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Hydro-Québec
Requête R-3401-98

CBRS INC. - HYDRO ONE

6 SEPTEMBRE 2000

Security Rated	Current Rating	Rating Outlook	Rating Status
Commercial Paper	A-1	Stable	New Rating
<i>Initiates Coverage</i>		VOLUME II – UTILITIES- GAS AND ELECTRICAL	

CBRS Rating Summary

Corporate Profile

On December 1, 1998 Ontario Hydro Services Company (OHSC) was incorporated as a commercial entity under the Ontario Business Corporation Act to be engaged in the transmission and distribution of electricity, as well as to provide energy related services. On May 1, 2000 the company changed its legal name to Hydro One and is one of the successor companies to the former Ontario Hydro monopoly, which is wholly owned by the Province of Ontario. Hydro One's borrowings and obligations carry no explicit provincial guarantee and CBRS' ratings reflect the company's stand-alone credit characteristics.

Hydro One has six wholly-owned operating subsidiaries that own substantially all of the transmission and distribution assets, liabilities, rights, obligations and employees transferred from Ontario Hydro under the terms of the Electricity Act, 1998. The company and its subsidiaries own and operate approximately \$6.7 B of transmission assets and \$3.4 B of distribution assets.

Credit Strengths

- Stable and consistent generation of cash flow
- Near monopoly position in the delivery of a regulated, essential service within the strongest demographic and commercial market in Canada
- Commercial Paper issuance is expected to be below corporate cash flow generation and Hydro One has established \$750 M in bank credit facilities to provide liquidity support for its commercial paper program
- Supportive relationship with sole shareholder (Province)
- Strong credit profile and established debtor position in capital markets provides good access to various forms of debt capital

Credit Risks

- The regulatory regime continues to develop in terms of policy making and performance based rate-setting and this transition to a viable competitive energy market carries near-term uncertainty
- Hydro One has significant cash flow demands arising from operations, debt service, debt re-financing, capital expenditures and dividends
- Structural subordination exists since subsidiaries own the assets and the holding company (Hydro One) is reliant on dividend and interest payment streams from subsidiaries to service debt obligations
- Cash flow deficiency may result from lower than expected consumption and/or unexpected expenditures, the recovery of which, may only be permitted in a subsequent rate order approval by the Ontario Energy Board (rate recovery time lag)
- No access to equity capital

Rating Opinion

CBRS has assigned an **A-1** credit rating to Hydro One's proposed commercial paper program that has been established with an internally managed upper limit of \$750M. The rating outlook for these securities is **Stable**.

The strong short-term rating reflects the company's near monopoly position in the regulated transmission and distribution of electricity within Ontario and its syndicated bank credit facilities that provide liquidity support to back-stop the company's commercial paper program. In addition, Hydro One's regulated activities, which constitute a substantial portion of its total business portfolio and service delivery, shield the company from commodity price risk and provide stable earnings and cash flow generation.

The company has arranged a committed \$250 M five-year term revolving credit facility and a committed \$500 M 364-day term renewable revolving credit facility through a syndicate of financial institutions and Hydro One's indebtedness via this borrowing facility will rank equal and concurrent with all other unsecured company indebtedness. These credit facilities provide important liquidity support to the company's commercial paper program.

In general, the assignment of our highest short-term credit rating to a corporate borrower requires, among other factors, access to fully dedicated banking facility that is equal to the size of the commercial paper program. Hydro One's short-term borrowing principal limit of \$750 M is backed by \$750 M in credit facilities that are intended to be used only for liquidity support, and not for general corporate purposes. CBRS' A-1 rating assignment reflects a one-notch discount to our highest short-term rating and is supported by the risk factors we discuss later in report, including, but not limited to, the early phase of regulatory transition, Hydro One's transition to a commercial company and its reliance on debt capital markets.

The short-term borrowing program will be used to bridge cash flow timing differences between the company's receipt of revenues and its outflow of expenditures, as well as to provide flexibility in market timing and debt management practices. For example, Hydro One may utilize its short-term borrowings to finance in-year capital expenditures pending the issuance of long-term debt. This flexibility permits the company to better manage its maturity schedule and its cost of borrowing. For example, the issuance of long-term debt to fund capital expenditures may not be cost-effective if the yield curve is very steep compared to historical term-maturity spreads. The short-term borrowing program provides the flexibility to provide a lower cost

funding or re-financing bridge until longer-term rates are more attractive.

Rating Analysis

In our analysis of Hydro One's short-term credit strength, CBRS evaluated the level and stability of the company's expected cash flow generation and its annual cash requirements. Hydro One's cash generated from operating activities will be substantial; however, the company will be reliant upon capital markets for the foreseeable future since its cash obligations exceed this internally generated cash. The following items represent the major cash outflows for the company:

- Operating activities;
- Proxy taxes;
- Debt service and debt re-financing;
- Capital expenditures; and
- Dividend payments to the Province of Ontario.

Hydro One will be able to fund operating activities, proxy taxes, dividends, debt service and maintenance capital expenditures from cash from operations but will require capital market borrowings to fund the remaining items. The company is unable to access equity capital markets and, since we do not expect the Province as the sole shareholder to inject any equity capital, the only external financing available to Hydro One is in the form of debt financing from financial institutions or the capital markets.

Capital Expenditure Forecast

2000	\$510 M
2001	\$642 M

Source: Hydro One

In general, our highest short-term rating demands cash flow generation well in excess of the total size of the short-term borrowing program since, in addition to providing liquidity support to the commercial paper limit, operational expenditures must also be met from cash flow.

Hydro One Debt Maturities

Since the company is reliant on the debt capital markets for the foreseeable future, CBRS will closely monitor Hydro One's debt burden on a long-term credit rating basis and its liquidity demands on a short-term credit basis.

In its re-structuring of the electricity industry, the Province estimated the value of Hydro One's asset base at \$8.61 B and, in the transfer of these former Ontario Hydro transmission and distribution assets, Hydro One issued \$8.61 B in notes payable to OEFC (a provincial crown corporation). Given Hydro One's inability to access equity capital markets and the Province's desire to establish a viable capital structure for the company, the Province executed a debt/equity swap. In this transaction, the government assumed a \$3.76 B common and preferred equity position with Hydro One, in exchange for debt forgiveness of an equal amount of Hydro One notes payable to OEFC. At the date of the debt/equity swap, Hydro One maintained \$4.85 in notes payable to OEFC for the remaining capitalization.

Hydro One: June 30, 2000 Debt Portfolio: Principal Outstanding to OEFC

2000	\$343 M
2001	\$577 M
2002	\$443 M
2003	\$651 M
2004	\$682 M
2005	\$307 M
2006	\$589 M
2007	<u>\$300 M</u>
	\$3,892M

Hydro One: June 30, 2000 Debt Portfolio: Principal Outstanding to Capital Market Bond Holders

2005	\$200 M
2010	\$400 M
2030	<u>\$400 M</u>
	\$1,000 M

Hydro One initially issued \$4.85 B in notes payable to OEFC to assume the debt portion of its capital structure. CBRS notes, however, that this note payable position to OEFC will decline over time as Hydro One issues debt in its own name, and on its own credit, to retire maturing Ontario Hydro debt obligations held by OEFC. To this end, Hydro One, in May 2000, successfully completed its first public debt offering with the issuance of \$1 B in tranches of 5, 10 and 30 years. In effect, as these re-financings of maturing debt take place, the company's note payable position to the OEFC declines and its long-term debt position (to capital market creditors) rises.

The recently issued \$1 B in capital market debt and the \$3.892 B in notes payable to OEFC comprise Hydro One's current \$4.892 B debt portfolio. It should be noted that debt obligations initially issued by Ontario Hydro and currently serviced by OEFC maintain an explicit Province of Ontario guarantee.

CBRS notes that all Hydro One debt obligations are senior and unsecured and are equal and concurrent (rank pari-passu), including notes payable to the Province, long-term debt issued in public capital markets, commercial paper and the revolving and term bank credit facilities.

Short Term Credit Considerations

The above noted schedule of long-term debt maturities respecting its note payable position with OEFC is important for our short-term credit analysis since CBRS considers the potential that the company may use its short-term borrowing program to temporarily bridge a portion of its long-term refunding requirements. In effect, maturing long-term debt becomes a current, short-term obligation the year it falls due.

Some of the key short-term credit strengths that contributed to our A-1 short-term rating assignment include:

- Stable revenue and cash flow collection stream as a result of regulated business activities and demand inelastic service within Canada's strongest provincial economy;
- 100% bank credit facility support respecting its \$750 M short-term borrowing principal amount limit;
- The five-year term facility includes a \$25 M swing line sub-facility to provide same day liquidity access;

- No foreign currency or floating interest rate exposure within the company's debt profile;
- Diverse customer mix;
- Incremental revenue opportunities exist, particularly in consolidation of the fragmented Ontario distribution network; and,
- Implied support of Province as shareholder.

With respect to the final bullet point, CBRS notes that the Province has demonstrated this supportive relationship already with its deferral of significant note receivable maturities from Hydro One as the company prepared its capital borrowing platform. Furthermore, it is our opinion that the Province will exhibit greater patience and financial tolerance than other investors since it has more than just a financial interest in Hydro One. Beyond its \$3.8 B equity investment, the Province has a policy and regulatory interest in establishing a successful commercial electricity industry. Balancing this financial and policy interest, however, may prove to be challenging for the Province and we will continue to monitor this unique position.

Some of the analytical risk factors CBRS considered in its short-term Hydro One rating include:

- Uncertain regulatory environment and continued restructuring of the competitive electricity market, the opening of which has now been deferred from the initial November 2000 target;
- Performance based rate setting by the Ontario Energy Board will present challenges in producing cost savings and operational synergies; however, the fulfillment (and potential over-achievement) of these performance benchmarks represents a significant opportunity for Hydro One.
- Hydro One has a short history as a commercial company but has executed on its business plans on-time and on-budget and has successfully implemented a voluntary retirement program to realize significant annual cost savings;
- By-pass of transmission system by large customers is a potential risk; however, CBRS regards this risk as manageable since OEB regulatory policy will likely discourage uneconomic by-pass and customers will maintain access to the grid for reliability and back-up purposes; and,
- Lower than expected usage and/or unanticipated expenditures (such as weather phenomenon like the 1998 ice storm) may cause revenue shortfalls and/or negative expenditure variances.

With respect to the final bullet point above, effective expenditure management and accurate estimates of electricity usage are critical key success factors and are important in both our short and long-term credit consideration. Declines in electricity usage may result from seasonal issues, weather-related factors, cost-sensitive consumption practices or higher alternate energy consumption and exogenous factors (i.e. ice storm) may cause unexpected expenditure outlays. Nevertheless, these

risks may present cash flow difficulties for Hydro One since the recovery of higher than expected costs and/or lower than expected revenue in a subsequent rate order is not assured. Furthermore, Hydro One's ability to re-capture these revenue shortfalls or expenditure variances, assuming they are approved, is still subject to regulatory lag and the timing delay may exacerbate the company's cash flow position.

Structural Subordination

CBRS notes that Hydro One is a holding company with several subsidiaries that hold all of the operating assets, while Hydro One carries all of the debt obligations to the Province and public market and financial institution creditors. As a result of this structure, Hydro One is reliant on interest payment and dividend flows from the operating companies to service its debt obligations and the potential exists that Hydro One debt could become structurally subordinated to its subsidiaries should they decide to issue debentures. CBRS does not expect such indebtedness to be incurred at the operating company level; however, it is a risk factor we note nonetheless.

Since Hydro One is reliant on inter-company dividends from its subsidiary operations, CBRS must assess the ability and timing of those cash flows to meet long and short-term debt service requirements. The greater the degree of unregulated activities at the operating company level, the higher the uncertainty in dividend cash flow available for payments to the holding company. CBRS must recognize the extent to which this relationship exacerbates structural subordination risk. Given that the Hydro One Networks subsidiary owns approximately 95% of the consolidated asset base and it is engaged in regulated activities, CBRS views this as a mitigating factor that contributes to Hydro One's high short and long-term credit ratings.

Municipal Electric Utility (MEU) Consolidation

As noted in our May 2000 long-term credit rating report, the current distribution network for electricity in Ontario is fragmented and inefficient. The consolidation of the 189 MEUs that are connected to Hydro One's current distribution system, as well as the 32 that are not, represents a significant business opportunity for the company should it be able to effect cost savings in the elimination of this duplication.

Bill 35 has conferred ownership of these local distribution utilities to municipal governments and these municipalities have begun to incorporate their utility interests to separate regulated and non-regulated activities consistent with Ontario Business Corporation Act provisions.

The Province has recently introduced legislation, Bill 100, which may impact the approach municipalities take respecting their ownership interest and, which may enhance Hydro One's dominance in the distribution of electricity within Ontario. In brief, the legislation prohibits the Ontario Energy Board from approving those portions of MEU rate orders that pertain to the servicing of debt obligations incurred to execute a capital structure re-alignment with the municipal owner.

While the proposed legislation has only gone through first reading in the legislature, CBRS expects that, if passed, it will have a favourable impact on Hydro One. To the extent that the municipality will be unable to receive interest payments via a re-capitalization, the local government does not necessarily have a motivation to maintain an equity position in its utility. The local government does not carry any specific expertise in the delivery of distribution services and could be motivated to sell its interest as long as its local rate-payers are provided reliable and cost-effective electricity.

As described in our long-term Hydro One report, a 33% transfer tax is levied on MEU sales to non-public sector entities prior to market opening to promote consolidation within the public sector. The transfer tax effectively crowds out private sector interest in any prospective MEU sale, while the proposed legislation's directive to the Ontario Energy Board to not allow rate setting to re-capture debt service for re-capitalization purposes may motivate municipalities to divest their interest in the local distribution company. Furthermore, there may be limited financial incentive for municipalities to merge and consolidate their local distribution interests with each other following Bill 100 rate setting restrictions.

In our opinion, the 33% transfer tax and Bill 100 effectively render Hydro One as the prime candidate to acquire MEUs such that the company may be able to achieve significant consolidation within the distribution sector. CBRS further notes that the company has the existing management expertise and distribution infrastructure to effect this consolidation.

CBRS will monitor the utility's ability to fund any prospective MEU purchases, particularly the larger local distribution companies, and the financing implications on Hydro One's leverage. A potential risk in funding the purchase of these distribution companies is that Hydro One pays an excessive amount. In addition, since the company can not issue equity capital for these financing purposes, we will monitor the Ontario Energy Board's position respecting full rate recovery of a 100% debt financed MEU acquisition.

Summary

CBRS is satisfied that Hydro One's short-term credit characteristics are consistent with its assigned A-1 rating and we will continue to observe the company's credit strengths and exposures to ensure that the factors contributing to this rating do not change in a material fashion. **CBRS**

HYDRO ONE INC.

(CDN\$ millions)

Year ended December 31

	1999	1998	1997
Abbreviated Financial Statements			
Revenues	\$3,125.0	\$3,048.0	\$3,099.0
Cost of Goods Sold	939.0	1,165.0	1,250.0
EBITDA	1,260.0	1,333.0	1,190.0
EBIT	918.0	1,033.0	888.0
Interest expense	381.0	559.0	584.0
Net earnings before unusual items	343.0	474.0	304.0
Net earnings after unusual items	375.0	474.0	225.0
Current assets	1,085.0	507.0	465.0
less current liabilities	1,874.0	1,456.0	1,697.0
Net current assets	(789.0)	(949.0)	(1,232.0)
Fixed + other assets	9,005.0	8,928.0	8,594.0
Total net assets	8,216.0	7,979.0	7,362.0
less other liabilities	746.0	420.0	334.0
less long-term debt	3,446.0	5,128.0	4,963.0
Equity: share capital	3,759.0	0.0	0.0
retained earnings	265.0	2,431.0	2,065.0
Total assets	10,090.0	9,435.0	9,059.0
Cash flow from operations	713.0	580.0	617.0
Proceeds from LT debt	0.0	0.0	0.0
Capital expenditure (net)	483.0	383.0	289.0
Investments/acquisitions	0.0	0.0	0.0
Repayment of debt	168.0	98.0	226.0
Capitalization (\$ - %)			
Short term debt	1,399.0- 16	1,059.0- 12	1,230.0- 15
Long term debt	3,446.0- 39	5,128.0- 60	4,963.0- 60
Deferred taxes	0.0- 0	0.0- 0	0.0- 0
Minority interest	0.0- 0	0.0- 0	0.0- 0
Equity	4,024.0- 45	2,431.0- 28	2,065.0- 25
Total capitalization	8,869.0-100	8,618.0-100	8,258.0-100
Coverage & Liquidity Ratios			
Net tangible assets	1.9x	1.4x	1.4x
Total debt:equity	55:45%	72:28%	75:25%
Total debt:EBITDA	3.8x	4.6x	5.2x
Interest coverage	2.4x	1.8x	1.5x
EBITDA interest coverage	3.3x	2.4x	2.0x
Cashflow / total debt	14.7%	9.4%	10.0%
All fixed charges coverage	2.3x	1.8x	1.5x
Current ratio	0.58-1	0.35-1	0.27-1
Profitability Ratios			
Net margin	12.0%	15.6%	7.3%
Asset turnover	0.3x	0.3x	0.3x
EBIT % total assets	9.1%	10.9%	9.8%
Return on average common equity	11.2%	21.1%	21.8%

