

# ***Collingwood PUC***

## ***Strategic Planning Session***

**August 18, 1999**

***Today's Presenters:***

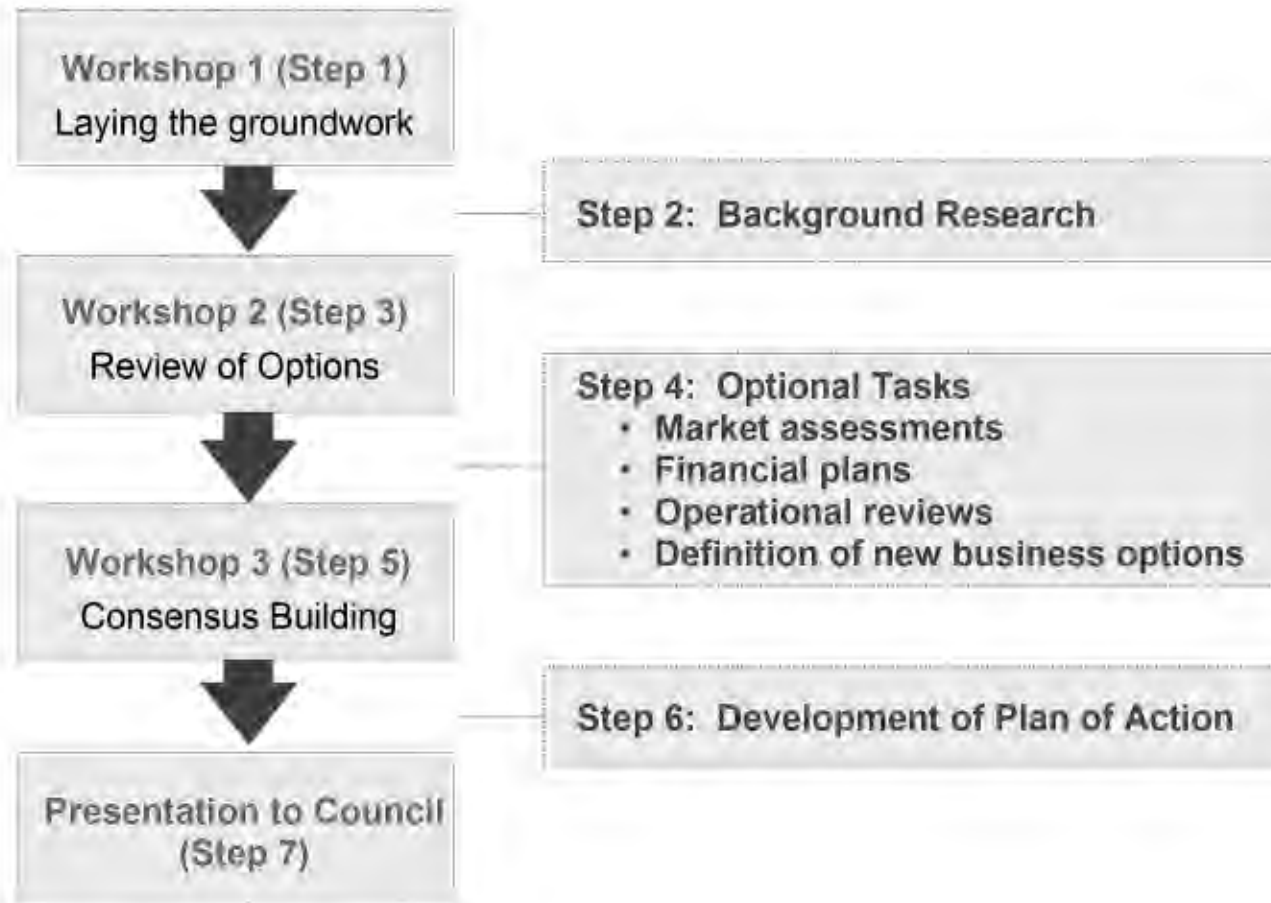
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# *Strategic Planning Workshops*

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## *KPMG's role*

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- \* **Preparation of background information.**
- \* **Meeting facilitation.**
- \* **Research and analysis.**
- \* **Helping to achieve consensus.**

# *Today's agenda*

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- \* **Introduction.**
- \* **Identify legal requirements and future market structure.**
- \* **Assess industry environment.**
- \* **Define Strategic Planning.**
- \* **Identify possible objectives and business options.**
- \* **Provide industry perspectives on partnerships and acquisitions.**
- \* **Assess basic business options.**
- \* **Next steps.**

# *What are you required to do?*

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- \* **Create one or more corporations under the Ontario Business Corporations Act (OBCA)**
  - To assume the functions of distribution and retailing of electricity.
  - In the first instance, the municipality is the sole shareholder.
  - Competitive retail (marketing) activities must be separated from the monopoly, distribution function.
    - Monopoly distribution also referred to as “wiresco” or the “LDC.”
  
- \* **Ownership of water system assets must remain within existing PUC, or be transferred to the Town**
  - Bill 35 does not allow OBCA corporations to assume water utility assets.
  - OBCA entities can, however, “manage” or “operate” a water utility system.

# *Restructuring issues*

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- \* **OBCA corporations created as a result of Bill 35:**
  - Must make “payments in lieu” of tax (PILs), calculated in the same manner as corporate income and capital taxes.
  - PILs include both federal and provincial components.
  
- \* **Valuation issues:**
  - If municipality retains ownership, there appears to be some latitude in setting asset value when setting up financial statements.
  - OEB, however, will probably *not* recognize any premium over original cost when setting distribution tariffs.
  - Higher asset value should increase tax shields for Capital Cost Allowance (CCA). May provide benefit to consumers.

# *Transfer Tax*

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- \* **In the event of a sale, municipality must pay a transfer tax of 33 percent based on “fair market value.”**
  - Tax applies to sale of any interest in utility property.
  - Tax will not apply if municipalities sell to Ontario Hydro Servco, or another MEU, before November 7, 2000.
  - Tax will be reduced by amount of any previous PILs.
  - Makes the “hold” option much more attractive.
  
- \* **Creates an uneven playing field with respect to utility acquisitions.**
  - A private-sector buyer has to bid 50 percent more than Ontario Hydro Servco to provide the same value after-tax.
  
- \* **Provincial government thinking:**
  - It wants to be fully compensated for loss of PILs (federal portion).
  - It believes Servco will be resource-constrained and cannot bid on all MEUs. (It has no access to additional equity capital.)

# *What is optional*

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- \* **You *may* set up a competitive retail company.**
- \* **Almost all of the assets and activities of the existing utility will likely be assumed by the monopoly, wiresco.**
  - Competitive retail function is “greenfield.”
  - Some utilities, however, are looking at putting utility “operations” in a competitive entity that will act as a “service provider.”



# *Electricity Cost Will Be “Unbundled”*

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## **Separate charges will be applied for:**

- \* **Generation.**
- \* **Transmission.**
- \* **Distribution.**
  - Distribution (“Wires”)
  - Metering
  - Billing and Collection
- \* **Stranded Debt (Competition Transition Charge, or CTC).**

## **Issues:**

- Competition applies only to generation component and, for some customers, to metering and billing.

# *Generation*

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## **Generation:**

- \* **Represents about 70 percent of current average electric bill.**
- \* **Wholesale buyers can procure power through:**
  - Hourly spot market. (To be the source of “default supply”.)
  - Bilateral physical contracts with individual generators.
- \* **Wholesale buyers include:**
  - Marketers.
  - Large (direct) industrial companies.
  - Municipal utilities.

# *Market Structure*

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## **The current wholesale cost of power paid by Collingwood PUC:**

- Is a “bundled” charge including both generation and transmission
- Represents about 92% of Collingwood PUC’s service revenues.

## **Transmission:**

- Province-wide, accounts for about 15% of average total power cost.
- Will be regulated. Charges may be based on monthly peak non-coincident demand.
- Charges will be based on “gross demand”.
  - utilities cannot reduce their costs through new embedded generation.
- Transmission charges are paid by “wholesale” customers
  - for retail consumers, transmission costs will be included in the distribution tariffs.

## *Default supply*

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- \* **Provides a “pass-through” of spot market energy prices.**
- \* **Automatically provided to retail consumers who do not select a competitive energy supplier.**
- \* **An affiliate providing “default supply” cannot engage in any other retailing activities.**
- \* **Implications:**
  - Default supply eliminates *most* of the risk to the LDC associated with volatile spot markets and power procurement.
  - Responsibility to arrange default supply does not provide LDCs with any advantage in competitive retail market.
  - May encourage consumers to switch to competitive supply options. (Consumers may prefer fixed price.)
  - Default supply *should* provide lowest price over time. (But short-run may differ.)

# Billing

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- \* **For customers served by a Competitive retailer, two billing options *must* be offered:**
  - Retailers may collect distribution tariffs on the LDC's behalf
  - Customers can elect to receive 2 bills, one from the LDC and one from the retailer
- \* **LDC's can, at their discretion, offer to collect energy charges on behalf of competitive retailers.**
- \* **For all customers, LDC will pay the IMO for energy usage at spot market rates, and will collect an equivalent amount either directly from the customer (if served by default supply) or from their retailer.**

# Metering

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- \* **In the short term, competitive metering will extend only to customers with demand *in excess* of 50 kW.**
- \* **This limit will fall over time.**
- \* **Over time, interval meters with automatic meter reading will become much more widespread.**

## Utility note:

- \* **Collingwood PUC has developed innovative technologies for automatic meter reading. This may be an important competitive advantage in the future.**

# *Restrictions on business activities*

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- \* **According to the Act, as long as the successor companies are owned by a municipality, they can carry out only the following business activities:**
  - Transmitting and distributing electricity.
  - Retailing electricity.
  - Distributing or retailing gas or any energy product that is carried through pipes or wires to the user.
  - Activities that “develop or enhance” their ability to carry on their transmission, distribution or retailing activities.
  - Activities that allow them to use their assets more effectively.
  - Managing or operating the provision of a public utility (i.e. water and waste-water services).
  - Renting or selling hot water heaters.
  - Providing services related to improving energy efficiency.

## *Restrictions on business activities (cont'd)*

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- \* **The Act specifically identifies a number of activities that are allowed under provisions relating to “the effective use” of utility assets. They are:**
  - Providing meter installation and reading services.
  - Providing billing services.
  - Providing telecommunications services.



# Codes of Conduct

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- \* **The OEB has issued:**
  - A Code of Conduct for Energy Marketers (*in draft*).
  - A Standard Supply Service Code (*in draft*).
  - An Affiliate Relationships Code for Electricity Distributors and Transmitters.
  
- \* **These Codes have stringent provisions regarding business separation. They require:**
  - Separate financial records and books of accounts.
  - Separate physical location for an energy services affiliate
  - At least 1/3 of LDC's Board of Directors must be independent of any affiliate.
  - LDC cannot share employees involved in day-to-day network operations with an energy services affiliate.
  - An LDC *can* share employees with affiliates provided that they are not directly involved in collecting, or have access to, confidential information.
  - No preferential access to customer records.

## *Codes of Conduct (cont'd)*

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- \* **There are limits on a utility's ability to invest in affiliates:**
  - Investments and loans (or loan guarantees) cannot exceed 25 percent of the LDC's total equity.
  
- \* **Restrictions are placed on tied marketing**
  - LDC's cannot endorse, or appear to endorse, the products and services of an energy services affiliate.
  - An affiliate cannot imply that it has favored access to LDC services.
  - Affiliates do not have preferential access to customer data.
  - Affiliates cannot use the LDC's name or logo to mislead consumers as to the distinction between the LDC and affiliate.
  - A third party, including an affiliate, that provides default supply on behalf of an LDC cannot market electricity or gas in the LDC's service territory.
  
- \* **Implications:**
  - Competitive affiliates will have to compete for customers just like any other supplier.

# Shared Services

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- \* **Under OEB Affiliate Code of Conduct, some sharing of services is acceptable:**
  - Legal services.
  - Human resources (including comp and benefits administration, and staffing).
  - Financial services and planning, including treasury services and shareholder and investor relations.
  - Insurance and risk management, and audit functions.
  
- \* **Shared services are subject to strict rules regarding transfer pricing.**
  - The price charged by an LDC to an affiliate can be *no less than* fair market value.
  - The price charged by an affiliate to an LDC can be *no greater than* fair market value.
  - In the absence of fair market benchmarks, cost-based prices must be used.

# *Risk assessment*

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**Even for the wiresco, risks will increase.**

- \* **Wiresco to be regulated by the Ontario Energy Board (OEB).**
  - More stringent review than under previous Ontario Hydro regulatory regime.
    - Less tolerance for cross-subsidization between customer classes.
    - Standards to be imposed on service quality (outages, service response time).
- \* **Distribution costs will be “unbundled” as an explicit charge.**
  - It will be much easier for consumers to compare distribution charges among jurisdictions. (Transparency)

# *OEB Regulation*

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- \* **A form of Performance-Based Regulation (PBR) will be applied.**
- \* **Initial tariff levels:**
  - In an initial year, tariffs will be set based on a utility's actual costs
  - At the utility's discretion, costs may be adjusted to include a "private-sector" return on capital
    - Returns on capital based on a "deemed" capital structure
    - For small utilities, 50:50 debt:equity ratio is assumed

## *OEB Regulation (cont'd)*

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- \* **A “price-cap” mechanism will be used to increase tariffs**
  - After the initial year, tariffs are allowed to increase annually by the factor  $(1 + i - X)$ .
    - $i$  represents forecast increase in input costs
    - “X” represents OEB target for productivity increase
  - Utilities can choose among alternative “X” values
    - higher “X” values associated with greater ability to keep “excess” profits from cost savings.
  - Indexing approach applies until end of each PBR period, when rates will be reset
- \* **Implications**
  - Utilities that do not achieve targeted productivity gains will be put at financial risk.

# *Government policy agenda*

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- \* **For the distribution sector, Bill 35 is designed to:**
  - Facilitate amalgamations among municipalities.
  - Allow utilities to achieve economies of scope (energy convergence, telecomm).
  - Provide for commercialization.
  - Enable privatization.
  
- \* **Ministry of Energy assumes that, overall, 25 percent cost savings can be achieved in utility operating costs.**

# *Summary*

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- \* **Radical change is occurring in the electricity sector.**
- \* **Risks, and opportunities, are increasing.**
- \* **Municipalities and MEUs need to understand their:**
  - Long-term interests and objectives.
  - Core competencies.
  - Capacity for bearing risk.



# Generic planning functions

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## Strategic Planning

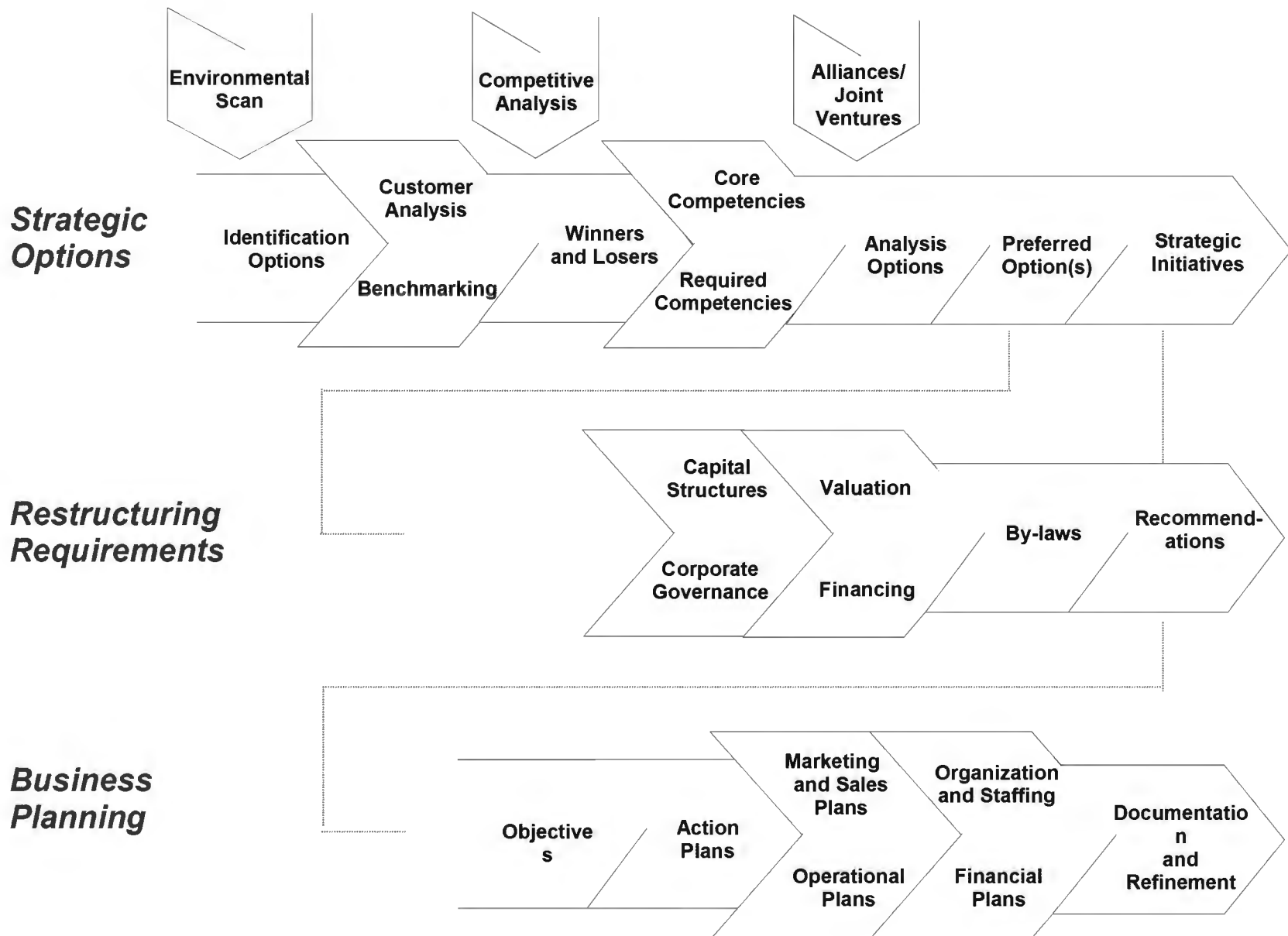
*“What the organization ought to do.”*

- Internal and external environmental scans.
- Current and future competitors, winners and losers.
- Distinctive competencies.
- Analysis of options and the potential for alliances.
- Preferred option(s).
- Strategic initiatives.

## Business/Operational Planning

*“What the organization can/will do.”*

- Market analysis, marketing and sales strategy.
- Operational initiatives.
- Management, organization and staffing.
- Detailed financial planning.
- Work plans and timing.
- Project leaders and participants.



# *Glossary of strategic planning terms*

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<b><u>Term</u></b>	<b><u>Definition</u></b>
<b><i>Core Values</i></b>	The principles that guide behaviours. They are common to all who share the Vision.
<b><i>Mission</i></b>	The reason for being of an organization. The business the organization is in.
<b><i>Vision</i></b>	A description of the ultimate destination or Desired State.
<b><i>Goal</i></b>	What is to be attained through a sustained effort over a medium term of three to five years.
<b><i>Objective</i></b>	What is to be achieved in a specific period of time. It is measurable, and time specific--usually within a period of one year or less.
<b><i>Strategy</i></b>	The means to achieve a goal or objective. A general statement.
<b><i>Tactic</i></b>	A sequence or set of specific actions used to execute a strategy. Usually assigned to a person, with a deadline.
<b><i>Results</i></b>	The actual performance relative to an objective.

# *What Are Your Objectives?*

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- \* **Maximize Net Present Value to City, as shareholder**
  - Income stream
  - Sale value
- \* **Ensure customer satisfaction**
  - Residential
  - Commercial
  - Industrial
- \* **Promote economic development**
- \* **Minimize risk**
- \* **Build asset for posterity**
- \* **Maintain municipal influence**
- \* **Maintain LDC employment**

# *Possible financial objectives*

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## **What are the objectives of the shareholder?**

- \* **Receive a one-time financial windfall through:**
  - Sale of the utility (whole or in part), or
  - Financial leverage (sell debt).
- \* **Receive an on-going income stream.**
- \* **Subsidize local users.**
  - Forego a financial return in return for enhanced service/lower rates.
  - Promote economic development.

# *How could you promote development?*

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## **Promote economic development:**

- \* **Provide low rates to industrial customers.**
  - Maximize efficiency. (Reduce costs of distribution.)
  - Reduce income to Town.
  - Provide access to fixed-cost power.
- \* **Provide enhanced infrastructure.**
  - Provide access to low-cost/high quality telecommunications infrastructure (fibre-optic network).
- \* **Improve energy efficiency of large customers.**
  - Load management.
  - Equipment financing.
  - Partner on cogeneration opportunities.

# *Governance issues*

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- \* **What reporting relationship should Collingwood PUC's successor companies have with the Town?**
  - What is the composition and role of the Board of Directors?
  - What level of influence does Council want to exert over electric utility operations?
  
- \* **Should governance of the ongoing water utility be changed?**
  - What connection should exist, if any, between the OBCA Boards, established above to oversee the electric utility, and the Commissioners of the existing water system?
  - Should current procedures for election of the Commissioners be changed?

# *What will consumers want?*

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## **What do residential consumers want from their energy supplier?**

- \* **A lower price and/or a fixed price.**
  - Not subject to spot market fluctuations.
- \* **Billing convenience.**
  - VISA, pre-authorized payment plans, bundled bills, Internet bills
- \* **“Green” power.**
- \* **Other possible features:**
  - Bundled product offerings (?)
  - Financing (water heaters/heat pumps).
  - Load management.

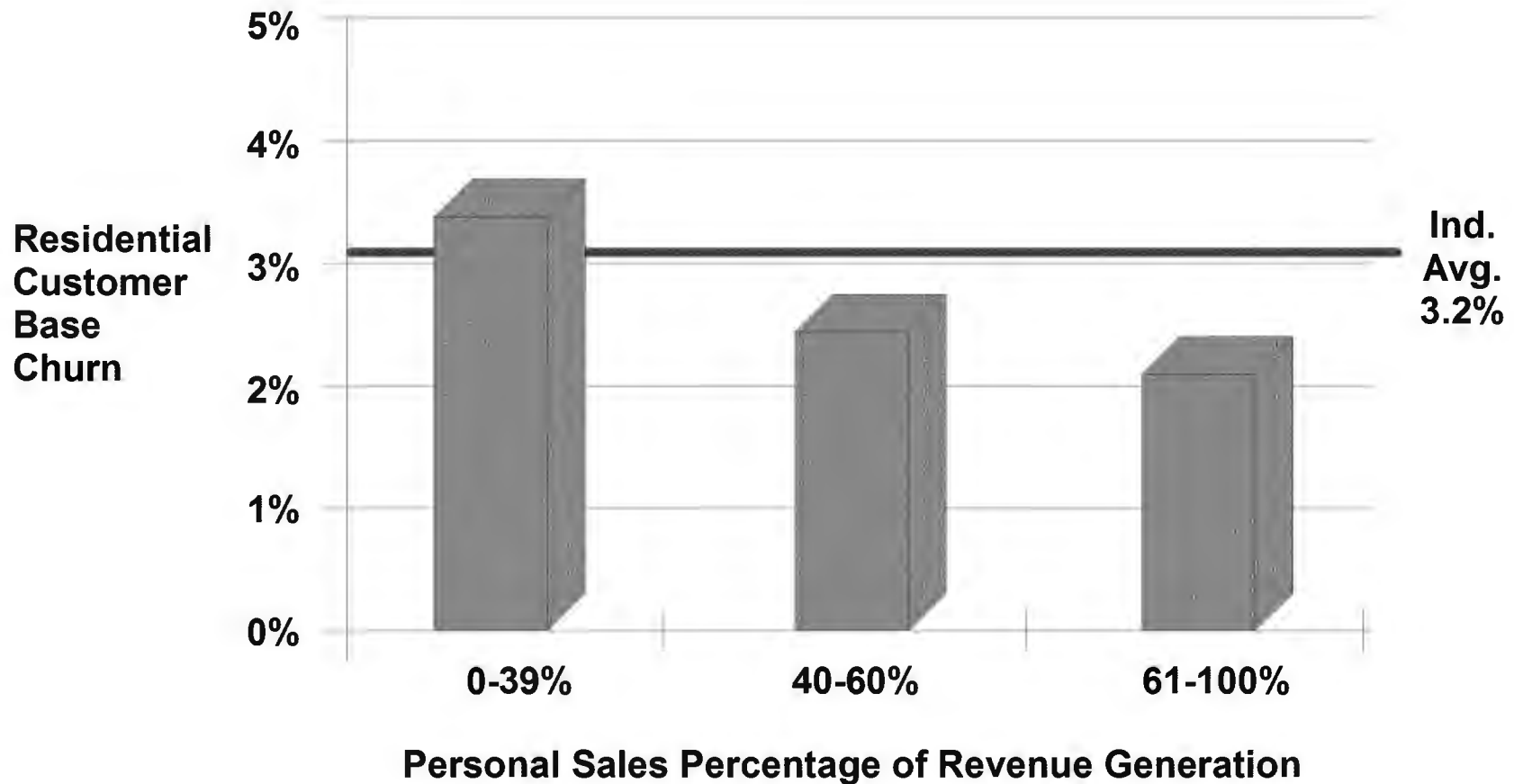


# *Marketing energy*

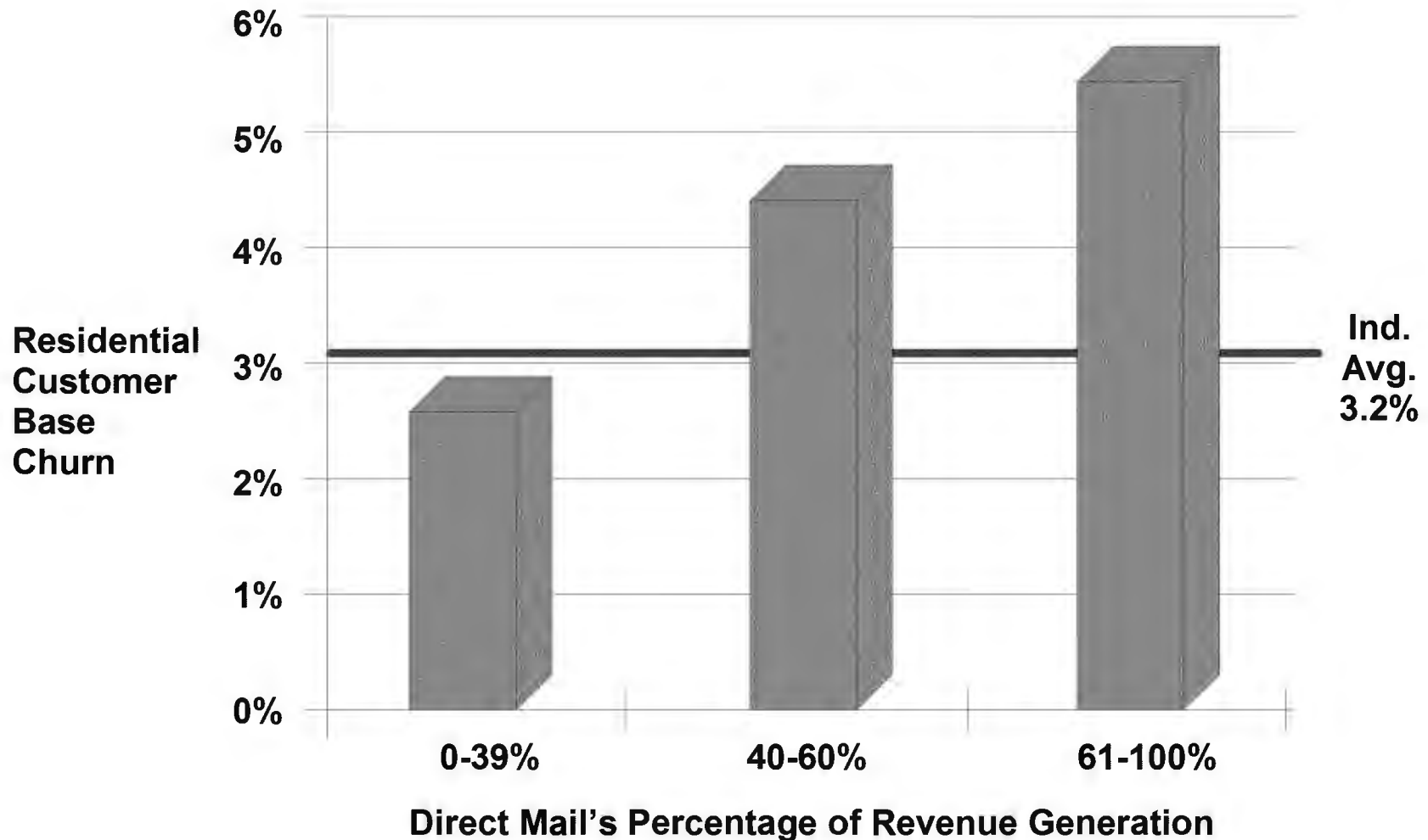
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- \* **Consumer and Business markets differ and will be approached separately.**
- \* **For consumers, energy is a partial means to an “end.” Some companies will bundle energy with HVAC services to provide complete offering (“cold beer, warm house”).**
- \* **Energy is different than telecommunications. Consumers will not buy more or use more if price is lower.**
- \* **To successfully compete only on price, companies need to be lowest cost (and, therefore, involved in generation?).**
- \* **The more personal the sale, the less likely is churn. Companies will seek leverage from face-to-face service and retail presence opportunities to sell energy.**

# *The more personal the sale, the less likely is churn*



## *The less personal the sale, the more likely is churn*



# *What will large consumers want?*

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## **What do commercial/industrial customers want?**

- \* **A lower price and/or a fixed price.**
  - May also want innovative rate structures (e.g. price tied to commodity of interest).
- \* **Guaranteed savings.**
- \* **Outsourcing of all energy procurement.**
- \* **Aggregation of bills across locations.**
- \* **Load management (?)**
- \* **Fuel switching (?)**
- \* **Joint-ventures partners for cogeneration.**

# Marketing issues

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- \* **Difficult to differentiate “core” product.**
- \* **Very aggressive players strategies are likely**
  - Door- to-door tactics were key in natural gas markets
  - Amway has entered US energy market.
  - Retailers may offer loyalty programs (e.g. points programs)
- \* **Alternative suppliers cannot, in fact, provide greater reliability or better power quality.**
  - Supplier failure may have financial consequences, but does *not* affect real-time delivery.
  - Power quality dependent on local distribution, not energy supplier.
- \* **Few products are comparable to “call answer”/”call waiting”.**
  - One example: remotely controlled water heaters.

# *Factors that will determine success*

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## **Success factors in the competitive, retail segment:**

### **\* Core talents:**

- Marketing expertise.
- Marketing *drive*.
- Brand identity.
- Access to lower cost power.
  - linkages with generators.
  - smart purchasing.
- Great customer service.
- Ability to innovate and respond quickly.

### **\* Factors in some segments:**

- Create value from data.
- Ability to partner with customers.

# *What do MEUs currently bring to the table?*

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- \* **Relationship with the customer.**
  - Reputation with customers.
  - Local accountability
- \* **Access to municipal capital.**
- \* **Borrowing power.**
- \* **People.**
  - Technical expertise
  - Operational expertise
  - Expertise in marketing utility services.

## *What don't MEUs bring to the table?*

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- \* **Consumer marketing expertise.**
- \* **Risk-management expertise.**



# *Business options*

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## \* **Participation in Electricity Markets.**

### — Retailing.

- procure electric power for the customers of your marketing affiliate.
- can include the supply of “green power.”
- *not* related to the provision of default supply. (Default supply does *not* require wiresco to fulfill procurement function.)

### — Brokering.

- matching buyers and sellers of electric power. Does *not* include taking a position on one’s own account.

### — Trading.

- trading in wholesale power markets for profit. May include taking positions in the market (i.e. being long or short on power in certain periods and in certain markets ).
- not necessarily related to energy loads in Arnprior Hydro’s service area.

## *Business options (cont'd)*

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- \* **Participation in natural gas markets.**
  - Consumers *may* wish to buy both electric power and natural gas from one supplier.
  - Facilitate fuel switching among customers with flexible equipment.
  
- \* **Cogeneration. Simultaneous production of electricity and thermal power.**
  - Attractive for large industrial and commercial facilities with steady requirements for steam and heat.
  
- \* **District heating/cooling.**
  - Supply of thermal energy (or cooling) through local distribution pipes.
  - Thermal energy could be supplied by cogeneration facilities.

## *Business options (cont'd)*

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- \* **Sale and/or financing of equipment.**
  - HVAC, appliances.
  - Power quality equipment.
- \* **Maintenance contracts.**
- \* **Warranty programs.**
- \* **Consulting services.**
- \* **Energy procurement and load management services.**

## *Business options (cont'd)*

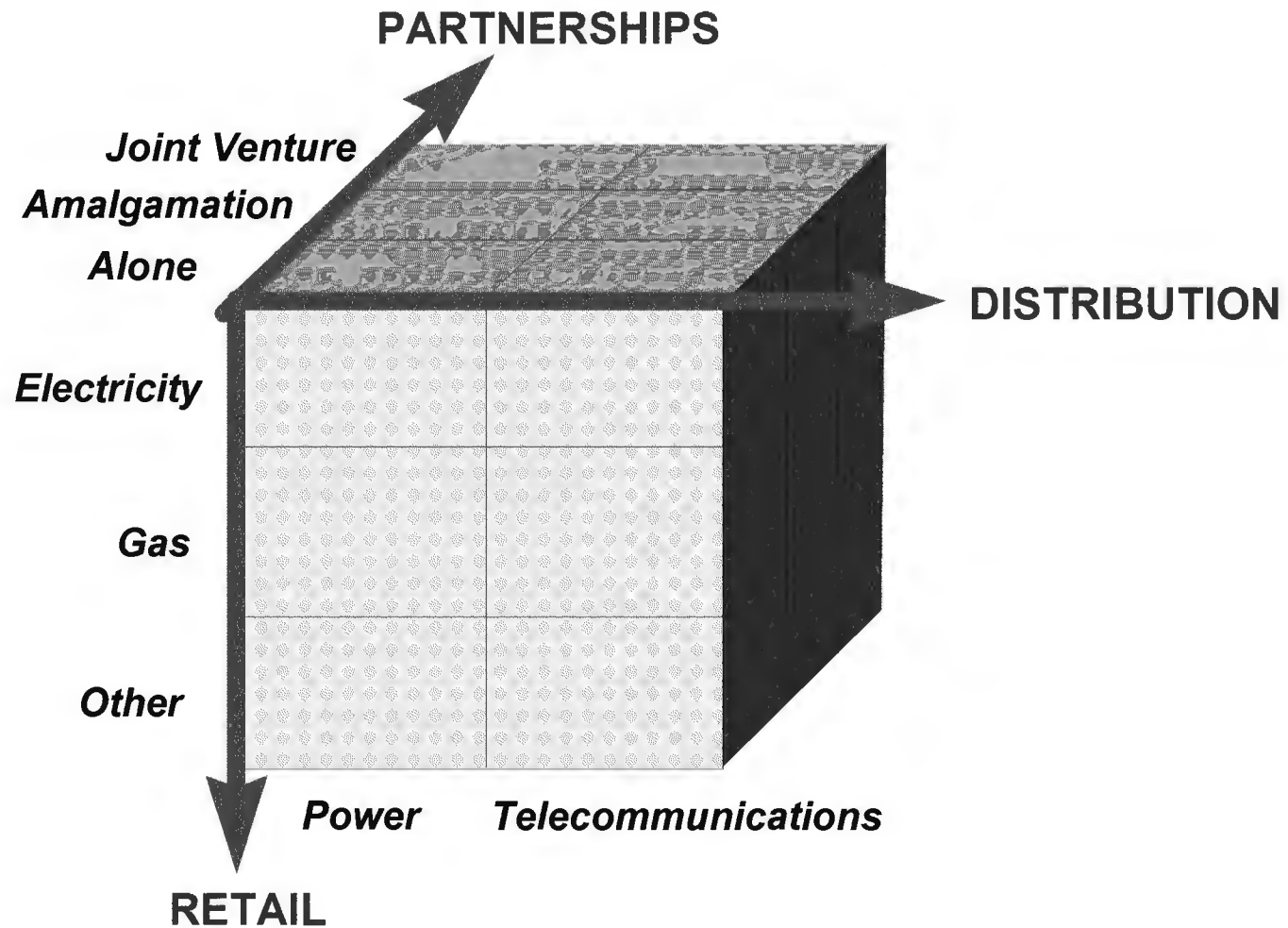
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- \* **Telecomm services. In order of increasing risk:**
  - Lease or rental of utility rights-of-way.
    - no direct provision of equipment or infrastructure.
  - Provision of fiber-optic capacity (or co-axial or copper capacity) to other telecomm suppliers.
  - Direct provision of services to the end consumer.
    - local telephone service.
    - cable TV.
    - private data line services.
    - Internet access.
    - home security.
    - lawn watering services.

# Business map

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# *What about partnerships/joint-ventures?*

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## **Who are potential partners?**

- \* **Natural gas transmission and distribution companies. (Consumers Gas, Centra-Union, TCPL)**
- \* **Large electric utilities. (Ontario Hydro, Quebec Hydro, US utilities)**
- \* **Telcos. (Bell, Sprint, AT&T)**
- \* **Cable companies.**
- \* **Cogeneration developers. (Tractebel)**
- \* **Other MEUs.**

# *What are the partnership options?*

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## **The spectrum of public-private partnerships:**

- \* **Conventional Tender Process.**
- \* **Contract out (Design-Build).**
- \* **Joint-ventures with a private company.**
- \* **Become a franchisee.**
  - Gain access to trademarks, brand labels/brand equity.
- \* **Outsourcing of specific functions.**
  - Metering, billing, call centre, maintenance, data processing, real estate management, fleet management.

# *What are the partnership options? (cont'd)*

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- \* **Operating agreement.**
  - Private sector operates the distribution system for a fee. Meets defined performance specifications.
  - Municipality retains control of revenues.
- \* **Lease arrangement (Concession agreement for wires).**
  - Municipality regains control at end of term.
  - Private operator takes on revenue risks.
- \* **BOT (Build-Operate-Transfer).**
  - Differs from option above in the addition of a capital asset.
- \* **Full privatization scenario.**



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# ***Industry Perspectives On Partnerships And Acquisitions***



# *Who have we talked to?*

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- \* **Potential buyers/partners.**
  - Canadian Niagara Power (Niagara Mohawk, Fortis).
  - Enbridge Consumers Gas.
  - General Public Utilities
  - Nova Scotia Power.
  - Ontario Hydro Services Inc.
  - TransAlta.
  - TransCanada Pipelines.
  - Union Gas.
  - Utilicorp (West Kootenay Power).
  - AEP.
  
- \* **Bond rating agencies.**
  
- \* **We also searched the economics literature.**

# Observations

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- \* **Different partners have different interests, dependent on their own unique circumstances.**
- \* **General principle:**
  - Each partner must bring something of interest to the other.
- \* **Different partners are each looking for different attributes.**
  - Depends on their own unique circumstances.
- \* **Buyers are generally interested in wires assets, not in marketing affiliates.**

## *Why is a wiresco attractive?*

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- \* **Stable, regulated rate of return.**
- \* **Under PBR, enhanced returns may be possible.**
  - Owners may be able to pocket efficiency improvements.
- \* **Provides asset base for owner's energy marketing and trading activities.**

## *Type of transaction*

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- \* **Long-term goal is generally outright acquisition.**
- \* **Willing to consider other arrangements in short-term.**
  - Minority interest (e.g., 10% ownership stake).
  - Partnership on operations.
- \* **Long-term lease of assets would also be considered.**
  - May be politically more palatable.
  - May be a way of avoiding the Transfer Tax.
- \* **Possible forms of payment.**
  - Cash.
  - Combination of debt and cash.
  - Cash, with a small equity component (monetization).

# Valuation factors

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- \* **Factors that increase value of the wiresco:**
  - High growth rate.
  - New assets.
  - Good management.
  - Staff near retirement age.
  - The fewer restrictions on sale, the better.
    - However, buyers *expect* restrictions on employment loss and HQ location.
  - Some inefficiency (?!).
    - Savings are easier to achieve.
    - Assumes that regulatory regime will at least cover initial costs.
    - Inefficiency, however, may be a significant disadvantage under Yardstick regulation.

# Contributed Capital

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- \* **OEB initially proposed that assets funded by Contributed Capital not earn a rate of return.**
  - Recent reports indicate a change of thinking.
  - Given importance of contributed capital for some utilities, could result in significant differences in distribution tariffs among municipalities, and large increases at time of asset replacement.
- \* **Where contributed capital is significant, buyers will make amount of purchase offer dependent on OEB regulatory treatment.**
  - Probably will not affect *which* utilities are attractive.
- \* **For Collingwood PUC, gross contributed capital represents about 16 percent of total utility capital.**
  - Contributed capital, net of accumulated depreciation, will be less.

# *Regulatory regime*

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- \* **In general, potential buyers are not concerned about regulatory uncertainty.**
  - Contributed capital issue is an exception.
  - Regulatory regime is only one of the factors that will determine a bid.
  - Believe that the OEB will be “fair and reasonable.”
  - Natural gas LCDs:
    - Have experience dealing with the OEB, and
    - Are already preparing for PBR.
- \* **When regulatory regime is known, the “dispersion” of bids may decrease.**
  - Initially, buyers will make ‘bets’ on regulatory approach (with some exceptions).
  - Once rules are known, scope for disagreement on value will decrease.



## *Utility size*

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### **Size is generally not a constraint.**

- \* **Most buyers will consider purchasing very small utilities, with some constraints.**
  - Do not want to end up with an isolated utility of inefficient scale.
  - Will look at large utilities first, if many come to the market at once.
  - Concerned about negotiation and transaction costs.
- \* **Size is a bigger issue for buyers who are only marginally interested.**
  - Some buyers are primarily looking for electrical load to complement generation.
- \* **Nevertheless, small utilities may wish to sell themselves as a group.**

# *Telecommunication assets*

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- \* **Telecommunications is generally not on buyers' "wish lists."**
- \* **Buyers either:**
  - Have not given telecom *any* thought.
  - Plan to use partners to evaluate, and bid on, telecomm assets.

## *Sale price*

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- \* **Cornwall Electric's sale price may have set unrealistic expectations.**
- \* **Not all utilities will sell at a multiple above book.**
- \* **Buyers do not expect regulator to allow a return on the goodwill associated with an acquisition.**
  - Premiums over book will, however, generate tax shields, that *may* be of value to a private purchaser (but which are more likely to benefit consumers).

## *Timing of a sale*

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- \* **Nothing is certain regarding best timing.**
- \* **Utilities that are first on the market will probably command a premium.**
  - Potential buyers want to establish a “beach-head.”
  - Number of potential buyers is at its peak.
    - In the longer run, there may be a shake-out among purchasers.
  - A rush to sell to OHSC may occur in advance of the Transfer Tax deadline.

# *Transfer Tax*

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- \* **Creates an uneven playing field with respect to utility acquisitions.**
- \* **Buyers believe that Servco will expand aggressively:**
  - Servco can obtain additional equity capital through partnerships.
- \* **Has dampened some investor's interest.**
- \* **Buyers are actively looking for ways to avoid the tax:**
  - Lease or partnership arrangements.
  - Operating and Maintenance (O&M) agreements.

# *Sale process*

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- \* **Many utilities have asked for binding purchase offers before they have decided to sell (e.g. Lindsay, Gloucester).**
- \* **Some buyers view this process skeptically:**
  - Believe utilities are looking for a free valuation.
  - Believe there was insufficient information disclosure.
  - May create an incentive to submit a bid with significant qualifiers (e.g., use “Bait and Switch” approach).
- \* **Nevertheless, potential buyers typically treat the process as if it were serious.**
- \* **Many RFPs set unrealistic objectives for the bidders**
  - Not possible to simultaneously maximize value, minimize rates and ask for on-going input into utility operations.

## *Distribution activities*

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### **Economies of scale much less significant than in retail sector, but still real:**

- One potential buyer believes that, longer term, a 100,000 customer base is required. Ministry of Finance believes 40,000 to 80,000 customers is sufficient.
- Experience in New Zealand suggests that significant consolidation will occur.
- ‘Networking’ can enhance small utility efficiency.
- Economic literature supports hypothesis of economies of scale.
- Source of efficiencies:
  - Shared computer systems.
  - Joint-service centres.
  - Shared overheads (regulatory and legal staff).

# *Energy marketing*

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- \* **Perceived to be a low margin business by everybody.**
  - Natural gas markets, in particular, are “picked over.”
  - Can be a loss-leader for higher value-added services.
  
- \* **Significant economies of scale, although estimates vary.**
  - One source maintains that a customer base of 300,000 to 400,000 is required.
  - Another maintains that medium to large municipalities can profitably enter the market.
  - Ultimately, 10 to 15 large energy companies are expected to dominate North America market for trading activities.



## *Bond rating agencies*

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- \* **We spoke to:**
  - Dominion Bond Rating Service (DBRS).
  - Standard & Poor's.
- \* **Believe that a single “A” rating yields the lowest cost of capital. For distribution, this will generally be achievable with:**
  - 2.0 to 3.5 times coverage ratio (free cash flow to interest charges).
  - 55 to 60 debt/total capital ratio.

## *Bond rating agencies (cont'd)*

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- \* **Other ratings issues:**
  - Quality of management is important.
  - High growth rates are preferred.
  - Residential customers better than industrial.
  - Larger is better than small (more load diversity).
  - PBR involves slightly more risk than traditional Cost of Service approach.

## *Bond rating agencies (cont'd)*

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- \* **Other issues.**
  - Believe that economies of scale are important, although threshold level is unclear.
  - \$100 million is the likely minimum size for a public debenture issue.
  
- \* **DBRS believes that income trust structure is the most efficient investment vehicle from a tax perspective.**
  - But may not be marketable in the current environment.
  
- \* **DBRS also believes that adjustment to a competitive market will be a challenge for management.**

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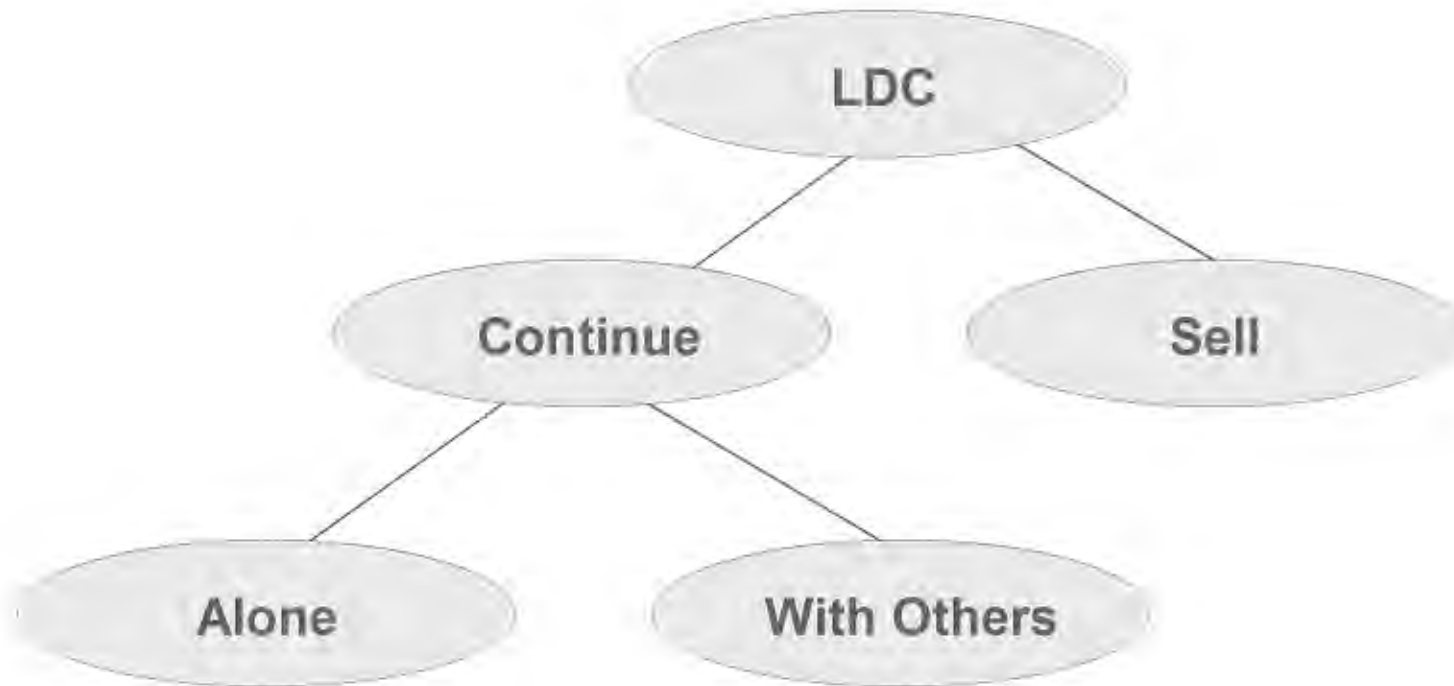
# ***Review Of Options***



## *Possible options - Distribution*

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## *LDC basic business options*

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**For the Town of Collingwood, the following options are available:**

- \* **Retain the utility. Options:**
  - “As is” as a stand-alone entity with its current service territory.
  - Amalgamate with neighbouring utilities.
  
- \* **Sell the utility. Relevant issues:**
  - Timing.
  - Full or partial divestiture.
  - Pursuit of “quasi-sale” options (e.g., long-term lease).

## *Retain the LDC (cont'd)*

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### **Pros**

- Town retains flexibility to choose among alternative financial objectives.
  - You can forego dividends in order to lower rates.
  - Town can receive an up-front payment through debt leverage, if desired.
- Town continues to benefit from economies of scope associated with joint operation of water system.
- Town can use the utility to support economic development initiatives
  - You can help customers with innovative load management technology

### **Cons**

- Town assumes future regulatory risk.
- Town foregoes premium that may be paid by purchasers as a result of:
  - Economies of scale and scope.
  - Strategic value of early sale.

# *Sell the LDC*

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## **Pros**

- \* **Town receives large up-front payment.**
  - Sale price may be greater than value of cash flow to Town because purchaser can access economies of scale and scope.
- \* **Town may receive “wind-fall” gains from purchaser optimism.**
  - Buyers may assume a more favourable regulatory regime than ultimately prevails. Pay more than utility is worth.
  - First on market may receive a “strategic” premium.
- \* **Employees and management *may* enjoy greater opportunity in the long run.**



## *Sell the LDC (cont'd)*

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### **Cons**

- \* **Town loses ability to manage utility's operating strategy.**
  - Service quality, however, will be regulated by the OEB.
- \* **Town loses efficiency benefits from joint operation of water system.**
- \* **Tariffs rise to provide buyer with a required rate of return.**
  - Rates, however, will also be regulated by the OEB.
- \* **Town pays a 33 percent Transfer Tax on the purchase price.**
  - Tax will not apply if you sell to Ontario Hydro Servco or another "tax-exempt" municipal utility before November 7, 2000.
- \* **Employees and management will face greater uncertainty in the short run.**

# *LDC amalgamation*

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- \* **Can be part of a long-term “hold” strategy, or**
- \* **Can be in preparation for a sale.**
  - With or without actual integration of operations.

## **Pros**

- \* **Obtain economies of scale:**
  - Facility rationalization, shared overheads (information systems, administration, call centre, regulatory/legal).
- \* **Share “best” practices.**
- \* **Obtain larger *local* customer pool for competitive marketing affiliate.**
- \* **Increase in size may increase the utilities’ market value.**
- \* **Reduces transaction costs (in the event of a sale).**

## *LDC amalgamation (cont'd)*

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### **Cons**

- \* **Transition costs.**
- \* **“Ratcheting up” of wages and benefits.**
- \* **Complicates decision-making.**
- \* **Loss of local control.**
- \* **Possible loss of local presence.**
- \* **Employees and management may have to compete for their position in a new organization.**

## *Expand into rural area*

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### **Purchase distribution assets from Ontario Hydro retail.**

- \* **Ontario Hydro Retail (Servco) no longer has an obligation to sell its assets at book value.**
  - Negotiations required.
  - Asking price likely to be far in excess of underlying value.
- \* **Rural rate assistance may be extended to low-density areas within MEU service areas.**
  - For a given purchase price, improves financial returns over what would have been achieved in the past.

# *What types of services could be shared?*

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## **Overhead/administrative functions:**

- \* **Specifically mentioned in the Draft Code of Conduct.**
- \* **Could conceivably be shared with Town, with affiliates, and/or with water system.**
- \* **Includes:**
  - Legal services.
  - Human resources (including comp and benefits administration, and staffing).
  - Financial services and planning, including treasury services and shareholder and investor relations.
  - Insurance and risk management, and audit functions.

# *What types of services could be shared? (cont'd)*

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## **Customer-service functions.**

- \* **Could be shared with water system, other utilities, and/or other MEUs.**
- \* **Includes:**
  - Billing and collection.
  - Call Centre.
  - Data processing/CIS.
  - Meter reading.
  - Fleet management.

# *What types of services could be shared? (cont'd)*

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## **Operational services.**

- \* **Could be shared with other MEUs.**
  - Line maintenance services.
  - Meter inspection and/or installation.
  - Load management.
  - System operation and monitoring.

# *Outsourcing*

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## **Should Collingwood PUC outsource services to third-party suppliers?**

- Meter reading.
- Data processing/Customer Information Systems (CIS).
- Billings and collection.
- Call centre.
- Line maintenance.

### **Issues:**

- Are outside suppliers cheaper?
- Impact on labour relations?
- Potential loss of control?



# *Outsourcing*

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## **Pros**

- Potential to reduce costs because of:
  - access to specialized expertise
  - access to economies of scale
- Reduced capital investment
- Reduced management attention

## **Cons**

- Additional oversight costs:
  - Costs to negotiate agreements
  - Ongoing need to monitor 3rd party performance
- Dependence on a third party
- Potential loss of flexibility and control
- Reduces opportunities for employees

# *Acting as a service provider*

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## **Should Collingwood PUC provide services to neighbouring utilities?**

- Meter reading.
- Data processing/ Customer Information Systems (CIS).
- Billings and collection.
- Call centre.
- Line maintenance.

### **Issues:**

- Cost competitiveness will be essential to long-term success.
- Potential customer base may be eroded by OHSC acquisitions.

# *Acting as a service provider*

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## **Pros**

- Income potential
- Can reduce the costs allocated to your own customer base
- Allows management to increase its skill and expertise
- Provides greater opportunities for employees
- May provide economic development benefits for Town of Collingwood.
- Collingwood PUC already has a track record of success.

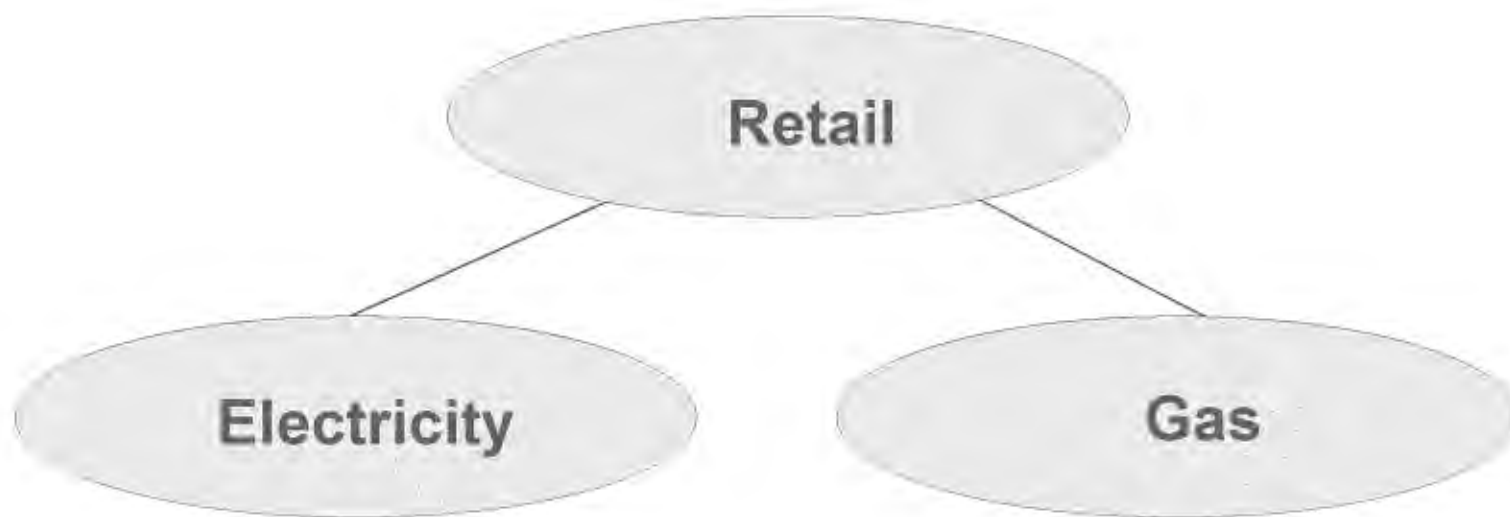
## **Cons**

- May require marketing and sales effort
- May require on-going capital investment
- Requires additional management attention and commitment
- Additional financial risk

# *Review of options -- Retail*

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# *Enter the retail energy market*

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## **Assumptions**

- Collingwood PUC will partner with a wholesale commodity supplier.
- Collingwood PUC acts as a local retail representative, but bears no price or volume risk.

## **Issues**

- Uncertainty over customer penetration and financial returns.
- Uncertainty over required investment.
  - marketing.
  - operations.
- Does the municipality want to compete with the private sector?
- Will local consumers be adequately served by the private sector?

## *Enter the retail energy market (cont'd)*

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### **Pros**

- Utility appears proactive.
- May satisfy customer expectations.
- Capitalizes on brand value and customer relationship.

### **Cons**

- Limited income potential.
- Potential for losses.
- Diverts management attention.
- Marketing activities are generally not valued by potential purchasers.

# *Retail amalgamation*

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## **Pros**

- Economies of scale.
- Easier to attract marketing partners.

## **Cons**

- Blurs brand identity.
- Potential conflict among municipal shareholders.
- Does not provide access to marketing expertise.
- May complicate any future divestiture decision.

## *Next steps*

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# **Appendix: Recent Regulatory Developments**



# *Regulatory developments*

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- \* **Ontario Energy Board (OEB) has just released a Draft Rate Handbook, as well as reports from the four PBR Task Forces:**

- Distribution Rates
- Yardstick Groupings
- Cap Mechanism
- Implementation

- \* **Issues**

- Rate Handbook is subject to revision
- Task Force recommendations are not binding
- Additional debate and discussion likely

## *Regulatory developments (cont'd)*

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- \* **Price-cap approach favoured over a revenue-cap**
  - easier to implement, and less confusing to consumers
  - increases risk to utility from volume fluctuations
  
- \* **Proposed approach to rate setting:**
  - In an initial year, tariff levels will be set based on a utility's actual costs
    - will be adjusted to include a “private-sector” return on capital
  - In subsequent years, rates are allowed to increase annually by the factor  $(1 + i - X)$ .
    - $i$  represents forecast increase in input costs
    - $X$  represents OEB target for productivity increase
  - At end of period, formal review is undertaken
    - rates may be reset

## *Regulatory developments (cont'd)*

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### **Productivity targets (the “X” factor)**

**\* OEB has concluded that**

- historical rate of productivity growth likely underestimates achievable future gains.
- actual level of inefficiency in MEU's today cannot be accurately determined.
- for initial period, productivity targets should be set conservatively (i.e. at a low level).
  - Potential risk from setting targets too high is more serious than risk from setting them too low. (If too high, utilities may face financial insolvency.)
  - Limited initial PBR term can limit potential for windfall profits.

## *Regulatory developments (cont'd)*

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- \* **“Earnings Differential” approach may be adopted for initial PBR period.**
  - In return for accepting a higher X-factor, a utility may be allowed to earn a higher rate of return.
  
- \* **Utilities that are not earning a commercial rate of return will *not* have to share productivity gains with consumers**
  - avoids penalizing municipalities that choose to forego a commercial rate of return.

## *Regulatory developments (cont'd)*

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### **Earnings sharing mechanism**

- \* **Within a PBR period, utilities may have to share “excess” earnings with consumers**
  - Sharing only occurs when earnings exceed a “deadband” limit
  - Limit ranges between 10% and 15%, depending on productivity target selected.
  - Shareholders can keep excess returns under deadband limit.
  - Earnings greater than deadband amount must be shared 75% with consumers and 25% with shareholders

## *Regulatory developments (cont'd)*

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### **“First generation” PBR**

- \* **Will be implemented for a 2 or 3-year period**
- \* **Parameters for inflation and productivity growth (“X-factor”) will be set for all MEU’s together**
  - for a given return on capital, “efficient” MEUs will have to meet the same targets for productivity growth as “inefficient” MEUs
- \* **At end of 3-year period, rates will be reset to achieve target return**
  - limits owners’ ability to profit from productivity growth above PBR target.
  - although not specifically stated, a utility will probably be unable to increase rates to cover PBR productivity targets that it was unable to meet.

## *Regulatory developments (cont'd)*

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### **“Second generation” PBR**

- \* **5-year period likely**
  - Longer term provides owners' with more incentive to make productivity improvements
- \* **Significantly more rigorous in terms of targets and information requirements**
  - Cost of service studies will likely be required
  - Productivity targets may be set independently for each utility
- \* **Utilities will be able to select their X-factor and earnings sharing mechanism**
  - Utilities accepting a higher X-factor will be given a less stringent earnings sharing mechanism. (Shareholders can keep more of any profits above deadband.)



## *Regulatory developments (cont'd)*

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### **Service performance measures.**

- \* **Will cover items such as:**
  - emergency response times
  - connection times for new services
  - telephone accessibility
  
- \* **Will not be tied to explicit financial penalties**
  - OEB can make retroactive adjustments to allowed returns
  - concerns over poor data quality at present

## *Regulatory developments (cont'd)*

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### **Reliability levels**

- \* **Tied to number and duration of power outages**
- \* **Going forward, reliability targets for individual utilities will be based on 5-year averages**

## *Regulatory developments (cont'd)*

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### **Distribution losses**

- \* **Energy charges will include an “uplift” to account for losses in the distribution system**
  - uplift percentage will be based on average losses over the past 5 years
  - utilities will be “at risk” for any increase in actual loss percentage (but will benefit if they can reduce losses)

# *Contributed Capital*

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**Represents assets contributed by developers for new services.**

- \* **Key question is whether contributed capital should be included in rate base**
  - A highly contentious issue. (Has a large impact on utility value.)
- \* **If *excluded* from rate base:**
  - Utilities cannot earn a return on associated capital
  - Utilities cannot claim associated depreciation expense for regulatory purposes.

## *Contributed Capital (cont'd)*

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### **Approach recommended by OEB Draft Rate Handbook:**

- \* **New contributed capital should *not* be included in the “rate base”. Rationale:**
  - Users should not have to pay twice for assets
  - Provides regulatory symmetry with gas LDCs
  
- \* **Contributed capital already in rate base should remain, but equity returns are limited to an MEU’s recent historical return**
  - Minimizes disruption with existing Ontario Hydro regulatory regime
  - Avoids changing regulatory rules after-the-fact.
  - Minimizes potential for large disparities in rates among MEUs.

# *Rate structure*

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## **Distribution Rates Task Force recommends the following approach for core distribution services**

- \* **Residential rates to be a combination of:**
  - Monthly service charge
  - A charge based on energy consumption (i.e. per KWh)
- \* **General Service Rates**
  - To be based on customer's monthly non-coincident peak demand
- \* **Existing allocation of distribution costs among customer classes will be accepted pending completion of a formal "cost of service" study**

# *Contestable services*

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- \* **For all customers, a monthly flat rate charge will be used to collect all costs “downstream” of the meter.**
  - Includes metering services, bill processing, account management and a proportional share of overhead.
  - For consumers taking metering and billing services from a competitive retailer, a credit offsetting *some* of the monthly charge may be provided.
    - Credit for contestable services may be based on MEU’s marginal costs
    - LDC will continue to provide some services for which cost recovery is still required. (i.e. Settlement process and account managment.)

