



LDC Consolidation: Mining Value for Customers and Shareholders

An address to the 7th Annual Ontario Power Summit session entitled

*“Distribution Consolidation:
New Drivers and CEOs Look over the Horizon”*

May 28, 2008

By Max Cananzi
President and CEO
Horizon Utilities Corporation



Thank you Dave Collie for that kind introduction – It’s a real pleasure to be here today in front of such a distinguished group of industry leaders to share some of my views on this great industry of ours and the distribution sector of which I am a part.

Again, my name is Max Cananzi. I am the President and CEO of Horizon Utilities Corporation.

Before I begin, let me express my thanks to the Power Summit organizers, and in particular David McFadden of Gowlings and the staff of Insight Information, for providing this type of forum to share ideas within our industry.

Outline

- Horizon's consolidation experience
 - *Background to 2000 and 2005 mergers*
- Distribution consolidation's benefit to date
 - *Comparing financials 1997 to 2006*
- New strategic drivers for consolidation
 - *Regulatory, customer, shareholder, societal*
- Setting a path for consolidation
 - *Transfer Tax rules, Hydro One's role*
- Mining value for customers and shareholders



2

As you can see from my outline, I am going to talk about what I believe to be some key distribution sector issues. It is my view that these are the issues that will get the policy train on track for serious LDC consolidation and enable us to get on with the job of strengthening the industry as a whole in this province - setting it on the right path.

I have 5 main groupings to my slides:

First, I want to let you know about Horizon's consolidation experience by giving you some background to our 2000 and 2005 mergers.

Second, I want to spend a significant amount of time on distribution consolidation's benefit to date by comparing financials for all MEUs in 1997 with all LDCs in 2006. I think this will be the first forum where this data has ever been presented comparatively

Third, I want to enumerate what I believe to be the new strategic drivers for consolidation – these are broken down into the categories of regulatory, technology, customers, shareholder, and societal.

Fourth, I want to discuss what is needed for setting a path for consolidation, including the Transfer Tax rules and the Hydro One role in consolidation

And, fifth, I want to close out on some points on the possibilities for mining value for customers and shareholders through consolidation.

Horizon Utilities – quick facts

- Delivers services to residents and businesses in Hamilton and St. Catharines
- 232,000 customers
- 370 valued employees
- \$419 million in assets
- Low residential and commercial rates
- Low controllable costs
- Generating full ROE and substantial dividends
- Excellent safety and reliability performance
- Focused on growth – partners welcome



3

Let me first tell you a little bit about Horizon Utilities.

We are one of the largest municipal LDCs in Ontario and the largest in the western portion of the Greater Golden Horseshoe area. We have 232,000 customers, 370 highly valued skilled employees and \$419 million in assets.

Our customers have the benefit of low residential and commercial rates. Not every LDC can make this claim. Most only focus on residential rates, but we have been very attuned to business customers as well.

We can have both low residential and commercial rates because we have the lowest controllable costs of any municipal LDC in the whole of the Greater Golden Horseshoe.

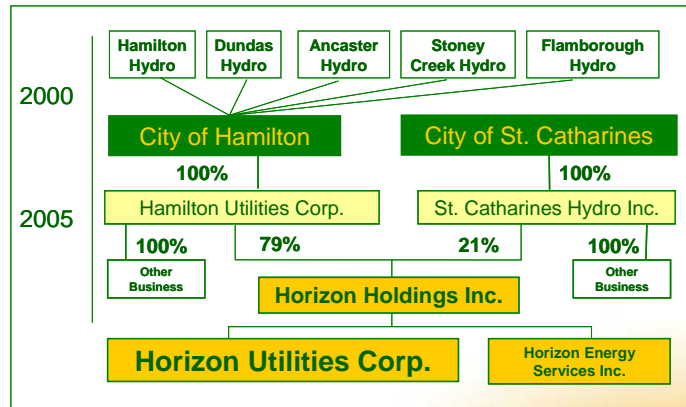
And with this financial strength, we have been earning a full rate of return and delivering substantial dividends for our shareholders.

The result is that Horizon not only has an excellent safety record and reliability performance, but it also has been recognized by credit rating agencies as a top performer and been given the highest LDC credit rating of any LDC in Ontario.

While we are one of Ontario's largest and best performing LDCs, our objective is to become an even still larger and more financially secure LDC, one that will have a prominent role whatever distribution rationalization might occur in Ontario.

It is for these reasons that we believe Horizon Utilities has a lot to offer merger partners. We also welcome acquisitions.

Horizon Utilities – two significant mergers



- Currently in merger negotiations with Guelph Hydro



4

Now that I have shed a little light on who we are, let me tell you a little about the mergers that brought Horizon to where it is today.

Horizon Utilities is a municipally-owned local electric distribution company (LDC), just like all the others, but we differ from many in that we are owned by more than one municipality – the City of Hamilton and the City of St. Catharines.

We took the new, non-geographic name of “Horizon Utilities Corporation” to reflect the joint commitment of both cities to the new company and as an indication we wanted to grow the merger through the inclusion of other shareholders of LDCs.

Horizon’s origins are in six separate municipal electric utilities. Its first big merger occurred in 2000 as the result of the municipal amalgamation that created a new and expanded City of Hamilton.

As part of this process, the five municipal electric utilities in Hamilton, Dundas, Stoney Creek, Ancaster and Flamborough were merged to create the 180,000 customer strong Hamilton Hydro Inc. as one of the largest LDCs in Ontario.

The creation of Horizon Utilities in 2005 – our second big merger – resulted from the merger of Hamilton Hydro Inc. and St. Catharines Hydro Utility Services Inc., the successor to the MEU in St. Catharines.

Horizon’s record on merger integration is commendable.

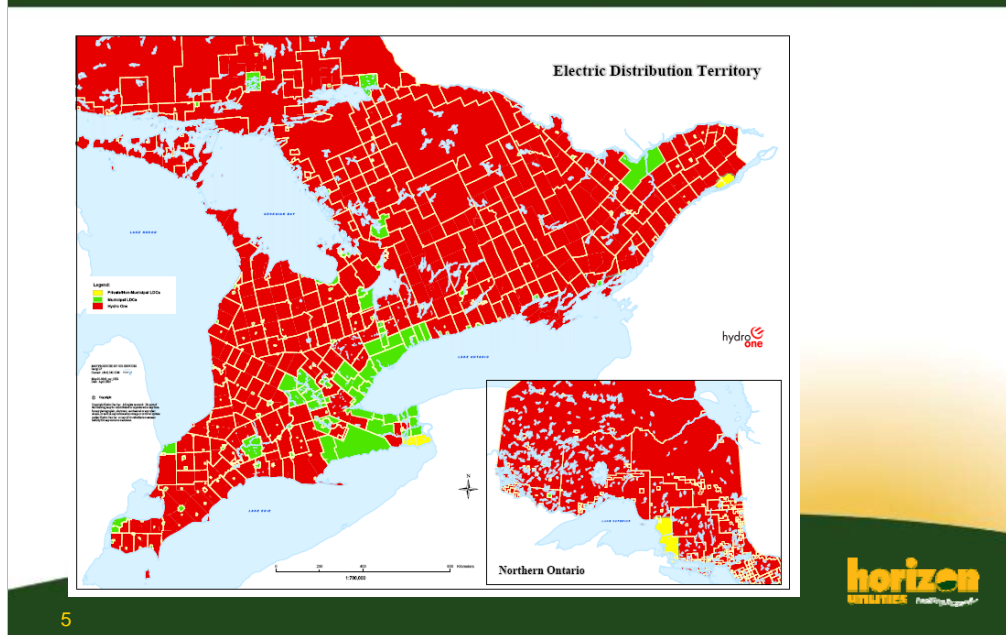
- The 2005 merger resulted in \$5 million of sustained annual operational savings.
- Residential rates actually decreased 2.3% in 2006, were not increased (0%) in 2007, and will decrease again by 1% in 2008.
- Commercial rates, for their part, have remained among the lowest in Ontario, increasing below inflation.
- Shareholders have received recapitalization dividends, repayment of debt notes, and substantial annual dividends.

Horizon’s shareholding structure is simple and open. Horizon Utilities Corporation is wholly owned by Horizon Holdings Inc., which is owned 79% by Hamilton Utilities Corporation and 21% owned by St. Catharines Hydro Inc. Other shareholders are welcome.

With all the regulatory incentives and benefits for customers and shareholders in mergers and acquisitions, the growth of Horizon is continuing. We are actually in the middle of another merger negotiation right now with Guelph Hydro, with the proposal now waiting on the approval of the three municipal councils.

And we do not intend on stopping here. We are committed to the vision of creating an exciting, low cost utility that is responsive to customers’ needs, pays dividends to its shareholders as appropriate, and has the clout to stand up for what is right for all of the communities it serves.

Ontario LDCs – still issues of business scale and service territory fragmentation

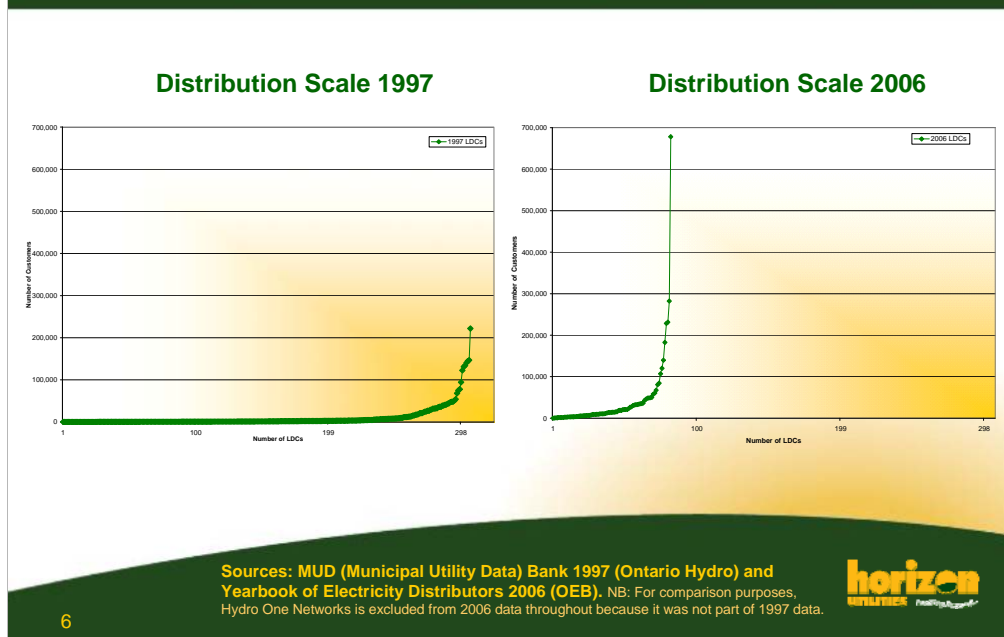


As an industry, we have recognized as progress the fact that there are now only about 83 distributors left in Ontario (after a few recent mergers), down from more than 300 back before 2000.

What is startling is, as my later slides will show, is how much more consolidation would benefit Ontario.

And while scale is an important issue, this map from Hydro One's website makes it clear the other consolidation issue is service territory fragmentation.

Distribution scale 1997 and 2006



I said earlier that I would be showing data that, to my knowledge, has not been presented in any other forum.

This slide on distributor scale in 1997 and 2006 – and then next seven after it – are based on a comparison of the last data collected by Ontario Hydro on municipal electric utilities, known as the MUD Bank (Municipal Utility Data Bank), and the OEB's current offering of the Yearbook of Electricity Distributors.

With nine years between the two sets of data, I believe there is a solid ground for comparison of the progress in the distribution sector here. My one qualification is that it is necessary to leave Hydro One out of the 2006 data because its predecessor, Ontario Hydro, was not included in the 1997 data.

The most startling piece of the scale comparison in 1997 and 2006 is just how flat the curve is in both cases and how steeply it increases at the end.

The curves are so flat because, in 1997, 254 of 305 MEUs had less than 10,000 customers and, today, 32 of 83 LDCs still have less than 10,000 customers.

Indeed, the two curves both start in the same place – Apple Hill, with 113 customers in 1997 and Newbury Power with 192 in 2006.

There were actually 208 “micro” MEUs with less than 3,000 customers – more than 2/3rd of them all – and there are still 10 micro LDCs today.

This next fact will surprise you the most. Where there were only seven MEUs with more than 100,000 customers in 1997, there are actually only eight today.

The reason is that the biggest got even bigger. Only three LDCs – Hydro One Brampton, Veridian and PowerStream moved into the 100,000-plus customer club.

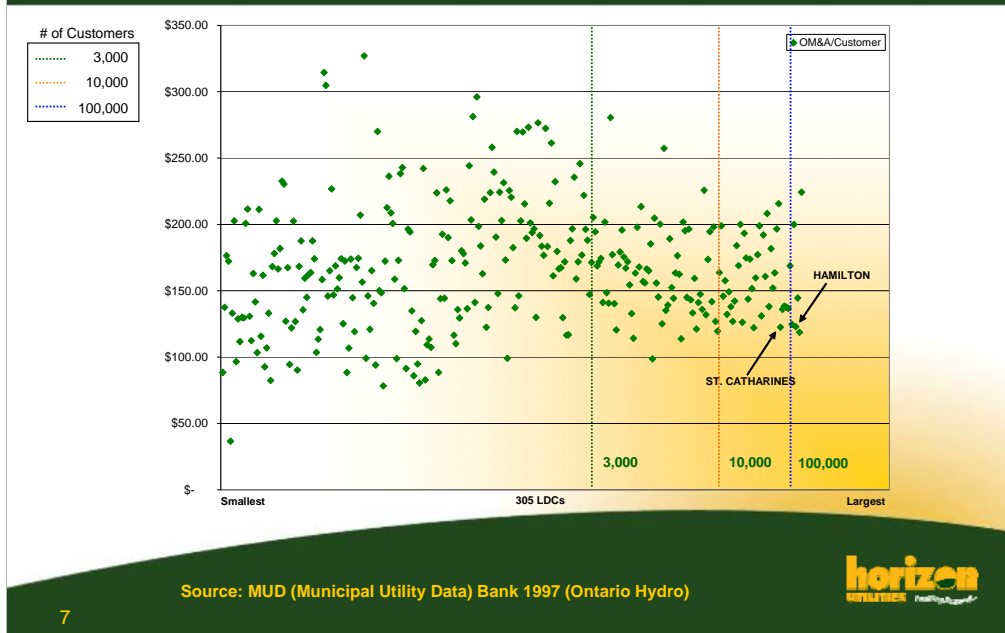
The number of medium sized utilities – those between 10,000 and 100,000 customers has not changed that much either. Where there were 44 MEUs in the medium category in 1997, there are now 42 in 2006.

The number of small LDCs – greater than 3,000 but less than 10,000 – did go down from 46 in 1997 to 22 in 2006, but together with the 10 micros is still is more than 1/3rd of all LDCs.

The result of this all is that average size has moved from 9,800 in 1997 to 42,000 customers in 2006 and the median size has moved from 1,500 to 14,000 customers (both excluding Hydro One Networks).

While we have made a lot of progress, with the average still so low and the median so far below the average, we still have a ways to go.

OM&A per customer 1997

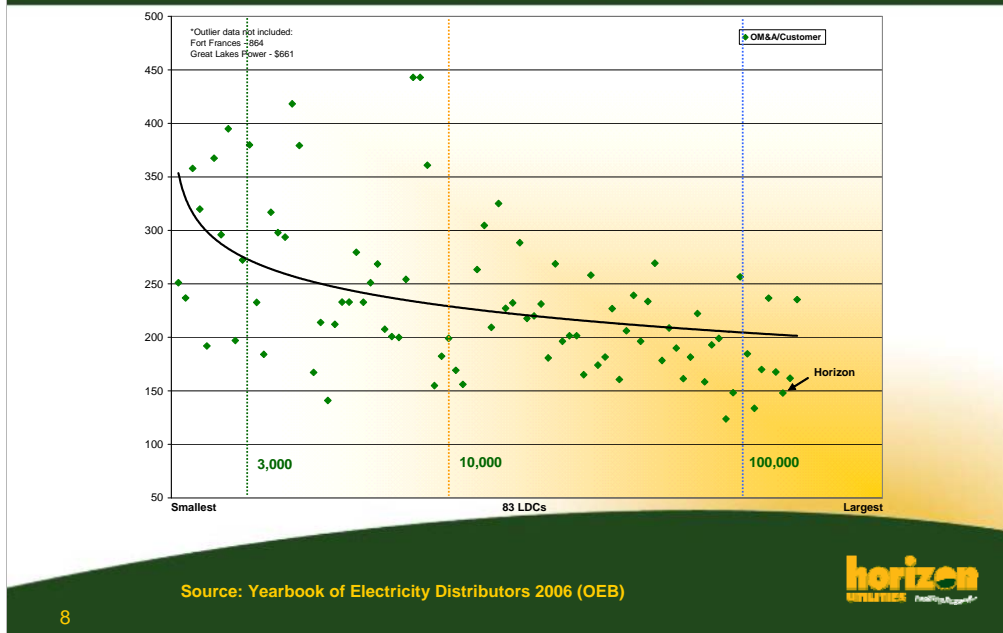


7

In this slide, I am showing operation, maintenance and administration for all 305 MEUs in 1997, with the X axis showing the MEUs from smallest to largest and the Y axis showing \$/customer.

The graph does not appear to have any particular pattern, although it does appear to have a funnel effect from smallest to largest, where the smallest have the highest and lowest costs in the \$75 to \$350 range and the largest appear to be bunched together in the \$125 to \$225 range.

OM&A per customer 2006



8

The contrast of LDC OM&A in 2006 and MEU OM&A in 1997, however, is quite instructive. Again, the X axis is smallest to largest and the Y axis is \$-per-customer-per-year. Where the 1997 data did not show a clear pattern of scale efficiency, the 2006 data shows a clear correlation of scale and lower costs.

What is notable in the 2006 data is that the OM&A for LDCs with more than 100,000 customers actually decreased 7% over the nine years since 1997 from an average of \$193 per customer to \$180 per customer.

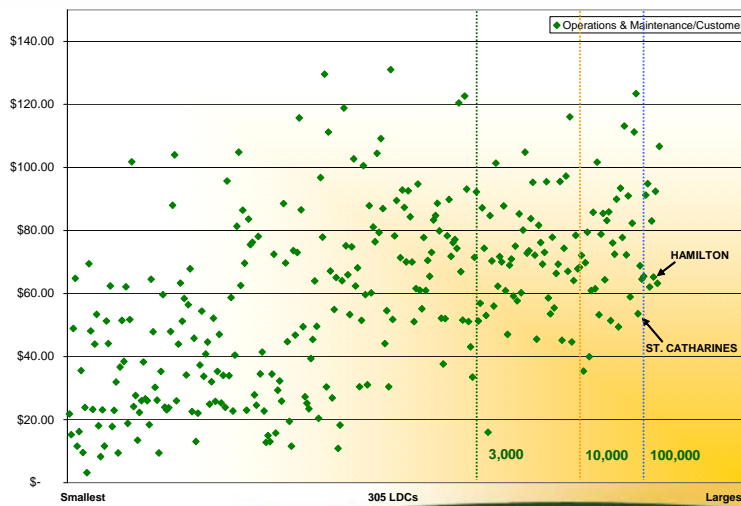
The average of all the other groupings increased, and in some case substantially.

- Micro LDCs increased from \$170/customer to \$291
- Small LDCs increased from \$163/customer to \$282
- Medium LDCs increased from \$160/customer to \$222

It is worth noting here that total inflation over the period from 1997 to 2006 was 18% according to the Bank of Canada.

In this circumstance, the decrease of 7% for large LDC is thus in the range of a 25% improvement. Similarly, this means the increases among the micro, small and medium LDCs are then all well above inflation, especially for the micro and small LDCs.

O&M per customer 1997



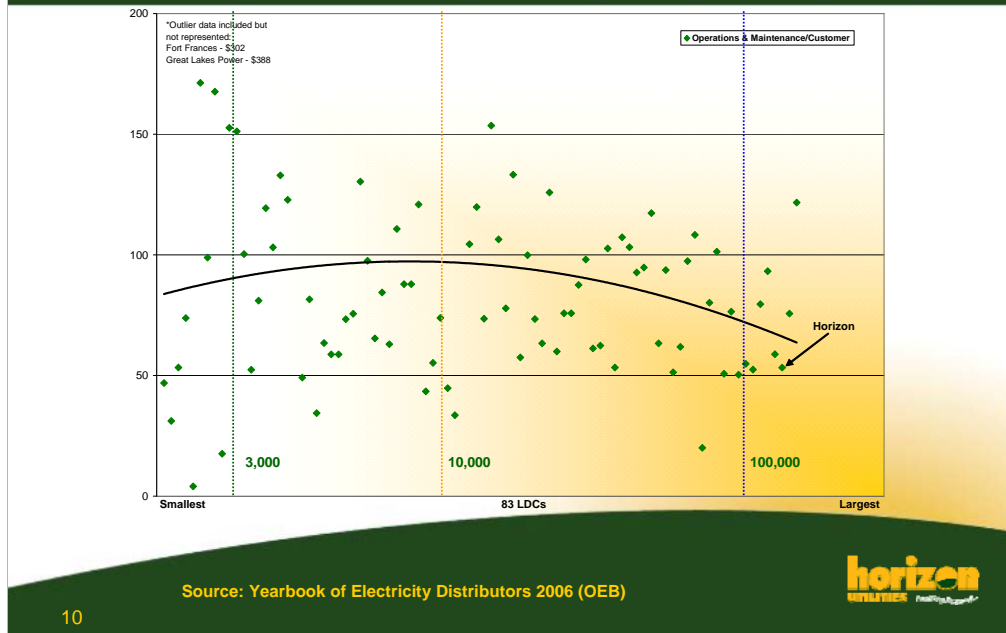
Source: MUD (Municipal Utility Data) Bank 1997 (Ontario Hydro)



When operation and maintenance is separated from administration, we get an opportunity to see what is actually driving the scale efficiencies – is it O&M or Administration or is it both?

Again, the 1997 data does not show a distinct pattern, but the very smallest appear to have the lowest costs, with all other MEUs grouping in the middle of the cost profile.

O&M per customer 2006



10

By 2006, however, there is a slight but very distinct advantage to scale on O&M.

Among the large LDCs, the O&M per customer actually decreased in real terms by 26% from \$100 to \$74 on average per customer, not counting for the 18% inflation.

The average of all the other groupings increased, and in some case substantially.

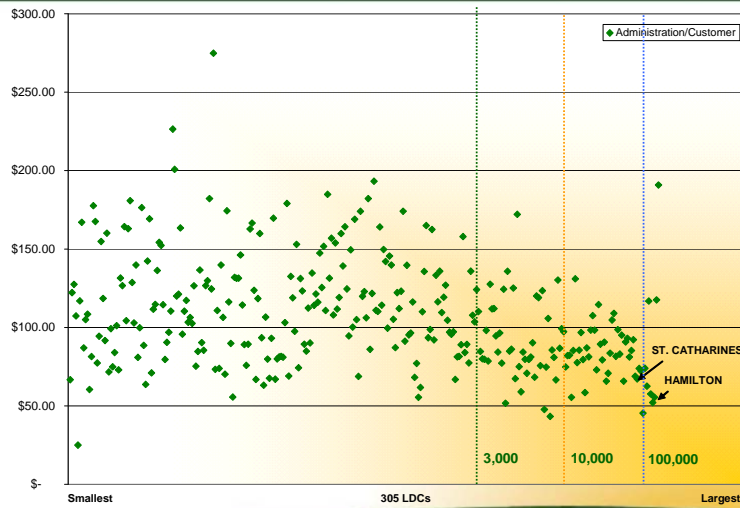
- Micro LDCs increased from \$53/customer to \$89
- Small LDCs increased from \$70/customer to \$92
- Medium LDCs increased from \$75/customer to \$90

In this case, then, some scale efficiencies are apparent, especially beyond 100,000 customers.

Before I leave this slide, I want to draw your attention to the very low O&M displayed among some of the smallest LDCs, far below \$50-per-customer-per-year. While these might be an exception for this one year, it may also be indicative of LDCs that are facing financial difficulty.

Without these exceptions, the trend line would be straighter downwards, showing a slight advantage to scale, likely moving from an average of about \$100 per customer for micro LDCs to \$75 or less for large LDCs.

Administration per customer 1997

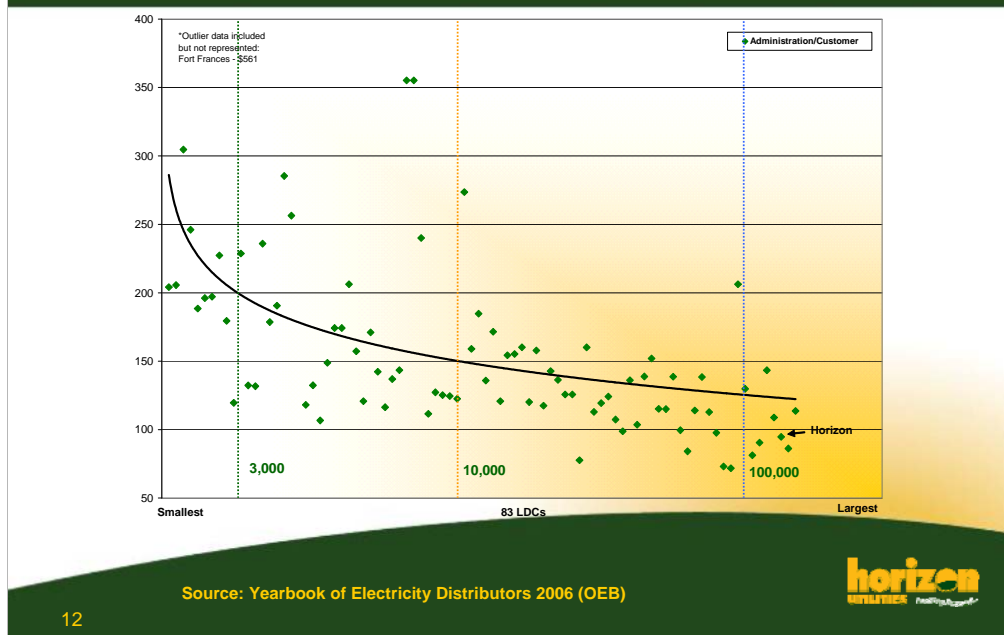


Source: MUD (Municipal Utility Data) Bank 1997 (Ontario Hydro)



When we turn to just administration per customer, the 1997 data is notable in that while top performers are evident at across the range of scale, the smaller MEUs tended on balance to have higher administration costs.

Administration per customer 2006



12

What is evident in the 2006 administration per customer data is that it shows a more dramatic effect for scale efficiencies, as is evident in the trend line's curve.

Where in 1997, as I said on the last slide, there were strong performers across the range of LDCs, in 2006, this is much less the case.

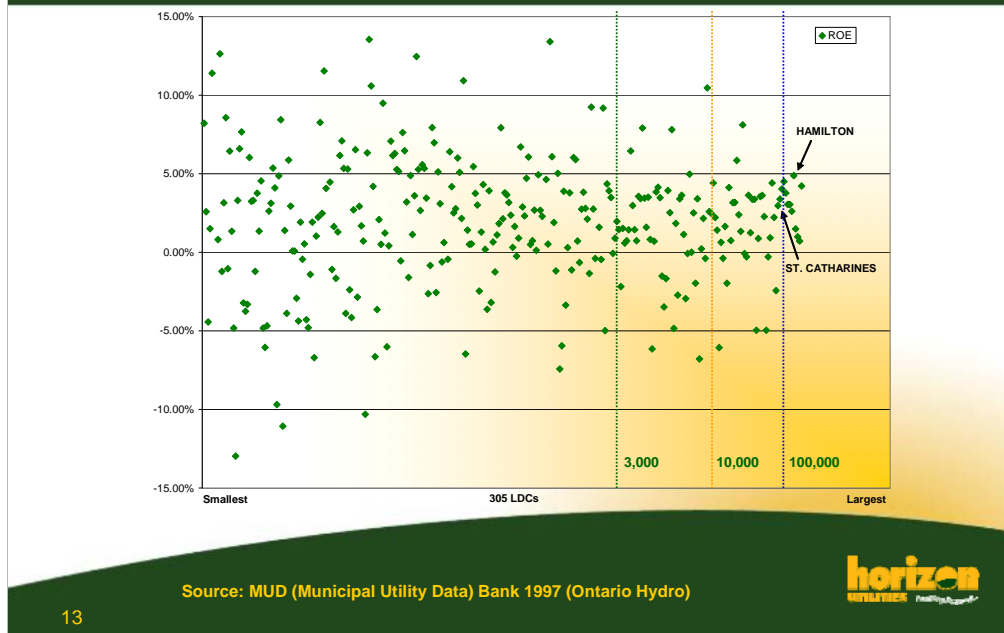
For instance, when we examine the averages of the groupings, the administration cost per customer at the micro end of the spectrum of LDCs increased from an average of \$117 in 1997 to \$202 in 2006, or 73%.

This is in sharp contrast to the large LDCs, where the administration cost per customer increased much less from an average of \$93 in 1997 to \$106 in 2006, or 14%.

The average of all the middle two groupings increased substantially. The small LDCs increased from an average of \$93 per customer in 1997 to \$190, or 104%.

The medium LDCs increased from an average of \$85 per customer to \$132, or 55%.

Return on Equity 1997



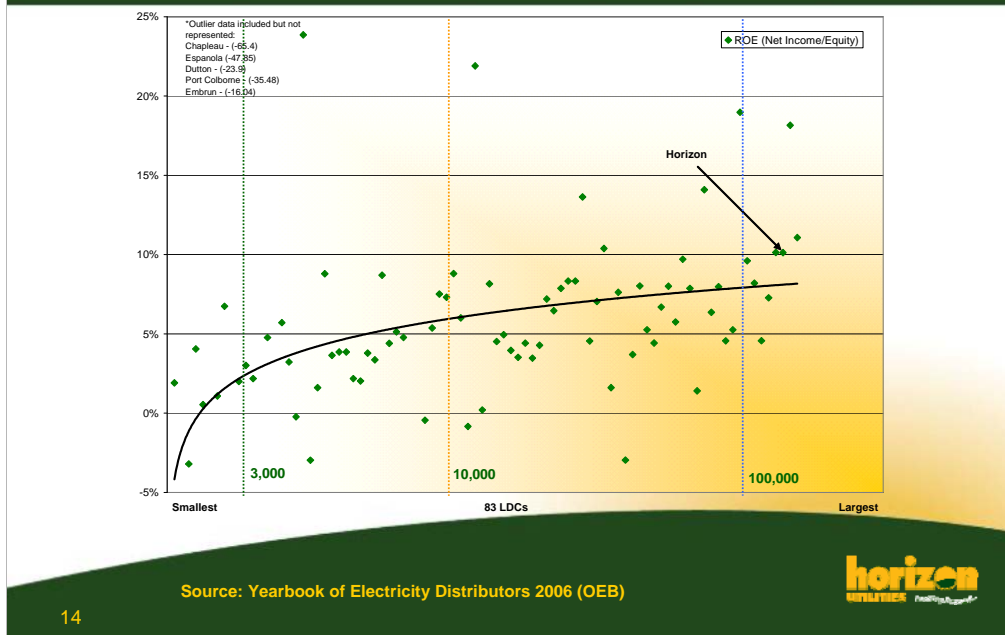
An examination of Return on Equity is a trickier metric for comparison because the MEUs, which were regulated by Ontario Hydro, were, in law, not-for-profits.

While LDCs are now commercial business permitted to earn a regulated Return on Equity, Ontario Hydro used working capital as the effective measure of a not-for-profit operation. If there was an excess of cash, the MEU was either required to initiate rebates or rate reductions.

Like the other data for 1997, there nonetheless appears to be a funnel with a wide range of ROE at the smaller scale and a narrower range at the larger scale.

The consequence was that the smaller LDCs would have had the widest fluctuations in performance on a year-to-year basis.

Return on Equity 2006



14

When we turn to the 2006 data, where the LDCs were permitted to earn a 9.88% ROE, there is a distinct correlation between LDC scale and return on equity, and it cascades downward as scale diminishes.

Among the large LDCs, the ROE average 9.90% in 2006, which is a small fraction over the permitted return. In contrast,

- Medium-sized LDCs had an ROE of 6.60%.
- Small-sized LDCs had an ROE of 4.65%.
- Micro-sized LDCs had an ROE of negative 7.25%. [note that a number are so far negative they have been left off the bottom of the graph]

Notably, of the 11 current LDCs returning a negative ROE in 2006, the average size was 7,600 customers.

Ontario's LDC scale and fragmentation A Regulatory Challenge

Province	LDCs #s	Largest LDC (Customers 2006)	Next Largest LDCs (Customers 2006)	Others/Notes
Ontario	83	Hydro One (1.2M)	Toronto Hydro (678K) Hydro Ottawa (282K) Horizon (231K) PowerStream (228K)	Average = 53K Median = 14K
British Columbia	13	BC Hydro (1.7M)	FortisBC (101K) New Westminster (29K)	8 others = < 70K
Alberta	20	Epcor (620K)	Enmax (458K) FortisAlbta (426K) ATCO (186k)	2 MEUs 14 rural coops
Saskatchewan	3	SaskPower (441K)	Saskatoon MEU (57K)	Swift Current MEU
Manitoba	1	Man. Hydro (510K)		
Quebec	10	Hydro Quebec (3.8M)	Sherbrooke MEU	8 other MEUs
New Brunswick	3	NB Power (370K)	St. John Energy (35K)	Edmunston MEU
Nova Scotia	7	NS Power (460K)	Antigonish (3K)	5 other MEUs
PEI	1	Maritime Elec. (70K)		
Nfld. & Lab.	2	Nfld. Power (227K)	Nfld. & Lab. Hydro (35K)	

Ontario Data Source: Yearbook of Electricity Distributors 2006 (OEB)



15

Well, what are we to make of this data? As this next slide show, in fact, no other province in Canada has so fractured a distribution system as Ontario.

Indeed, in his recent luncheon speech to the Ontario Electricity Network, OEB Chair Howard Wetston commented on this challenge for the regulatory workload in Ontario, stating:

"Comparisons with other provinces are not always particularly helpful but it may be worth mentioning that the OEB 'rate regulates' about 83 electricity distribution companies in Ontario. All the other provinces combined 'rate regulate' 27."

Ontario is unique, I believe, because municipalization of the distribution sector predated the phenomenon of vertical integration. And other than municipal amalgamations, there was no mechanism for distribution consolidation until the passage of the Energy Competition Act in 1998.

The result still today, even with all the consolidations since 1998, is a highly fragmented distribution sector where the median size LDC is far below the average, and the average is well below the scale in other provinces.

To be clear, I am not advocating one distribution company for Ontario, as is the case in some of the other provinces.

In my view there needs to be continued consolidations until we get to a small number of large distributors that can serve different regional needs. The additional benefit is that benchmarking, as a form of regulation and a proxy for competition, can thrive with a small number of large distributors.

Consolidation drivers – customers

- Customer cost of living / cost of doing business
 - New generation sources more costlier – gas, renewables, distributed generation, etc.
 - Transmission build for new generation increases costs
 - Addition of CDM to “supply mix” puts upward pressure on price
 - General worsening economic conditions and fuel price pressures
- Customer cost comparison of LDCs
 - “Cost allocation” regulatory requirement to remove cross-subsidies will increase interest in comparison of rates
 - Customers operating in multiple LDCs – Schools Energy Coalition may be a harbinger of stakeholder interests to come
- Energy product and service offerings
 - Customers will look to LDCs to provide products, services, and leadership



16

This then leads me to the number of drivers for consolidation that, given the existing conditions, may serve to bring additional consolidation.

Let me begin with the customer drivers – I have three to note.

The first is what I would call the customer’s “cost of living/cost of doing business”.

Over the next few years, customers will be facing increased electricity costs for a variety of reasons, including:

- more costlier new generation sources from natural gas, renewables, DG, etc.
- higher transmission costs resulting from the cost of connecting renewables,
- upward pressure on price from adding the costs of CDM to the “supply mix”, and
- a general worsening of economic conditions and fuel price pressures.

The second customer driver is what I would call cost comparison by customer across LDCs.

While most customers currently think that all LDCs have similar rates, and differ only on local service, the rates for LDCs actually differ quite significantly. Some of this is will be attributable to cost management, but most customers would not be aware of the effect of cross-subsidies between classes of customers.

I believe we are already seeing the increased scrutiny of rates and rate comparisons through the interventions of groups like Schools Energy Coalition, which may be a harbinger of stakeholder interests to come.

The third is the differentiation of LDCs by their energy product and service offerings.

Customers will increasingly be looking to LDCs to provide products, services, and leadership, and their ability to respond will be an indication of their strength.

Consolidation drivers – technology

- LDCs being remade by technology
 - Customer and billing systems
 - Business information and resource planning tools
 - System automation for enhanced reliability
 - “Smart” meters
 - Future outlook – smart grids
- New technology offerings – character
 - High fixed cost / high depreciation – requires constant investment
 - Increasingly complex – requires constant attention
 - Pace of change makes it easy to fall behind

The next key driver for consolidation, in my view, will be technology.

The most striking thing about how LDCs have changed in recent years is how they are being remade by technology.

All LDCs have experienced the challenge of establishing new customer information and billing systems to meet the complex requirements of industry unbundling and customer choice.

But this is only the beginning of where information technology is remaking the business. IT is now at a state where it is advantageous for LDCs to be implementing resource planning tools to effectively manage business information.

Technology is also making it possible to enhance system reliability through increased system automation. When “smart meters” are layered on this capability, the future outlook will be one of “smart grids”.

I raise these point is the context of consolidation because the character of the new technology offerings is one of high fixed cost and high depreciation. Moreover, it not only requires constant investment, its increasing complexity requires constant management and attention. The challenge for LDCs is that the pace of change makes it easy to fall behind.

Consolidation drivers – regulatory

- Performance-based regulation
 - “Cost-of-service” not sustainable in performance based regulatory framework
 - IRM will expose the potential that scale through consolidations can offer
- Regulatory burden
 - Not what was anticipated as “light-handed” regulation
 - Significant cost savings due to scale
- Public information
 - Uniformity of reporting and compliance better
 - Truer comparison possible, leading to increased levels of public scrutiny



18

Following in this theme of consolidation drivers, I want to draw your attention to the regulatory ones, of which I can see three.

The first is “performance-based regulation”. I believe a number of LDCs have been continuing to operate in the cost-of-service mindset, but this will not be sustainable going forward.

When the IRM framework (incentive rate making) fully takes hold, I believe scale will be revealed to be a very significant consolidation driver, one which is available to save the performance of the LDC. The reason is that the 3rd Generation IRM, by seeking to provide long-term sustainability and predictability, may make it difficult for a small LDC to absorb cost variability.

My second regulatory driver is the “regulatory burden” itself. Today, these regulatory costs are substantial and onerous even for large, well resourced LDCs. While some of the requirements are made easier through electronic filings, full third-party review with interventions by customer and other interest groups, all funded by the LDC as the applicant, make the process very challenging and requires the assistance of consultants and lawyers.

The result is that there are significant cost savings to be found in LDC consolidation – spreading these fixed costs over a large base.

My third point on regulatory drivers for consolidation is “public information”. What we are witnessing is a movement, generally, to more uniformity of reporting and a stricter emphasis on compliance. The OEB should be applauded for assembling the Yearbook and other public data because it makes truer comparisons possible, and leads to better transparency and public scrutiny.

In my humble view, the increased availability of public information can only be an asset and its result will be a movement to consolidation.

Consolidation drivers – shareholders

- Competing uses of shareholder capital
 - Infrastructure deficit
- Shareholder return on equity investment
 - Perception growing that returns not in line with regulatory risks being managed
 - Pressure for full rate of return

The next consolidation driver I would like to address is the interests of shareholders.

With the conversion of MEUs as public utilities to LDCs as commercial businesses, municipal shareholders were given one of the few avenues available to them to be in a commercial business. Many had an optimistic outlook on their financial performance and the positive effect on the municipal balance sheet.

Now that there has been almost a decade of commercial experience, the perception appears to be growing that the financial returns are not in line with regulatory risks being managed.

But even if the full return can be realized, shareholders are beginning to see competing uses for capital, especially with the infrastructure deficit that exists in Ontario. And since the local control advantages of direct ownership of an LDC are narrowed through the framework of third-party regulation by the OEB, the need for continued ownership may increasingly be raised against the competing use of the capital.

Consolidation drivers – societal

- “Culture of Conservation”
 - Conservation now a prior consideration to supply decisions
 - Sophistication in program design and delivery an advantage
- Sustainable Communities
 - Community energy management and planning – Local Integrated Resource Planning (LIRP)
 - “intelligent” distribution network of Conservation, DM, DR, DG
- Competitive power market
 - Centralized procurement – a problem searching for a long-term solution
 - If OPA is a transitional body, then larger LDCs are an attractive solution to the problem

The final consolidation driver I would like to address falls under the grouping of what might be called “societal” issues.

The one we have become familiar with most recently is the “Culture of Conservation”. The significance of this for the distribution sector is that conservation is now a prior consideration to supply decisions – in short, we need to be thinking how to use less before we plan supply to meet demand.

If we are to be successful in implementing a conservation culture, it is my view is that we will increasing need sophistication in program design and delivery, and this is something where LDC scale will be important.

The next societal driver we face is the phenomenon of “sustainable communities”. While this will have a variety of implications, for the distribution sector it means community-based energy planning and management.

An LDC would put such Local Integrated Resource Planning into practice through – and I believe this is the not too distant future – what we might call an “intelligent” distribution network.

This is a distribution system that not only manages delivery, but also CDM, demand reduction, and distributed generation. These are the types of solutions that will be required to meet the new era of local expectations and larger, more sophisticated LDCs are a vehicle to help deliver these results.

My final societal driver is the desire for the benefits of a competitive power market. I think we can all agree that centralized procurement arrived as a temporary solution to market jitters and that it is indeed a problem searching for a long-term solution.

If the OPA’s role is transitional, if only in procurement, then larger LDCs that can handle LSE responsibilities are an attractive solution to this problem.

Consolidation path – Transfer Tax

- Exemption from 33% capital transfer tax
 - Competing policy pressures at work in exemption renewals
 - Effectiveness of having repeated windows in question
- Tax liability and PILs payments
 - Requirement for exemption decreases as LDCs build PILs credits
 - Tax risk exists for LDCs with low PILs – exemption will be decreasingly required for those LDCs who built up PILs credits
- Private LDCs and tax leakage
 - Increasing pressure from private equity to acquire LDCs
 - Tax leakage to federal government an issue
- Renewal of existing exemption arrangements uncertain



21

The first of my two consolidation path issues is the transfer tax. For those of you not familiar with this instrument, there is a 33% capital transfer tax on the sale and merger of LDCs, with the proceeds applied to the larger industry's stranded debt in Ontario.

We are likely all more familiar with the tax "exemption" that has periodically been made available for public sector transactions. The justification for this limitation, as I understand it, is that it protects the Province from tax leakage to the federal government, since all the PILs currently go to the stranded debt.

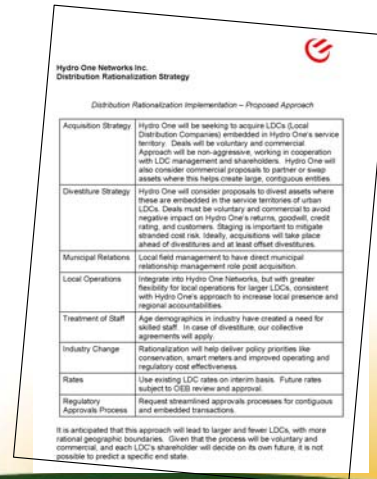
There are nevertheless competing policy pressures at work in the exemption renewals. They not only have had limited recent success, they disadvantage private LDCs that have the resources to make investments in infrastructure renewal and there is not a large enough pool of LDCs which can create a market to buy other LDCs.

Another factor – one that is little known and understood – is that the more successful LDCs are, the less need there is for the exemption since the tax liability is offset by the PILs payments credits. As a result, there is actually tax risk for underperforming LDCs with low Net Income and, consequently, low PILs payments. The greater the build up of PILs credits among well-performing LDCs, the lesser the need for the exemption.

While renewal of existing exemption arrangements – in effect until this October – are uncertain, my own view is, first, that the tax is too significant a penalty on transactions and, second, that we need a permanent arrangement that allows there to be a sustained effort for consolidation.

Consolidation path – Hydro One’s role

- Tenets:
 - Voluntary and commercial transactions
 - Acquire LDCs “embedded” in its service territory first
 - Divest where it is embedded in “urban” LDCs
 - Mitigate stranded costs resulting from customer loss
- Results:
 - Little or no activity (to date)



Hydro One Networks Inc. Distribution Rationalization Strategy	
Distribution Rationalization Implementation – Proposed Approach	
Acquisition Strategy	Hydro One will be seeking to acquire LDCs (Local Distribution Companies) embedded in Hydro One's service territory. Deals will be voluntary and commercial. Approach will be non-aggressive, working in cooperation with LDC management and shareholders. Hydro One will also consider commercial proposals to partner or lease assets where this helps create large, contiguous entities.
Divestiture Strategy	Hydro One will consider proposals to divest assets where these are embedded in the service territories of urban LDCs. Deals must be voluntary and commercial to avoid negative impact on Hydro One's returns, goodwill, credit rating, and customers. Staging is important to mitigate stranded cost risk. Ideally, acquisitions will take place ahead of divestitures and at least offset divestitures.
Municipal Relations	Local field management to have direct municipal relationship management role post acquisition.
Local Operations	Integrate into Hydro One Networks, but with greater flexibility for local operations for larger LDCs, consistent with Hydro One's approach to increase local presence and regional accountabilities.
Treatment of Staff	Age demographics in industry have created a need for skilled staff. In case of divestiture, our collective agreements will apply.
Industry Change	Rationalization will help deliver policy priorities like conservation, smart meters and improved operating and regulatory cost effectiveness.
Rates	Use existing LDC rates on interim basis. Future rates subject to CEBI review and approval.
Regulatory Approvals Process	Request streamlined approvals processes for contiguous and embedded transactions.

It is anticipated that this approach will lead to larger and fewer LDCs, with more rational geographic boundaries. Given that the process will be voluntary and commercial, and each LDC's shareholder will decide on its own future, it is not possible to predict a specific end state.

Let me turn to Hydro One’s role in consolidation.

The former Ontario Hydro took on the supplier of last resort role of serving the higher-cost rural areas where municipal utilities had not yet been established. The statutory rules, however, were such that it had to give way when new ones were created or existing ones expanded through municipal annexations or amalgamations.

While Hydro One has not been required to sell since 1998, its role in LDC consolidation has still not been made clear – is it an aggressive growth company or is it passive supplier of last resort?

This presents a challenge to the City of Hamilton – one of Horizon’s shareholders and one of the largest cities in Ontario. Hydro One serves more than 25,000 customers inside the City’s boundaries, but the City and Horizon Utilities have not yet had any success with Hydro One.

At this juncture there is no workable mechanism for solving this issue, and not just in Hamilton. Let me give you an example – it is as if the Ontario Provincial Police were holding on to policing in the big cities to maintain market share and cross-subsidize more rural areas?

Most of us would say that this is not good public policy?

Where are we at in Ontario on this matter? In March of 2007, the Minister approved a new acquisition and divestment policy for Hydro One.

In simple terms, Hydro One’s seeks to buy the small LDCs “embedded” in its service territory, and is prepared to sell its assets and customers where it is “embedded” in the area of urban distributors, such as in Hamilton.

In the absence of being able to offset divestments with acquisitions, Hydro One appears to be falling back on demanding full mitigation for all lost revenue.

The result is that the Minister approved rationalization policy has not achieved the desire outcome.

The result of the inability of Ontario to come up with a solution is not only that we cannot have a single distributor like Horizon in a large municipality like Hamilton, we do not have an opportunity to create large regional LDCs.

Mining value for customers and shareholders

1. Customers & shareholders benefit from consolidation
 - 1997 to 2006 OM&A and ROE data shows advantage of scale
 - Inter-provincial comparison shows Ontario exception to scale
 - Needs continued government support
2. Costs & returns under pressure for improvement
 - Increasing electricity costs from new generation and conservation sources will lead search for LDC efficiencies
 - IRM will continue to require LDCs to improve
 - Shareholder finances will increasingly look for full LDC returns
 - Technology and regulatory costs savings significant
3. Shareholder opportunities & customer benefits
 - Ontario's conditions are prime for LDC consolidation



23

So let me conclude by stating that there is a very significant opportunity in Ontario for mining value for customers in lower rates and shareholders in higher returns.

In doing the homework for the comparison of MEUs in 1997 and LDCs in 2006, I hope I have convinced you that there are significant untapped economies of scale to be reaped in Ontario's LDC sector.

If we were simply to apply the average and the low end OM&A of the large LDCs in 2006 (ex. Hydro One Networks) – which is \$180 to \$150 per customer per year – to the whole LDC sector (ex. Hydro One Networks), the annual savings are approximately \$70 million to \$180 million per year.

This is respectively 10% and 25% of OM&A and it does not even raise the issue of including Hydro One's costs in the improvement.

While there may have been perceived benefits of small scale operation in the past, this was not accepted in other provinces and the increased cost pressures for the electricity industry in Ontario suggest consolidation will be advantageous.

As I have noted, there are five groups of drivers – customers, technology, regulatory, shareholder and societal drivers – but industry consolidation can still benefit from continued government encouragement and support.

In short, Ontario's conditions are ripe for LDC consolidation.

- Costs and returns are under pressure for improvement.
- Incentive Rate Making will continue to require LDCs to improve.
- Municipal finances will increasingly look for full LDC returns.
- Technology and regulatory costs savings are significant.
- Shareholders have opportunities for increased returns.
- And, customers have opportunities for decreased rates.

Thank you. I look forward to your questions.



Vision:

- *Our vision is to be the leader in providing innovative energy solutions to the communities we serve*

Mission:

- *Our employees create value for shareholders, customers and the communities we serve through the safe and reliable delivery of electricity and innovative energy solutions*

