
1 Q. For those Canadian Crown-owned electrical utilities, whose debt is guaranteed by
2 the province, please provide the DBRS criteria for being considered “self-
3 sustainable” and not create an impact on provincial credit ratings.

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6 A. DBRS does not have a specific report on the criteria for being considered “self-
7 sustainable”. However, PUB-Nalcor-254, Attachment 1 is a commentary published
8 by DBRS entitled “Manitoba Hydro: Recent Developments and Their Impact on the
9 Provincial Credit Profile”. Page 5 of this commentary provides insight into DBRS’s
10 considerations in this subject area.



Insight beyond the rating.

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Manitoba Hydro: Recent Developments and Their Impact on the Provincial Credit Profile

The Manitoba Hydro-Electric Board’s (Manitoba Hydro or the Utility) finances will remain under pressure because of the May 2018 rate decision by the Manitoba Public Utilities Board (PUB). The decision will result in debt peaking higher than previously expected and contribute to ongoing public-sector debt growth.

However, the outlook for the Province of Manitoba’s (the Province or Manitoba) credit ratings remains stable. Manitoba’s credit ratings are solidly placed in the A (high) category, as DBRS continues to classify the debt issued on behalf of Manitoba Hydro as self-supporting and thus excludes it from DBRS’s measure of tax-supported debt.

Manitoba Hydro’s financial strategy has shifted in recent years, as the Utility and government sought to restore the Utility’s balance sheet quicker and reach its financial ratio targets sooner. The strategy included requesting much higher rate increases, although doing so now appears unlikely given the tone and direction of the PUB decision. The result is that debt will peak higher and not begin to fall until the late 2020s.

Nevertheless, the financial outlook for Manitoba Hydro is not significantly different from what it was two years ago when the Utility was planning for more gradual rate increases and a 20-year timeframe to achieve its target equity ratio. The most recent forecast suggests net debt is somewhat higher while earnings are weaker, though DBRS notes that there was considerable uncertainty with respect to the financial forecast in 2016 on account of the major capital projects.

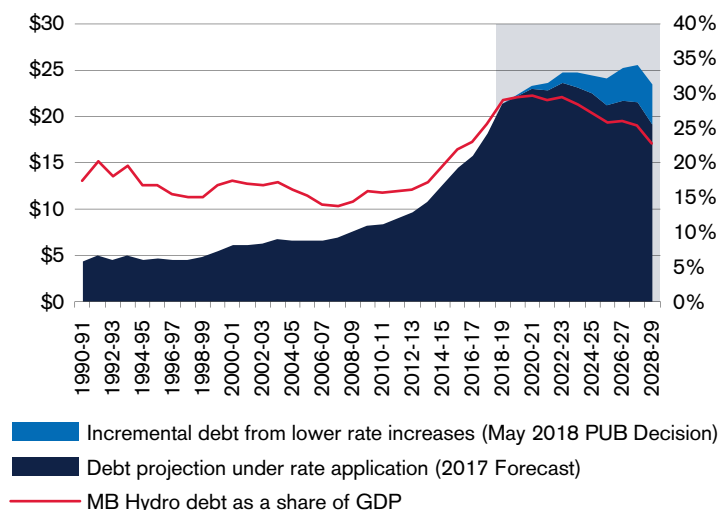
Manitoba Hydro’s history is punctuated by periods of major capital projects. During a project’s construction phase and in the years immediately thereafter, the Utility’s operations and finances are significantly affected. Typically, debt rises sharply and profitability weakens. Then, with gradual rate increases, the financial metrics improve over time. The Bipole III Transmission Reliability Project (Bipole III) and the Keeyask Infrastructure and Generating Station Projects (Keeyask) are long-life assets that will significantly increase reliability of the electricity grid and generating capacity. While export prices in recent years have been softer, movement toward a low carbon economy and rising electricity demand should be conducive to export market conditions in the medium to longer term.

Summary

- Manitoba Hydro’s balance sheet is under pressure. The large capital projects have necessitated substantial new debt issuance.
- Manitoba Hydro’s profitability and credit measures will remain challenged through the medium term.
- Manitoba Hydro will continue to recover its costs from ratepayers. Cash flow from operations remains sufficient to meet operating requirements (i.e., expense and maintenance capex).
- DBRS continues to exclude the debt issued on behalf of Manitoba Hydro from its measure of tax-supported debt.
- DBRS expects Manitoba Hydro’s financial outlook to stabilize in the coming years when Bipole III (2018) and Keeyask (2021) are completed.

Exhibit 1: Manitoba Hydro Debt Forecast

Long-term debt (CAD billions) and as a Share of GDP



Source: The Manitoba Hydro-Electric Board.

DBRS understands that the elected government remains strongly committed to improving the Utility's finances and operational independence. As such, DBRS expects Manitoba Hydro's financial outlook will stabilize in the coming years.

Manitoba Hydro has not yet published its financial statements for the fiscal year ended March 31, 2018, or a revised financial forecast that incorporates the recent PUB decision. This commentary draws upon the financial forecast contained in the rate application and a revised financial forecast (Exhibit 93) provided by Manitoba Hydro to the PUB during the rate hearings. The financial forecast filed in the proceeding as Manitoba Hydro Exhibit 93 supports the Board's decision on the level of the overall rate increase.

Regulatory System

Manitoba Hydro is a Crown corporation established by provincial legislation to "provide for the continuance of a supply of energy adequate for the needs of the Province and to engage in and promote economy and efficiency in the development, generation, transmission, distribution, supply and end-use of energy." (*The Manitoba Hydro Act*)

Manitoba Hydro does not operate under the typical regulatory system for public utilities. The PUB, a rate-setting tribunal, has a more limited mandate, as it does not approve Manitoba Hydro's capital expenditures. Rather, major capital expenditures and export contracts are reviewed and approved by the Province. As well, the Utility is not regulated under a traditional cost of service or incentive rate model, where rates are based on the recovery of all prudent costs plus a set allowed return on the rate base. Instead, rate increases for Manitoba Hydro are determined by the PUB using its judgement to balance the interests of ratepayers (affordability) with the financial health of the Utility.

Major Capital Projects

Manitoba Hydro's balance sheet has deteriorated significantly in recent years. Leverage at the Utility had risen to 85% as at December 31, 2017, which is significantly above the target capital structure of 75% debt and restricts financial flexibility. This deterioration and the subsequent higher rate requests are principally because of two major capital projects that were initiated under the previous government.

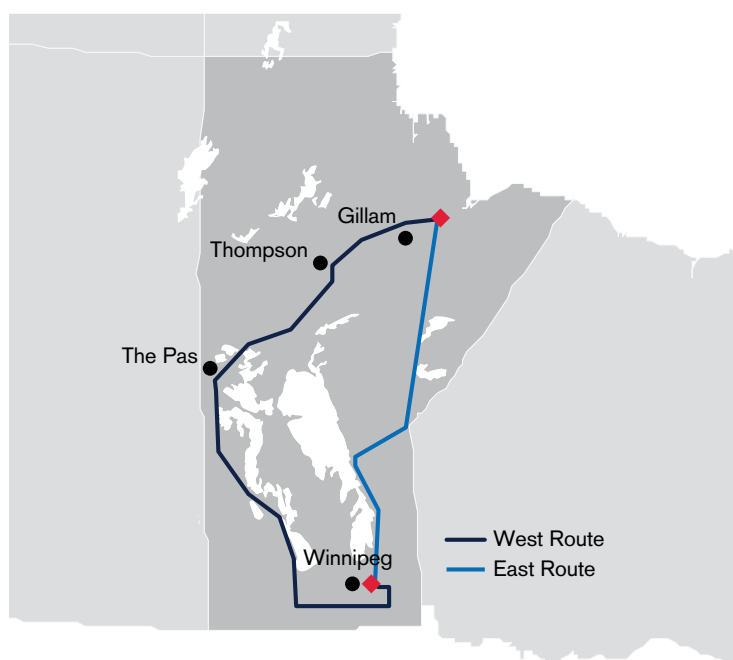
Bipole III

Bipole III consists of a 500-kilovolt high-voltage direct current transmission line (1,400 kilometres (km) and nearly 2,600 towers) and associated converter stations. The new transmission asset, which will increase transmission capacity, is necessary to ensure the reliability of the provincial electricity system. The major electricity generation assets are in the far north, and electricity is transmitted along three major transmission lines, two of which run parallel to one another on the same right-of-way.

Controversy emerged over the route selection and unrealistic budget. The government directed Manitoba Hydro to proceed with the western route because of environmental concerns related to the eastern route. The western route was estimated to cost an additional \$900 million.

Construction began during winter 2013/2014, and the asset is expected to be in service by August 2018. The control budget has escalated to \$5.0 billion from \$3.28 billion at onset of construction. The transmission line and converter stations are complete, and commissioning is now underway. Manitoba Hydro is on track for Bipole III to be in-service in August 2018.

Exhibit 2: Bipole III



Source: The Manitoba Hydro-Electric Board.

Keeyask

Keeyask is a 695-megawatt generation station on the Nelson River in northern Manitoba. The project includes the seven-unit powerhouse, seven-bay spillway, more than two km of dams and 23 km of dykes. In 2014, the PUB recommended that the project proceed because of domestic demand requirements that will emerge in the mid-2020s and favourable export market conditions.

Construction began in July 2014, and generators are now expected to be in service by August 2021. The control budget has escalated to \$8.7 billion from \$6.5 billion at onset, while the in-service date has been pushed back by 21 months.

A Boston Consulting Group (BCG) review in 2016 found that the decision to proceed with Keeyask was “imprudent” in that a number of financial and execution risks were not adequately considered.

In the recent regulatory hearings on Manitoba Hydro’s 2017/18 and 2018/19 General Rate Application, a consultant engaged by the PUB identified the risk that project costs could rise to \$9.5 billion to \$10.5 billion because of lower-than-planned productivity by the principal civil contractor.

Progressive Conservative Government (2016–Present)

The PC government – led by Brian Pallister – was elected in 2016 after 17 years of NDP governments in the province. At the outset, the new Premier committed to addressing concerns regarding Manitoba Hydro’s finances, rising electricity rates and the major capital projects.

The new government appointed a new Board of Directors and committed to improving the Board’s operational independence. The previous Board of Directors had set a target of restoring the balance sheet, with the aim of achieving an equity ratio of 25% within 20 years. The new Board, being concerned with the financial outlook, set a ten-year time frame and initiated a series of measures to achieve this objective, including significant headcount reductions (825 employee departures, representing 15% of total staff by early 2018) and applications for higher rate increases. The new Board also suggested an equity injection by the Province, but the Province declined.

The newly appointed Manitoba Hydro-Electric Board also commissioned a review by BCG on Manitoba Hydro’s financial, operating and capital plans, with particular focus on the remaining risk associated with the projects and whether they should be cancelled or deferred. The review determined that the projects should continue.

Recent Developments

1. Resignation of the Board of Directors (March 2018)

The Board of Directors resigned on March 21, 2018, citing concerns about Manitoba Hydro’s finances and governance, as well as its inability to meet with the Premier. DBRS understands that the impasse between the Board and the government relates, in part, to a proposed \$67.5 million payment to the Manitoba Metis Federation related to the regulatory process for the proposed \$453 million Manitoba-Minnesota Transmission Line.

The Province subsequently appointed a new Board of Directors with the same mandate to restore the Utility’s finances. DBRS’s discussions with the Province and management indicate that the resignations have not had a substantive impact on the Utility’s strategic direction.

Exhibit 3: Keeyask Generating Station Manitoba Hydro’s artist rendering



Source: The Manitoba Hydro-Electric Board.

2. Public Utilities Board Rate Decision (May 2018)

Manitoba Hydro's plan to return to the target equity ratio within ten years required annual rate increases of 7.9% for six years, followed by rate increases of 4.54% for one year, then rate increases of 2.0% for two years. Collectively, these increases would have resulted in a cumulative rate increase of 77% over the ten-year period.

The PUB denied the 7.9% rate increase and ordered a rate increase of 3.6% effective June 1, 2018. The PUB also finalized 3.36% rate increases previously approved as interim effective August 1, 2016, and 2017. Among other recommendations, the PUB recommended that Manitoba Hydro defer \$160 million in capital expenditures; work to identify further opportunities for operating, administrative and capital savings; and review its demand-side management programs.

The PUB stated that “a particular equity level or pace to achieve such a target should not determine rate increases ... particularly when Manitoba Hydro is undergoing record expansion ... of its capital assets.” The PUB was also persuaded that the applied-for increase of 7.9% departed from the principles of rate stability and predictability and would lead to short-term job losses and negatively affect industries and consumers, especially lower-income households and First Nations communities. The PUB dismissed Manitoba Hydro's proposed debt management plan, which would have seen \$3.1 billion in debt retired by 2027.

The PUB will, however, host a technical conference to consider the “establishment of a minimum retained earnings or similar test to provide guidance in the setting of consumer rates in a rule-based regulation.” The conference is expected to occur within the next 12 to 18 months.

The PUB made several policy recommendations to the provincial government, including the following:

- Providing the PUB with the legislative authority to review and approve Manitoba Hydro's capital expenditures;
- Introducing a comprehensive bill affordability program;
- Transferring a portion of carbon tax proceeds to Manitoba Hydro; and
- Suspending the annual debt guarantee fee and capital taxes related to Bipole III paid by Manitoba Hydro to the Province to offset the \$900 million in added cost that resulted from the political decision to re-route the transmission line.

DBRS does not expect the Province to adopt the PUB's recommendations to transfer carbon tax revenue to the Utility or forego \$900 million in debt guarantee fees and capital taxes. The PUB has made similar policy recommendations in the past that have not been adopted by the Province.

3. Review Manitoba Hydro Projects

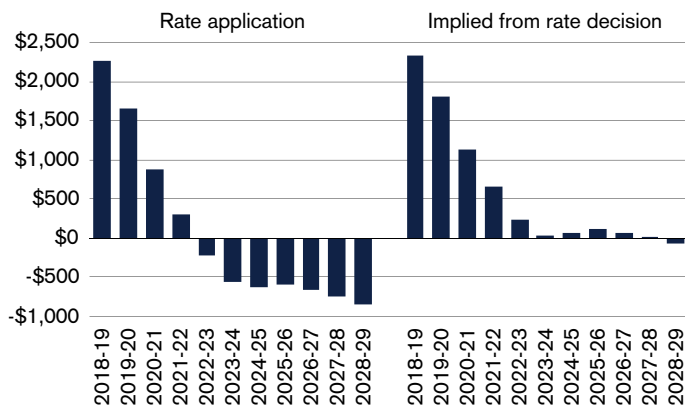
Premier Pallister announced that the government would commission an expert panel to review Manitoba Hydro's projects. DBRS understands that the inquiry is ultimately intended to identify learnings to prevent similar errors from being made in the future. While an inquiry may help provide the public with a better understanding of the issues facing Manitoba Hydro, it will not substantially change the financial outlook.

Financial Outlook

Manitoba Hydro had applied for a 7.9% rate increase effective April 1, 2018. While the application envisioned further rate increases, Manitoba Hydro was not specifically seeking approval for future rate increases. The tone and direction of the PUB rate order, however, suggests that the PUB is unlikely to raise rates at the pace desired by the Utility. As such, Manitoba Hydro's balance sheet, earnings and cash flows will remain under pressure for the foreseeable future.

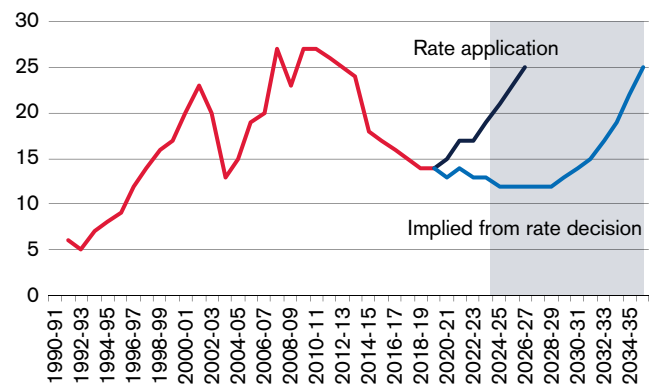
The rate decision suggests Manitoba Hydro's debt level will peak \$1.9 billion higher than expected and remain elevated through the 2020s. The outlook stands in stark contrast to the plan put forward by the Utility to reduce debt beginning in 2022–23. Under the revised outlook, Manitoba Hydro is unlikely to reach its equity ratio target (25%) before the mid-2030s. The current outlook suggests the equity ratio will fall to about 12%, which is somewhat lower than the 15% envisioned in the rate application.

Exhibit 4: Forecasted New Debt Financing Requirements
CAD millions. Excludes refinancing requirements.



Source: The Manitoba Hydro-Electric Board.

Exhibit 5: Equity Ratio
Equity in the capital structure (%)



Source: The Manitoba Hydro-Electric Board.

While the outlook has weakened from expectations, it is not dissimilar from what was forecasted in 2016. At that time, debt was rising sharply, there was significant uncertainty regarding the total cost of the capital projects and the Utility was planning for more modest electricity rate increases (annual increases of 3.95% until 2029). Under this scenario, the equity ratio was projected to fall to 12% as well, with debt peaking at around \$23.5 billion.

There are downside risks to the outlook. Most significantly, it is not clear from the PUB decision what the regulator believes is the appropriate level of retained earnings; the technical conference should provide more clarity on the PUB’s long-term vision of the financial health of Manitoba Hydro though. In addition, Keeyask or other capital projects could face further delays, or export market conditions could be weaker than expected. If these events were to materialize, they could weigh on operating results and lead to further debt accumulation.

Nevertheless, the Province appears committed to improving the finances and operational independence of Manitoba Hydro, and the PUB is required to consider the financial health of the Utility in setting electricity rates in the Province.

DBRS expects that Manitoba Hydro will continue to generate sufficient cash flow to meet its operating requirements (expense and maintenance capex) and that significant policy interventions to subsidize electricity production or eliminate debt by the Province are not forthcoming. As such, DBRS continues to categorize the debt issued on behalf of Manitoba Hydro as self-supporting and thus excludes it from DBRS’s measure of tax-supported debt.

If the outlook for Manitoba Hydro’s finances deteriorate significantly or if policy measures were to be adopted by the Province that effectively result in the Province’s assuming responsibility for operating costs or debt servicing, DBRS could consider reclassifying some or all of Manitoba Hydro’s debt as tax-supported debt, which, depending on the magnitude, could have rating implications for the Province.

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