



City of
Peterborough

To: Members of Committee of the Whole

From: Allan Seabrooke, Chief Administrative Officer

Meeting Date: October 31, 2016

Subject: Report CAO16-014
City of Peterborough Holdings Inc. (CoPHI) Recommendation
to Council – Peterborough Distribution Inc. (PDI) Divestment to
Hydro One Inc.

Purpose

A report to inform Council that correspondence from City of Peterborough Holdings Inc. (CoPHI) to Council, pertaining to the divestment of Peterborough Distribution Inc. (PDI) to Hydro One has been received. Navigant Consulting will make a brief presentation at the October 31, 2016 meeting on evaluation and next steps.

Recommendation

That Council approve the recommendation outlined in Report CAO16-014 dated October 31, 2016, of the Chief Administrative Officer, as follows:

That the presentation relating to the recommendation from the City of Peterborough Holdings Inc. (CoPHI) regarding the potential sale of Peterborough Distribution Inc. (PDI) be received at the meeting held October 31, 2016 and that the recommendation from CoPHI be considered at a future special Committee of the Whole and special Council meeting.

Budget and Financial Implications

There are no budget or financial implications to approving the recommendation which is presented for information purposes.

There are substantial financial considerations and options for the City should an eventual transaction occur divesting PDI.

Background

Based on Council direction, CoPHI has been engaged in exclusive negotiations with Hydro One to divest PDI. PDI is the regulated business of Peterborough Utilities Group (PUG), and is directly owned by CoPHI. The City is the sole shareholder of CoPHI, and City Council approval is required to divest part or all of PDI. In previous discussions with Council pertaining to the potential divestment of PDI, staff advised that when a CoPHI recommendation was received by the City that it would be immediately provided to Council. The negotiations with Hydro One have progressed to a stage whereby CoPHI has now provided this recommendation to Council for consideration (Appendix A).

Navigant Consulting who have been engaged by the City to provide the City with an independent third party review of CoPHI's recommendations and documentation are present this evening to provide Council with a brief overview on next steps and the decision framework that is the basis for their future evaluation to Council.

As approved by Council, the community engagement plan will now proceed and will culminate with a future staff report to be considered at a special Committee of the Whole and special Council meeting, with recommendations, results of the community engagement plan, and Navigant's evaluation. There are no decisions requested or required from Council on the matter this evening.

Submitted by,

Allan Seabrooke
Chief Administrative Officer

Appendix A – Correspondence dated October 26, 2016 from CoPHI

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Chief Administrative Officer

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PETERBOROUGH UTILITIES GROUP
1867 Ashburnham Drive, PO Box 4125, Station Main
Peterborough ON K9J 6Z5

October 26, 2016

John Kennedy, City Clerk
City of Peterborough, City Hall
500 George St. N.
Peterborough, ON
K9H3R9

Dear Mayor and Councillors,

Re: Proposed Sale of Peterborough Distribution Inc. to Hydro One

On behalf of the Board of Directors of City of Peterborough Holdings Inc. (CoPHI), I am writing to report to you on the results of our review of Hydro One's recent offer to purchase Peterborough Distribution Inc. (PDI) and to transmit to you the recommendation of the CoPHI Board in that regard.

CoPHI's Board of Directors is mandated to act in the best interests of CoPHI and the City of Peterborough. We take this mandate very seriously.

Ontario's local distribution sector is in a state of evolution. For the past two years, the CoPHI Board and senior management have reviewed the implications for the City's investment in PDI of the far reaching changes in public policy, regulation, technology and customer expectations that are afoot in the sector.

These changes are one of the key factors driving consolidation in the Ontario distribution sector. In the 1990s, there were over 300 distribution utilities in the Province. Since then, consolidation has reduced the number of distributors to 65, including PDI. Most observers expect this trend to continue; indeed, the Report of the Distribution Sector Review Panel concluded that the optimal number of electricity distribution companies for Ontario is eight, with each distributor having hundreds of thousands of customers. As discussed below, this trend raises serious issues about the continuing viability of smaller distributors such as PDI.

PDI has a strong record of financial performance and excellent customer service. Despite PDI being a low cost utility with low customer rates, the capacity to provide the City with dividends has continued to decline. Historically, PDI has been able to provide the City with an annual dividend of approximately \$1.2 million and the projected annual dividend will be as low as \$700,000. This future dividend low point may decline further as additional regulated, industry and customer driven capital investment is required. In summary, the future return to the City will decline and is at risk.

PDI's future performance, however, is less certain. Surrounded by Hydro One's service area, PDI's business is not expected to grow, either in terms of new customers, or in terms of demand growth from existing customers. At the same time, new regulatory requirements and required system and infrastructure upgrades are expected to significantly increase PDI's costs over the medium to long term.

Indeed, our analysis indicates that, over the next five years, PDI's annual dividend to the City of Peterborough will decrease by approximately 30 to 40 per cent. The value of PDI has declined in recent years by approximately \$12 million, and value will continue to decline over the next five years. The total premium (value) that can be lost by inaction is now approximately \$35 million. There are substantial financial risks to Peterborough and its residents from holding on to PDI for too long.

CoPHI's Board of Directors has concluded that PDI, a small utility of 36,317 customers, will be unable to effectively operate in this changing environment, due to its inability to achieve the scale necessary to reduce costs, and to access the capital needed to effectively maintain existing, and address future, customer service and regulatory standards.

We have therefore concluded that it is in the best interests of the City of Peterborough and its residents to sell the assets of the PDI.

In completing this analysis, we have identified five key goals to guide our evaluation of any transaction that would affect the future of PDI:

1. Create the best financial value for the City;
2. Protect customers from increases in distribution rates;
3. Ensure customer service excellence;
4. Increase local jobs and economic activity; and
5. Ensure fair treatment for existing employees.

The Hydro One Offer to Purchase the Assets of PDI

CoPHI has received an offer from Hydro One for the purchase of the assets of PDI. We have evaluated the Hydro One offer from the perspective of the five factors referred to above. Specifically, we have considered the potential service and financial effects on Peterborough residents, both as electricity ratepayers and as taxpayers. We have considered whether the City should entertain a sale of PDI in order to redeploy the proceeds to other public investments that present better opportunities for value and revenue generation, which could support community and social enhancement. We have also considered the effects on economic development and employment in our City.

Based on our review, we have concluded that it is a favourable and compelling offer, which meets or exceeds each of the five factors. The Hydro One offer will deliver:

- A strong financial deal for Peterborough;
- Lower electricity distribution rates;
- Guaranteed service levels;
- New jobs and economic development for Peterborough; and,
- Job security for existing PDI employees.

By resolution dated October 25, 2016, the CoPHI Board voted unanimously to endorse the sale of PDI to Hydro One, and to refer it to the City of Peterborough as CoPHI's sole shareholder.

Hydro One's summary offer is attached to this letter as Appendix "A." A copy of the Board's October 25, 2016, resolutions is attached to this letter as Appendix "B." What follows is a summary of the key benefits of the proposed transaction.

A Strong Financial Deal for Peterborough and its Taxpayers

The proposed transaction would mitigate the risk that PDI will decline in value both as an asset and in its ability to deliver low distribution rates and a significant dividend to the City of Peterborough.

Hydro One has offered a purchase price of approximately \$105 million for the assets of PDI. This price includes a significant premium over book value, comparable to the premiums realized in respect of the recent sales of other Ontario distribution utilities.

The net cash proceeds of the sale, after paying debt, taxes and other sale-related costs, are expected to be in the range of \$50 - \$55 million. Appropriately reinvested, the net cash proceeds from the sale would yield an expected annual return of up to \$3 million to support City programs and services. While we recognize that any reinvestment is the decision of the City, we can suggest our planned renewable power generation projects can offer this type of return. In any case, reinvestment is a significant improvement over the projected PDI dividend of approximately \$700,000.

On the basis of this analysis, CoPHI has concluded that the transaction is a significant financial improvement for the City of Peterborough and its residents.

Lower Electricity Distribution Rates

Ontario residents are very concerned about growing electricity bills. While PDI only controls the distribution component (~22% of the total electricity bill), current forecasts predict that without any sale, over the next five years, PDI's distribution component of the total bill will likely increase by at least 17%. This is again due to both the need to make continued investments in the system, and the lack of growth in customers and in new customer demand.

Under the terms of the transaction, Hydro One will, subject to OEB approval, protect PDI customers from increases in the distribution component of the total bill for at least 10 years. In the first five years following a sale, the rate for the distribution component paid by PDI customers would be frozen at current levels, and reduced by 1%. In the following five years, rate increases for the distribution component will align with the rate of inflation.

PDI customers will also share in the value of the efficiencies that Hydro One achieves during that five-year period, and these guaranteed savings will be used to offset Peterborough rates in years eleven onwards.

Hydro One is also considering a number of further options to protect PDI customers in years eleven onwards, including the creation of a new rate class for the customers of the distributors it has purchased. This would also be subject to OEB approval.

Further details are set out Appendix "A."

One thing is certain given changes in the sector: hydro distribution rates will go up if we do not take action. CoPHI's analysis confirms that Hydro One's offer will lower Peterborough's hydro distribution rates and lock in rate stability for at least the next ten years.

Job Security for Existing PDI Employees

Hydro One's offer protects the interests of PDI's existing employees.

All existing employees will be offered employment with a one-year service and location guarantee as well as recognition of past service for seniority purposes. Existing PDI staff will also benefit from local and province-wide positions available with Hydro One.

Based on our analysis, the terms of the proposed transaction meet the requirement of treating existing PDI employees fairly.

Guaranteed Service Levels

PDI has an excellent track record of customer service, and it is important that any transaction have regard to ensuring service levels.

It is anticipated that the PDI employees who serve PDI customers today will continue to do the same job should this deal be accepted. The transaction would add Hydro One's extensive resources to the pool available to meet the needs of Peterborough customers where required. As a result, CoPHI is confident that the excellent service that PDI customers have come to expect would continue with Hydro One.

In fact, Hydro One's commitment to customer services is backed by monetary compensation. Customers will receive a \$50 account credit if Hydro One misses a scheduled appointment, among other key commitments. Additional details outlining Hydro One's commitment to customer service excellence are included in Appendix "A."

New Jobs and Economic Development for Peterborough

As part of its offer, Hydro One will locate a new Regional Operations Centre and a new Fleet Maintenance Garage in Peterborough.

These new facilities are expected to create 30 new jobs in addition to the 70 Hydro One jobs already located in the City.

The two new facilities are also expected to bring economic activity of between \$100 and \$150 million over the next five years and generate additional annual municipal tax revenue of approximately \$100,000.

PDI territory is "the missing puzzle piece" in Hydro One's service area, and it constitutes a unique fit with Hydro One's existing asset base. As a result, CoPHI strongly believes that no other purchaser could provide the value, strategic investments, and economic development opportunities that Hydro One has built into this offer for PDI.

Conclusion

Based on our review, we are confident that the proposed sale to Hydro One meets or exceeds each of the five requirements for a potential transaction. We strongly recommend that the City of Peterborough proceed with this transaction. Time is of the essence.

As noted above, over the next five years:

- PDI's annual dividend to the City of Peterborough will decrease by approximately 30%-40%.
- The value of PDI could decline significantly.
- Local electricity distribution rates are forecast to go up by 17 percent.

In addition, delay would cause Peterborough to miss the benefit of short term tax measures which were passed to encourage industry consolidation. These incentives would potentially yield savings of \$11.5 million to the City of Peterborough, but they are scheduled to expire at the end of 2018. In our view, there is a significant cost to delay.

Accordingly, in light of the foregoing, we strongly and unanimously recommend that the City of Peterborough accept the Hydro One offer, having regard to the overall benefits that it offers to the customer and to the City as shareholder.

Sincerely,



David Bignell
Chair
City of Peterborough Holdings Inc.

c.c. Allan Seabrooke, CAO City of Peterborough

Hydro One Inc.

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www.HydroOne.com

Michael Vels
Chief Financial Officer

September 26, 2016

1867 Ashburnham Drive
PO Box 4125, Station Main
Peterborough, ON K9J 6Z5

Dear John,

I am pleased to provide you with a summary proposal to purchase the assets of Peterborough Distribution Inc. (PDI). We are excited about the opportunities that this transaction offers to your customers and to Hydro One, and the associated large scale business development within the City of Peterborough. It represents significant investments in facilities, jobs and the continuing long standing presence of Hydro One within the municipality of Peterborough. The integration of PDI assets into the regional operations of Hydro One would leverage the local knowledge of the talented staff in PDI as Hydro One extends its operational and customer-centric focus to the Peterborough service territory. PDI customers would experience a decrease in rates and lower rates than they would otherwise have experienced for up to and possibly longer than ten years, while benefiting from the significant customer service investments that Hydro One is making.

Hydro One is prepared to offer \$105 million for the net assets, excluding debt, of PDI. Enclosed is a Summary of Terms outlining the principal elements to be finalized in the appropriate legal agreements.

We understand how important PDI is to the City of Peterborough. We have given careful thought to how we would ensure a transaction that would be successful on all fronts for the City of Peterborough and for your customers and employees. We fully understand and believe we are aligned with you regarding the importance of a successful integration of your business into ours.

The following are key terms that make the Hydro One proposal unique:

1. **Price:** The City of Peterborough will realize value of PDI equal to \$105 million.
2. **Customer Rates:** Base distribution rates will be reduced by 1% and frozen for five years. In addition, we intend to request OEB approval of a 10-year rate rebasing deferral period as outlined in the OEB handbook for distributors. In addition to the aforementioned rate reduction and freeze for five years, this would provide further benefit to Peterborough customers as follows:
 - a. the OEB's Price Cap adjustment mechanism would result in distribution rate increases that align with inflation for years six to ten;
 - b. we would offer, through an Earnings Sharing Mechanism, a guaranteed share of Hydro One's years six to ten earnings efficiencies.

APPENDIX A

3. **Jobs:** all transferred PDI employees will be offered employment with a 12 month service and location guarantee recognizing past service for seniority purposes.
4. **Economic Development:** Hydro One currently employs approximately 70 people in Peterborough. With this transaction Hydro One will plan to construct a new regional centre within Peterborough, that can house Hydro One and Peterborough employees, and should bring an additional 30 Hydro One jobs to Peterborough.
5. **Service Levels:** We have provided a Service Level Commitment reflecting Hydro One's pursuit of excellent customer service. Of particular note are the Service Guarantees that are direct pledges to customers, backed by monetary compensation should guarantees not be fulfilled. With respect to network reliability, Hydro One will be leveraging the local knowledge of the acquired PDI staff to enable us to continue the same or better level of service to your customers.

Hydro One has extensive experience seamlessly integrating Ontario utilities as demonstrated with the most recent successful full operationalization of Woodstock and Haldimand with no billing or service issues. As of last month, those customers are enjoying lower rates and a seamless transition to our Hydro One family.

Hydro One has transitioned to a publicly traded Canadian company that will always stay local and in touch with its customers:

- Our head office and management authority will always remain proudly based in Ontario.
- The citizens of Ontario will through the Province always maintain a minimum ownership position of 40%.
- Because of ownership limits, no one person other than the Province of Ontario can own more than 10% of the Company, and so there is no ability for non-Ontarians to control the company.
- Customer rates continue to be set by the Ontario Energy Board, the same as before Hydro One became publically traded, and in the same manner that PDI is currently regulated.
- Hydro One's current public float is 61% owned by institutions and 39% by retail investors, the majority of whom are based in Ontario. Ownership of the company also includes increasing stakes held by the Company's unions and non-represented employees and as recently announced by the Province, First Nations.
- Hydro One's experienced Board of Directors is fully independent with a strong and public focus on customer service and cost reduction. In addition, this Board has put in place an independent ombudsman directly reporting to the Board on customer service issues.
- The new management team at Hydro One has already recognized material operating cost efficiencies that will be reflected in customer rates going forward, and has instituted a

APPENDIX A

broad range of exciting customer experience initiatives to improve our customer's ability to manage their electricity bills.

John, we are very excited about the opportunity to complete this transaction and become your partners in servicing the Peterborough community. We look forward to working with you and your team to finalize the details. Our employees live and work in your community and they would welcome the opportunity to welcome your employees and customers.

Yours sincerely,

A handwritten signature in black ink, appearing to read "M. H. Vels", written in a cursive style.

Michael H. Vels
Chief Financial Officer

cc. Mayo Schmidt, (President & CEO)
Richard Bertolo

APPENDIX A

Summary of Terms

Sale of Peterborough Distribution Inc. (PDI) to Hydro One

Purchase Price: \$105 million for the net assets, excluding debt, of PDI and subject to adjustments to capture changes, to the favour of either party, between December 31, 2015 and closing.

Distribution Rates: 1% distribution rate reduction and distribution rate freeze at those reduced levels for 5 years post-closing, subject to OEB approval.

- In connection with the OEB application for approval of the sale, Hydro One intends to ask the OEB to approve an approach that would result in distribution rate increases that align with inflation during years 6 through 10, as well as giving customers in the PDI service area a guaranteed share of Hydro One earnings during years 6 through 10, to be used to offset rates in years 11 onwards, subject to OEB approval.

New Regional Operations Centre: Hydro One plans an Operations Centre and Fleet Maintenance Garage having a combined space requirement of approximately 45,000 square feet and that should bring approximately 30 jobs in Peterborough (in addition to the existing 70 Hydro One jobs and the PDI employees retained).

- Hydro One will purchase real property from the City at \$40,000 per acre with no development fees.

PDI Employees: Hydro One will employ PDI staff, with a 12-month service and location guarantee, and recognition of past service for seniority purposes.

Customer Service Level: Hydro One will continue reporting customer experience as mandated by the OEB for its entire customer base, expanded to include the areas formerly served by PDI.

- Customers will have full access to Hydro One's suite of customer services:
 - Extended Call Centre hours (7:30 am to 8:00pm)
 - Utilization of a 24/7 Interactive Voice Response system
 - Targeted 80% of calls will be answered within 30 seconds during normal operation periods
 - Targeted 85% of customer correspondence will be resolved within 24 hours
 - Access to Hydro One's innovative outage app, and outage alerts via text or email
 - Service Guarantees: a \$50 credit to the customer's account should Hydro One:
 - Miss a scheduled appointment
 - Fail to connect a new service within 5 business days
 - Fail to return a phone call within 1 business day
 - Access to an independent ombudsman as an avenue of final appeal for customers

Community Support: The community will benefit from eligibility in Hydro One programs, including:

- Hydro One's Safe Communities Donations Program – up to \$25,000 per project
- Employee Volunteer Grant Program – up to \$1,000 per employee for charitable or non-profit organizations where the employee commits to 50 or more hours per year.
- Hydro One participation in local United Way

Environmentally Sensitive Lands: Certain PDI lands will not be included as part of the transaction. Hydro One will be entitled to use those lands, rent free, for a period of up to 10 years post-closing.

Resolutions of the City of Peterborough Holdings Inc.**RECOMMENDATION FOR THE DISPOSITION OF THE REGULATED BUSINESS OF PETERBOROUGH DISTRIBUTION INC. (PDI):**

The City of Peterborough Holdings Inc. (COPHI) Board has over the past two years been evaluating the Ontario regulated electricity industry developments, Provincial government policy, and supporting industry evaluations, all of which point to a rapidly changing and consolidating electricity distribution sector, and

The COPHI Board has assessed that PDI, as a small utility in this changing industry, will be unable to effectively operate in the long-term, due to its inability to achieve scale to reduce costs, or access necessary capital and technology to effectively maintain existing, and address future, customer service and regulatory standards, and

The Provincial Government has introduced specific tax incentives expiring December 31, 2018 , to incentivize industry consolidation by reducing the overall tax burden, potentially yielding savings of \$11.5 million to the City of Peterborough;

IT IS UNANIMOUSLY RESOLVED that the COPHI Board recommend to the City of Peterborough that the City approve and authorize the disposition of the regulated business of Peterborough Distribution Inc.

RECOMMENDATION TO ACCEPT THE HYDRO ONE INC. OFFER TO ACQUIRE THE REGULATED BUSINESS OF PETERBOROUGH DISTRIBUTION INC. (PDI):

The COPHI Board believes that the disposition of PDI is in the best interests of COPHI and the City of Peterborough, and all the communities and customers that PDI serves, and

The COPHI Board has developed transaction evaluation criteria to encompass and address the following key community stakeholders in PDI:

- The Customers through PDI's service and distribution rates;
- The Communities we serve, through PDI being a local economic contributor;
- The City, as shareholder, receiving a return;
- The Employees, who contribute to PDI's success, and

The COPHI Board has received an Offer from Hydro One to acquire the regulated business of PDI and to construct a Regional Operations Centre; and the COPHI Board has negotiated key terms that attains the above noted transaction evaluation criteria.

IT IS UNANIMOUSLY RESOLVED that the COPHI Board recommend to the City of Peterborough that the City accept the Hydro One Offer to acquire the regulated business of Peterborough Distribution Inc., as summarized and presented by COPHI, subject to the completion of final due diligence, and all legal documentation supporting the Offer terms, to the satisfaction of City Administration.