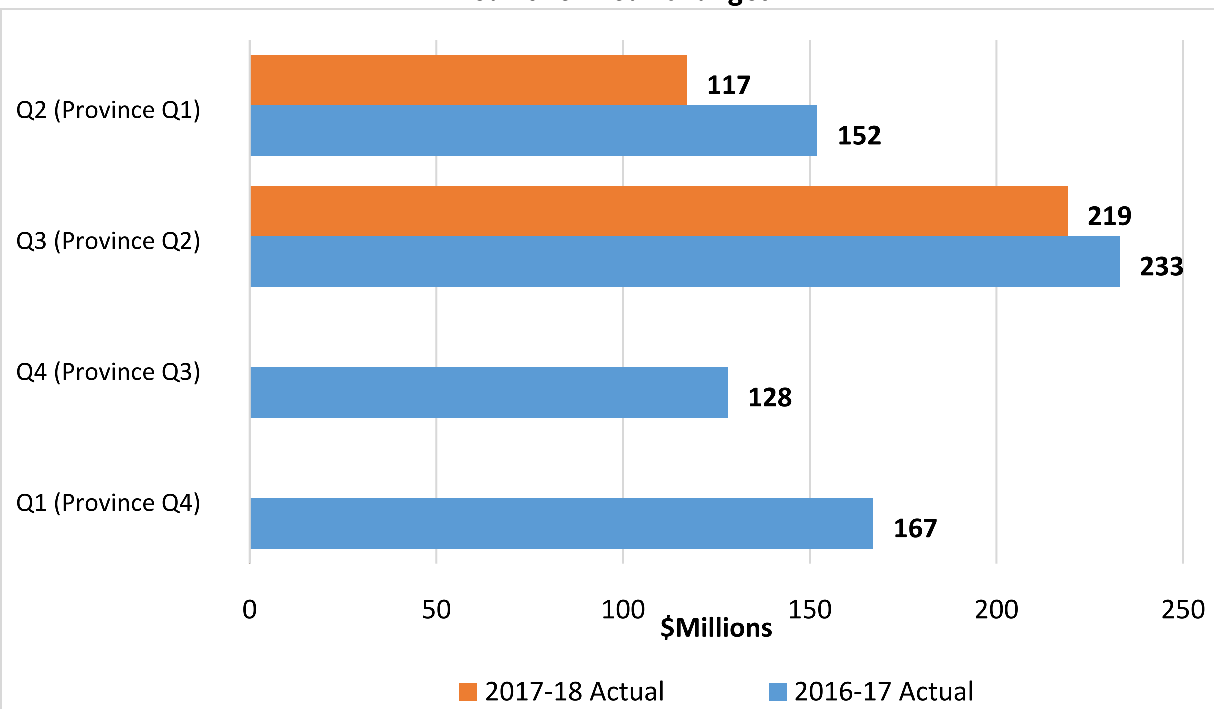
HYDRO ONE LTD: Third Quarter 2017 Update (draft)

KEY FACTS

YEAR-OVER-YEAR CHANGES

Hydro One Quarterly Net Income Attributable to Common Shareholders: Year-over-Year Changes



THIRD QUARTER (PROVINCE Q2): YEAR-OVER-YEAR CHANGES

Net income Attributable to Common Shareholders in Hydro One's third quarter was $219 million, a decrease of $14 million (-6%) compared to the third quarter of 2016. The corresponding net income attributable to the Province reflecting its 49.9 per cent of common shares is $109 million. Earnings-per-share for the three months ended September 30, 2017 was $0.37 compared to $0.39 in the previous year and the decrease was driven by lower net income.

SIGNIFICANT FACTORS THAT REDUCED NET INCOME

- Transmission revenues decreased, due milder weather in 2017 which lowered average Ontario peak demand. This was offset by higher transmission revenues driven by OEB's September 28th decision on the 2017-2018 transmission rates filing, including higher disposition of certain OEB-approved variance accounts, higher export service credits, and higher rate revenues. (Note: The Company's past 2017 Q1 and Q2 financial statements actuals were based on transmission rates in effect before the Sep. 28th OEB decision).
- Distribution revenues decreased due to lower energy consumption.
- Transmission and distribution revenues were also impacted by a reduction in the 2017 allowed regulated return on equity (ROE) from 9.19% to 8.78%

Hydro One noted the following three factors negatively impacted the comparability of third quarter earnings:

- Higher OM&A costs primarily resulting from consulting costs related to the acquisition of Avista Corporation, which was partially offset by reduced vegetation management costs.
- Higher depreciation expense.
- Increased financing charges primarily due to a higher weighted average long-term debt portfolio during Q3 of 2017 compared to the previous year, including long-term debt assumed as part of the Hydro One Sault Ste. Marie acquisition in the Q4 of 2016, as well as the issuance of Convertible Debentures in August 2017.

<u>NOTE: Deferred Tax Benefit Risk</u>

The Q3 results reported by Hydro One do not include any impacts arising out of the OEB's decision with respect to Hydro One's deferred tax benefit associated with the November 2015 IPO.

Hydro One notes that in October 2017, it filed with the OEB a Motion to Review and Vary the OEB's decision and that it also filed an appeal with the Divisional Court of Ontario ('the Appeal').

- The outcome of the Motion to Review and Vary as well as the Appeal are uncertain. However, the Company mentioned in the Q3 Investment Community Teleconference (held on Nov. 10, 2017) that it expects to have successful results in both cases by late Q1 or Q2 2018.

- If the OEB decision is upheld, based on the facts known at this time, Hydro One reports that the exposure from the potential impairments would be a one-time decrease in net income of up to approximately $885 million (Provincial proportionate impact of up to $440 million). There would also be a cash flow impact of an annual decrease to Funds from Operations (FFO) in the range of $50 to $60 million.

PROVINCIAL FISCAL YEAR-TO-DATE: YEAR-OVER-YEAR CHANGES

Hydro One's net income to common shareholders in the second and third quarters (first half of province's fiscal year) was $336 million which is a decrease of $49 million (-13%) compared to the same period a year ago ($385 million). The corresponding net income attributable to the Province, reflecting its 49.9 per cent of common shares is $168 million.

- The decrease was due largely to the milder weather in 2017 resulting in lower average Ontario peak demand and a decrease in lower energy consumption, higher OM&A costs related to the acquisition of Avista Corp., higher depreciation expense, and increased financing charges due to higher weighted average long-term debt portfolio from long-term debt assumed as part of the Hydro One Sault Ste. Marie acquisition in Q4 of 2016, as well as the issuance of Convertible Debentures in August 2017.

<u>ADDITIONAL DETAILS</u>

DIVIDENDS

- During the three months ended September 30, 2017, preferred share dividends in the amount of $4 million and common share dividends in the amount of $131 million were declared and paid.

- On November 9, 2017, the Company declared quarterly cash dividend to common shareholders of $0.22 per share ($131 million) to be paid on Dec. 29, 2017 to shareholders of record on Dec. 12, 2017.
- On November 9, 2017, preferred share dividends in the amount of $5 million were declared.

Common Share Dividends and Provincial Portion					
Quarter[1]	Dividend Payment Date	Amount	Provincial Shares (#)	Provincial Ownership (%)	Province's Total Dividend
Q1-2017	30-Jun-17	$0.22	296,803,660	49.88%	$65,296,805
Q2-2017	29-Sep-17	$0.22	296,803,660	49.88%	$65,296,805
Q3-2017	29-Dec-17	$0.22	296,803,660[2]	49.88%[2]	$65,296,805[2]

1 Quarter preceding the dividend declaration/payment date.
2 Assuming no additional share sales.

Province's Preferred Share Dividends		
Quarter[1]	Dividend Declaration Date	Province's Total Dividend
Q1-2017	3-May-17	$4M
Q2-2017	8-Aug-17	$5M
Q3-2017	9-Nov-17	$4M

1 Quarter preceding the dividend declaration date.

OEB DECISION AND ORDER ON HYDRO ONE NETWORKS INC.'S TRANSMISSION RATES REVENUE REQUIREMENTS

- On September 28, 2017, the OEB issued its Decision and Order on Hydro One Networks Inc.'s 2017 and 2018 transmission rates revenue requirements
- The OEB concluded that the net deferred tax asset resulting from transition from the payments in lieu of tax to the Ontario Electricity Financial Corporation (OEFC) Regime to the Federal Tax Regime should not accrue entirely to Hydro One's shareholders and that a portion should be shared with ratepayers.
- The OEB proposed a basis for sharing a portion of the tax savings by reducing the amount of cash taxes approved for recovery in Hydro One Networks' 2017-2018 transmission rates.
- On November 9, 2017, the OEB issued a Decision and Order that modified the portion of the tax savings that should be shared with ratepayers. This proposed methodology would result in an impairment of Hydro One Networks' transmission deferred income tax regulatory asset of up to approximately $515 million.

- If the OEB were to apply the same methodology for sharing in Hydro One Networks' 2018-2022 distribution rates, for which a decision is currently outstanding, it would result in an impairment of Hydro One Networks' distribution deferred income tax regulatory asset of up to approximately $370 million.
- In October 2017, the Company filed a Motion to Review and Vary the OEB's decision and filed an appeal with the Divisional Court of Ontario (‘the Appeal’).
- The Motion seeks allocation of the full amount of future tax savings from the Deferred Tax Asset of $2,595 million to shareholders; a recovery of $5 million in 2018 for allowance for funds used during construction relating to the Niagara Reinforcement Project; and the recovery of approximately $1 million related to costs for the Ombudsman’s Office.
- With respect to the Deferred Tax Assets, in both the Motion and the Appeal, the Company's position is that the OEB made errors of fact and law in its determination of allocation of the tax savings between the shareholders and ratepayers.
- The outcome of the Motion to Review and Vary as well as the Appeal are uncertain. However, the Company mentioned in the Q3 Investment Community Teleconference (held on Nov. 10, 2017) that it expects to have successful results in both cases by late Q1 or Q2 2018.
- If the decision is upheld, based on the facts known at this time, the exposure from the potential impairments would be a one-time decrease in net income of up to approximately $885 million, resulting in an annual decrease to Funds from Operations (FFO) in the range of $50 to $60 million.

AVISTA CORPORATION MERGERS AND ACQUISITION UPDATE

- On July 19, 2017 Hydro One announced the $6.7 billion enterprise value acquisition (Merger) of Avista Corporation
- On September 14, 2017, Hydro One and Avista Corp. filed applications with state utility commissions in Washington, Idaho, Oregon, Montana, and Alaska, as well as with the Federal Energy Regulatory Commission (FERC), requesting regulatory approval of the Merger on or before August 14, 2018.
- Also on September 14, 2017, Avista Corp. filed the preliminary proxy with the Securities and Exchange Commission related to shareholder approval of the Merger. Required filings with a number of other agencies will be made in the coming months.
- To date, four putative class action lawsuits have been filed by purported Avista Corporation shareholders in relation to the Merger:
    1. Fink v. Morris, et al., was filed in Washington state court and the amended complaint names as defendants Avista Corporation’s directors, Hydro One, Olympus Holding Corp., Olympus Corp., and Bank of America Merrill Lynch. The suit alleges that Avista Corporation’s directors breached their fiduciary duties in relation to the Merger, aided and abetted by Hydro One, Olympus Holding Corp., Olympus Corp. and Bank of America Merrill Lynch.
    2. Jenß v. Avista Corp., et al.
    3. Samuel v. Avista Corp., et al.
    4. Sharpenter v. Avista Corp., et al.
       (2, 3, and 4 were each filed in the US District Court for the Eastern District of Washington and name as defendants Avista Corporation and its directors. The lawsuits allege that the preliminary proxy statement omitted material facts necessary to make the statements therein not false or misleading.)
- The class actions are consistent with expectations for US merger transactions and, while there is no certainty as to outcome, Hydro One believes that the lawsuits are not material to Hydro One.

RISK FACTORS RELATING TO THE MERGER

1. **Hydro One may fail to complete the Merger**
    - The completion of the Merger is subject to receipt of Avista Corp's shareholder approval and satisfaction of other approval conditions.
    - Failure to obtain the required approvals or satisfy or waive the conditions in the Merger Agreement may result in the termination of the Agreement, which may have a negative effect on price of the Instalment Receipts, the Debentures and the Hydro One common shares and will result in the redemption of the Debentures.
    - The Company could suffer significant losses including obligation to pay Avista Corp. a termination fee of $103 million (USD).

2. **The purchase price could increase**
    - If a superior proposal to acquire Avista Corp. is made, and if Avista's board of directors recommends change to Avista's shareholders which is adverse to Hydro One, Avista Corp. is required to negotiate in good faith with Hydro One regarding any revisions to the Agreement, which may result in an increase to the purchase price or changes to other terms and conditions.

3. **Length of time required to complete the Merger is unknown**
    - The closing of the Merger is subject to the receipt of required Avista Corporation shareholder and regulatory approvals and the satisfaction of other closing conditions contained in the Agreement.
    - There is no certainty as to when these conditions will be satisfied, if at all.

4. **Foreign exchange risk**
    - Cash consideration for the Merger is required to be paid in USD, while funds raised in the Debenture Offering, will constitute a significant portion of the funds ultimately used to finance the Merger, are denominated in CAD
    - Increases in the value of the USD vs CAD prior to payment of the final instalment will increase the purchase price translated in CAD and thereby reduce the proportion of the purchase price for the Merger ultimately obtained by Hydro One under the Debenture Offering, which may cause a failure to realize the benefits of the Merger
    - This risk has been partially mitigated through entering into a foreign exchange forward agreement to convert $1.4 billion Canadian to US dollars which is contingent upon the closing of the Merger.

5. **Additional demands will be placed on Hydro One as a result of the Merger**
    - For the completion of the Merger, additional demands will be placed in the Company's managerial, operational and financial personnel and systems.

6. **Sources of funding to be used to fund the Merger may not be available**
    - Hydro One plans to finance the cash purchase price at the closing of the Merger by:
        - i) Net proceeds of the first instalment and final instalment under the Debenture Offering
        - ii) Net proceeds of any subsequent bond or other debt offerings
        - iii) Amounts drawn under Company's $250 million credit facility
        - iv) Existing cash on hand and other sources available to company

- But there is no guarantee that adequate sources of funding will be available to Hydro One or its affiliates at the desired time or at all, or on cost-efficient terms.

7. **Hydro One expects to incur significant Merger-related expenses**
    - Majority of the costs will be non-recurring expenses resulting from the Merger and consist of transaction costs such as, financing of the Merger and obtaining regulatory approval.

ADDITIONAL KEY INFORMATION

ONTARIO'S FAIR HYDRO PLAN

- The Fair Hydro Plan and First Nations Rate Assistance Program came into effect on July 1, 2017 and resulted in a reduction of approximately 25% on electricity bills for typical Ontario residential customers.
- The Province also launched a new Affordability Fund aimed at assisting electricity customers who cannot qualify for low-income conservation programs
- Hydro One customers saw the full benefits of the Fair Hydro Plan for all electricity consumed after July 1, 2017. A typical rural residential customer using 750 kWh per month will see savings on their monthly bills of 31% on average, or approximately $600 annually.

PENSION AND OPEB COSTS (REGULATORY RISK FACTOR)

- On September 14, 2017, the OEB issued its final report, Regulatory Treatment of Pension and Other Post-employment Benefits (OPEBs) Costs (Report), that establishes the use of the accrual accounting method as the default method on which to set rates for pension and OPEB amounts in cost-based applications, unless that method does not result in just and reasonable rates.
- It established the variance account, effective January 1, 2018, to track the difference between the forecasted accrual amount in rates and actual cash payments made.
- Currently the Company reports and recovers pension expense on a cash basis, and maintains the accrual method with respect to OPEBs.
- Transitioning from cash basis to accrual method may have material negative impacts for customers including a higher cost recovered through rates, more volatility relating to predict the effect on rates, and the pension offset (which is $900 million as of Dec. 31, 2016) will have to be recovered in rates on an accelerated basis.
- As the Report establishes that a basis other than the accrual accounting method may be acceptable if resulting in just and reasonable rates, the Company believes cash basis treatment would continue to be supportable.

Electricity Finance Branch
Corporate Electricity Finance Division
November 2017