Will the Ontario Government Destroy Hydro One Ltd (TSX:H)?

Description

In 2016, I wrote that **Hydro One** (TSX:H) had the potential to deliver consistent and reliable profits for shareholders. Since then, shares have fallen by around 20%, pushing the dividend yield up to nearly 5%.

Importantly, the main drivers of the thesis haven't change. However, one factor wasn't incorporated into my pitch: government.

The underlying business is still strong

Let's review what made Hydro One such a compelling stock a few years ago.

The biggest advantage the company had is that 99% of its revenues were regulated. That meant that its profit stream was incredibly predictable. Hydro One enjoyed guarantees for the size of its customer base as well as the prices it can charge. Typically, these contracts had built-in pricing escalators, ensuring the company can raise prices and profitability steadily over time.

None of this has changed. As of last quarter, 99% of its business continues to be fully regulated. With 30,000 kilometres of transmission lines covering 98% of Ontario, the value of its underlying business should remain intact for years to come.

Over the next five years, management anticipates growing at 5% annually and retaining its investment-grade credit rating. It remains committed to its 70-80% payout ratio, meaning investors should continue to expect a roughly 5% dividend over the next few years.

Nothing about the business or its operating conditions suggests the company won't deliver on these promises — that is, unless the government gets in the way.

This is biggest risk factor

As far as businesses go, Hydro One has an incredibly low risk factor. Still, in January, the company paid a $103 million breakup fee to **Avista**, a west coast utility it had been trying to acquire. The fee was triggered after regulators in Washington and Idaho denied the merger of approval.

The deal was nixed for the same reason Hydro One became a publicly traded stock to begin with.

In 2015, the Ontario government privatized Hydro One, executing one of the largest privatizations in Canadian history. This opened the floodgates for investors to get direct exposure to a terrific business. Importantly, the Ontario government retained ownership of 47% of the outstanding shares, giving it a dominant influence over the direction of the company.

In Idaho, regulators determined that approving the merger would give an outside state (Ontario) “significant control and influence over the utility.” Washington state regulators denied the bid, citing the possibility of Ontario’s government “meddling in Avista’s operations.”

According to *The Canadian Press*, regulators specifically cited Premier Doug Ford’s previous forced removal of Hydro One’s CEO, after which the entire board of directors quit. It wrote that this was clear “evidence that the province was willing to put political interests above those of shareholders.”

What’s next?

The future is murky for Hydro One, but it’s not the company’s fault. Operationally, business has never been better. With reasonable plans for future growth, investors should expect a reliable 5% dividend over the next five years. The company’s stock price, however, may see volatility based on the high level of government ownership and influence.

Income investors likely won’t regret accumulating shares, but know that the stable story of Hydro One has changed due to recent events.

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