-setting mechanism or IRM filing for our distribution rate application submitted on March 31. For the Transmission segment, we are expecting to receive a decision on our rate filing for the 2017 and 2018 during the third quarter. At the same time, we are already working preparing the planned 5-year IRM filing in that segment early next year. We intend to continue to invest in rate base to drive earnings in both our transmission and distribution businesses. I would like to now take the opportunity to provide an overview of the Avista transaction announced on July 19 and briefly identify areas of interest to our investors. In addition, we've provided supporting information and the related rationales and strategic benefits in the deck associated with today's second quarter results. We utilized conservative leverage and a fully funded equity structure in our acquisition of Avista. Investor demand for the convertible debentures offered in our CAD 1.4 billion bought deal was oversubscribed with strong demand from both retail and institutional investors. The securities sold out with an extremely short period, a great testament to the high level of investor support that we received on the Avista transaction, which is truly a historical achievement for Hydro One. Locking in our equity portion, we will be able to realize mid-single-digit accretion in the first full year post close, while retaining a strong investment-grade rating for Hydro One. Further, we anticipate an improvement in credit ratings at Avista. This is a compelling transaction that brings together 2 industry leading regulated utilities with over 230 years of collective operational experience as well as shared corporate cultures and values. I'm very impressed with the team that Scott Morris has assembled and Scott's strong leadership, while we look forward to collaborating on our respective best practices, including bringing Avista and Hydro One's strong cultures to a North America footprint. The combination creates one of North America's largest regulated utilities with over CAD 32 billion in assets and a leader in electricity transmission and distribution as well as natural gas local distribution businesses. Through the transaction, Hydro One will expand in the complementary and diversified regulated assets, inclusive of natural gas local distribution, this expansion is a natural progression for Hydro One and will allow us to increase regulated earnings in a constructive regulatory jurisdiction. Collectively Hydro One and Avista will provide safe and reliable electricity and natural gas services for more than 2 million retail and industrial customers and holds assets throughout North America, including Ontario, Washington, Oregon, Idaho, Montana and Alaska. This transaction will not resolve their workforce reductions. We anticipate driving efficiencies through enhanced scale, innovation, shared IT systems and increased purchasing power, which will provide cost savings for customers and continual improvement in customer service.

Delivering value to customers is a core focus for both Hydro One and Avista, together we are stronger. I would like to emphasize our collective commitment to providing customers with the best possible experience. The transaction is accretive to EPS and gives us further headroom for

We do anticipate a closing date in the second half of 2018. On a total enterprise basis, we will become a Top 20 North American investor-owned utility. In summary, Avista and Hydro One are highly complementary. This transaction is a reflection of the discipline and collaborative approach both leadership teams undertook to efficiently and effectively build shareholder value by coming together to unlock the full potential of our collective strengths.

And with that, I'd like to turn the call over to Chris Lopez, for some additional color on the financial results. Chris?

Chris Lopez

Thank you, Mayo; and good morning everyone. Turning to the second slide, our second quarter revenue, net of purchased power, was lower by 2.8% year-over-year. This is reflective of a few exogenous factors. First, the decision on our 2017-18 transmission filing made on May 31, 2016 is anticipated in the near term. As a result, the increase in revenue associated with our planned capital and maintenance spend for the current year will be realized once a decision has been received since it is expected to be retroactive to January 1, 2017.

We anticipate recognizing the catch-up through revenues expended improving the system during the first, second and third quarters in the third quarter of this year.

Second, as Mayo mentioned, milder weather coupled with spring storms resulted in weak demand and moderate increase in costs. The mild weather in the second quarter of this year impacted Ontario's peak demand in the transmission segment. Additionally, our considerable effort to restore power to 580,000 customer homes and businesses, due to multiple spring storms, while greatly appreciated, affected our costs in the distribution business.

Lastly, as a reminder, the OEB- approved allowed return on equity was formulaically adjusted downward late last year, reflecting the prevailing interest rate at that time. The allowed ROE declined from 9.19% in 2016 to 8.78% in 2017, which resulted in lower earnings to both the distribution and transmission segments. Since then , these rates have been steadily increasing. If we were to calculate the ROE today based on the formulaic mechanism, which includes the current long-bond rates and utility spreads, the ROE would be approximately 9%.

On the OM&A front, costs increased by 4.6% from last year as a result of the previously mentioned higher storm restoration costs and the acquisition of Hydro One's Sault Ste. Marie, formerly known as Great Lakes Power in the fourth quarter of 2016. We continue to offset these costs with the operational improvement initiatives that we discussed earlier.

Below the operating cost line, the higher financing charges were the results of an increased weighted average long-term debt portfolio including long-term debt assumed as part of the Hydro One Sault Ste. Marie acquisition and higher depreciation due to rate based growth in 2017.

Moving over to investing activities, assets placed in service are up CAD 42 million for the first 6 months, compared to the same period last year. While we placed CAD 337 million of assets into service this quarter, it is marginally down on a year-over-year comparison, as we had successfully placed two major local area supply projects: Guelph Area Transmission Refurbishment and Toronto Midtown Transmission Reinforcement project during the second quarter of 2016. These investments were further augmented by completion of the previously mentioned, Move-to-Mobile wireless field automation platform, which has equipped our field employees with wireless tablets connecting them and the company's core operating systems.

Our overall year-on-year capital investments decreased by 2.6% in the second quarter. Investment in the Transmission segment increased by 5.9%. The largest driver of this increase was the work on the Leamington Transmission Station project, to address the electricity needs in the Windsor and Essex counties. The Capital Project Execution program is an area that has been enhanced over the last year and was the primary reason for achieving the planned capital expenditures, and assets placed into service in 2016 with accuracy and precision.

application, which resulted in a change in the average annual impact on distribution rates over the 5-year term of the rate application from an increase of 3.7% to an increase of 3 5%.

In addition, the productivity and stress factor has been revised from 0.6% to 0.45%. This represents a positive outcome for both ratepayers and shareholders alike. On the transmission side, as mentioned earlier, we are expecting a decision from the OEB in the third quarter associated with the 2017-18 rate application that we filed back on May 31, 2016. As a reminder, this was a 2-year filing and the next transmission filing, which we expect to make in late first quarter next year, will be a 5-year rate filing under the OEB's incentive regulatory model for the 2019 to 2023 term.

In terms of financial strength, as you see on slide 7, we continue to have a very strong balance sheet with conservative leverage. Our weighted average cost of debt is low at 4.3%, our redemption schedule is fairly smooth with an average term of 15.4 years. And we also have significant liquidity. On July 19, 2017, S&P and Moody's affirmed the A level credit rating of Hydro One Inc. and S&P affirmed its rating of Hydro One Limited.

Both firms revised their outlook to negative from stable as a result of the pending Avista acquisition. Our commitment to a strong balance sheet allows us to maintain a conservative cost of capital and provide substantial strategic benefit towards the organic and inorganic growth of the company.

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

Omar Javed

Thank you, Mayo and Chris. Before we ask the operator to explain how she'd like to organize the Q&A polling process, I'd like to note that we understand a large majority of the sell-side research analysts that cover Hydro are currently restricted on their coverage in light of the convertible debenture offering we recently announced associated with the Avista transaction. Accordingly, we expect there will be fewer questions than we usually receive on these quarterly calls. So with that please go ahead, Christine, and explain how the polling process will work.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question is from the line of Robert Catellier of CIBC Capital Markets.

Robert Catellier - *CIBC World Markets Inc., Research Division - Executive Director of Institutional Equity Research*

Hi, good morning. I wonder if you could start by talking about the dividend. So as you know, there was no specific announcement that was made with the Avista acquisition but the payout ratio guidance was maintained. So can you give us a little bit more color on what the intentions might be for the dividend at the close of that acquisition? So what I'm thinking is, is there a possibility of an increase at the close or would you consider a larger annual increase once you start to realize the expected synergies?

Mayo M. Schmidt - *Hydro One Limited - CEO, President and Director*

Hi, Robert. Mayo. The Board will be reflecting on that. We have about 12 months anticipated plus or minus to get to close. So I think they are certainly going to take that under consideration but the intent certainly is to maintain the 70% to 80% focus that we have today. We certainly take your point and it will be discussed with the Board at the time, I guess, over the next coming months -- next coming quarters.

Okay. And just on the change of the productivity factor, can you walk us through what's that decision in the distribution rate case?

Mayo M. Schmidt - *Hydro One Limited - CEO, President and Director*

I'm not sure, Robert, I understand your question. So you are talking about the DX rate case and the productivity and [and terms we are looking for]?

Robert Catellier - *CIBC World Markets Inc., Research Division - Executive Director of Institutional Equity Research*

Yes, the productivity factor that was revised from 0.6% to 0.45%.

Chris Lopez

Robert, it's Chris Lopez here. Yes, so, in doing the green sheet update, or blue sheet update that we do, we reflect on a number of items. And what we reflect on there is, we've already included a number of productivity improvements in our base numbers that have gone into the application. So 0.6% stress factor is for those entities that require additional savings to get to a long-term average that's within the average of the industry. And we believe that we don't need the 0.6%, we need 0.45% to achieve that same long-term average.

Robert Catellier - *CIBC World Markets Inc., Research Division - Executive Director of Institutional Equity Research*

Okay. And then my final question is on the rate base CAGR. I noticed there was a change in the timeline for some of the top transmission projects, notably the Lennox Circuit Breaker replacement, which was moved to 2023. That's outside the 5-year CAGR period. Yet the rate base CAGR is unchanged. So could you just walk us through how we should be looking at the interplay of those 2 items?

Chris Lopez

Robert, Chris again. That would be 1 item. We approach our capital spend profile over the 5 years as a wholesale, so the CAGR that you're seeing today reflects the current rate cases that are in front of the OEB and our current long-term business plan. So adjusting for one-off projects, we don't update the CAGR, but we would expect the CAGR to still stay within that range.

Robert Catellier - *CIBC World Markets Inc., Research Division - Executive Director of Institutional Equity Research*

So, you have other projects that could possibly make it up?

Chris Lopez

Yes.

Operator

Our next question is from Linda Ezergailis of TD Securities.

Just some questions on your cost, your OM&A is up CAD 12 million year-over-year. I'm wondering if you could help us understand how much might be related to the labor agreement that was effective May 1, and how much might be related to storm costs and maybe other timing differences as well?

Chris Lopez

Hi, Linda, Chris Lopez. Yes, so the two largest items that are affecting that CAD 12 million increase are the costs associated with storm restoration and the second item is the acquisition of Sault Ste. Marie that was not in our numbers last year at the same period. So those 2 items together make up about 80% of the cost increase.

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

Okay. And can you just as a follow-up walk us through the major attributes of your labor agreement and how that might affect your OM&A over time or is there not supposed to be much of an increase?

Mayo M. Schmidt - *Hydro One Limited - CEO, President and Director*

Yes, I don't think there's really any update to that. I mean, we certainly look at annual changes year-to-year on our employee costs. However, there's nothing anticipated out of the ordinary course, it's just sort of looking at the material cost of living, but I think you'll see that pretty steady.

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

Okay, that's helpful. And just to understand the quarter a little bit better as well from a revenue perspective. Can you give us loosely some estimate of the effects of mild weather perhaps on revenue in the quarter?

Chris Lopez

Linda, Chris Lopez here. So the revenue difference that you see there, about half of that was made up of mild weather and half of that was the ROE adjustment.

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

And is that revenue net of power costs?

Chris Lopez

Yes.

Operator

Thank you. I'm not showing any further questions at this time. I'd like to turn the call back over to Omar Javed for any further remarks.

Thank you, Christine, the management team here at Hydro One thanks everyone for investing your time with us this morning during what we know is a busy period. We appreciate your interest and to the extent you have any questions that weren't answered, please feel free to reach out and we'll get them answered for you. Thanks 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.