KPMG

cutting through complexity™

Collingwood Utility Services

Review of Options

24 May 2011

Background

The Context for this Review

During the initial electricity restructuring process in Ontario, the Town of Collingwood undertook a review of its ownership options with respect to the local electricity distribution utility. This review led to the Town's decision in 2000 to retain ownership of its distribution utility and to pursue opportunities for utility expansion.

This review also resulted in the current utility structure, in which a holding company (Collingwood Utility Services Corp., or "Collus") and affiliated service companies provide management and support services to both a wholly-owned electricity distribution utility ("Collus Power") and to the municipal water utility (Collingwood Public Utilities Service Board, or "CPU").

With the passage of time and changes in the Ontario electricity sector, Collus has initiated a new assessment of the ownership options for the Town. This report contains the results of this review.

Report Structure

In the first part of this report, we review general developments in the electricity sector and their implications for municipal distribution utilities. The specific topics addressed are as follows:

- The current structure of the Ontario electricity distribution sector.
- Policies for promotion of a Smart Grid.
- Industry financial pressures.
- Regulatory environment.
- Implications for decision-making by the Town.

In the second part of this report, we review ownership options and the issues that will influence the specific market value of a particular utility. We then conclude with a summary of the advantages and disadvantages of the status quo option and the sale option.

Industry Environment

The Current Structure of the Ontario Electricity Distribution Sector

The Province remains concerned about the current structure of the electricity distribution sector, which includes the continued operation of approximately 80 municipally-owned Local Distribution Companies ("LDCs"). It believes that the fragmented nature of the sector results in additional costs through foregone economies of scale and because of additional requirements for regulatory oversight.

In light of these concerns, many observers expect the Province to take steps to encourage additional LDC consolidation. As in prior periods, these measures are likely to include a time-limited Transfer Tax holiday for mergers and acquisitions involving publicly-owned utilities. Any holiday could also extend to transactions with private-sector purchasers, although the likelihood of this is unknown.

The Province is also concerned, however, that expensive and hard-to-serve rural areas will be left out of any series of voluntary transactions. Hence, initiatives to encourage municipal consolidation may be tied to specific measures to create a number of large, regional utilities. Each of these regional utilities would cover all customers in a given area of the Province.

Transfer Tax

Tax Liability On Sale of Municipal Electric Utility

Under the Ontario Electricity Act., the Town will pay a Transfer Tax equal to 33% of the proceeds if it sells its ownership interest in Collus to another entity. The Transfer Tax payable will be reduced by the amount of any Payments in Lieu of corporate income taxes (PILS) paid since market restructuring.

From time to time, the provincial government has introduced time-limited exemptions (or "holidays") from this tax for sales of municipally-owned utilities to entities owned by municipalities or by the province (e.g. Hydro One). No such exemption is currently in force, although we expect that an exemption may again be introduced after the next provincial election.

The exemptions introduced to date have not applied to sales to private-sector utilities. In a few instances, privately-owned companies such as Fortis, in order to reduce the effect of the tax, have structured transactions in the form of lease arrangements with an option to buy.

Because the Transfer Tax is reduced by any PILS paid to date, the impact of the Transfer Tax should be reduced over time.

The presence of the Transfer Tax means that, if a sale transaction is contemplated, it would make sense to wait until a new exemption is introduced to complete the transaction.

Smart Grid

The Province is promoting the development of a Smart Grid. A Smart Grid entails the application of Information Technology to create a more responsive and reliable electricity system. A Smart Grid is linked to the desire to encourage more renewable and distributed generation and to promote electricity conservation. A Smart Grid can entail or facilitate:

- Sending real-time price signals directly to consumers and to end-use appliances in order to manage load and/or create demand response.
- Accommodating sources of renewable power that may have fluctuating or uncertain output (e.g. wind and solar).
- Managing distributed sources of power that may be located on customer premises and which thereby reverse the normal direction of power flows.
- Automating repair functions so that the grid can self-correct in case of outages or asset failures.

The first step in the development of a Smart Grid is the installation of Smart Meters across all electricity customers in Ontario. Smart meters provide the hourly demand data and capability for two-way information flow that is the necessary foundation for Smart Grid implementation.

The Province's desire for a Smart Grid appears to be driven by the following:

- The desire to promote "green energy" such as solar and wind generation.
- The desire to give Ontario companies an edge in emerging technology fields (e.g. green energy, smart grid technology, distributed generation).
- A belief in the value of conservation and other measures to reduce environmental impacts.

Financial Pressures

Electricity rates in Ontario have been rising at rates greater than inflation as a result of a variety of factors. These include:

- The introduction of the HST.
- Increases in transmission and distribution charges as a result of the need for repair and renewal of electricity networks, implementation of Smart Meters, and general increases in regulatory and other costs.
- The construction of new clean energy plants (natural-gas fired combined cycle) to supply additional capacity in parallel with the phase-out of coal generation.
- The impact of OPA contracts for renewable power at above-market rates.

This has resulted in additional political sensitivity to power costs and may make future Provincial policies somewhat uncertain and subject to change.

Regulatory Environment

Regulatory Oversight

During the initial market restructuring process in the late 1990's, the Ontario Energy Board (OEB) assumed oversight over the Ontario electricity distribution sector. In this role, the OEB controls electricity rates and service standards, and sets rules with respect to utility operation.

Under the OEB's current rate setting approach, LDCs are required to submit a full Cost of Service application every 3 to 4 years. This rebasing process results in rates that cover allowed utility costs and that provide for a regulated return on a utility's invested capital (or Rate Base). The Rate Base takes into account a utility's investment in Property, Plant and Equipment (PPE) and working capital.

Between rebasing applications, the OEB adjusts an LDC's rates through an annual indexing process. This indexing process takes into account general cost trends and changes in the financial market conditions.

Because of the cost and management time involved, OEB rate setting and regulatory processes put significant pressure on all LDCs, but particularly smaller LDCs with limited management resources.

Implications of the Industry Environment

Changes in the industry environment noted earlier may have implications for a decision now by the Town of Collingwood with respect to its ownership options:

- Anticipated provincial actions to encourage consolidation could result in an increase in sale transactions in the future. This could either increase or decrease individual utility value depending on these measures' impact on the balance of buyers and sellers in the marketplace. A Town that is ultimately looking to sell its utility would be wise to position itself now to best take advantage of potential future changes in policy and hence in buyer interest. This may mean examining sale options before changes in provincial policy affect buyer interest or market value, perhaps negatively.
- The move to a Smart Grid may increase utility spending requirements and the need for specialized technical expertise at the LDC level.
- General concerns over the pace of rate increases could result in regulatory or government action to minimize rate increases, potentially depressing future returns to utility owners. However, no specific actions have been announced by the government to date.

Restructuring Options

The Town of Collingwood has a number of options with respect to its electricity LDC. The two major options are:

- **Status Quo.** The Town can continue ownership and operation of the utility under its current structure.
- **Sale.** The Town can entertain offers for purchase from interested parties. A number of variants are open under this Option. These include:
  - The Town could sell its ownership interest in its entirety.
  - The Town could seek to sell only a partial interest in the utility, retaining either a minority or majority share.

These options, and their variants, will be discussed in further detail in the sections below.

We have assumed that the Town is not interested in expanding its ownership interest by purchasing other utilities or in entering into merger discussions with other utilities.

Utility Valuation

In theory, regulated utilities should sell at values close to their book value since they are regulated based on their actual costs and by applying a regulated return on their invested capital. In practice, utilities often trade at a premium above book value.

A purchaser's willingness to pay a premium over book value for a given utility will depend, in part, on its ability to reduce costs relative to those incurred under the utility's current ownership structure. The ability to reduce costs will influence a purchaser's future expected income stream, since such purchasers will generally be able to retain some of the operating savings for at least a period of time.

In the longer term, operating cost reductions, if achievable, will generally be passed through to consumers and should thus result in lower rates.

Purchasers may also pay a premium for "strategic" assets that can help them gain further in-roads into a sector or geographic region. For example, Collus may have strategic value as a utility that is at the centre of an area with a number of other potential acquisition targets. A buyer that purchases Collus may have an operating cost advantage in purchasing additional utilities in the area in the future. This may be a factor that influences market value if there is strong provincial policy support for additional LDC consolidation.

Operating Synergies

Potential sources of operating synergies for a purchaser are as follows:

- **Billing and Collecting Costs.** A purchaser from the utility sector may be able to expand its existing billing and collection system to service customers in Collingwood at relatively low incremental cost. This may result in savings from the elimination of Collus's existing operations in this area.
- **Regulatory Costs.** A utility purchaser would likely integrate Collus's operations into its existing business and apply for harmonized rates on an overall basis. This would allow it to eliminate the costs of a separate rate application for Collus, saving costs associated with periodic rate filings and regulatory reporting.
- **Operating Costs.** A purchaser with nearby or adjacent service territories may be able to integrate operating and maintenance functions and to combine service centres, leading to efficiencies in the deployment of line staff and in real estate costs.
- **Other Overhead Costs.** Certain support functions such as Human Resources, Engineering, and Finance may be provided from a combined utility more efficiently than they could be provided by separate stand-alone utilities. It must also be noted, however, that Collus already obtains some of these types of synergies by providing support services jointly to both the LDC (Collus Power) and the Town's water utility (CPU).

The synergies that can be achieved will be very dependent on the specific purchaser of the utility. Identifying the specific quantum of synergies that might be obtained in this case would require a detailed analysis of utility operations of both a purchaser and Collus Power.

Operating Disynergies and Rate Harmonization

Dis-Synergies

A sale transaction may also result in dis-synergies, or increases in costs relative to today's operating structure. Potential sources of dis-synergies are as follows:

- **Harmonization of Wages and Benefits.** A purchaser may provide its employees with higher wages and benefits than are currently available at Collus. Integration of the utilities would thus result in an increase in wages and benefits for Collus's existing employee base, increasing overall payroll costs. Harmonization may be a particular issue for Collus, since it has lower wage rates than many potential purchasers based in the GTA.
- **Costs of Integration.** Integration of Collus's operations into those of a utility purchaser would lead to some initial costs of integration. These would include the costs of harmonizing systems and processes.
- **Costs of On-Going Operation.** Integration of Collus's operations into those of a utility purchaser may lead to some additional on-going costs related to the operation of a utility with a larger and more geographically-dispersed service territory. These include costs for transportation and travel time and perhaps a loss in some decision-making effectiveness because of a remote management team.

Rate Harmonization

If Collus is purchased by a buyer that now has higher costs, and hence higher rates, then harmonization of rates could increase rates for Collus consumers, even without changes in the cost structure at Collus itself. This is not a dis-synergy, because it does not reflect increases in operating costs as a result of a merger. However, it will nevertheless have a negative result for Collingwood consumers. The potential for this impact will depend on the specific rate structure of any proposed purchaser and its plans for rate harmonization.

Affiliate Relationships

Impact of a Sale Transaction on Relationships with the Town and Water Utility

Collus provides management and support services to both the LDC and to the water utility. Any sale transaction could result in changes in these management and support service arrangements, and this could have an impact on costs going forward at the Town and the water utility. Any such impacts would ultimately need to be examined as part of the financial analysis, from the Town's perspective, of any proposed transaction.

Potential purchasers of the utility may have a variety of preferences with respect to operating structure:

- A purchaser may wish to continue Collus's current approach to combining support services, and would thus be interested in continuing to provide services to the water utility and potentially also to the Town.
- A purchaser of the LDC may wish to operate it independently of the water utility and the Town and may thus wish to sever existing affiliate transactions. This decision would likely depend on the purchaser's ability to obtain management and support services from its other existing, operating companies.

Because potential buyer interests in this regard are unknown, analysis of this issue now would be premature.

Issues Related to Ownership Options - I

In this section, we discuss some general issues related to the evaluation of the Town's ownership options.

Issues

- **Rate Impacts.** The long-term impact on rates of the Status Quo option, relative to the Sale Option, will depend on the utility's operating costs on a stand-alone basis relative to those that would be incurred by a potential purchaser. It the utility can operate more cost-effectively on a stand-alone basis, then rates should be lower. Conversely, if stand-alone costs are higher, then rates will be higher.
- **Utility Consolidation.** It is possible, but of uncertain probability, that a future provincial government may mandate the consolidation of distribution utilities on a regional basis. In this case, the Town may lose control over the utility in any event and may also have limited influence on a transition process.
- **Business Complexity.** The business of operating a local distribution utility is becoming more complex with the transition to a Smart Grid, increased requirements for regulatory reporting and compliance, and greater expectations with respect to customer service. These developments will put a premium on technical and business expertise going forward. A utility operating on a stand-alone basis will need to be comfortable with these challenges.
- **Demographic Challenges.** Like many other utilities in the Province, Collus is facing issues associated with the aging of its work force and the need to replace retiring employees. If operated on a stand-alone basis, the utility will need to have a plan for addressing potential future staff shortfalls. For a purchaser in a Sale transaction, expected future retirements at Collus may be viewed positively, since they provide an opportunity to reduce head count without incurring severance costs.

Issues Related to Ownership Options - II

Issues *(Continued)*

- **Control.** As a regulated utility, Collus Power is subject to oversight by the Ontario Energy Board (OEB). Thus, decisions on rates and service quality for any owner are constrained by OEB rules in place. Under the Status Quo option, the ability of the Town to control rates and service quality is therefore subject to limits. In decisions to date, we note that Collus Power has applied in its rate applications for the maximum rates allowed under OEB guidelines. Hence, the Town has not exercised its option to accept lower rates of return than allowed by the OEB. Under the Sale Option, the Town would lose direct control over rate applications made, but can take comfort that utility decisions will still be subject to external regulatory oversight.

Issues Related to Ownership Options - III

Partial Sale Options

As noted earlier, the Town could seek to sell only a partial interest in its LDC, thus retaining either a minority or majority equity stake. The advantages and disadvantages of a partial sale transaction will combine those from both the Status Quo and Sale options, with the specific mix depending on the nature of the proposed transaction. In essence, a partial sale represents a "hybrid" option that may vary in its impact.

We have some general comments with respect to a partial sale or divestiture transaction:

- **Governance.** The involvement of multiple owners means that governance issues will need to be carefully addressed. This will avoid problems related to future owner disagreement on utility operations and policy. Issues to be addressed will include requirements for approval on major decisions, rights of first refusal in the event that one owner wants to sell its ownership interest in the future, and a general need for agreement on policy decisions with respect to rates and dividend income.
- **Buyer Interest.** Only certain buyers may entertain a partial sale transaction, thus reducing the potential pool of purchasers.

Issues Related to Ownership Options - IV

Partial Sale Options *(Continued)*

- **Private Participation.** In certain cases, private purchasers (e.g. Borealis, Fortis) have purchased up to a 10% interest in municipally-owned LDCs. This allows them to obtain an ownership interest without triggering the application of true (as opposed to payments in lieu of) federal corporate income tax payments. This can avoid the application of the Transfer Tax on sale transactions. These private purchasers are typically interested in:
  - Gaining the opportunity to provide management and support services, and/or
  - Being given a first right of refusal or other option, in the event that a municipality decides to sell its remaining ownership stake in the future. These rights of first refusal can restrict future municipal decisions with respect to its utility.

Evaluation of Status Quo Option

Under a Sale Option, the Town retains the risks and the rewards of utility operation. These rewards include the retention of direct, decision-making control.

Specific advantages and disadvantages of the Status Quo option are outlined below.

Advantages

- **Income Potential.** The Town retains the potential to earn a future dividend stream from the utility.
- **Control.** The Town retains direct control of the utility and its decisions with respect to levels of customer service, promotion of economic development, and rate levels, subject to OEB oversight.
- **Operating Synergies with the Town.** The Town retains the ability to obtain operating cost synergies through the integration of support functions with the water utility.

Disadvantages

- **Business Risk.** The Town retains the risks of being in the electricity distribution business, which is growing steadily more complex over time. Thus, the Town will need to ensure that the utility has the requisite management resources and risk management processes. As with any business, the expected future earnings stream may be impacted by adverse events.
- **Policy Challenges.** This option does not address the likely push for additional consolidation of LDCs in the province.

Evaluation of Sale Option

Under a Sale Option, the Town transfers ownership of the business to a new owner. It thus isolates itself from the business risks of electricity distribution, but also foregoes the ability to earn an associated income stream. Specific advantages and disadvantages of the Sale option are outlined below.

Advantages

- **Cash Payment.** Town will achieve an immediate cash payment that can be used for municipal purposes.
- **Reduced Risk.** The Town distances itself from the risks of being in the electricity distribution business.

Disadvantages

- **Transfer Tax Payable.** In the absence of an exemption, the Town will pay a Transfer Tax equal to 33% of the proceeds from a sale transaction, less any corporate income taxes or PILS that have been paid since market restructuring. This will reduce the net proceeds received.
- **Loss of Income Stream.** The Town will eliminate the potential to earn a future dividend stream. The foregone dividend stream may be higher than the potential to earn interest income if the proceeds from sale are invested in interest-bearing instruments.
- **Loss of Control.** The Town loses direct control of the utility and its decisions with respect to levels of customer service, promotion of economic development, and rate setting (although these remain constrained by OEB oversight).
- **Loss of Operating Synergies.** The Town may lose the ability to obtain operating cost synergies through the integration of support functions with the water utility.
- **Loss of Local Employment.** The Town may lose some local employment if a buyer reduces costs by centralizing some functions at its head office.

Summary and Conclusions

For discussion.