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Energy shift

Understanding the consolidation of Ontario's electricity market

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Context for change

Utilities across the globe are grappling with a number of competing forces that are altering the traditional power and utilities business model. These megatrends include:

- **changes in customer expectations and behaviour**
- **new forms of competition**
- **grid and economic impacts from increasing renewable and distributed energy**
- **pressures from policy makers, regulators and other stakeholders**

The combination of these forces is creating significant uncertainty, which is resulting in an inflection point in the evolution of the energy sector. But, will this result in growth, a flat-line of market activity or a death spiral of the traditional utility players?

In parallel to this energy transformation, governments around the world are concerned about sustainability issues as well as seeking efficiencies from publically owned assets to fund service delivery and reduce debt. Government budgets have been squeezed since the global financial crisis, while population growth and an aging demographic are putting pressure on public service delivery, creating an impetus to monetize owned utility assets and to shift costs from tax to rate payers where possible. Similarly, policy makers are looking for ways to address stakeholder desire for sustainable energy including carbon commitments.

The energy environment in Ontario is very much being moulded by these global disruptive forces, highlighted by rising residential and commercial electricity rates; increasingly challenging regulatory measures; the pending sale/merger of Hydro One Brampton; and the announcement of the planned IPO and private sector investments into Hydro One. This, combined with other forces, including measures announced in the recent Ontario budget, is expected to spur additional local distribution company (LDC) consolidation and potentially broaden private sector ownership of the Ontario energy sector.

With the potential for significant changes to Ontario's energy landscape, we share our insights for you to consider while assessing your response to business model disruptions.

How is energy transformation playing out in Ontario?

After decades in which their operating model changed little, regulated distribution utilities in Ontario now face an inflection point in their evolution. The megatrends we see globally are affecting Ontario in a number of ways:

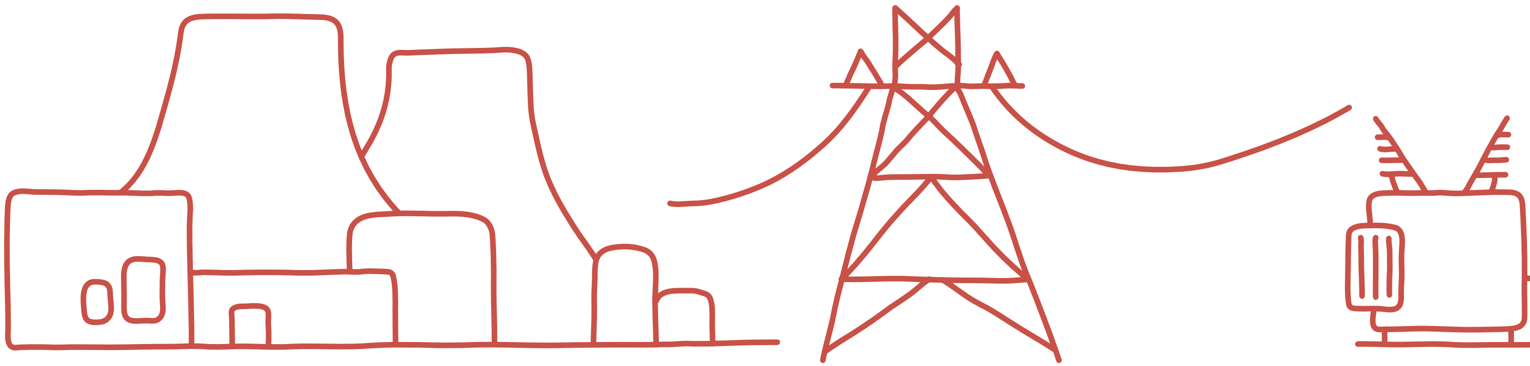
Urbanization is a global phenomenon that has an indirect but measurable impact on utilities' operating models. In our 14th Annual Global Power and Utilities Survey, 77% of respondents ranked urbanization as having either medium or high importance to their business. In Ontario, this is very much the new normal. We are continuing to see a consolidation of population into big urban areas, causing a corresponding population decline in rural areas
The shifting industrial landscape in Ontario adds to this with its significant restructuring in primary industries including manufacturing, steel mills and pulp and paper production, that have been heavy consumers of electricity in the past. The shifting demographics of Ontario municipalities are creating challenges for many utilities as they deal with the changing electricity demand and affordability that accompanies population growth or decline.

The **supply** side is changing too, with the dramatic transformation of Ontario's generation sources over the last few years. Coal generation has been phased out and a new fleet of gas-fired, nuclear, hydroelectric, wind and solar

facilities have emerged. This new mix of renewable and distributed generation has also added complexity to the grid. According to Ontario's *Long Term Energy Plan*, renewable resources are expected to grow to 46% of Ontario's total generating capability by 2025 (21% when not including hydro). These changes in demand and supply are forcing utilities and the market operator to rethink their strategies for ensuring secure, reliable and affordable electricity for customers and stakeholders, while also meeting the mandated clean energy agenda.

On top of this, **customers** are now more empowered and tech savvy. Their expectations are being shaped by their experiences in other industries, including financial services and retail, which provide personalized, relevant and on-demand services. With more than four million smart meters now installed across the province and an emerging smart home ecosystem of solutions, new smart technologies are redefining the way electricity customers are connected to the system that serves them. Further, the role for consumers is changing from one of simply using power but also supplying power or being asked to participate in load reduction or other conservation matters. This newly complex relationship with both residential and commercial customers is challenging the traditional, trusted relationship with their local utility. While being squeezed between demands for quality, reliability and customer responsiveness, utilities are also being asked to **drive greater efficiency** to keep rates stable and affordable for customers. The Ontario Energy Board's *Renewed Regulatory Framework*, for example, seeks to promote performance based incentives, enable innovation and improve productivity and competitiveness. The planned privatization of Hydro One, potential LDC M&A, and policy and regulatory changes that open the door for private sector capital and utility consolidation have sent a clear signal from government that utilities will be expected to do more than just talk about efficiencies.

Convergent forces of changes in customer behaviour, new forms of competition and distributed energy and regulatory reform are creating new opportunities and challenges for LDCs, their shareholders and other stakeholders and should be top of mind when examining strategies to increase revenues and control costs.



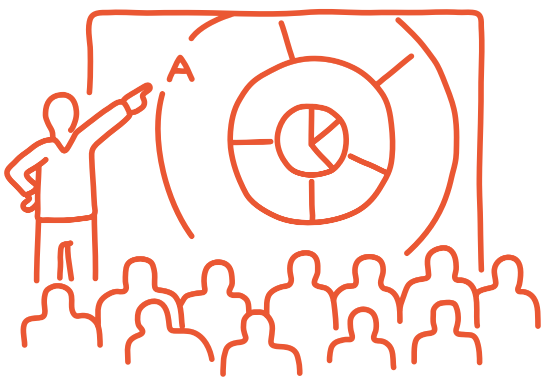
What options do LDCs have to respond to government pressure for sector efficiencies?

While policy mandates are encouraging the market to find synergies and economies of scale amongst logical LDC groupings, this doesn't limit potential responses to mergers and acquisitions. In addition to M&A there are a number of avenues for LDCs to gain efficiencies and economies of scale, including introducing shared services and partnering with others. We are already seeing these trends globally. According to our 18th Annual Global CEO Survey, 52% of power & utilities CEOs are planning to form new alliances with suppliers, governments, customers and competitors with the aim of delivering efficiencies, innovation

and shared risk. For Ontario LDCs and their stakeholders, however, each potential route brings with it important considerations which must be weighed to support continuing viability of the business model.

For many the option being considered is a formal strategic combination — merger, acquisition or sale. In a sale or merger, there's a balance between shareholder value and retaining control over service levels in local municipalities. For buyers, it's more complicated. They need to pay attention to dividend ratios and current debt levels of potential targets. There's also the need to provide continuity in operations, maintain local community buy-in and achieve shareholder objectives. These are challenging and in some ways conflicting objectives. Not participating, however, could result in missing out on opportunities to increase shareholder value or achieve a long term sustainable level of performance. Where strategic alliances are considered, it's important to have checks and balances in place to ensure existing governance or revenue streams are not negatively impacted, while also delivering a material reduction in non-operational costs and capital.

What are the key considerations for LDCs pursuing consolidations or acquisitions?



A consolidation or acquisition can be a catalyst that changes how an LDC operates. For example, the combination of PowerStream, Horizon Utilities, Enersource and Hydro One Brampton would create the province's second largest LDC with almost a million electricity customers— an astronomical step change for all parties involved. The question is, how can these companies come together in a way that increases overall value compared to the status quo? For a transaction to be accretive to shareholders, there must be value and synergies created by bringing two or more organizations together, often realized through a reduction in costs, increased free cash flow and a reinvigorated culture. However, at the same time, there is a need to protect the ongoing operational value of the underlying business while the integration is underway. Striking the balance between achieving synergies at minimal cost and not interrupting business as usual is essential. With this in mind, there are a number of considerations when evaluating potential strategic options:

Clear objectives

- **Finding the right partner** is a key success factor. It is important for each partner to understand the differences in the basis for rates, timing within the rate setting cycle, demand patterns and future load growth, operations, current asset base and culture.
- **A clear forward-looking vision** requires a clear understanding of the key strategic goals and objectives of potential partners including security of supply, affordability and impact to customers and sustainability and conservation goals.
- **Consolidation efficiencies** should be identified up front, and a clear baseline with metrics that will be used to measure progress should be agreed on in the early stages. The status and timing of recent rate filings must also be considered, particularly for LDCs with relatively high growth as there is a natural trade-off between retaining synergies and putting new capital expenditures into rate base (and rates) when filing for rates. Additionally,

with the backdrop of most LDCs being municipally owned, management and shareholders need to be realistic about the level of efficiencies that can be delivered, especially as this could mean reducing employment in their local community.

Governance

- **Accountability and decision making** for LDCs must balance the leadership structures of each organization and also the respective municipalities. Clear governance must be put in place, including decisions on who should lead the new, combined entity or partnership. Understanding changes to legislation, board impacts and potential changes to articles of incorporation are important considerations.

Financial implications

- **Investment decisions** by LDCs must balance dividends and debt capacity in their decision-making and take into account the required funding of future capital expenditures.
- **Tax implications** have changed due to recent policy announcements and may impact consolidation and acquisition decisions. The transfer tax on selling to a non-municipal party has been reduced from 33% to 22%. Municipality owned LDCs with fewer than 30,000 customers are exempt from transfer tax, and the burden of exit taxes has also been reduced. However, compared to other sectors, investing in an LDC brings somewhat unique tax disadvantages for private investors.
- LDCs have many characteristics that support robust **valuations.** This includes predictable cash flows based on regulated returns and an underlying business model of providing a service that every household and business needs. However, increasing capital expenditures put a drag on near-term cash flows and in recent years across the province, robust dividend pay-outs have generally been funded through increased leverage. Additionally, while minimum returns are largely guaranteed through regulation, maximum returns are also inherently limited, which limits the price and multiple of rate base that investors are willing to pay.

Managing people through the change

- **Workplace culture** is often underestimated in consolidation activities. Employee engagement strategies to help staff adapt to what might be a new or different workplace culture are important considerations for success. Both management and employees need to understand the new business model, including its goals and targets, to help make the integration successful. Maintaining and enhancing public value and customer service is key throughout the process.
- **Labour relations** and employment considerations need to be addressed when considering consolidation activities or acquisitions. Understanding how changes to the overall operating model will impact employment agreements (whether individual or collective) is imperative and requires detailed understanding and planning. Given the complexity of the LDC environment in Ontario, transparency in the consolidation process is an important success factor.

What should shareholders and purchasers think about from an investment perspective?

There's a compelling business case for industry consolidation that's been proven across North America over the last 10 years. Applying lessons learned from this experience will help realize the financial and operational business goals from the changes in the industry. The business case can be summarized in the following key areas:

- **Economies of scale**: allowing larger consolidated LDCs to serve more customers at a lower cost and have the consolidated LDC retain synergies for a reasonable amount of time (ie. up to ten years).
- **Capital costs and access to capital**: lower capital costs can in turn encourage investment in upgrades/improvements and adapt to new technology.
- **Operational efficiencies**: including increased ability to share infrastructure, staff and equipment.
- **Regulatory strategy and costs**: ensuring appropriate efficiencies are realized from filing fewer, integrated rate applications (instead of two, three, or more), will effectively lower the cost of regulatory oversight to LDCs the OEB, and ultimately ratepayers.

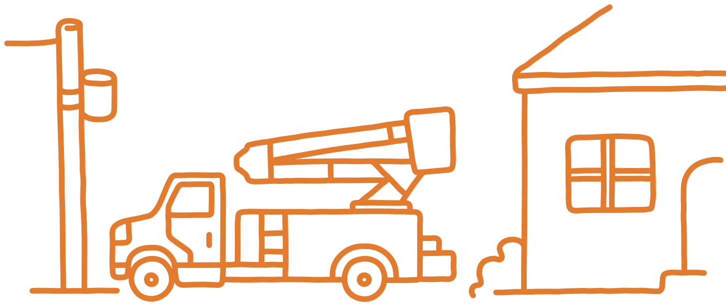
Still, the investment needs to be a solid strategic and financial fit. For investors looking to purchase all or part of a utility, financing is key, as is gaining a good understanding of the company being acquired. Investors should also understand the level of government control that will remain around the assets, since there may not be the same range of flexibility as with other investments. For instance, with the IPO of Hydro One, the Ontario government will continue to be the largest shareholder holding at least 40% and no other shareholder or would be permitted to own more than 10% of the company. There are also other conditions that will restrict operational and strategic span of control from a shareholder perspective. In addition, the traditional risks associated with running a utility will remain – including regulatory, capital expenditure requirements and operational risks that could impact the investment longer term. The key for interested purchasers and shareholders is determining the right price that factors in these potential changes.

So, what's next? How could Ontario's energy landscape change in the coming years?

As we see the forces of energy transformation continue to evolve globally, there are several considerations for Ontario in the coming years.

- **Policy and regulatory changes have a real impact, both direct and indirect.** Direct impacts include policy announcements, namely privatization and consolidation. Indirect impacts will be felt through increased competition and innovation based on conservation demand management efforts.
- **When an industry transforms, changes to business models are inevitable.** There won't be a single winning utility business model but rather a range of models that will result in success. The balance between protecting the incumbent equal service utility model and enabling new models will not be easy to strike but must be proactively considered.
- **Increasingly, the velocity and direction of energy transformation will be uncertain and difficult to predict.** As global market forces increase, the energy transformation pull force from increasing customer expectations and technology changes will make it increasingly difficult to successfully push the desired form of energy transformation in terms of policy and regulation.
- **The balance between security, affordability and sustainability will evolve as energy transformation matures.** Tension between these forces differ by market and change over time. Responses should be considered in advance and ultimately deployed to consider the public good (safe, reliable, affordable power to all).

Simply said, transformative forces that are apparent and global are real and driving change in Ontario. As the sector transforms globally and locally, we should expect to see business model transformation too, including M&A, consolidation, a push for changes in how utilities are funded and new, innovative ways to add value and increase shareholder returns. Uncertainty is inherent in these changes for operators, investors, policy makers, regulators and consumers. According to our 14th Annual Global Power and Utilities Survey, 58% of respondents don't rule out a downward or even death spiral for disintermediation, disruptive technology and customer behaviour. Whether these predictions are overdone or not, Ontario's current energy landscape brings to life that change is happening now and quickly. Market players, including shareholders and new entrants, need to stay ahead of this change. Ultimately, if they don't, the challenges they're currently facing will only intensify.



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