CITY of STRATFORD

Chief Administrative Officer

17 July 2014

MANAGEMENT REPORT

To: Finance and Labour Relations Sub-Committee

From: Ronald R. Shaw, Chief Administrative Officer and

Andre Morin, Director of Corporate Services

Re: Festival Hydro Report

OBJECTIVE:

To consider options for the sale, merger, or retention of Festival Hydro.

BACKGROUND:

As you are aware, the City of Stratford has received three unsolicited expressions of interest for the purchase or merger of its Local Distribution Company, Festival Hydro. We have taken careful steps to ensure that Council can make an informed decision on this highly significant issue.

The City retained Deloitte LLP to carry out a Strategic Options Analysis that assessed the risks and benefits of the retention, sale or, merger of Festival Hydro. Deloitte presented their analysis at a Public Meeting on 24 June 2014. Council also heard a presentation by the CAO and the Director of Corporate Services that disclosed current financial information, presented options for potential sale proceeds, and commented on the current political environment. Council also considered questions and comments from the public at this meeting. The minutes of that public meeting are attached for your review and consideration.

The expressions of interest that we have received are a clear reflection of the value of Festival Hydro to the City and its taxpayers and a reflection on how the value of the company and our investment in it has increased. Festival Hydro has provided the City with ongoing annual revenues in excess of $2,000,000 per year. Council should now decide if they wish to sell this asset for a large but finite amount of money, or if it would be best to retain Festival Hydro and continue receiving a substantial amount of annual revenue indefinitely.

ANALYSIS:

Deloitte's Strategic Options Analysis considered the qualitative and quantitative impact of the sale, merger, or retention of Festival Hydro from both the ratepayers and taxpayers perspectives. The results of their evaluation are outlined below:

Summary of Results

Evaluation Criteria	Weighting	Status Quo Option	Merger Option	Sale Option (1.4x Premium)	Sale Option (1.6x Premium)
1. Ability to Meet Service Quality Requirements Over Time	18.50%	4.0	6.0	10.0	10.0
		0.7	**1.1**	**1.9**	**1.9**
2. Long-Term Rate Stability	17.50%	8.0	6.0	6.0	6.0
		1.4	**1.1**	**1.1**	**1.1**
3. Value to the Shareholder	24.00%	8.0	8.0	8.0	10.0
		1.9	**1.9**	**1.8**	**2.4**
4. Strategic Importance to Local Community	22.00%	10.0	6.0	2.0	2.0
		2.2	**1.3**	**0.4**	**0.4**
5. Economic Factors	18.00%	2.0	6.0	10.0	10.0
		0.7	**1.1**	**1.8**	**1.8**
Total Score		**7.0**	**6.5**	**7.1**	**7.5**
Percentage of Available Points		**70%**	**65%**	**71%**	**75%**
Ranking		2	3	2	1

Score varies between the two Sale Options depending upon the sale premium of either 1.4x or 1.6x. A premium of 1.6x would provide significant additional benefit to the shareholders

Deloitte concluded that Festival Hydro must be sold at least 1.6 times its fair market value for the sale option to rank higher than retention. Their analysis showed that the merger option was not viable because the benefits do not outweigh the drawbacks. Therefore, we believe that Council should decide between sale and retention. Important factors that must be considered are outlined below:

i) Loss of annual revenue from Festival Hydro:

If Council chooses to sell Festival Hydro, the City will have to compensate for the annual loss of $2,381,000 in revenue (2014). To recover this amount, there are options:

a. One is to increase municipal property taxes by 5.1% on average, with a 5.5% increase to residential taxes.
b. While the City has the option of investing some of the proceeds from the sale of Festival Hydro, it is unlikely that we will be able to invest enough money at a high enough interest rate to earn the same annual income that Festival Hydro currently gives us(within the current market conditions). For example, to earn $2,381,000 annually, we would have to invest $34,014,286 at a 7% interest rate.
c. However, the revenue generated through the sale of Festival Hydro would allow Council to pay down enough debt to compensate for the loss of revenue by eliminating $2.7 million in annual principal and interest payments. There would be some cost to the City in regard to penalties for early payment. Nonetheless, the reduction in principal and interest payments will happen regardless as the principal will paid off over time.

ii) Use of proceeds:

Should Council elect to sell, the City will receive substantial one time revenue. As noted immediately above, the first priority should be to replace the loss of annual revenue. The obvious strategy would be as outlined in sub-item c. It is important to note that, even after paying down that debt, there will be money left over to pay down the entire City's debt supported by property taxes which would free up money to reduce taxes and/or invest in infrastructure annually. In fact, there would still be substantial money left over to invest immediately in some capital priorities.

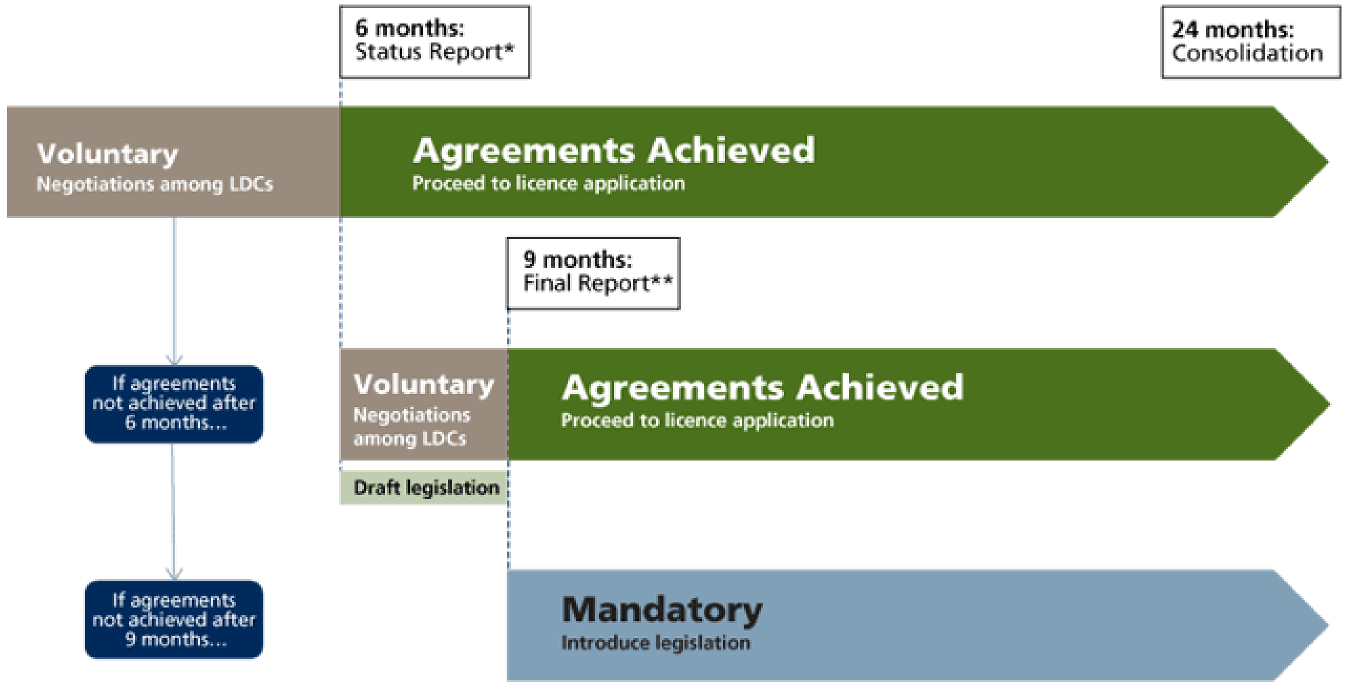
Having said that, it is important to note the City can expect to receive this money anyway, but over a long period of time. The revenue stream should be indefinite if the company continues to be well run and profitable.

iii) Current political environment:

While considering options for the sale or retention of Festival Hydro, special consideration must be given to the current Provincial political mandate. In April 2012, the Ontario Ministry of Energy established the Ontario Distribution Sector Review Panel to advise the Provincial Government on ways to improve efficiencies in the sector. In December 2012, the Panel published a report titled "*Renewing Ontario's Electricity Distribution Sector: Putting the Consumer First*," which recommended that Ontario's 73 Local Distribution Companies be consolidated into 8 to 12 larger[1] regional distributors within two years of the report's publication. The Panel argued that the large number of Ontario distribution companies is a barrier to the innovation and efficiency needed in the sector, and that the current structure will not support the needs of Ontario consumers through the next decade. The report concluded that amalgamation will result in $1.2 billion in savings over the next ten years, and will help facilitate infrastructure upgrades.[2]

While some stakeholders argued in favour of mandatory consolidation, the Panel recommended that existing Local Distribution Companies be encouraged to voluntarily merge their distribution assets. However, the Panel recommended the Province legislate mandatory consolidation if voluntary agreements cannot be reached.[3] The Panel's proposed timeline for consolidation within a two-year time frame is outlined below:

[1] The Panel recommended that each LCD should serve a minimum of 400,000 customers.
[2] "Renewing Ontario's Electricity Distribution Sector: Putting the Consumer First," *Ontario Ministry of Energy*, December 2012 http://www.energy.gov.on.ca/en/ldc-panel/.
[3] "Renewing Ontario's Electricity Distribution Sector: Putting the Consumer First," *Ontario Ministry of Energy*, December 2012 http://www.energy.gov.on.ca/en/ldc-panel/.



Similarly, in a speech to the Electricity Distributors Association in March 2013, Ontario Minister of Energy Bob Chiarelli stated:

> "Let me be very clear that our government will not legislate forced consolidation…we are interested in promoting consolidation on a voluntary basis in the sector, we must find ways to deliver the savings to ratepayers that the Panel identified…Our government sees this as an imperative and as a priority."[4]

Therefore, while the Province has no immediate plans to force the consolidation of Ontario Distribution Companies, they have made it clear that consolidation is a significant part of their mandate.[5]

It is important to note that we believe it will be difficult for the Province to force the future sale or merger of Festival Hydro if we maintain our service levels, infrastructure,

[4] "Chiarelli rejects recommendation to merge electricity distributors," *Ottawa Business Journal*, 18 March 2013 http://www.obj.ca/Canada%20-%20World/2013-03-18/article-3202549/Chiarelli-rejects-recommendation-to-merge-electricity-distributors/1.

[5] The Provincial call for voluntary consolidation appears to be the driving force behind the recent sale of several distribution companies. Norfolk Power was sold to Hydro One in April 2013. Haldimand County Utilities Inc. was sold to Hydro One in December 2013. In May 2014, Cambridge and North Dumfries Hydro purchased Brant County Power. In the same month, the City of Woodstock sold its Local Distribution Company to Hydro One.

and rate stability. If Council chooses retention, we can expect that Festival Hydro will continue to be a well-run and profitable municipal asset. If we are forced to sell Festival Hydro in the future due to the provincial consolidation mandate, we still expect to receive competitive offers. Festival Hydro has increased in size and value since its inception, and could quite possibly continue to grow. Once sold, this municipal asset will never be returned to us. Retention will allow us to keep our options open.

iv) Economic development:

Municipal ownership of Festival Hydro has helped us stay economically competitive. For example, Festival Hydro was a key player and provided the City with the flexibility required to bring the Data Center to Stratford. They were a true partner in helping secure the Centre in Stratford. Selling Festival Hydro to a larger utility may result in rate increases, particularly for commercial and industrial customers. However, Deloitte is of the opinion that larger Distribution Companies will be able to better absorb future requirements and directives and will therefore be in a better position to keep rates down in the longer term.

v) Public opinion:

The 24 June Public Meeting clearly demonstrated that public opinion is strongly in favour of retaining Festival Hydro.

FINANCIAL IMPACT:

The sale of Festival Hydro will enable the City to invest in infrastructure and put money into reserves. While proceeds will enable us to repay the City's outstanding debt, it is important to remember that there will be penalties incurred for repaying the balance early. Furthermore, interest rates on our outstanding debt are very low (ranging from 2.47% to 4.96%), and the required payments are decreasing annually as the principal is repaid.

The sale of Festival Hydro presents a tremendous opportunity to produce a large but finite amount of revenue for the City of Stratford. Retention will allow the City to continue receiving a substantial source of annual revenue indefinitely. More detailed financial impacts were outlined in the various reports tabled with Council.

CONCLUSION:

This is a complex matter involving a host of issues that have been raised during the course of this review.

In the end, it is our opinion it is in the City's interest to protect this asset and continue to own it for the following reasons:

- The City should expect that the revenue stream will be indefinite. While the money is attractive and can be put to very good use immediately to deal with the City's infrastructure construction and maintenance demands, it would mean giving up an indefinite source of revenue.
- The value of the company has increased over time and it is our hope that it will continue to increase over time.
- If the political climate changes and we are forced to sell, we expect that there will be competition to purchase this asset well into the future.
- Festival Hydro Inc. has proven to be a cooperative and strategic partner in economic development and we can expect that to continue.
- The community values the asset and the level of service it provides.
- Once sold, it is a permanent decision. It cannot be undone.

Our final comment is that this is, of course, not without risk. We are at the risk of the Province who could legislate changes that affect local distribution companies in regard to both profitability and value. We are at their mercy.

RECOMMENDATION:

That the City retain ownership of Festival Hydro Inc. at this time.

Respectfully submitted,

Ronald R. Shaw	Andre Morin
Chief Administrative Officer	Director of Corporate Services