Credit Opinion: Manitoba Hydro Electric Board

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Manitoba, Canada

Ratings

Category	**Moody's Rating**
Outlook	Stable
Bkd Commercial Paper	P-1

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Opinion

Rating Drivers

Manitoba Hydro-Electric Board's (MHEB)'s Prime-1 rating reflects the explicit guarantee of the Province of Manitoba (Province)

The Province is rated Aa1 with a stable outlook

The Province owns 100% of Manitoba Hydro-Electric Board's (MHEB) equity and holds over 90% of MHEB's debt

Extensive ownership, financial and public policy linkages to the Province

Regulated utility with predominantly low cost hydro-electric generation

Corporate Profile

MHEB is a vertically integrated regulated electric and gas utility which is 100% owned by the Province. MHEB's 14 hydroelectric generating stations typically generate the vast majority (>90%) of the energy the company delivers. The balance of energy delivered comes from thermal and wind assets and imports. MHEB's natural gas segment delivers over 2 billion cubic meters of natural gas to approximately 100 communities in the Province.

MHEB is a provincial Crown Corporation, and in addition to owning 100% of MHEB, the Province directly provides over 90% of MHEB's debt. The Province also unconditionally guarantees virtually all of MHEB's third party debt, including the promissory notes issued under MHEB's promissory note program (commercial paper or CP program). Only $76 million or less than 1% of MHEB's total debt is neither held nor guaranteed by the Province Manitoba. This $76 million is comprised of Manitoba Hydro-Electric Bonds related to "mitigation projects".

SUMMARY RATING RATIONALE

MHEB's Prime-1 (P-1) rating reflects the Province's guarantee of MHEB's promissory note program, together with our belief that the Province manages its own liquidity in a professional manner and will have ready access to capital markets over the next year at a minimum.

Recent Developments

In November 2009, MHEB filed a general rate application (electrical), seeking average rate increases of 2.9% effective April 1, 2010 and April 1, 2011. In February 2010 the Manitoba Public Utilities Board's (PUB) approved a 2.8% interim rate increase, effective April 1, 2010.

However, final resolution of the rate application has been delayed, largely because of the PUB's extensive review of MHEB's risk management practices. This review was prompted by a complaint made by a former consultant to the company in December 2008 under the Province's whistleblower protection laws claiming that MHEB had seriously miscalculated hydrology risk. The Audit Committee of MHEB's Board of Directors and the PUB each engaged independent consultants to assess the validity of these claims. While these reports recommend a number of improvements to risk processes and modelling capabilities, they conclude that MHEB is managing its risk profile appropriately within established risk tolerances. We will continue to monitor the progress of the PUB's risk review, but do not expect this to have any material impact on MHEB's credit profile.

DETAILED RATING CONSIDERATIONS

PROVINCIAL GUARANTEE

MHEB's Prime-1 (P-1) rating reflects the Province's guarantee of MHEB's promissory note program, together with our belief that the Province manages its own liquidity in a professional manner and will have ready access to capital markets over the next year at a minimum. MHEB and a similar entity, British Columbia Hydro & Power Authority (BC Hydro), are unique among Moody's-rated companies and are not readily comparable to other regulated electric utilities. Both are 100% owned by their respective provincial shareholder and the provincial shareholder owns virtually all of the companies' debts. The ratings of both MHEB and BC Hydro reflect the guarantee of the utility's rated debt by the respective provincial shareholder. We observe that MHEB continues to independently support all of its outstanding debt, make water rental payments in excess of $100 million annually to the Province, and earn positive net income thereby maintaining or achieving modest improvements in its financial profile.

Other Considerations

PLANNED GENERATION DEVELOPMENTS WILL BOOST EXPORTS AND ANTICIPATE DOMESTIC DEMAND GROWTH

MHEB meets its customers' needs largely with low-cost power from its hydroelectric plants. Approximately 35% of MHEB's electric revenues come from export sales during normal water years, although low power prices meant that exports represented only 27% of electric revenues for the fiscal year ending March 31, 2010. MHEB continues to have a number of major capital projects in various stages of development. These projects will meet anticipated growth in domestic demand for the next 25-30 years and also allow MHEB to tap increasing demand for renewable energy in export markets. The new generation developments will be partially underpinned by long-term export sales contracts with several US utilities. In April 2010, MHEB entered into power purchase agreements with Xcel Energy for the sale of at least 325 MW of capacity (375MW in summer) between 2015-2025, which will increase by 125 MW from 2021 if MHEB's proposed Conawapa hydroelectric plant has entered service. The agreements remain subject to regulatory approval. MHEB continues to negotiate definitive contracts for a further 750 MW of capacity sales to other US utilities pursuant to binding term sheets signed in 2007 and 2008. These agreements would be conditional upon the construction of the proposed plants at Keeyask and Conawapa as well major new transmission investments. MHEB's policy is to only enter into long-term contracts to the extent of firm energy that could be generated by `dependable flow', which assumes a repetition of the worst river flows on record (1939-41). We understand MHEB's export contracts all contain curtailment provisions which apply if hydrology conditions are more severe than previously experienced, and these help mitigate the low probability, high impact risk associated with extreme drought. We regard this strategy as prudent, but believe that the risk that MHEB could be required to purchase power to meet export commitments has not been entirely eliminated, partly because we believe any attempt to exercise this type of force majeure protection could be subject to dispute.

MHEB's major development projects include the 200 MW run of river Wuskwatim project currently under construction. Wuskwatim, together with associated transmission investment, has an estimated capital cost of $1.6 billion and a current expected in-service date of 2011. Two other major run of river projects, Keeyask and Conawapa, are in early stage development. Keeyask is currently envisioned as a 695 MW project with an estimated budget of $5.6 billion and an earliest in service date of 2019 while Conawapa is currently expected to be a 1,485 MW project with an estimated budget of $7.8 billion and a potential in service date of 2023. MHEB's major transmission project, known as Bipole III, is a new high voltage direct current (HVDC) transmission line on the west side of the Province. The Bipole III line is required to improve the reliability of MHEB's high voltage direct current transmission system and to provide additional capability to deliver power from new generation to southern markets. The current targeted in-service date is 2017, at an estimated cost of $2.2 billion. We note that MHEB's latest estimates resulted in an approximate one-year deferral for the entry into service of both Keeyask and Conawapa projects, and an increase in their combined cost of approximately $2.5 billion. Similarly, revisions to timetable and budget may be made in respect of Bipole III when a review of that project is completed later this year.

BORROWING REQUIREMENTS AND WEAK SPOT EXPORT POWER PRICES LIKELY TO RESULT IN FAILURE TO MEET FINANCIAL TARGETS IN MEDIUM TERM

MHEB achieved its minimum 25% equity target with an as reported equity/total capitalization of 27% at March 31, 2010. Favourable hydrology conditions enabled MHEB to achieve this level earlier than the original 2012 target. However, according to management's 2010 financial forecast, the company will be challenged to maintain its minimum 25% equity ratio after fiscal 2012 and may not achieve the target again until sometime during the middle of the next decade. Although management's forecast assumes a 2.9% annual average electric rate increase in 2011 and 3.5% average electric rate increases annually thereafter, borrowings required to finance MHEB's significant capital program and weak spot export power prices are expected to drive the company's equity ratio below 20% later this decade. This ratio is projected to strengthen rapidly after Conawapa enters service, and we also note that some combination of larger rate increases, an earlier and more dramatic recovery of export power prices or a reduction in debt-financed capital spending could assist MHEB in achieving its financial targets earlier than is indicated by its 2010 financial forecast.

As noted above, MHEB's rating primarily reflects the Province's guarantee and liquidity support. However, MHEB's financial ratios, including interest coverage, are an indication of the extent to which it is capable of supporting its debt independently, which is a consideration in the rating of the Province. MHEB's financial forecasts indicate that management expects to generate sufficient cash flow to service the interest on its debt. However, the anticipated weakening of MHEB's financial profile means that the company has less cushion against unexpected events such as poor hydrology, capital cost overruns or construction delays. Should such unexpected events arise, MHEB might need to seek larger rate increases, curtail its capital spending or take other actions to ensure that the company continues to be able to independently service its debt.

Liquidity Profile

MHEB's CP borrowings are guaranteed by the Province of Manitoba. While the Province does not maintain committed bank credit facilities in support of its short-term borrowing programs, Moody's believes that the probability that the Aa1-rated Province would be unable to obtain funding on a timely basis either from the capital markets or its bankers is highly remote. Accordingly, Moody's is comfortable with the Prime -1 rating assigned to MHEB's provincially guaranteed CP program despite the absence of committed back-up facilities at either MHEB or the Province. While MHEB maintains $500 million uncommitted credit facilities in support of its $500 million CP program, Moody's generally views uncommitted facilities as providing little in the way of support for CP borrowings. Accordingly, our Prime -1 rating of MHEB's CP program relies principally on the guarantee of the Province.

Rating Outlook

The Stable Outlook reflects the outlook of the guarantor, the Province of Manitoba.

What Could Change the Rating - Up

A change in the rating of the guarantor

What Could Change the Rating - Down

A change in the rating of the guarantor

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