



Moody's Investors Service

## Credit Opinion: **Manitoba Hydro Electric Board**

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Global Credit Research - 08 Feb 2010

*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 2.1 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 \$77 million or less than 1% of MHEB's total debt is neither held nor guaranteed by the Province

Manitoba. This \$77 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 Moody's belief that the Province manages its own liquidity in a professional manner and will have easy access to capital markets over the next year at a minimum.

### **Recent Developments**

In November 2009, MHEB's board of directors approved the corporation's Integrated Financial Forecast (IFF09-1) for the period 2009/10 - 2019/20 inclusive. IFF09-1 reflects the various impacts of the recession as well as the weak spot export power prices that prevailed during 2009. MHEB's base case expectation that weak spot export power prices will persist for some time, combined with large borrowing requirements related to MHEB's heavy capital spending program, is expected to result in a weakening of the company's financial profile. Consequently, MHEB expects to undershoot one or more of its key financial targets (Debt/Equity ratio of 75:25 or less; Interest Coverage ratio of 1.2:1.0 or more; and Capital Coverage ratio (excluding major new projects) of 1.2:1.0 or more) in the medium term.

MHEB filed a general rate application (electrical) on November 30, 2009. The GRA seeks average rate increases of 2.9% effective April 1, 2010 and April 1, 2011. Since MHEB does not expect a final decision from the Manitoba Public Utilities Board (PUB) on the GRA until late summer of 2010, MHEB has requested that the PUB approve the April 1, 2010 rate increase of 2.9% on an interim refundable basis. MHEB hopes to receive a decision on its request for an interim refundable rate increase in February 2010.

The Province's Ombudsman is investigating a complaint made in December 2008 under the Province's whistleblower protection laws claiming that MHEB has seriously miscalculated hydrology risk. The details of the whistleblower's allegations have not been made public, and Moody's notes that MHEB has defended its risk management policies vigorously. A report by independent consultants in September 2009 concluded that MHEB's management of drought risk was reasonable and adequate. The Audit Committee of MHEB's Board of Directors has also engaged KPMG to provide an independent assessment of its drought risk management, long term-contracts, hydrologic modeling and power trading governance. KPMG is expected to present its final report in March 2010. The PUB is expected to consider the report later in the year; and it may be several months before the Ombudsman concludes the formal review of the whistleblower's complaint. Moody's will monitor these developments to determine what, if any, impact they might have 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 Moody's 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. Moody's observes that MHEB continues to independently support all of its outstanding debt, make water royalty 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. These assets are valuable in that they provide the company with the opportunity to sell excess supply into neighbouring states and provinces during peak periods and import energy during off-peak periods. Approximately 35% of MHEB's electric revenues come from export sales during normal water years. 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. MHEB has signed binding term sheets for long-term export sales contracts with several US utilities that will partially underpin new generation developments. These contracts continue to be subject to regulatory approvals, and represent in total around 1,250 MW of capacity. The agreements are conditional upon the construction of new generation and interconnection facilities. 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). Moody's notes that this prudent policy does not entirely eliminate the risk that MHEB could be required to purchase power to meet its contractual commitments in extreme drought conditions.

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 \$4.6 billion and an earliest in service date of 2018 while Conawapa is currently expected to be a 1,485 MW project with an estimated budget of \$6.3 billion and a potential in service date of 2022. 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. Bipole III will act as a back-up to the current system as well as carry power from new generation to the south and to export markets. The current targeted in-service date is fiscal 2017/18, at an estimated cost of \$2.2 billion.

Moody's expects that MHEB will finance the construction of its major development projects with a combination of additional long-term borrowings from the Province and internally generated funds. Management's 2009 financial forecast, which incorporates an expectation of weaker near to medium-term export revenues, indicates that MHEB will be more reliant on debt financing than had been expected in earlier forecasts.

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

MHEB achieved its minimum 25% equity target with an as reported debt/total capitalization of 75% at March 31, 2009. Favourable hydrology conditions enabled MHEB to achieve this level earlier than the original 2012 target. However, according to management's 2009 financial forecast, the company will be challenged to maintain its 75:25 debt/equity target after fiscal 2011 and may not achieve the target again until some time during the next decade. Although management's forecast assumes 2.9% annual average electric rate increases in each of fiscal 2010 and 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 debt/equity ratio to approximately 80:20 later this decade. This ratio is projected to strengthen rapidly after Conawapa enters service, and Moody's also notes 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 2009 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. In the event of such unexpected events, 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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