

RECOMMENDATIONS
ON
THE FUTURE OF ORILLIA'S HYDRO UTILITY
BY
THE BILL 35 TRANSITION COMMITTEE

Transition Committee Members

Mayor Ken McCann – City of Orillia – Chair

Dan Valley, Commissioner – O.W.L.P.

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April, 2000

RECOMMENDATIONS

1. That the City of Orillia retain ownership of the assets of the Orillia Water, Light and Power Commission by establishing a distribution company and a generation/services company.
2. That City Council select the holding company model to hold the City's investment in the two subsidiary companies.
That the shareholder direction for the holding company require Council approval for any proposed distribution of dividends received from the competitive subsidiary.
3. That a Board of Directors consisting of five members be appointed by City Council for the holding company.
That the shareholder direction encourage the holding company to minimize the size of the boards of its subsidiaries.
4. That City Council establish a policy that members of City Council and City staff not be eligible for appointment to the Board of the holding company or its subsidiaries.
5. That Council appoint a Committee to oversee the recruitment process, interview candidates, and make recommendations to Council regarding the Board of Directors of the holding company, and that such Committee consist of two members of Council, one member of the community at large, one representative of the existing Commission, and the City Manager.
6.
 - a) That the appointments to the initial Board of Directors be made for a combination of one-year, two-year, and three-year terms.
 - b) That, as each initial term expires, directors be appointed or re-appointed for a three-year term.
7. That no limit be placed on the number of times that a Director can be re-appointed.
8. That compensation levels of the Board of Directors be subject to Council approval, and that the recruitment committee be mandated to submit a recommendation to Council regarding the initial compensation structure.

9. That the City Solicitor be authorized to draft a shareholder direction for use by the recruitment committee, which minimizes the range of issues requiring shareholder approval beyond those listed in this report.
10. That the holding company be required to submit progress reports on its activities semi-annually to City Council.
11. That Council request the Board of the holding company to undertake a review of the telecommunications initiative on a priority basis in the first year of the Corporation's business plan.
12. That Council agree to a recapitalization of the generation company that would produce a commercial debt/equity ratio in the range between 60/40 and 70/30.
13. That, with respect to the generation company's operations, Council approve the principle of moving from a rate minimization approach to a profit maximization approach over a transition period of three to five years.
14. That Council agree to a recapitalization of the distribution company that would produce a debt/equity ratio of 50/50, as will be used by the OEB in its rate approval process.
15. That, with respect to the distribution company's operations, Council approve the principle of moving to the permissible rate of return on equity over a transition period of three to five years.
16. That the shareholder direction preclude the corporation from entering into new retail businesses, including commodity retailing, either directly or through a subsidiary, without the express approval of City Council.

1. BACKGROUND

- 1.1. The Energy Competition Act, 1998, is intended to end the monopoly of Ontario Hydro over electricity generation and transmission. It provides customers with the right to purchase their power from a competitive power supply market expected to develop over the next decade.
- 1.2. The Act requires that municipalities wishing to be in the business of generating, distributing, or selling electricity will have to incorporate companies under the Ontario Business Corporations Act (OBCA) to carry on these businesses. The deadline for these incorporations is November 7, 2000.

- 1.3. The distribution of electricity within a municipality (as opposed to the competitive sale of the electricity commodity) will continue to be a monopoly business regulated by the Ontario Energy Board (OEB), and will have to be carried out by a company which is separate from any affiliate involved in competitive activities.
- 1.4. The local distribution company (LDC) will be obligated to arrange for the provision of electricity to those customers who do not choose a competitive retailer, known as “standard supply”.
- 1.5. In 1999, Mayor McCann appointed a Transition Committee to investigate and report to Council on the implications, opportunities, and options for Orillia in the new electricity market. The Committee consists of the Mayor and City Manager, a commissioner and the General Manager of the Orillia Water, Light and Power Commission (OWLP), and the legal advisers for the City and the Commission.
- 1.6. In August, 1999, the Committee presented its initial briefing to City Council. A public forum was held in the Council Chamber on September 14, at which members of the public were provided with the opportunity to express their views. The Committee has continued to meet regularly during the intervening months to discuss the options presented to Council last fall. A final public forum was held on April 4, 2000, to receive feedback on a discussion paper issued by the Committee in March, 2000.
- 1.7. Although the Minister of Energy, Science, and Technology had indicated to City Council that the rules of the new marketplace would be clear by November, 1999, this regrettably has not occurred. Although the OEB has released some key decisions on issues such as LDC rates, according to press reports the Minister has indicated he will introduce legislation to overturn any OEB decision with which he disagrees.
- 1.8. Given this climate of uncertainty and the threat of governmental intrusion into the OEB’s decisions, the Transition Committee’s advice to City Council is to proceed with caution.

2. RETAIN OR DISPOSE?

- 2.1. Municipalities are the legal owners of the municipal electrical utility (MEU) operating within their boundaries. The Act provides the municipality with

the right to sell its MEU, subject to OEB approval for any sale of the distribution system.

- 2.2. There will be a 33% transfer tax on the sale of MEU assets, based on their fair market value, with the exception that sales to another MEU or to Ontario Hydro Services Company (OHSC) will be exempt from the transfer tax until November 7, 2000.
- 2.3. As at December 31, 1998, OWLP held assets with a total net book value of \$27.6 million (total assets less liabilities). These assets include cash and short-term investments of approximately \$7 million. The 1999 year-end book value is projected to be only slightly higher.
- 2.4. To date, no sale of MEU assets has been approved by the OEB, so it is difficult to predict what criteria the regulator would apply in examining a sale. The Minister has indicated that the primary concern should be the impact on the rates paid by the consumer.
- 2.5. Those municipalities still exploring the possibility of a sale would appear to fall into three categories:
 - ◆ Those who need the cash proceeds to pay down municipal debt which has reached unsupportable levels.
 - ◆ Those whose corporate philosophy does not justify being in the electricity distribution business, and who wish to invest the proceeds in the core businesses of the municipality.
 - ◆ Those who do not expect to survive the current provincial preoccupation with municipal restructuring, and who wish to share the proceeds with their current citizens rather than see them distributed to their neighbours after amalgamation.
- 2.6. Although the cash proceeds from a sale would obviously be of benefit to the City of Orillia for debt retirement and infrastructure investment, there are other options available for earning a return on the municipality's assets which are potentially less likely to incur the disapproval of the OEB or the Minister. The history of Orillia is closely tied to a proactive and progressive electric utility promoting economic development, so electrical distribution and generation can justifiably be characterized as a core business of the municipality.

- 2.7. The only one of the above categories which could arguably apply to Orillia is the third one related to municipal restructuring. The conventional wisdom among local politicians and provincial representatives suggests that the City of Orillia will not survive in its current form beyond five years. For this reason, an argument could be made that the MEU assets should be distributed to Orillia taxpayers before the MEU's ownership is transferred to a larger municipal shareholder with a different geographic boundary.
- 2.8. The Transition Committee also notes that there has been hardly any official interest expressed by potential purchasers to City Council in the acquisition of any of the OWLP's assets or businesses, although it is recognized that the City has not been actively soliciting such interest.
- 2.9. There have been overtures by neighbouring municipalities, such as the City of Barrie and Severn Township, who have expressed interest in discussing strategic alliances, up to and including merger. OWLP is also part of the Upper Canada Energy Alliance. The future of that relationship, which has already produced many positive benefits, remains under discussion.
- 2.10. The Transition Committee is concerned that the City's ability to meet the incorporation deadline of November 7, 2000 will be seriously compromised if work is halted while these alliance/merger discussions proceed. It therefore suggests that these discussions continue, but that the City's timetable proceeds regardless.
- 2.11. The Committee believes that there are a number of factors that support the option of retention of the utility by the municipality:
 - ◆ It has a high level of public support.
 - ◆ It retains the value of the business for the benefit of the shareholder.
 - ◆ It provides City Council, through the shareholder agreement and the appointment of directors, an opportunity to exert some influence over the utility's activities.
 - ◆ It presents the opportunity for a reasonable rate of return for the municipality as shareholder.
 - ◆ It recognizes the experience of OWLP's staff.

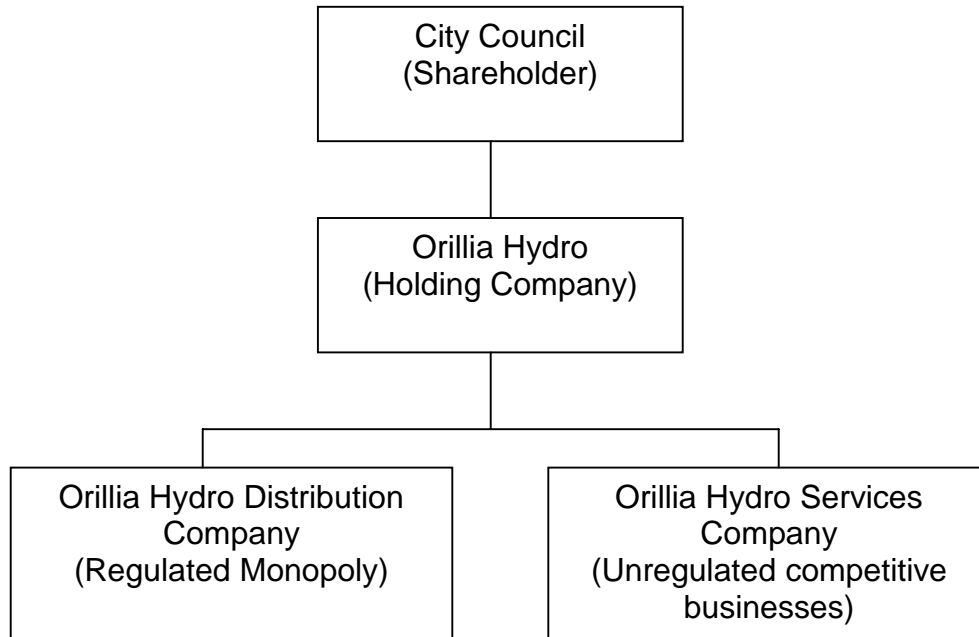
- ◆ The distribution business carries minimal risk for the shareholder.
- ◆ The generation business offers the opportunity for reducing customers' power bills.
- ◆ It does not preclude a sale of some or all of the utility's businesses, or a merger with another utility, at some point in the future, when the rules may be clearer and the transfer tax may be reduced.

Recommendation

That the City of Orillia retain ownership of the assets of the Orillia Water, Light and Power Commission by establishing a distribution company and a generation/services company.

3. CORPORATE STRUCTURE

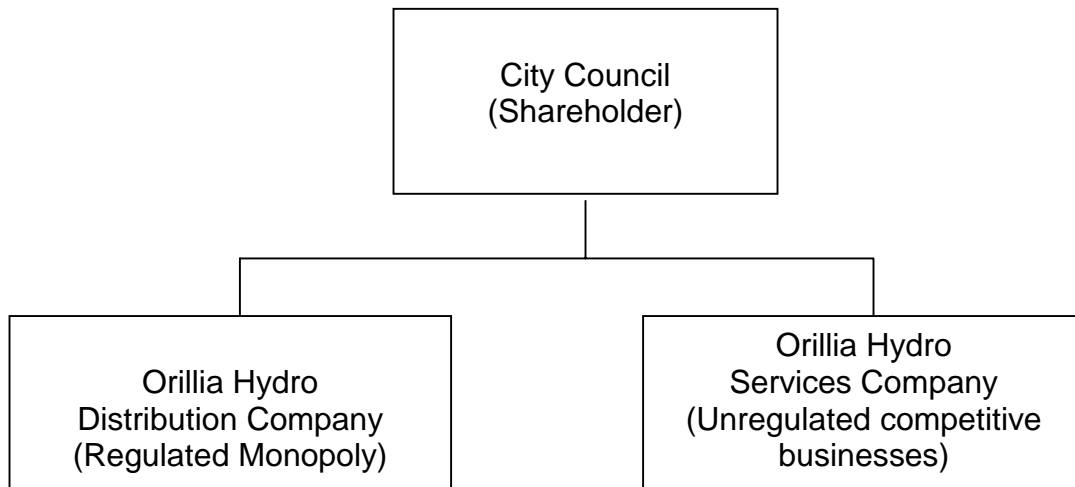
- 3.1 If a municipality retains its electric distribution utility, it must incorporate a new company under the Ontario Business Corporations Act by November 7, 2000, to carry on the utility's distribution business. If, like Orillia, the utility is involved in businesses other than distribution, a separate company must be established to carry on these competitive activities.
- 3.2. As the initial shareholder, the City will have the normal rights of a sole shareholder under the OBCA, including:
 - ◆ The right to appoint directors.
 - ◆ The right to restrict directors' powers under a "unanimous shareholder agreement".
 - ◆ The right to approve fundamental changes to the corporation, i.e. merger.
 - ◆ The right to receive dividends.
- 3.3. Of the three structures presented in the Committee's initial briefing, two merit serious consideration. The holding company approach is the one being favoured by most municipalities with both monopoly and competitive businesses:



- 3.4. In the holding company model, the City of Orillia would be the sole shareholder of a company established to hold the City's investment in both the regulated and unregulated businesses. The holding company would own the shares of the subsidiary companies and manage the subsidiaries' activities.
- 3.5. The advantages of this model include:
- ◆ The City would only have to deal with one Board of Directors to establish the overall objectives for all businesses.
 - ◆ A directorship on a company dealing with both regulated and competitive businesses is more likely to attract high-calibre candidates.
- 3.6. Under the holding company approach, City Council would appoint the directors of the holding company, and the holding company would appoint the director(s) of the affiliates.
- 3.7. The disadvantage of this model is that any profits from the competitive operations such as generation flow to the holding company. The decision as to how to use such profits, i.e. to return them to the distribution

company to depress hydro rates, or to flow them through to the municipality to be used for community investment or tax decreases, would be made by unelected appointees unless the shareholder specified otherwise. Accordingly, if the holding company model is selected, it is suggested that the shareholder direction require Council approval for the proposed distribution of dividends from the competitive subsidiary.

- 3.8. The other structure which merits consideration in Orillia's situation is the establishment of two separate companies reporting directly to City Council:



- 3.9. The advantage of this direct ownership model is that the profits from the competitive operations such as generation flow directly to the City of Orillia. The decision as to how to use such profits would be made by elected representatives accountable to the public and not by unelected appointees. However, there is a legal concern about the ability of the municipality under this model to flow such dividends back to the distribution company without contravening the bonusing prohibitions in the Municipal Act. While such concerns are not totally absent in the holding company model, they are certainly greater in the direct ownership model.

- 3.10. Directors under the OBCA have a fiduciary obligation to act in the best interests of the corporation. This may at times be in conflict with the best interests of the shareholder, in which case the shareholder's recourse is

to remove the directors at the next shareholders' meeting. By flowing the profits from generation directly to the City, the risk of such conflict is minimized and public accountability is enhanced.

- 3.11. The disadvantage of this direct reporting model is that City Council would have to deal with two separate Boards in establishing the overall objectives, and the risk of inefficiencies and lack of co-ordination would be increased. It is also likely that the number of directors to be recruited would be larger than in the holding company model. However, it is arguable that the combination of skills required for the board of the competitive company may well be different from that of the board of the regulated monopoly, thereby making it easier to recruit an appropriate combination of skills for each.
- 3.12. It will also be important to ensure that the chosen corporate structure facilitates the flow of dividends to the municipality in as tax-effective manner as possible, to minimize leakage of profits to the senior levels of government in the form of taxes.

Recommendation:

That City Council select the holding company model to hold the City's investment in the two subsidiary companies.

That the shareholder direction for the holding company require Council approval for any proposed distribution of dividends received from the competitive subsidiary.

4. BOARD OF DIRECTORS

- 4.1. The incorporation documents for an OBCA company usually specify a range for the number of directors. The Act allows a minimum of one director.
- 4.2. Those municipalities which have already made the decision demonstrate a variety of choices, from five in Barrie, seven in Burlington and Oakville, to eleven in Peterborough.
- 4.3. Although the new company's operating budget will be in the range of \$25-\$30 million annually, most of this budget represents the flow-through of power costs. Excluding depreciation, interest, and this power cost flow-

through, the new company's distribution and generation functions are estimated to require annual operating expenditures in the \$4 million range. This is equivalent to a medium-sized city department and comparable to an agency such as the Police Services Board. An initial board of five directors would seem to be more than adequate for an operation of this size. This number can easily be increased if the need arises in the future.

- 4.4. A holding company does not need to have any employees, since the management of each of the operating companies is responsible for most operations. The Board of each subsidiary company would not have to be large, and could initially consist of the president of that operating subsidiary. The OEB's Affiliate Relationship Code requires that one-third of the directors of the distribution monopoly be independent from the board of the competitive affiliate, the holding company, and the municipal shareholder.

Recommendation:

That a Board of Directors consisting of five members be appointed by City Council for the holding company.

That the shareholder direction encourage the holding company to minimize the size of the boards of its subsidiaries.

- 4.5. Many municipalities are appointing members of Council to the new Boards. The rationale is that such appointments will facilitate communications between the corporation and the Council. There are a number of arguments against this approach:
- ◆ The Orillia experience in recent years suggests that such liaison appointments are not an adequate substitute for regular, formal reporting.
 - ◆ The fiduciary obligations of a director under the OBCA to act in the best interests of the corporation may impair a Councillor's ability to represent the interests of the City at Board meetings.

- ◆ Conversely, a director who is a member of Council may find it difficult to reconcile these competing interests when acting at a Council meeting in the best interests of the community.
 - ◆ The presence of elected representatives on the Board, regardless of their personal skill-sets, may fuel the perception that the corporation is not being run as a business.
- 4.6 Similar arguments can be made about the conflicting roles if a member of the City's senior management were to be appointed to the Board.

Recommendation:

That City Council establish a policy that members of City Council and City staff not be eligible for appointment to the Board of the holding company or its subsidiaries.

- 4.7. Under the OBCA, any individual can become a director if he or she is over the age of 18 years, of sound mind, and solvent. A majority of the directors must be resident Canadians, as defined in the OBCA. There is no requirement that Board members be affiliated with the City of Orillia as residents, property owners, or taxpayers.
- 4.8. The Transition Committee believes that the primary objective is to recruit a board with the appropriate complementary set of skills. It does not, therefore, support any residency restrictions.
- 4.9. The initial briefing to Council identified the following desirable mix of complementary skills and experience:
- ◆ Experience in company governance, corporate financial structuring, competitive market development, or corporate structural transitions;
 - ◆ Experience in a regulated environment, a competitive wholesale or retail environment, a monopolistic service or utility, or the public sector;
 - ◆ Skills in marketing, finance, human resources, communications, corporate and energy law, health and safety, labour relations.

It is recognized that the appropriate mix of skills may vary somewhat between the regulated and competitive businesses if Council selects the direct ownership model.

- 4.10. The initial briefing also identified specific personal characteristics that would be desirable, including personal integrity; appreciation of social and environmental issues; understanding of public accountability; independent judgement; and time availability and commitment.
- 4.11. Some of the larger municipalities have engaged consulting firms to assist them in the recruitment of directors. This approach has considerable merit where the catchment area is large and the Council cannot reasonably expect to be aware of all potential candidates. It also has the advantage of introducing an objective third party into the selection process, although the final decision remains with Council.
- 4.12. In a community the size of Orillia, the expenditure of consulting fees in the area of \$35,000 is not considered to be warranted for such an assignment. Through appropriate advertising and networking with interested organizations, the Committee believes that an appropriate mix of candidates can be recruited without consulting assistance. However, the inclusion of community members on the selection committee would provide valuable insights and perspectives, as was the case in recent executive recruitments for the municipality.
- 4.13. The Mayor has advised the Committee that he does not wish to be an ex-officio member of the recruitment committee.

Recommendation:

That Council appoint a Committee to oversee the recruitment process, interview candidates, and make recommendations to Council regarding the Board of Directors of the holding company, and that such Committee consist of two members of Council, one member of the community at large, one representative of the existing Commission, and the City Manager.

- 4.14. Although the term for a director can vary between one to three years, a one-year term is used by the majority of companies listed on the Toronto Stock Exchange. A term of a director under the OBCA cannot expire later than the conclusion of the third annual meeting of shareholders following his election. Most municipal appointments by Orillia City Council are for three year terms, with staggered expiry dates to ensure continuity. The

Committee supports the latter model because of its familiarity for members of Council, and because the shareholder always has the right to replace a director at any time.

Recommendation:

- a) That the appointments to the initial Board of Directors be made for a combination of one-year, two-year, and three-year terms.**
- b) That, as each initial term expires, directors be appointed or re-appointed for a three-year term.**

4.15. The current policy of the City for citizen appointees to agencies, boards, and commissions is to limit their tenure to two consecutive three-year terms, although a number of exceptions to this policy have been approved in recent years. There is currently no limit on the number of terms that can be served by an elected OWLP Commissioner. The Committee believes that the overriding criterion for the appointment of directors should be the calibre of the candidate.

Recommendation:

That no limit be placed on the number of times that a Director can be re-appointed.

4.16. The compensation for directors is left to the discretion of the Board, unless the articles, by-laws or the shareholder direction require that director compensation be approved by the shareholder. In the unique circumstances of Bill 35, it is recommended that Board compensation be a matter for Council approval, at least in the formative years of the new corporation. The Police Services Board, with a similar budget to the new corporation, pays \$1,500 to the Chairman and \$1,000 to the members. The OWLP's remuneration, which is established by City by-law, consists of \$3,150 for the Chairman and \$2,520 for the members, one-third of which is considered a tax-free expense allowance. It is noted that directors under the OBCA have statutory liabilities which may not apply to existing Commissioners.

4.17. While it will be important to ensure that compensation levels are not unreasonable in comparison with other City appointments or other utility corporations, the key criterion should be that the chosen levels do not dissuade appropriate candidates from accepting a directorship. It is therefore suggested that the recruitment committee be given the mandate to discuss directors' fees with interested candidates, to research practices in other jurisdictions, and to present a recommendation to Council as part of its report.

Recommendation:

That compensation levels of the Board of Directors be subject to Council approval, and that the recruitment committee be mandated to submit a recommendation to Council regarding the initial compensation structure.

4.18. Before initiating the recruitment process, it will be necessary to outline Council's expectations regarding the degree of autonomy which the new Board will enjoy. The less independence the Board is given, the harder it will be to attract high-calibre directors.

4.19. Under the OBCA, shareholder approval is required for specific actions such as:

- ◆ Amendments to the articles of incorporation or by-laws.
- ◆ Plans to amalgamate or dissolve the company.
- ◆ Changes to the share structure.
- ◆ Sale of substantially all of the corporation's assets.
- ◆ Appointment of auditors.
- ◆ Changes to the structure and membership of the Board.

4.20. Beyond these statutory requirements, the shareholder can determine the extent to which it will become involved in the management and policy decisions of the corporation by listing additional items in the shareholder direction which require the prior approval of Council.

4.21. The Directors are legally accountable for the performance and actions of the Corporation, although some of this liability can be mitigated through insurance or indemnities. If the shareholder retains certain director responsibilities or turns down the recommendations of the Board, then

the City generally assumes the legal liability for such decisions and cannot hold the Board accountable.

4.22. Items which should be considered for inclusion in the shareholder direction are:

- ◆ Board compensation.
- ◆ Loans to directors or officers.
- ◆ Expansion of the service areas beyond the City of Orillia.
- ◆ Investment controls.
- ◆ Borrowing limits.

Recommendation:

That the City Solicitor be authorized to draft a shareholder direction for use by the recruitment committee, which minimizes the range of issues requiring shareholder approval beyond those listed in this report.

4.23. The corollary of the recommendations regarding maximizing Board autonomy and excluding direct Councillor representatives is the need for a regular, formal reporting system to the shareholder, so that Council is fully informed, particularly during the formative stages of the new marketplace. While the City Treasurer will likely require financial reports at least quarterly, if not monthly, a semi-annual report to Council on the Corporation's overall activities is also suggested.

Recommendation:

That the holding company be required to submit progress reports on its activities semi-annually to City Council.

5. THE BUSINESS OF POWER

A. TELECOMMUNICATIONS

5.1 In 1998, OWLP installed a city-wide high speed data communications network to service the Commission's needs as well as those of the public and private sectors. The concept was to use the bandwidth not required for OWLP's own purposes to generate new revenue streams for the

Commission, while enhancing the attractiveness of Orillia from an economic development standpoint.

- 5.2. Because of the confidential nature of some of the competitive content, an updated business plan has been provided under separate cover to members of Council. While some of the original objectives have been met, the network has not met its customer connection objectives for 1999.
- 5.3. The telecommunications industry continues to undergo rapid change, with new technology and new competitors entering the marketplace every year. The capital investment in the network has already been undertaken by OWLP, so ongoing operating costs relate primarily to marketing efforts.
- 5.4. The Transition Committee invited proposals from three companies to undertake an analysis of the OWLP's telecommunications business and to prepare recommendations for Council as to whether the business should be retained, expanded, or sold. Because of the level of activity in the industry, only one proposal was received, and the Committee was of the opinion that the proposed consulting fee of \$55,000 did not represent good value. Accordingly, the Committee did not proceed further.
- 5.5. While there may well continue to be good public policy reasons for public ownership of a communications network, the year 2000 will be critical in establishing the commercial viability of OWLP's initiative.

Recommendation:

That Council request the Board of the holding company to undertake a review of the telecommunications initiative on a priority basis in the first year of the Corporation's business plan.

B. GENERATION

- 5.6. At present, the OWLP generates between 20 and 30 percent of the community's power requirements, depending on water flows. Since this power is generated at a cost considerably below the price paid to Ontario Hydro for the remaining 70 to 80%, the blended price reduces the Orillia customer's hydro bill below what it would otherwise be.

- 5.7. With the unbundling of the current hydro bill into the separate components of distribution, transmission, and commodity costs, the issue in the new regime will be whether Orillia's ownership of generating capacity can and/or should continue to be used to reduce the consumer's hydro bill.
- 5.8. It should be stressed that forecasting the impacts of current decisions on future revenue flows from the generation business is very sensitive to assumptions that one makes about the future direction of commodity prices for electricity. If one agrees with the Ministry that the experience in other jurisdictions which have introduced competition into the energy industry will be repeated in Ontario, then hydro costs in the long term will decrease and the profits from generation will be lower. If one believes the industry skeptics who argue that restructuring of the industry will inevitably lead to higher commodity prices, the outlook for generation profits is considerably more optimistic.
- 5.9. In order to minimize the leakage of profits to the senior levels of government in the form of corporate taxes, it would be desirable to maximize the debt/equity ratio of the generation company, since interest payments are tax-deductible. Discussion with industry experts and external consultants suggests that Orillia's generation business can sustain a debt/equity ratio of 70/30. This has been confirmed by the financial modelling undertaken for the Transition Committee.
- 5.10. For the sake of simplicity, it is suggested that this debt initially be held by the City. Should the City in the future wish to replace the revenue stream from interest payments with a capital infusion, the debt could be placed on the external markets.
- 5.11. If one were to assume a book value of \$10 million for the generation business in the transfer by-law, a 70/30 debt/equity ratio would result in a debt of \$7 million. At a financing rate of 7%, this would produce an income stream to the municipality of \$490,000 annually.

Recommendation:

That Council agree to a recapitalization of the generation company that would produce a commercial debt/equity ratio in the range between 60/40 and 70/30.

5.12. There are potentially two different approaches which the generation company could take with respect to how to price and sell the locally generated power:

Option A: Sell into the grid at the highest price obtainable, and produce after-tax profits which could be used to either lower distribution rates, decrease property taxes, or invest in community infrastructure.

Option B: Sell the locally generated power to the local distribution company, in a similar fashion to OWLP's current practice on a cost-plus basis, as part of the distribution company's standard supply obligation, thereby reducing the cost-of-power component of the customer's hydro bill.

5.13. Option A may ultimately prove to be the only one available, since Option B requires OEB approval which has not yet been confirmed.

5.14. The OWLP has undertaken financial modelling for the Transition Committee, in consultation with the City Treasurer and external consultants, to determine the order-of-magnitude impact of these options on both the City's financial return as shareholder and the customer's hydro bill. Wherever possible, the modelling undertaken by OWLP staff uses assumptions between the optimistic and pessimistic extremes. The earlier caution about the sensitivity of these forecasts to changes in the price of the commodity should be stressed.

5.15. It is estimated that the profit maximization approach for the generation company – Option A - would produce an average rate of return on equity in the neighbourhood of 20%, and an annual average net income to the City over the next 20 years of \$600,000 to \$700,000. The customer's annual hydro bill is forecast to be approximately 3% higher than it would be under Option B. Using an average monthly residential hydro bill of

\$60, this represents an increase of 6 cents per day. Again, it should be noted that OWLP's modelling assumes an increase in the cost of power over the forecast period in accordance with the opinions of various industry observers, rather than the decrease forecast by the provincial government as a result of the introduction of competition.

- 5.16. If OEB approval is received, the generation company would have the ability to pursue the second approach in Option B of selling the local production to the LDC as part of its standard supply obligation. If this power were supplied on a cost-plus basis similar to the current OWLP practice, the resultant blended price would reduce the consumer's monthly hydro bill by approximately 3% compared to the profit maximization option.
- 5.17. It is suggested for Council's consideration that a balance should be struck between the competing objectives of profit maximization and rate minimization in the first few years of the new marketplace. This can best be achieved by phasing in the transition from rate minimization to profit maximization over three to five years. The specific details of that phase-in should be recommended by the new Board as part of its initial business plan.

Recommendation:

That, with respect to the generation company's operations, Council approve the principle of moving from a rate minimization approach to a profit maximization approach over a transition period of three to five years.

C. DISTRIBUTION

- 5.18. The distribution functions of the OWLP have to be unbundled and carried out by a separate company, whose rates will be regulated by the OEB using a mechanism called Performance Based Regulation (PBR). This is a rate-setting mechanism that attempts to link penalties and rewards (usually in terms of profits) to desired results or targets.
- 5.19. PBR will essentially act as a price capping mechanism, setting the upper limit on rates that the LDC can charge its customers. The goal of PBR is to provide incentives for utilities to drive distribution costs down in order to

reduce rates while still offering a return on equity. This is a radical departure from the cost-plus approach currently used by municipal utilities.

- 5.20. It should be re-emphasized at this point that the costs over which the municipality can exert some influence through the distribution company represent less than 20% of the customer's monthly hydro bill. The major determinant which will decide whether that bill goes up or down will continue to be the price of the commodity, over which the municipality has no control, with the exception of that portion generated locally and discussed in the preceding section.
- 5.21. Although the final rate handbook has not yet been issued, the OEB has indicated that it recognizes that the LDC will face some regulatory and operational risk, albeit at a lower level than the competitive businesses. It will therefore permit a 9.88% return on equity in the initial rate submissions.
- 5.22. The OEB also recognizes that the LDC's are commercial entities, despite operating in a regulated monopoly. It will therefore deem a utility of Orillia's size to have a 50/50 debt/equity ratio for the purposes of rate setting. This will ensure that the shareholder does not earn a return based on 100% equity ownership.
- 5.23. Using the book value of \$10 million for the generation business referenced in Section 5.11. would leave \$17.5 million as the book value of the distribution business. A 50/50 debt/equity ratio would result in a debt of \$8.75 million. At a financing rate of 7%, this would produce an income stream to the municipality of \$612,500 annually.
- 5.24. As with the generation business, the shareholder has the choice of specifying through the shareholder direction that the LDC should pursue a policy of rate minimization or profit maximization within the regulatory framework established by the OEB.
- 5.25. As with the generation business, it is suggested for Council's consideration that a balance should be struck between these competing objectives by phasing in the transition to the maximum return on equity permitted by the OEB over a period of three to five years.

- 5.26. Based on OWLP's modeling, which uses conservative assumptions as to the cost reductions to be achieved through PBR, the customer's hydro bill would increase approximately 3% annually if a five-year transition to full market return was used. The specific details of this phase-in should be recommended by the new Board as part of its initial business plan.
- 5.27. It is estimated that this approach would produce an average rate of return on equity over a 20-year period in the neighbourhood of 8%, and an average annual net income to the City of \$700,000.

Recommendations:

That Council agree to a recapitalization of the distribution company that would produce a debt/equity ratio of 50/50, as will be used by the OEB in its rate approval process.

That, with respect to the distribution company's operations, Council approve the principle of moving to the permissible rate of return on equity over a transition period of three to five years.

- 5.28. Once the guiding principles have been established by Council, the City Treasurer and the OWLP Treasurer would be tasked with pursuing a number of other specific financial issues. These include the amount of OWLP's current assets, such as working capital and contingency funds, which should be transferred to the new company pursuant to OEB regulations, and the desirability of revaluing the assets of the competitive generation business prior to transfer.

D. RETAIL

- 5.29. As noted in the Committee's initial briefing to Council, it is generally accepted in the industry that the actual retailing of the electricity commodity will be a high risk, low margin business which will be dominated by some very large, sophisticated, and aggressive companies. Moreover, the emerging threshold for a viable retail strategy is in the range of 200,000 customers, as compared to Orillia's 11,800. Since customers who do not wish to switch to one of the new retailers can stay with the LDC's standard supply service, there appears to be no

public interest rationale for the municipality to permit its corporation to enter into the commodity retailing business.

Recommendation:

That the shareholder direction preclude the corporation from entering into new retail businesses, including commodity retailing, either directly or through a subsidiary, without the express approval of City Council.

CONCLUSION

The recommendations in this report represent an attempt to balance the ratepayers' interest in minimizing increases in their hydro bills with the taxpayers' interest in growing the value of their assets and generating a return for the benefit of the community. A summary of the impact on ratepayers and taxpayers based on the financial modelling undertaken for the Transition Committee is attached.

ADDENDUM RE: FINANCIAL MODELLING

<u>Model Assumptions</u>	<u>Distribution</u>	<u>Generation</u>
Effective tax rate	45%	38%
Debt equity ratio	50%	70%
Interest rate on City debt	7%	7%
Dividend payout ratio	100%	100%
Customer growth rate	1%	--
Inflation rate	2%	.2%
Efficiency gains	-1.5%	-1.5%
PBR productivity factor	-1.5%	--
PBR input price index	1.25%	--
Initial IMO price per mWh generated	--	\$38
Annual increase in spot price first 10 years	--	2%
Number of mWh generated	--	85,000
Savings from participation in UCEA	0	0

Model Results

Scenario 1 :profit minimization for distribution, fully levered
:use generation cash flow to subsidize distribution rates

Annual average cash flow to City – 2001 to 2020: \$1,059,000

Average rate of return on equity: 0.2% distribution
0.0% generation

Increase in customer rates: 5.2% in 2001, 0.7% - 0.9% annually thereafter

Scenario 2 :profit minimization for distribution, fully levered
:profit maximization for generation

Annual average cash flow to City – 2001 to 2020: \$1,685,000

Average rate of return on equity: 0.3% distribution
25.2% generation

Increase in customer rates: 7.7% in 2001, 0.9% - 1.1.% annually thereafter

Scenario 3 :profit maximization for distribution
:use generation cash flow to subsidize distribution rates

Annual average cash flow to City – 2001 to 2020: \$1,886,000

Average rate of return on equity: 9.6% distribution
0.0% generation

Increase in customer rates: 12.5% in 2001, 0.7% annually thereafter

Scenario 4 :profit maximization for distribution and generation

Annual average cash flow to City – 2001 to 2020: \$2,514,000

Average rate of return on equity: 9.7% distribution
25.2% generation

Increase in customer rates: 15% in 2001, 0.9% annually thereafter

Scenario 5 (recommended) :profit maximization for distribution and generation
phased in over 5 years

:
Annual average cash flow to City – 2001 to 2020: \$2,379,000

Average rate of return on equity: 8.3% distribution
25.2% generation

Increase in customer rates: 5.3% in 2001, 3.2% in 2002, 3.3% in 2003, 3.1%
in 2004, 3.0% in 2005