The Single Biggest Risk for Hydro One Ltd. Rears its Ugly Head, Again

Description

I, for one, am still a believer in the income-generation power (pardon the pun) and long-term capital appreciation ability of regulated utilities. With a regulated utility comes a sense of security and long-term stability — factors investors hoping for a relatively smooth stream of future cash flows prefer.

That said, some regulated utilities such as **Hydro One Ltd.** (TSX:H), have experienced weakness this year on investor concerns that raising utilities rates over time may prove to be much more difficult than anticipated following the company's initial public offering (IPO) approximately two years ago.

Hydro One's IPO was one which brought newfound optimism to a sector which has remained relatively subdued in terms of growth expectations in recent years. With a large percentage of Canadian power generation still government owned and operated, the move for the Ontario government to cede control of the power generation of the country's most populous province was a move which brought investors ready to reap the long-term benefits of privatization in an industry which many saw as poorly run. After all, taking some of the best minds in the industry, attracting them to the utility, and generating synergies from the IPO should be easy, right?

The concept of the privatization of public utilities is one which, in my opinion, should continue to be given credence by investors. The art of streamlining operations, exploring strategic opportunities and partnerships, and attracting private money should, in theory, lead to growth above and beyond what a government-run monopoly could provide.

That said, a recent decision from the Ontario Energy Board (OEB) in which the regulator has stymied Hydro One's plans of increasing rates by 0.5% and 4.8% in 2017 and 2018, respectively, has brought concerns that the utility may not be as readily able to raise rates at will as once was thought to be the case.

The regulator went one step further in its assessment of Hydro One's proposed rate increases, linking the increases to unnecessary improvements in infrastructure and compensation package increases — two factors which may continue to be put under the microscope as the Ontario government attempts to make good on its pledge to create a "fair" Ontario. With Hydro One's profitability in direct conflict with a government mandate to lower rates for consumers, investors will need to assess what price makes sense for Hydro One's shares — a share price which has dipped nearly 5% year to date already.

Bottom line

Hydro One is likely to experience continued medium-term volatility given the Ontario government's need to fulfill its mandate to lower energy bills for the average Ontario resident, while simultaneously raising revenue by issuing new shares in secondary offerings over time.

As a long-term holding, Hydro One may indeed make sense. I would wait for a more attractive entry point, however.

Stay Foolish, my friends.

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chrismacdonald