Town of Midland as Sole Shareholder of the Midland Power Utility Corporation

June 21, 2016

The purpose of this presentation is to provide an overview of the process and information assembled to-date into one document for Town Council to consider and choose a direction for its 100% share ownership of Midland's Power Utility Corporation.

PART ONE – A BRIEF HISTORY

A brief outline of major events and the timelines are:

- As a result of various Government sponsored studies numerous recommendations for change were made:

  Macdonald Committee Report in 1996
  Ontario White Paper in 1997
  Energy Competition Act 1998

- The Ontario Government mandated the restructuring of local distribution from Municipal Commissions to Business Corporation Act Companies in 1998 and Municipalities became the shareholders. Municipalities were given the discretion to retain, sell, or merge their Local Distribution Companies.

Changes since 1998 include:

- Distribution companies are regulated by the OEB.
- Ontario Hydro no longer exists and was restructured into multiple entities these being, Generation, Transmission, Distribution, System Planning, System Operations.
- Local distribution became a regulated, for profit commercial enterprise owned by municipalities governed by Boards of Directors.
- The Distribution sector continued to consolidate - in 1999 there were 307 Municipal Electric Commissions and in 2013 Ontario had around 70 Local Distribution Companies.

Changes since 1998 continued

- The Province commissioned the Drummond Report and in February of 2012 the Drummond Commission recommended a consolidation of Ontario's remaining 73 Local Distribution Companies along regional lines to create economies of scale. Larger regional LDC could also integrate water service operations and have greater involvement in conservation programs.

- In April of 2012 the Province commissioned the Ontario Distribution Sector Review Panel to find "efficiencies in the distribution sector, including consolidation" and the concept was to merge local distributions companies with Hydro One.

Changes since 1998 continued

- In December of 2012 the Provincial Distribution Sector Review Panel recommended that the 73 LDCs should be consolidated into 8 to 12 larger regional distributors; minimum size for southern Ontario 400,000 customers

  - Was to be voluntary first then mandatory consolidation.

  - Voluntary merger with new regional utilities was to be at fair market value.

  - Mandatory mergers if voluntary not achieved within two years – mandatory mergers will value LDC assets at book value.

changes since 1998 continued

But Minister of Energy Bob Chiarelli said of the Distribution Review Panel:

- He will not force LDC consolidation by legislation (March 18, 2013).
- But sector must bend the cost curve (June 20, 2013).

Discussion in Midland began as far back as 2008 when Midland was contacted by Hydro One relating to their interest in a potential acquisition of the MPUC.

A very brief chronological outline of subsequent activity follows:

- Further activity took place again in 2011.

- The subject was once again raised in October of 2013 when Hydro One expressed interest in a potential purchase of the MPUC.

- On October 17, 2013 a special meeting of Council was held and at that meeting a recorded vote was held on the following motion:

> **"That Council agrees to consider the sale of the MPUC subject to acceptable terms and conditions"**

The motion was supported by 6 votes in favour and 2 against.

- Staff were directed to contact a consultant to assist with the development of a process for the obtaining of quotes for the potential sale of the MPUC.

- On November 7, 2013 Mark Rodger provided a PowerPoint presentation to Council.

- To assist with this process on November 12, 2013 the Town retained the leading experts on such transactions Mark Rodger of the law firm Borden Ladner Gervais and Dr. Lawrence Murphy, President of Henley International Inc. for valuation and financial advice and a financial contribution was made by Hydro One to help with that cost. This process was expected to result in an offer in May 2014.

- April 2014 Town is advised that discussions with Hydro One have come to an end and no transaction will occur at this time.

- March of 2015 Minister Chiarelli sets out a roadmap and questions if in the 21st century do the Province and Municipalities really need to be in the distribution business.
    - Existing LDC sector configuration “just doesn’t make sense.
    - Our system has established and enshrined some major inefficiencies that disadvantage ratepayers.

- April 2015 - 3 year Transfer Tax and Departure Tax relief for small LDCs with less than 30,000 customers starting Jan 1, 2016 approved.

- April 2015 Mark Rodger makes presentation and suggests that in a competitive RFP Midland can canvas the new market.

- August 2015 Mark Rodger travels to Midland to attend meeting with MPUC large users and gives a presentation on LDC issues and Midland's RFP.

- In February of 2016 Council passed a motion requesting the MPUC Board and staff to informally seek out and identify interest in possible partnerships with MPUC including sale, merger or other business arrangement.

- MPUC reports back to Shareholder on May 31, 2016.

- By my count Council went onto meet at least 34 more times to consider various aspects of the questions surrounding the MPUC and tonight will represent at least the 39th meeting.

These items collectively have led many Municipal Councils as Shareholders of their Local Distribution Companies to debate the issues.

PART TWO – SHAREHOLDER OPTIONS:

1. Status Quo: do nothing

2. Merger: combine with another/other LDCs

3. Disposition: sell the utility (in whole or in part)

4. Shared Services: capture scale and scope efficiencies through group purchasing

Status Quo:

- All indications for a LDC of our size is that Status Quo is not a viable option for the long term future and the vast majority of former LDCs have already moved towards sale, merger or expanded business model.

- Status Quo is not an option supported by the Board of Directors for the MPUC. The MPUC Board and staff recommended that Council continue with additional investigations and merger negotiations. MPUC acknowledges they do not have the capacity, (human and financial) to take on innovation and emerging technology.

Status quo continued

- Council has also expressed its desire not to accept Status Quo in a vote at the conclusion of the special Council Meeting of May 17, 2016.

- The expertise of Mark Rodger of BLG suggests that Status Quo is not an option for a small LDC and by not moving towards a sale or merger will expose our LDC to business change and risk of some form or Provincially-driven consolidation.

- Status quo holds the risk that we end up with a depreciated stranded asset.

OBSERVATION

While our use of current energy sources will not end because we run out of uranium, gas, and oil it is more likely to change because the business models they employ and the products that sustain them will be disrupted by superior technologies, product architectures, and business models. Compelling technologies such as solar, wind, electric vehicles, and autonomous (self-driving) cars will disrupt and potentially sweep away the energy industry as we know it.

If status Quo is no longer an issue then Council needs to decide on an action in order to move forward with a detailed examination of alternatives.

Alternatives to be examined ideally would protect and maximize the benefits identified by Council (see Appendix A) including competitive rates, and provide a financial return to the Town by way of an annual dividend if a merger or through a return on investment if a sale.

We must remember in moving forward that we will never know the right path, but we must not be afraid to move ahead because of a fear of getting it wrong.

If we fail to act then in the short term we risk losing the time sensitive preferential tax treatment approved for small LDC and we become an outlier resulting in a possible loss of value in moving forward.

2. MERGER

In comparing differences between a Sale and a Merger there are some items that would not be significantly impacted but others that could be negatively impacted as compared to an outright sale.

- Mergers would not necessarily protect or increase the share value for the Town of Midland as technological advancement will impact a larger LDC in a manner similar to a small LDC if customers find innovative ways to move off of the grid.

- Mergers would impact only a portion of the total cost but that impact could be either an increase or decrease.

- In a sale or merger scenario the current market terms may provide for a distribution rate reduction and a 10 year distribution rate freeze. Who wins and who loses with LDC rate harmonization?

merger continued

- With a Merger Midland Council will almost certainly lose majority control of its LDC and become a minority shareholder of a larger LDC and therefore subject to whatever direction the Majority Shareholder(s) wishes to take.

- Those decisions include the new corporation's dividend policy, continuing or additional mergers further deteriorating of voting influence, possible requests for capital infusion or even outright sale unless somehow protected in the merger agreement.

- Merging with another small LDC makes little sense as it places the slightly enlarged LDC in the same "status quo" which Council and the MPUC Board has rejected.

merger continued

- Merging with a larger LDC does not directly translate into larger Dividends for Midland as each LDC sets its own Dividend Policy and many have dividend levels much lower than Midland’s LDC.

- Midland and the Merging LDC would each need to be at the same Debt to Equity Ratio and if not and Midland PUC has a lower Debt to Equity Ratio then Midland will be seeking additional compensation from the larger LDC.

- Under a Merger Midland through its smaller representation on the Board of the new LDC would still have some influence as a Shareholder but influence would be greatly diminished.

Merger continued

MPUC in evaluating merger proposals employed Council's October 2015 ranking of a series of 6 objectives (see Appendix A) pertaining to ownership of the MPUC and those six objectives provided by Mark Rodger together with Council's top three were:

1. Maximizing Asset Value
2. Maximizing Local Employment
3. Other
4. Utility Control
5. Lowest price to Ratepayers
6. Ensure high quality Service

merger continued

- The work done by MPUC was admittedly done as a high level scan and they recognized additional information would be required. Both of the LDC Entities recommended by MPUC from their high level scan offer the opportunity of Merger, Sale, Partial Sale, Collaboration and even a Fee for Services.

- The MPUC recommendation states a desire to continue with two specific investigations for merger options and for the purpose of this report we have deleted the names in order to protect their identity. However it is sufficient to say that if Council decides to move forward with either a Merger or Sale option that continuing discussions with these firms is a possibility as both have indicated they are open to a sale or merger option, and no doubt other parties would also be interested.

3. SALE

- Sale of shares results in immediate full payout when transaction closes.
- Less complex and lower transaction costs (as compared to mergers).
- Buyer typically pays majority of transaction costs (but no cost recovery if Town does not proceed with sale).
- No further involvement on the part of the Town in the PUC Board. Control is surrendered through a Share Purchase Agreement.
- Share purchase agreement subject to OEB approval.
- No further Dividends.

sale continued

- Offset loss of Dividends with income generated from investment of principal.

- Very high on Council's list is the Protection of the Sale Proceeds in order to perpetuate earned income. This would be addressed by developing a form of Heritage Trust in which the principal is protected and ideally a portion of the income earned set aside to see the principal grow so that the purchasing power of the income is maintained in relative terms. (see Appendix C) A possible investment for this fund would be secure Municipal Debentures ideally where we are both the issuer and the buyer. Until we see what a willing buyer will offer for the LDC we would simply be speculating as to the return we would need to be equal to a dividend stream and if the offer is not adequate then Council is under no obligation to accept any offer.

sale continued

- Sale avoids future uncertainty regarding returns to shareholder due to fluctuating needs of the LDC for infrastructure improvements and loss of potential revenues due to technology advances.

- Return on investment could improve as interest rates continue to inch their way back to normal.

- LDC continues to be fully regulated monopoly by the OEB.

The regulator protects customers who must obtain an essential commodity from a monopoly provider in the absence of a competitive market. OEB is responsible for ensuring that the LDC sets “just and reasonable” electricity rates, and that distributors meet standards of service, policy requirements, and technical specifications. Finally, it balances the needs of the customer with the equity investor’s desire for a reasonable return on investment.

4. **SHARED SERVICES**

- Would be a potential fall back option for investigation if Council does not choose a sale or merger option. Concept would be to find improved purchasing power to lower costs and gain greater efficiencies through innovation.

PART THREE - NEXT STEPS

Prior to preparing an RFP, Council should provide as much clarity as possible on desired outcomes so that the process is more efficient and the quality of the responses can be improved. Specifically Council should direct, if possible, that the RFP should address:

1) Merger Only
2) Sale Only
3) Both a Sale and a Merger

Further Council should confirm/modify the listing of its priorities in a future business arrangement as contained in Appendix A.

PART THREE - NEXT STEPS

In moving forward a comprehensive Request for Proposals must be prepared, or in Midland's case potentially updating the RFP previously constructed by Mark Rodger and Dr. L. Murphy. Town staff do not have the expertise to update and fully evaluate responses to an RFP of this magnitude and undertaking this RFP is a very serious and time consuming process and one we cannot enter into lightly.

As Interim CAO I would recommend Council request a cost quotation from Mark Rodger (sole source) for his services to prepare/update the RFP and subject to Council approval to issue a call for those interested in responding and to evaluate the responses and make a recommendation to Midland Council.

In the RFP we might use as guiding principles the following:

1. That in any negotiation/arrangement we will engage only with quality organizations based upon rigorous due diligence of their past performance and their ability to meet our future needs.

2. Any sale or merger must be better than the status quo for it to be accepted. In particular:

Past Dividends:

In the years immediately following the conversion of the PUC to a for Profit Commercial Enterprise Council and the MPUC Board agreed to reinvest the dividends back into the enterprise in order to make appropriate upgrades. The Board had been debt adverse and did not believe in acquiring debt until the last 5 or 6 years and as a result dividends to the Town only began in earnest in 2004. Since that time the dividend record for the 6 years prior to 2011 remained at $300,000 per year and for the past 6 years the dividends record has been:

2011	$400,000	2012	$400,000
2013	$417,000	2014	$400,000
2015	$550,000	2016	$600,000

This distribution does not equate to a stated or declared dividend policy being X% of net income because the LDC is now moving towards incurring more Debt in order to increase the Debt to Equity Ratio for purposes of OEB Rate Base applications which permit a mix of 60% Debt to 40% Equity. This is briefly touched on below under Rate details.

Future Dividends:

MPUC Commissioned the Accounting Firm of BDO in 2014 to examine their records and based on their volume of business and expenses to forecast possible future dividends and their forecast was:

- 2017 to 2021 $700,000
- 2022 to 2026 $800,000
- 2027 to 2031 $900,000

This forecast also made mention there were no guarantees of dividends and holding onto the MPUC exposes it to financial, business and regulatory risks including government intervention as well as the possibility that the financial value may decrease in the long-term.

3. Service:

Any deal must meet or exceed the 2015 MPUC service levels. The OEB sets minimum service levels and the LDC must meet or exceed these levels.

These service levels include:

- safety,
- system reliability,
- service quality, and
- customer satisfaction.

MPUC has exceeded the minimum requirement targets or service levels and if not met then OEB can assess penalties including suspension of the LDC licence.

4. Rates:

MPUC Rates for Residential consumers are slightly higher and MPUC rates for Commercial and Industrial consumers are slightly lower and we would expect a detailed rate plan or forecast for MPUC’s service territory, set out on a customer class basis for a minimum of 5 years following closing of any transaction.

This would include a detailed description of the Proponent’s rate harmonization strategy.

Rate details continued

RATE DETAILS (only go into this section at Council requests)

The Province has warned consumers that the Generation/Transmission cost will be going up significantly over the next 5 years. Because LDC costs form a minor portion of the overall bill then savings in LDC costs in Midland or for any other Ontario LDC is most likely to have very little impact on the overall cost for the consumer.

Rates that LDCs can charge their customers vary from one LDC to another and this is due in part to the costs and condition of the local LDC.

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Rate details continued

OEB approves Distribution Rates. The LDC applies to the OEB to recover their costs plus an allowed amount for “Deemed Capital Structure as well as an amount for an Equity Rate of Return. In general terms the Generation/Transmission cost would amount to approximately 75% of the users bill and the remaining 25% would represent the costs associated with Distribution and the return on deemed capital and return on equity.

The “Ratebase” calculation is a process used to define a specific dollar value called the “Total Rate Base” in order for the OEB to use that number to apply a formula to calculate and approve a specific dollar allowance that the LDC may then add to its Cost of Power and Operating Expenses to arrive at the amount allowed to raise from the LDC users.

Rate details continued

While the terms are confusing in practice it appears straight forward and the long and short of it is simply to calculate a notional amount that the LDC may add to their existing expenses in order to recover an appropriate sum from the consumers.

For this presentation we will not go through the finer details but instead we will acknowledge that the "Rate Base Amount" for the MPUC was $14,192,856 and the OEB formula when applied to this amount then allowed the LDC to include in its overall cost for rate recovery the sum of:

60%	**For return on "deemed Capital Structure (mixed rates of returns used for this calculation)**	**$370,206**
40%	**For return on Equity @9.19%**	**$521,729**

Rate details continued

In summary MPUC Rates are made up of:

Generation/Transmission cost (approx. 75%)
Operating, maintenance and administration costs
Interest on imputed debt
Return on Equity

The government has approved legislation that gives the acquiring LDC or new shareholder a 10 year window on rebasing. This means any synergies or reductions in cost due to the sale or merger in the first 5 years flow directly to the new shareholder. In years 6 to 10 there is a cost sharing mechanism in place where the cost savings would be shared between the ratepayer and the new shareholder.

Appendix A – Council Priorities in a Sale or Merger

1. Maximizing Asset Value
2. Maximizing Local Employment
3. Other Business and Community Project – non-regulated business
4. Utility Control
5. Lowest Price to Ratepayers
6. Ensure High Quality Service

Appendix B – Items to be Considered in any Business Arrangement

1. The proposed treatment of any MPUC debt obligations involved in the transaction

2. How MPUC employees will be treated after the closing of the transaction, including details of any employment and location guarantees and/or severance arrangements regarding MPUC employees

3. How the Proponent will support economic development initiative of Shareholder or the Town of Midland. These could include but not limited to a commitment to bring new jobs or to invest in new facilities within the Town of Midland

4. How the Proponent will interact with and inform the community on issue concerns related to the transaction

Appendix B continued

5. Any commitments by the Proponent to maintain operations from MPUC's premises after closing of any transaction.

6. Assumption of the existing MPUC rental agreements with the Town for Town owned property on which LDC substations are now located. Rent for the small building and antennae on the water tower at Hanley Street. MPUC pays a total of $70,000 per year for these rental agreements.

7. A portion of the property owned by the MPUC was identified as the ideal location for a future Water Tower and this should be addressed through a severance - possibly while Midland is the sole shareholder.

Appendix B continued

8. Any commitments by the Proponent to maintain service levels and quality standards, including the Proponent’s consequences for failing to meet those standards after closing of any transaction.

9. Future operational and capital plans, structure of and distribution infrastructure renewal strategy for MPUC following completion of any transaction.

10. How the sale or merger of the MPUC by the Proponent would facilitate greater scale and scope economies and additional efficiencies in relation to the Proponents existing distribution franchise area(s)

11. How the sale or merger of the MPUC by the Proponents would plan for rate harmonization and the impact on Midland PUC customer rates for all user classes

12. Address MPUC current plans for capital upgrades to 2026

13. Plan for the New LDC to maintain Midland's streetlights

14. Midland PUC provides in-kind hours of work for Town banners, lighting etc. how will a new LDC address this

15. $80 per hour regular time and $160 for overtime. How will these rates compare with a new LDC.

Appendix C – Treatment of Sale Proceeds

The proceeds from a sales transaction could be used for long-term investment purposes and/or investment in municipal projects.

The proceeds from a sale could be protected in a number of ways

- Internal loan (we pay ourselves)
- Heritage Trust Account
- Special by-laws
- Other

Appendix C continued

-Generally Municipalities can invest in:

-Bonds, debentures and promissory notes from governments

-Corporate Bonds

-Commercial Paper or Promissory Notes

-Deposit receipts and deposit notes, certificates of deposit or investment

-Asset backed securities

-Shares issued by a Canadian Corporation

Appendix C continued

-Investment in bonds, promissory notes, commercial paper and asset backed - securities are limited in the regulation to investments that are of higher quality using ratings set out by Investment/Bond Rating Services thereby reducing the risk and related rate of return for these investment types.

-Investments in corporate bonds and shares can only be done by entering into agreement with LAS and One Fund to act as our agent.

The most secure investment is in Midland itself and to use all or a portion of the funds available to debenture capital projects using a market rate of interest and that rate today would be close to 4%.