**MANITOBA HYDRO**

**2012/13 & 2013/14 GENERAL RATE APPLICATION**

**VOLUME I**

**INTEGRATED FINANCIAL FORECAST & ECONOMIC OUTLOOK**

## INDEX



***Appendices***

# MANITOBA HYDRO
# 2012/13 & 2013/14 GENERAL RATE APPLICATION

## VOLUME I

## INTEGRATED FINANCIAL FORECAST & ECONOMIC OUTLOOK

### 4.0 OVERVIEW OF TAB 4

Tab 4 discusses the Integrated Financial Forecast ("IFF") and financial outlook of Manitoba Hydro. Section 4.1 provides an overview of the 2011 Economic Outlook, Section 4.2 discusses IFF11-2, and Section 4.3 discusses Manitoba Hydro's Financial Targets.

### 4.1 ECONOMIC OUTLOOK

The Economic Outlook is prepared in the spring of each year, which is the start of the annual forecasting cycle at Manitoba Hydro. The forecasts reported in the Economic Outlook are based on a consensus view of several independent sources including Canada's primary financial institutions in addition to several other independent sources, all of which are well known and respected. The most recent forecasts of each of the sources at the end of Q1 are used in the spring Economic Outlook. The spring Economic Outlook provides a forecast of economic and financial variables that are used in business analyses throughout the corporation and are inputs in other forecasts. Variables such as real gross domestic product ("RGDP"), and residential customer projections are inputs to the Load Forecast; interest, escalation and exchange rates are used in a number of component forecasts that are inputs to the IFF.

Due to the continued uncertainty and volatility pertaining to the current economic environment, the forecasts of key near term variables including escalation rates, interest rates and exchange rates that impact the IFF were reviewed in the summer of 2011, with source forecasts available as of the end of Q2 2011. Under most conditions, the summer review is considered the last point in time in the annual planning cycle that new information can be incorporated into the annual IFF. In the event that there occurred a significant financial markets event that made the more current quarterly forecasts for the near term materially different than the spring or summer forecasts, consideration is given to incorporating the more current forecasts for the near term into the IFF process.

This year, the continued falling forecasts of near term interest rates and changes to the forecasts of near term escalation rates and exchange rates over Q3 2011 were considered materially different than the spring and/or summer forecasts and were therefore updated in fall 2011, with source forecasts available as of the end of Q3 2011.

The 2011 Economic Outlook report that was produced in the spring is provided in Appendix 4.1. Also provided in Appendix 4.1 is an update to Appendix A of the Economic Outlook, 2011-2032 report to reflect the latest consensus of source forecasts for the near term as of October 2011.

As a result of these subsequent reviews, the values of certain variables that were used in the IFF differ from those in the 2011 Economic Outlook, 2011-2032 report that was produced in the spring. The Manitoba Hydro short-term and long-term interest rates, shown in the table below, incorporate the relevant spreads and the provincial guarantee fee. The revised variables are as follows:

| | Manitoba CPI % change | Short term Interest Rate | Long term Interest Rate | CAD/USD |
|---|---|---|---|---|
| **2011/12** | 2.0 | 1.90 | 4.75 | 0.98* |
| **2012/13** | 2.0 | 2.25 | 4.70 | 0.99* |
| **2013/14** | 2.0 | 3.20 | 5.05 | 0.99 |

*Note: CAD/USD exchange rate was unchanged from the spring 2011 Economic Outlook for 2011/12 and 2012/13.

## 4.2 INTEGRATED FINANCIAL FORECAST

IFF11-2 sets forth the projected financial results and financial position of Manitoba Hydro for the 20 year period to 2031/32. Its purpose is to provide an indication of the Corporation's long-term financial direction and to serve as a baseline for the financial evaluation of strategic alternatives. The IFF serves as the primary forecast to determine the need for rate increases and the detailed forecasts in years two and three of the IFF form the basis of the revenue requirement portion of the Corporation's electric and gas rate applications.

The forecast IFF11-2 can be found in Appendix 4.2 and was approved by the Manitoba Hydro-Electric Board ("MHEB") on April 26, 2012.

IFF11-2 is an update of IFF11-1 for the following changes that have impacted the projected financial results of Manitoba Hydro:

- The lower General Consumers Revenue ("GCR") resulting from warmer than normal winter weather in 2011/12 and the revenue reduction associated with the 1% rate reduction directed in Order 5/12.
- Net extraprovincial revenues have decreased in 2012/13 compared to IFF11-1 largely due to lower projected export sales volumes and higher projected generation costs resulting from lower than forecast water supply conditions.
- In Order 32/12, the Public Utilities Board ("PUB") approved an interim rate increase of 2.0% effective April 1, 2012.
- The Canadian Accounting Standards Board ("AcSB") issued a decision on March 30, 2012 to provide an option to extend the mandatory International Financial Reporting Standards ("IFRS") changeover date by one year to April 1, 2013. As a result, net income and retained earnings impacts of the transition to IFRS are deferred from 2012/13 to 2013/14 in IFF11-2.
- IFF11-2 proposes an additional 2.5% interim rate increase effective September 1, 2012 required to deal with the further deterioration in net income since IFF11 was approved.

The MH11-2 forecast contains the projected financial results of the Electric operations and can also be found in Appendix 4.2. In this Application, 2012/13 and 2013/14 are the two years for which rate increases are sought. Tab 5 of the Application provides detailed explanations of the actual and forecast revenues and expense related to Electric operations for 2009/10 to 2013/14.

Since MH10-2 was approved by the MHEB in March 2011 (and updated in May 2011 for the revised Bipole III cost estimate), there have been a number of changes which have impacted the projected financial results of Manitoba Hydro Electric operations. Most significantly, extraprovincial revenues have fallen from record high levels since 2008 largely due to reductions in export prices. Lower export prices can be attributed to the reduced value of capacity in the near term resulting from the carryover of excess capacity from the economic recession in the Midwest Independent Transmission Systems Operator

("MISO") market area, a delay in the implementation of and the value of carbon pricing, as well as lower natural gas prices.

Table 4.2.1 below summarizes the changes in net income between MH11-2 and MH10-2. In comparison to MH10-2, Electric operations net income is projected to be approximately $1.0 billion lower over the 10-year period to 2021/22 mainly due to lower electricity export prices (net of lower fuel and power purchased).

**Table 4.2.1 - Comparison of Electrical Operations MH11-2 to MH10-2**
**Increase/(Decrease)**
***(millions of $)***

| | 2012-2014 | | | 2012 - 2022 | | |
|---|---|---|---|---|---|---|
| | MH11-2 | MH10-2 | Variance | MH11-2 | MH10-2 | Variance |
| General Consumers at projected rates | 3,921 | 3,975 | (54) | 17,715 | 17,615 | 100 |
| Extraprovincial | 1,067 | 1,470 | (403) | 5,862 | 7,447 | (1,585) |
| Other | 39 | 22 | 16 | 180 | 87 | 92 |
| Total Revenues | 5,027 | 5,468 | (441) | 23,756 | 25,149 | (1,393) |
| Operating and Administrative | 1,377 | 1,237 | 139 | 5,999 | 5,028 | 971 |
| Finance Expense | 1,277 | 1,333 | (56) | 7,350 | 7,234 | 116 |
| Depreciation and Amortization | 1,108 | 1,270 | (162) | 4,727 | 5,612 | (885) |
| Water Rentals & Assessments | 338 | 338 | (0) | 1,267 | 1,261 | 6 |
| Fuel & Power Purchased | 486 | 580 | (94) | 2,287 | 2,744 | (456) |
| Capital and Other Taxes | 261 | 263 | (1) | 1,242 | 1,274 | (32) |
| Corporate Allocation | 26 | 28 | (2) | 93 | 102 | (9) |
| | 4,873 | 5,049 | (176) | 22,965 | 23,254 | (289) |
| Non-controlling Interest | (2) | 14 | (16) | (28) | (83) | 55 |
| **Net Income** | 152 | 433 | (281) | 763 | 1,812 | (1,049) |

General Consumers Revenue is higher over the first ten years of MH11-2 mainly as a result of projected higher domestic customer growth.

The reduction in extraprovincial revenues in the first ten years of MH11-2 is substantially attributable to lower projected export market prices.

Operating, maintenance and administrative expense increases compared to MH10-2 is primarily related to costs that are no longer eligible for capitalization, which will be expensed in accordance with IFRS. These increases are substantially offset by related reductions in depreciation and amortization and will not have a significant net impact on the annual net income of Electric operations.

Depreciation and amortization expenses are lower than MH10-2 due to the removal of asset retirement costs from depreciation rates and the elimination of the amortization of rate-regulated assets under IFRS partially offset by the change to the Equal Life Group methodology for calculating depreciation rates (as required with the transition to IFRS). Additionally, depreciation and amortization expenses are lower due to increases in estimated asset service lives.

Over the ten-year forecast, Finance expense is higher than MH10-2 as lower extraprovincial revenues increase the corporation’s borrowing requirements resulting in higher debt and finance expense. This is partially offset by projections of lower interest rates and a stronger Canadian dollar compared to MH10-2.

The rate increases proposed for 2012/13 and 2013/14 have been approved by the MHEB for submission to the PUB. Proposed rate increases subsequent to 2013/14 may be changed in subsequent forecasts and are presented for illustrative purposes only. Each year’s revision to the Integrated Financial Forecast is based on the current year’s assumptions including energy supply and demand, projected interest and escalation rates, projected prices for exported energy, operating and capital forecasts and other factors. Changes in any of these assumptions will have an impact on the projected future results. Actual rate applications made in future years will depend upon the circumstances and outlook at that time and will be subject to the review and approval of the MHEB.

## 4.3 20 YEAR FINANCIAL OUTLOOK & FINANCIAL TARGETS

Over the 20-year period to 2031/32, consolidated net income in IFF11-2 is projected to be approximately \$2.1 billion lower than IFF10-2. Over the 20 forecast period, net extraprovincial revenues are projected to be \$4.0 billion lower in IFF11-2 compared to IFF10-2. Approximately half of the reduction can be attributed to the lower projected electric export prices over the entire forecast period. The remaining decrease over the 20-year period is a result of the one-year deferral of Conawapa generating station, the reduction in the new U.S. interconnection capability from 1000 MW to 400 MW in the period 2021/22 to 2025/26, the reduction in the contracted energy delivered to Wisconsin

Public Service in the period 2019/20 to 2025/26, increased domestic Manitoba load to IFF10-2.

Manitoba Hydro has the following three primary financial targets for consolidated operations:

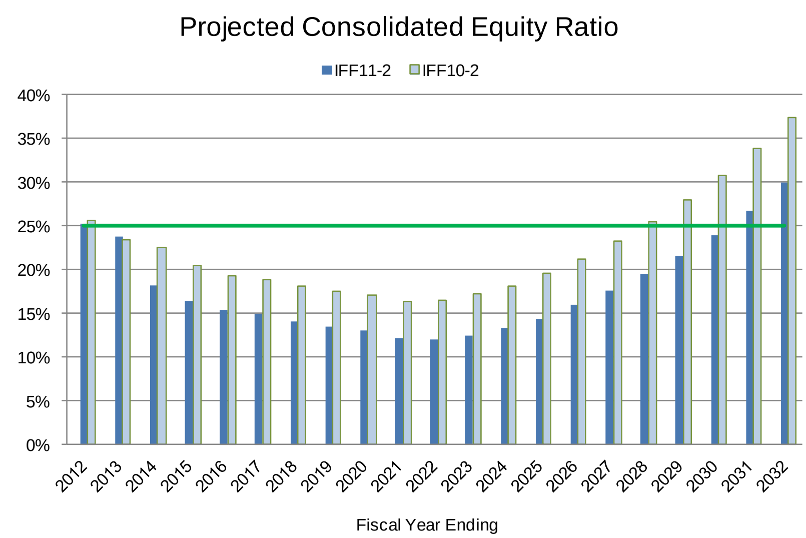
1. Debt/Equity: Maintain a minimum debt/equity ratio of 75:25.
2. Interest Coverage: Maintain a minimum annual gross interest coverage ratio of greater than 1.20.
3. Capital Coverage: Maintain a capital coverage ratio of greater than 1.20 (excepting new major generation and transmission).

The Corporation is embarking on a period of major investment in its generation and transmission systems. It is recognized that it may not be possible to maintain financial targets during years of major investments in the generation and transmission system and that financial ratios will deteriorate during this investment period. However, as is demonstrated in the following charts, a steady improvement to financial ratios is anticipated following this period of investment.

**Equity Ratio**

Figure 4.3.1 below provides the projected consolidated equity ratio for IFF11-2 compared to IFF10-2. Manitoba Hydro's equity ratio was 27% at March 31, 2011 and is projected to be 25% at March 31, 2012. High levels of capital investment in major new generation and transmission combined with reduced net extraprovincial revenues result in a projected deterioration of the equity ratio to 12% by 2021/22. In the longer term, the equity ratio is projected to show steady improvement following the in-service of Keeyask and Conawapa generating stations and returns to the target of 25% by 2030/31.

Figure 4.3.1

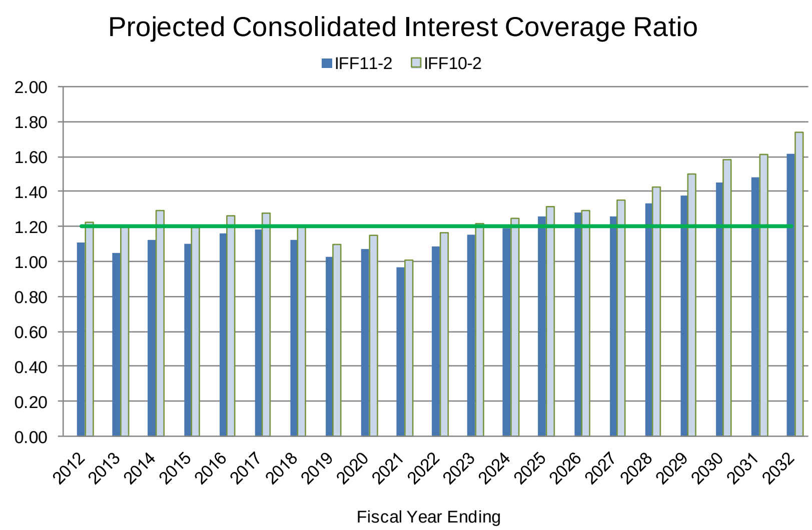


**Interest Coverage Ratio**

Figure 4.3.2 below provides the projected consolidated interest coverage ratio for IFF11-2 compared to IFF10-2. Manitoba Hydro's interest coverage ratio was 1.27 for 2010/11 and is projected to be 1.11 for 2011/12. The reduction in net extraprovincial revenues compared to IFF10-2 results in interest coverage ratios lower than target for the next 12 years of the forecast and it is projected to drop below 1.0 in 2020/21.

In the longer term, interest coverage is projected to return to the 1.20 target level following Conawapa generating station in-service in 2024/25 and to grow steadily thereafter.

Figure 4.3.2



**Capital Coverage Ratio**

Figure 4.3.3 below provides the projected consolidated capital coverage ratio for IFF11-2 compared to IFF10-2. Manitoba Hydro's capital coverage ratio was 1.20 for 2010/11 and is projected to be 0.93 for 2011/12. Capital coverage is below target for the next two years of the forecast and then projected cash flows are sufficient to enable this target to be met in remaining years of the forecast.

Figure 4.3.3