

**DOMINION BOND RATING SERVICE LIMITED -  
HYDRO ONE INC.**

**6 SEPTEMBRE 2000**

# Hydro One Inc.

(formerly Ontario Hydro Services Company Inc.)

Current Report: September 6, 2000

**RATING**

<u>Rating</u>	<u>Trend</u>	<u>Rating Action</u>	<u>Debt Rated</u>
R-1 (low)	Stable	New Rating	Commercial Paper

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RATING HISTORY (as at Dec. 31)	<u>Current</u>	<u>1999</u>	<u>1998</u>	<u>1997</u>	<u>1996</u>
Commercial Paper	R-1 (low)	NR	NR	NR	NR

**COMMENTARY**

DBRS is assigning a rating of R-1 (low) with a Stable trend to the commercial paper program of Hydro One Inc. ("Hydro One"), based on the following considerations. (1) The capital structure is favourable, with an initial 56% debt-to-equity ratio that is comparable to private sector utilities, and which allows for reasonable coverage ratios. (2) As a regulated utility, earnings and cash flows should be relatively stable. While capital expenditures over the next few years will increase materially to address an asset maintenance backlog that had been deferred by the former Ontario Hydro, internally generated cash flows are expected to be largely adequate, even after dividend payments. External financing needs will be material, however, given a

relatively heavy debt refinancing schedule over the next few years. Financing requirements will also be strongly influenced by the potential acquisition of municipal electric utilities. Acquisitions could pressure key debt ratios as DBRS does not expect the Province to make any further equity contributions. Other challenges Hydro One must contend with include: (1) Uncertainty with respect to the transition towards operating as a commercially viable entity. This will require a significant change in culture at Hydro One. (2) Hydro One is now subject to regulatory overview, and future earnings will be sensitive to interest rates through the approved ROE.

**RATING CONSIDERATIONS**

Strengths:

- Strong business franchise based in Ontario
- Regulation ensures earnings and cash flows remain relatively stable
- Realistic capital structure initially set at 56% debt-to-equity ensures reasonable coverage ratios
- Potential for material improvement in operating efficiencies through rationalization

Challenges:

- Uncertainty during transition to commercially viable entity: significant culture change required
- Subject to regulatory overview / future earnings sensitive to interest rates through approved ROE
- Material capital expenditures required to address asset maintenance deferred by former Ontario Hydro
- Lack of access to public equity market: key debt ratios could come under pressure

**FINANCIAL INFORMATION**

	Industry Avg*	12 Mos.	For years ended December 31			
	<u>1999</u>	<u>1999</u>	<u>1999</u>	<u>1998</u>	<u>1997</u>	<u>1996</u>
Fixed Charges Coverage (times)	2.00	2.45	2.45	1.46	1.50	1.64
Net Debt in the Capital Structure	62.4%	53.3%	52.1%	71.6%	75.0%	75.9%
Cash Flow/Total Debt (times)	0.14	0.14	0.15	0.09	0.09	0.11
Cash Flow/Capital Expenditures (times)	1.23	1.16	1.48	1.51	1.86	2.23
Approved ROE	10.09%	9.88%	9.35%	-	-	-
Operating Income (\$ millions) (before extras.)	-	982	997	829	888	973
Net Income (\$ millions) (before extras.)	-	383	422	270	304	383
Operating Cash Flow (\$ millions)	-	674	713	580	538	673
Electricity Sold (Distribution) (GWh)	-	-	18,100	18,300	18,800	18,600
Electricity Throughputs (Transmission) (GWh)	-	-	144,100	143,000	144,800	143,000

(1) 1999 consists of 9-mos. Hydro One + 3-mos. allocation of Ontario Hydro results. 1996-8 is an allocation of Ontario Hydro results that reflect the operations of Hydro One.

\* DBRS industry average for Canadian gas distributors.

**THE COMPANY** Hydro One Inc. (formerly Ontario Hydro Services Company Inc.), one of the successor companies of the former Ontario Hydro, holds and operates transmission and distribution assets based in Ontario. The Company is wholly owned by the Province of Ontario. Debt issued directly by Hydro One Inc. is not guaranteed by the Province.

**PRINCIPAL AMOUNT** Limited to \$750 million.

## RATING CONSIDERATIONS

**Strengths:** (1) Hydro One's franchise area is among the fastest growing in Canada. Transmission operations cover virtually all of Ontario. The distribution/retail franchise is somewhat less attractive as it includes a large geographic area (basically most of rural Ontario outside major urban centres) with a low population density/high cost of service. (2) The Company is a regulated utility, which ensures a relatively stable and consistent level of earnings. Hydro One has a monopoly in terms of transmission services across the province, and distribution services throughout most of rural Ontario. The relatively high cost of retail distribution services (to rural customers) makes the region less attractive to competitors.

(3) Hydro One has a realistic capital structure, with the initial debt-to-equity ratio set at 56% (preferred shares treated as common equivalents), which is comparable to that of private sector utilities. This ensures that coverage ratios are reasonable and are expected to remain above 2 times. The Company has mainly fixed-rate, Canadian dollar debt. This minimizes currency, interest rate and liquidity risk.

(4) The Company is in a good position to improve operating efficiencies, as it begins to rationalize distribution and transmission activities. The process has begun with a voluntary retirement program that was essentially completed on May 1, 2000.

(5) There are significant opportunities for growth in distribution operations, as the municipal electric utilities ("MEUs") have begun to merge. Many of the 221 rural-based MEUs are too small and fragmented to be efficient and Hydro One is in a good position to rationalize many of them, attaining significant synergies in the process.

**Challenges:** (1) Uncertainties exist with respect to the transition towards operating as a commercially viable enterprise. The transition will require a significant

adjustment in culture at the Company, and will likely take some time to fully implement.

(2) The Company is subject to regulatory oversight, which represents an additional level of bureaucracy. Potential does exist, however, for the introduction of light-handed regulation, which would reduce the regulatory burden.

(3) Future earnings will be tied to interest rates via the approved return on equity. Set at 9.35% for 1999 and 9.88% for 2000, the approved ROE for 2000 is somewhat low compared to other alternative investments, but comparable to other Canadian investor-owned utilities.

(4) Given the deferral of asset maintenance by the former Ontario Hydro, Hydro One's capital expenditures are expected to increase materially over the next few years as it addresses the required maintenance backlog. However, internally generated cash flows should be adequate to meet these funding requirements, even after dividend payments to the province.

(5) DBRS does not expect the province to make any further equity injections. Key debt ratios and balance sheet strength would come under pressure if internally generated cash flows are insufficient to finance growth and/or funding requirements.

(6) The Company has a relatively heavy debt refinancing schedule over the next few years. New debt issues will not be guaranteed by the Province of Ontario, although it remains the sole owner of Hydro One.

(7) The distribution franchise (largely rural Ontario) has a high cost of service due to its low population density. Electricity rates have historically been subsidized, a process that is expected to continue indefinitely.

(8) Rationalization of Ontario's municipal electric utilities will likely create a period of instability for distribution operations as this process continues, and could increase competitive pressures in retail sales when the market opens up sometime during 2001.

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## THE RESTRUCTURING OF ONTARIO HYDRO

Under the industry restructuring which became effective April 1, 1999, five separate entities were created from the former Ontario Hydro. (1) Ontario Power Generation Inc. (OPG), which holds and operates all the generating assets. (2) Ontario Hydro Services Company Inc. (now Hydro One Inc.), which holds and operates all the transmission and distribution assets. (3) Ontario Electricity Financial Corporation (OEFC), which is responsible for managing and retiring the outstanding debt and certain other liabilities of the former Ontario Hydro. (4) Independent Electricity Market Operator (IMO), a non-profit corporation that will perform the central market operating functions. (5) Electrical Safety Authority (ESA), a non-profit corporation that will conduct electric installation inspections. The financial restructuring, which primarily involved OPG, OHSC (now Hydro One) and OEFC was effected as follows: The \$38.1 billion in outstanding debt and liabilities, (including non-utility generation and past unfunded nuclear liabilities) as at April 1, 1999, of the former Ontario Hydro were assumed by OEFC. These debt

obligations will retain the pre-existing government guarantee, and as they mature, they will be either retired or refinanced by OEFC with the government guarantee. The combined value of the successor companies was identified at \$17.2 billion. This resulted in stranded debt of \$20.9 billion (\$38.1B - \$17.2B), to be offset by \$13.1 billion in defined (present value) dedicated revenue streams, leaving \$7.8 billion in residual stranded debt with no backing assets or cash flow. Step 1 of the process involved a transfer of assets from Ontario Hydro to the various successor companies in exchange for an equal amount of debt. In step 2, the Province assumed a portion of OPG and OHSC's (now Hydro One's) debt in exchange for equity. (A) \$8.5 billion in assets were transferred to OPG. The province assumed \$5.1 billion of OPG's debt in exchange for equity, leaving that company with a 40%/60% debt-to-equity capital structure. (B) \$8.6 billion in assets were transferred to OHSC (now Hydro One). The province assumed \$3.8 billion of OHSC's (now Hydro One) debt in exchange for equity, leaving the Company with a 60%/40%

debt-to-equity capital structure. OEFC will service the \$20.9 billion in debt and liabilities of the former Ontario Hydro through the following sources: (a) Debt service from the successor companies (issued in the assets-for-debt transfer). (b) Debt service from the province, which assumed \$8.9 billion of debt in the debt-for-equity exchange (which may be repaid through the collection of dividend payments from the successor companies). (c) Payments-in-lieu of taxes from the successor companies and the MEUs. These “deemed taxes” are intended to put government entities on an equivalent commercial footing with their private sector counterparts, and help pay down the debt. (d) A Competition Transition Charge (CTC) that will be levied on the generation and/or consumption of electricity to service the residual stranded debt. This will be used to service the \$7.8 billion in stranded debt.

There are a number of assumptions and uncertainties associated with the valuation process that could impact the level of residual stranded debt, currently identified at \$7.8 billion. These include the following: (i) The used fuel and nuclear waste liability could exceed that assumed in the financial restructuring process. Due to the proposed nuclear risk sharing agreement, the Province and OPG nuclear liabilities could rise. (ii) The valuation of Hydro One reflects the book value of assets for regulatory purposes, rather than the market value that would be applicable in a sale of assets. (iii) The valuation of OPG was derived using a discounted cash flow methodology. The assumptions used in the process, including electricity prices, the discount rate,

and the success of the nuclear asset optimization program (“NAOP”) could differ substantially from actual results. (iv) The value of dedicated revenue streams (\$13.1 billion) is also subject to material uncertainties including the underperformance of the successor companies, and in particular nuclear generating assets, the distribution of proceeds with respect to OPG asset sales (it must reduce market share to 35% from the current 85% by 2010), the impact of transfer taxes resulting from the potential acquisition of MEUs, and the impact of the 3.8 cents per kWh price cap (until 2004) in the electricity generation market.

#### **Ontario Hydro Stranded Debt Costs as at April 1, 1999**

	C\$ billions
Short-term Debt	\$ 2.8
Long-term Debt	27.7
Non-Utility Generation Contracts	5.3
Used Fuel and Nuclear Waste Provision	<u>2.3</u>
Total Debt & Liabilities Assumed by OEFC	\$ 38.1
LESS: Value of Successor Companies	
Ontario Hydro Services Company Inc.	\$ 8.6
Ontario Power Generation Inc.	8.5
IMO/ESA	<u>0.1</u>
	\$ 17.2
EQUALS: Gross Stranded Debt	\$ 20.9
LESS: P.V. of Dedicated Revenue Streams	<u>13.1</u>
EQUALS: Residual Stranded Debt	\$ <u>7.8</u>

	<u>Hydro One Inc.</u>		<u>Ontario Power Generation Inc.</u>	
	(\$ billions)	%	(\$ billions)	%
Total debt	4.845	56.3%	3.422	40.0%
Preferred equity	0.323	3.8%	0.000	0.0%
Common equity	<u>3.436</u>	<u>39.9%</u>	<u>5.126</u>	<u>60.0%</u>
Total Capitalization	<u>8.604</u>	<u>100.0%</u>	<u>8.548</u>	<u>100.0%</u>

As Hydro One has a natural monopoly business franchise (transmission and distribution) and is fully subject to regulation, earnings are expected to be more stable than for OPG. Hence Hydro One is able to sustain higher debt levels than OPG, which will be operating in a more competitive environment.

#### REVENUE BASE

(\$ millions)	For years ended December 31 *							
	<u>1999</u>	<u>%</u>	<u>1998</u>	<u>%</u>	<u>1997</u>	<u>%</u>	<u>1996</u>	<u>%</u>
Transmission	1,237	40	1,178	39	1,095	35	1,112	36
Distribution (includes retail)	1,816	58	1,746	57	1,846	60	1,880	60
Other	<u>72</u>	<u>2</u>	<u>124</u>	<u>4</u>	<u>158</u>	<u>5</u>	<u>137</u>	<u>4</u>
TOTAL *	<u>3,125</u>	<u>100</u>	<u>3,048</u>	<u>100</u>	<u>3,099</u>	<u>100</u>	<u>3,129</u>	<u>100</u>

\*1996-98 is an allocation of Ontario Hydro's results that reflect Hydro One's operations. 1999 consists of 9-mos Hydro One and 3-mos. allocation of OH results.

Distribution (including retail) accounted for 58% of revenues in 1999 and is growing, supported by the booming Ontario economy. Distribution revenue includes costs related to the sale and delivery of electricity, the cost of providing electrical distribution services, and retail services such as metering and collections, as well as the cost of power. Power users throughout Ontario are required to subsidize rural users in order to ensure that a rural

customer's bill is no more than 15% higher than the average urban residential electric utility bill. This cross subsidization has cost urban electricity users about \$120 million annually. Transmission, with much more limited growth in rate base (until some of the new interconnections are constructed) generated 40% of total revenues in 1999. Transmission revenues consist of tariffs that provide for the connection to, and the use of, the provincial transmission grid.

**OPERATING INCOME**

Operating income for the periods shown was composed of the following:

	<i>Dec. 1999</i> <u>Net Fixed Assets</u>	<i>Operating Income (excluding non-recurring charges, incl debt guarantee fee)</i>							
		<i>1999*</i>		<i>1998*</i>		<i>1997*</i>		<i>1996*</i>	
		<i>\$ MM</i>	<i>%</i>	<i>\$ MM</i>	<i>%</i>	<i>\$ MM</i>	<i>%</i>	<i>\$ MM</i>	<i>%</i>
Transmission	67%	626	63%	621	75%	625	70%	636	65%
Distribution (incl. Retail)	29%	370	37%	200	24%	281	32%	335	36%
Other	4%	<u>0</u>	<u>0%</u>	<u>8</u>	<u>1%</u>	<u>(18)</u>	<u>(2)%</u>	<u>2</u>	<u>0%</u>
<b>TOTAL</b>	<b><u>100%</u></b>	<b><u>997</u></b>	<b><u>100%</u></b>	<b><u>829</u></b>	<b><u>100%</u></b>	<b><u>888</u></b>	<b><u>100%</u></b>	<b><u>973</u></b>	<b><u>100%</u></b>

\*1996-98 is an allocation of Ontario Hydro's results that reflect Hydro One's operations. 1999 consists of 9-mos. Hydro One and 3-mos. allocation of OH results.

EBIT earnings from distribution operations had been trending downwards, while transmission generated earnings have been relatively flat. Rates and returns for the different operating segments of the former Ontario Hydro (generation, transmission and distribution) were not unbundled and the above allocation is based on assumptions that may not be applicable in the future. The following highlights are noted: (1) Transmission and distribution functions will continue to operate in a monopoly environment. (2) The current breakdown of rate base and earnings (i.e., about two-thirds transmission / one-third distribution) will likely change over the next few years and will be affected by the following factors: (a) Material capital expenditures, including the construction of export interconnections with Hydro-Quebec and at Ontario-U.S. border points, will increase the transmission rate base and earnings. (The Market Design Committee recommended the addition of 2,000 MW of badly needed interconnection

capacity). This is required to help address the market power issue related to OPG. (b) The potential acquisition of municipal electric utilities would increase distribution assets and earnings.

The allowed return on equity at 9.35% in 1999 and 9.88% in 2000 is too low to encourage continued long-term investments and commitments to electricity. U.S. regulators recognized this, and allowed returns on equity about 150 basis points higher than in Canada. This differential partially reflects a different risk profile (comparative returns are for generation-transmission utilities), and a more competitive environment. However, interest rates may be nearing a trough, and ROEs could begin to rise over the near-term. It should be noted that a low return on equity adversely affects coverage ratios, which may ultimately influence credit ratings over the longer term.

**CASH FLOW ANALYSIS**

Historical cash flows\* requirements are indicated below:

(\$ millions)	<u>1999</u>	<u>1998</u>	<u>1997</u>	<u>1996</u>
Net income (before extras.)	422	270	304	383
LESS: Dividends	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>
Retained Earnings (A)	422	270	304	383
Capital expenditures	483	383	289	302
LESS: Asset Sale Proceeds	245	0	0	0
LESS: Depreciation	<u>324</u>	<u>276</u>	<u>266</u>	<u>273</u>
Cash required to fund capital expend (B)	-86	107	23	29
<b>Free Cash Flow (A-B)</b>	<b><u>336</u></b>	<b><u>163</u></b>	<b><u>281</u></b>	<b><u>354</u></b>

\* 1996-8 is an allocation of Ontario Hydro that reflects Hydro One's operations. 1999 consists of 9-mos. of Hydro One and 3-mos. allocation of OH results.

The table shows that Hydro One, with a mature system, has historically generated substantial cash surpluses, net of capital expenditures. Future cash flows will be materially affected by the following factors: (1) Payments in lieu of deemed taxes. These funds payable to the province will be used by OEFC to service the former Ontario Hydro's \$20.9 billion in gross stranded debt. As long as the province retains a 90% ownership interest in Hydro One, proxy federal and provincial incomes taxes are payable to OEFC.

(2) Dividend payments to the province, including dividends on the 5.5% preferred shares. These payments to the province will be used to service the debt assumed by the province in its debt-for-equity swap. (3) Higher capital expenditures, as Hydro One addresses the asset maintenance backlog that was deferred by the former Ontario Hydro. (4) Potential acquisition of some of the merging municipal electrical utilities.

## FIXED ASSETS – DECEMBER 31, 1999

(\$ millions)	<i>Gross Fixed</i>	<i>Construction</i>	<i>Accumulated</i>	<i>Net Fixed</i>	<i>%</i>	<i>Accum. Deprec./</i> <i>Gross Fixed Assets</i>
	<i>Assets</i>	<i>in Progress</i>	<i>Depreciation</i>	<i>Assets</i>		
Transmission	7,629	248	2,287	5,590	67%	29.0%
Distribution (incl. retail)	3,711	47	1,310	2,448	29%	34.9%
Communications	322	1	178	145	2%	55.1%
Administration	245	4	73	176	2%	29.3%
<b>TOTAL</b>	<b><u>11,907</u></b>	<b><u>300</u></b>	<b><u>3,848</u></b>	<b><u>8,359</u></b>	<b><u>100%</u></b>	<b><u>31.5%</u></b>

The transmission rate base is roughly double that of distribution. At year-end 1999, transmission assets were 29% depreciated, while distribution assets were 35% depreciated. Transmission assets are being depreciated over an average term of 51 years, distribution assets (including retail) are being depreciated over 41 years, communications assets over 22 years, and administration and services assets over 38 years.

## CAPITAL STRUCTURE – YEAR-END\*

(\$ millions)	<b>1999</b>		<b>1998</b>		<b>1997</b>	
	<i>\$MM</i>	<i>%</i>	<i>\$MM</i>	<i>%</i>	<i>\$MM</i>	<i>%</i>
Bank Debt + S-T Notes	0	0.0%	568	6.6%	572	7.0%
Long-term Debt due in 1 Year	1,399	15.8%	491	5.7%	658	8.0%
Long-term Debt	<u>3,446</u>	<u>38.8%</u>	<u>5,128</u>	<u>59.5%</u>	<u>4,963</u>	<u>60.0%</u>
Total Debt	4,845	54.6%	6,187	71.8%	6,193	75.0%
Preferred Equity (Common Equivalent)	<u>323</u>	<u>3.6%</u>	<u>0</u>	<u>0.0%</u>	<u>0</u>	<u>0.0%</u>
Total Debt and Equivalents	5,168	58.3%	6,187	71.8%	6,193	75.0%
Common Equity	<u>3,701</u>	<u>41.7%</u>	<u>2,431</u>	<u>28.2%</u>	<u>2,065</u>	<u>25.0%</u>
Total Capitalization	<u>8,869</u>	<u>100.0%</u>	<u>8,618</u>	<u>100.0%</u>	<u>8,258</u>	<u>100.0%</u>
Current Ratio (times)	0.58X		0.35X		0.27X	
Net Debt in Capital Structure **	52%		72%		75%	
Fixed Charges Coverage (times)	2.45X		1.46X		1.50X	

\* 1997-98 data is an allocation of Ontario Hydro's results that reflects Hydro One's operations. 1999 consists of 9-mos. of Hydro One and 3-mos. allocation of Ontario Hydro results. \*\*Net of cash balances.

Small or negative working capital balances in a utility can usually be justified by the stability and certainty of its revenue.

Hydro One's current outstanding debt is held by a government-owned entity, OEFC, and is essentially considered a "private placement". As this debt matures, Hydro One will refinance (and/or repay) these obligations through the public debt markets. Initially, the mix of publicly-held versus privately-held debt will be relatively low (under 20% by 2000 year-end), but is expected to grow rapidly over the next few years (see debt maturity schedule on next page). Debt securities issued through the public debt markets will rank pari passu with debt obligations held by OEFC. The proportion of debt in the capital structure results in a relatively strong fixed charges coverage ratio of

2.36 times in 1999, which is comparable to utilities in the private sector.

*The 5.5% preferred shares are redeemable at the option of the province if it sells enough common shares of Hydro One to the public such that the province's holdings are reduced to less than 50% of the number outstanding. Hydro One may elect to pay all or part of this redemption price by issuing additional common shares to the province. If the province does not exercise its redemption right, Hydro One would have the ability to reduce the dividend yield on the preferred shares to 50 basis points less than the then current market yield for similarly rated preferred shares. As such, DBRS treats these preferred shares as common equivalents in debt ratios.*

## BANK LINES

A \$750 million syndicated stand-by bank line will act as a backstop to all commercial paper issuance. This includes a \$500 million, 364-day bank line and a \$250 million 5-year bank line. Hydro One has the option to increase bank lines to support a Board authorized \$1 billion commercial paper borrowing limit.

## DEBT MATURITY SCHEDULE

Hydro One's initial debt portfolio consists of notes issued to OEFC that mirror, in general, parts of the specific bond issues of the former Ontario Hydro and the direct obligations of Hydro One Inc. The debt maturity schedule as of June 30, 2000, is indicated below:

<u>Year</u>	<u>Principal Amount</u> (\$millions)	<u>Coupons</u>	<u>Average Coupon</u>
2000	343	6.1%	6.1%
2001	577	6.3%-7.2%	7.0%
2002	443	9%-12.5%	11.0%
2003	651	5.4%-13.5%	7.2%
2004	682	6.8%	6.8%
2005	507	6.9%-8.9%	7.7%
2006	589	7.2%-14.3%	9.3%
2007	300	9.1%-9.7%	9.2%
2010	400	7.2%	7.2%
2030	<u>400</u>	<u>7.4%</u>	<u>7.4%</u>
TOTAL	<u>4,892</u>	<u>5.4%-14.3%</u>	<u>7.9%</u>

Some of the outstanding debentures have high coupon interest rates. However, the average rate that Hydro One must pay to OEFC is about 200 basis points below the weighted average rate on the former Ontario Hydro's

imbedded cost of debt. Hydro One has the option to defer \$343 million of its notes maturing in 2000 to March 31, 2001.

## REGULATION

Under the Power Corporation Act (prior to April 1, 1999) Ontario Hydro had broad powers to generate, supply and deliver electricity throughout Ontario. The Board of Directors was responsible for setting wholesale and retail electricity rates and regulating rates that the municipal electric utilities charged to retail customers. Policy statements were largely set by the Ontario Hydro Board of Directors, subject to government directives.

A wholesale electricity rate freeze, implemented in 1993, will continue until December 31, 2000. Electricity rates were "bundled", which meant that generation and transmission costs were not separately billed. Retail customers have been billed the same way. Until competitive rates arrive, customers will continue to pay bundled rates for electricity. Revenues will be collected from, and allocated to, customers with the allocation to Hydro One's transmission and distribution businesses set by OEB rate orders. The Province has announced that the transition charge will be 0.70 cents per kWh.

The OEB has attained substantial powers under the new Ontario Energy Board Act 1998. These include: (a) setting

transmission and distribution rates for electricity; (b) providing rate protection for rural and remote electricity consumers; and (c) ensuring distribution companies fulfill their obligations to connect and service their customers.

The OEB adopted an interest rate oriented methodology for adjusting the future allowed return on equity, setting the allowed ROE at 9.35% for 1999 and 9.88% for 2000. Future rate adjustments will be based on the change in long-term Government of Canada bond yields. This methodology coincides with the practices followed by the National Energy Board and other provincial utility regulators, but is in contrast to that of U.S. regulators, which do not use the interest rate methodology to the same degree. As a result, comparable (for combined generation-transmission utilities) returns allowed to U.S. electric utilities are in the 11.3%-11.5% range, or about 150 to 200 basis points higher than the rates the OEB has allowed Hydro One in 1999 and 2000. The higher allowed return in the U.S. was set to encourage investment in regulated utilities, and also reflects the higher risk profile inherent in a more competitive environment.

## Hydro One Inc.

(formerly Ontario Hydro Services Company Inc.)

### Balance Sheet (1)

(\$ millions)

	As at December 31				As at December 31		
	<u>Jun-00</u>	<u>1999</u>	<u>1998</u>		<u>Jun-00</u>	<u>1999</u>	<u>1998</u>
<b>Assets:</b>				<b>Liabilities &amp; Equity:</b>			
Cash + s-t investments	305	468	44	S-T debt	0	0	568
Accounts receivable	480	536	398	L-T debt due 1 yr	479	1,399	491
Material and supplies	84	81	65	A/P + accr'ds	303	475	397
<b>Current Assets</b>	<b>869</b>	<b>1,085</b>	<b>507</b>	<b>Current Liabilities</b>	<b>782</b>	<b>1,874</b>	<b>1,456</b>
Net fixed assets	8,463	8,359	8,383	Long-term debt	4,412	3,446	5,128
Post employment benefits	356	377	0	Post employ. benefits	475	453	305
Def'd debt costs + pension assets	464	241	476	L-T pay. + other liab.	507	293	115
L-T rec + other	37	28	69	Preferred equity	323	323	0
				Common equity	3,690	3,701	2,431
<b>Total</b>	<b>10,189</b>	<b>10,090</b>	<b>9,435</b>	<b>Total</b>	<b>10,189</b>	<b>10,090</b>	<b>9,435</b>

### Ratio Analysis (1)

	12 Mos. ended	For years ended December 31				
	<u>Jun-00</u>	<u>1999</u>	<u>1998</u>	<u>1997</u>	<u>1996</u>	
<b>Liquidity Ratios</b>						
Current Ratio	1.11	0.58	0.35	0.27	0.41	
Accumulated depreciation/Gross fixed assets	32.0%	31.5%	31.3%	30.4%	29.2%	
Cash flow/Total debt (2)	0.14	0.15	0.09	0.09	0.11	
Cash flow/Capital expenditures	1.16	1.48	1.51	1.86	2.23	
Cash Flow-dividends/Capital expenditures	0.75	1.48	1.51	1.86	2.23	
Net debt in the capital structure (2)	53.3%	52.1%	71.6%	75.0%	75.9%	
Average coupon on l-t debt	-	7.7%	9.0%	-	-	
Deemed equity	35.0%	35.0%	-	-	-	
Common dividend payout (before extras.)	60.4%	0.0%	0.0%	0.0%	0.0%	

### Coverage Ratios (3)

EBIT interest coverage	2.66	2.45	1.46	1.50	1.64
EBITDA interest coverage	3.58	3.29	1.98	2.02	2.17
Fixed charges coverage	2.45	2.45	1.46	1.50	1.64

### Earnings Quality / Operating Efficiency

Operating margin	31.7%	31.9%	27.2%	28.7%	31.1%
Net margin (before extras., after pfd)	12.9%	13.5%	8.9%	9.8%	12.2%
Return on avg common equity (before extras.)	6.3%	13.8%	12.0%	14.9%	20.9%
Profit returned to Government (before extras.)	103.2%	32.4%	10.3%	9.5%	7.5%
Approved ROE	9.88%	9.35%	-	-	-
Rate base (Transmission) (millions)	-	\$5,637.9	-	-	-
Rate base (Distribution) (millions)	-	\$2,466.8	-	-	-
Distribution lines (Km)	-	113,400	116,947	119,182	118,985
Transmission lines (Km)	-	28,889	29,066	29,080	29,080
Customer/Employee	-	165.8	187.3	186.4	175.8
Growth in customer base	-	-4.5%	0.5%	1.1%	-
GWh throughputs/Employee	-	28.8	30.9	31.3	29.5

### Segmented Information (\$ millions)

	12 Mos. ended	Three months ended		For years ended December 31			
	<u>Jun-00</u>	<u>Jun-00</u>	<u>Jun-99</u>	<u>1999</u>	<u>1998</u>	<u>1997</u>	<u>1996</u>
<b>Segmented Results:</b>							
Transmission	631.1	347.0	342.2	626.3	621.0	624.6	636.0
Distribution (incl retail)	338.9	178.0	209.4	370.3	200.2	281.0	335.4
Other (4)	(1.3)	0.0	1.7	0.4	7.7	(17.6)	1.6
<b>Operating Income</b>	<b>968.8</b>	<b>525.0</b>	<b>553.2</b>	<b>997.0</b>	<b>829.0</b>	<b>888.0</b>	<b>973.0</b>
<b>Segmented Assets:</b>							
Transmission		6,718	6,417	6,658	6,107	6,001	5,924
Distribution (incl retail)		3,471	3,499	3,431	3,168	2,892	2,911
Other		0	167	1	160	166	167
<b>Total Assets</b>		<b>\$10,189</b>	<b>\$10,083</b>	<b>\$10,090</b>	<b>\$9,435</b>	<b>\$9,059</b>	<b>\$9,002</b>

(1) 1999 consists of 9-mos. Hydro One + 3-mos. allocation of Ontario Hydro results. 1996-8 ratios reflect the allocation of Ontario Hydro results which represent Hydro One operations.

(2) Preferred equity treated as a common equivalent.

(3) Before capitalized interest, AFUDC and debt amortizations.

(4) DBRS has allocated transitional costs/credits/debt guarantee fee based on revenue breakdown.

**Hydro One Inc.**  
(formerly Ontario Hydro Services Company Inc.)

<b>Income Statement</b> (1) (\$ millions)	12 Mos. ended		Six months ended		For years ended December 31		
	<u>Jan-00</u>	<u>Jan-00</u>	<u>Jan-99</u>	<u>1999</u>	<u>1998</u>	<u>1997</u>	<u>1996</u>
Transmission	1,273	641	605	1,237	1,178	1,095	1,112
Distribution (incl retail)	1,762	866	920	1,816	1,746	1,846	1,880
Other - int'l	17	0	55	72	124	158	137
<b>Total Revenues</b>	<b>3,052</b>	<b>1,507</b>	<b>1,580</b>	<b>3,125</b>	<b>3,048</b>	<b>3,099</b>	<b>3,129</b>
<b>Expenses:</b>							
OM&A	848	383	374	839	723	627	602
Municipal + property taxes	0	0	0	0	0	0	0
Debt guarantee fee	0	0	8	8	31	32	31
Purchased power	891	436	484	939	1,165	1,250	1,218
Depreciation + amortization	344	163	161	342	300	302	305
<b>Total Operating Costs</b>	<b>2,083</b>	<b>982</b>	<b>1,027</b>	<b>2,128</b>	<b>2,219</b>	<b>2,211</b>	<b>2,156</b>
<b>Operating Income</b>	<b>969</b>	<b>525</b>	<b>553</b>	<b>997</b>	<b>829</b>	<b>888</b>	<b>973</b>
Interest expense	372	187	226	411	569	580	583
Non-cash financial charges	(23)	(10)	(5)	(18)	(10)	(12)	(8)
Other (income)/expense	(19)	(11)	(4)	(12)	0	16	15
<b>Net interest costs</b>	<b>330</b>	<b>166</b>	<b>217</b>	<b>381</b>	<b>559</b>	<b>584</b>	<b>590</b>
<b>Pre-tax income</b>	<b>639</b>	<b>359</b>	<b>336</b>	<b>616</b>	<b>270</b>	<b>304</b>	<b>383</b>
Payments in lieu of income taxes	229	115	80	194	0	0	0
<b>Net income bef extras.</b>	<b>410</b>	<b>244</b>	<b>256</b>	<b>422</b>	<b>270</b>	<b>304</b>	<b>383</b>
Non-recurring + extraordinary items	(8)	0	55	47	(204)	79	0
<b>Net income bef pfd div</b>	<b>418</b>	<b>244</b>	<b>201</b>	<b>375</b>	<b>474</b>	<b>225</b>	<b>383</b>
Preferred dividends	18	18	0	0	0	0	0
<b>Net income</b>	<b>400</b>	<b>226</b>	<b>201</b>	<b>375</b>	<b>474</b>	<b>225</b>	<b>383</b>
<b>Net income (before extras., after pfd)</b>	<b>392</b>	<b>226</b>	<b>256</b>	<b>422</b>	<b>270</b>	<b>304</b>	<b>383</b>
Depreciation	319	156	161	324	276	266	273
Other non-cash charges	(28)	5	0	(33)	34	(32)	17
<b>Operating Cash Flow</b>	<b>683</b>	<b>387</b>	<b>417</b>	<b>713</b>	<b>580</b>	<b>538</b>	<b>673</b>
LESS: Common dividends	237	237	0	0	0	0	0
Capital expenditures	591	312	204	483	383	289	302
<b>Cash flow before working capital</b>	<b>(145)</b>	<b>(162)</b>	<b>213</b>	<b>230</b>	<b>197</b>	<b>249</b>	<b>371</b>
LESS: Working capital	150	26	(205)	(81)	60	(97)	190
<b>Free cash flow</b>	<b>(295)</b>	<b>(188)</b>	<b>418</b>	<b>311</b>	<b>137</b>	<b>346</b>	<b>181</b>
LESS: Other investments	(274)	21	9	(286)	0	4	(3)
PLUS: Net financing	46	46	(168)	(168)	(98)	(226)	(149)
<b>Net Change in Cash Flows</b>	<b>25</b>	<b>(163)</b>	<b>241</b>	<b>429</b>	<b>39</b>	<b>116</b>	<b>35</b>

(1) 1999 consists of 9-mos. Hydro One + 3-mos. allocation of Ontario Hydro results. 1996-8 is an allocation of Ontario Hydro results that reflect the operations of Hydro One operations.

**Distribution Throughputs**

Residential	-	-	-	9,412	9,882	10,152	10,044
Commercial	-	-	-	3,982	4,209	4,324	4,278
Industrial	-	-	-	2,172	1,647	1,692	1,674
Other	-	-	-	2,534	2,562	2,632	2,604
<b>Total - GWh</b>	<b>17,710</b>	<b>8,976</b>	<b>9,366</b>	<b>18,100</b>	<b>18,300</b>	<b>18,800</b>	<b>18,600</b>

**Transmission Throughputs - GWh**

145,458	72,881	71,523	144,100	143,000	144,800	143,000
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