



Local Electricity Distribution Company Consolidation
Achieving Low Customer Rates
with Full Shareholder Returns

By Max Cananzi, President and CEO, Horizon Utilities Corporation

An address to the session entitled:
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Thank you, Mayor Krassilowsky, for your kind introduction. – It's a real pleasure to be here today in front of such a distinguished group of municipal leaders to share some of my views on Ontario's electricity industry.

Before I begin, let me express my thanks to the AMO Annual Conference organizers for providing this type of forum for owners of local electricity distribution companies to improve their knowledge of Ontario's electricity distribution sector.

Horizon Utilities – quick facts

- Delivers services to residents and businesses in Hamilton and St. Catharines
- Municipally owned 100%
- 232,000 customers
- 370 valued employees
- \$419 million in assets
- Low controllable costs
- Low residential and commercial rates
- Generating full returns and substantial dividends
- Focused on growth – partners welcome



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Let me begin by telling you a little bit about Horizon Utilities.

We are one of Ontario's largest municipal "LDCs" - local distribution companies with 232,000 customers, 370 highly valued, skilled employees and \$419 million in assets.

Our customers benefit from 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.

Our belief is that an LDC's value to the community is to ensure reliable service at the lowest possible rates in order to contribute to the economic attractiveness, competitiveness, and sustainability of the community.

This does not mean that by supporting our communities in this manner that we have to sacrifice shareholder returns. In fact despite the fact that we have one of the lowest cost structures of any utility, at no expense to reliability, Horizon has been earning the maximum allowable regulated rate of return and providing our municipal shareholders substantial dividends.

And we hope we can continue to grow, to become an even more financially secure LDC, providing greater benefits to the communities we serve. We are looking for like minded utilities or communities to join us in playing a prominent role in whatever distribution rationalization might occur in Ontario.

Outline

1. LDC customer rate comparisons
 - Not all rates are similar
2. LDC controllable costs comparisons
 - Relationship of scale to cost
3. LDC financial performance comparisons
 - Relationship of scale to returns
4. Horizon Utilities' three merger initiatives
 - Hamilton (2000), Hamilton and St. Catharines (2005), Horizon and Guelph Hydro (2008)
5. Consolidation drivers
 - Societal, technological, regulatory

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My presentation will focus on five areas:

Firstly a quick rate comparison. I will show you how widely distribution rates vary in Ontario and how the rates between residential and commercial classes of customers have cross-subsidization issues.

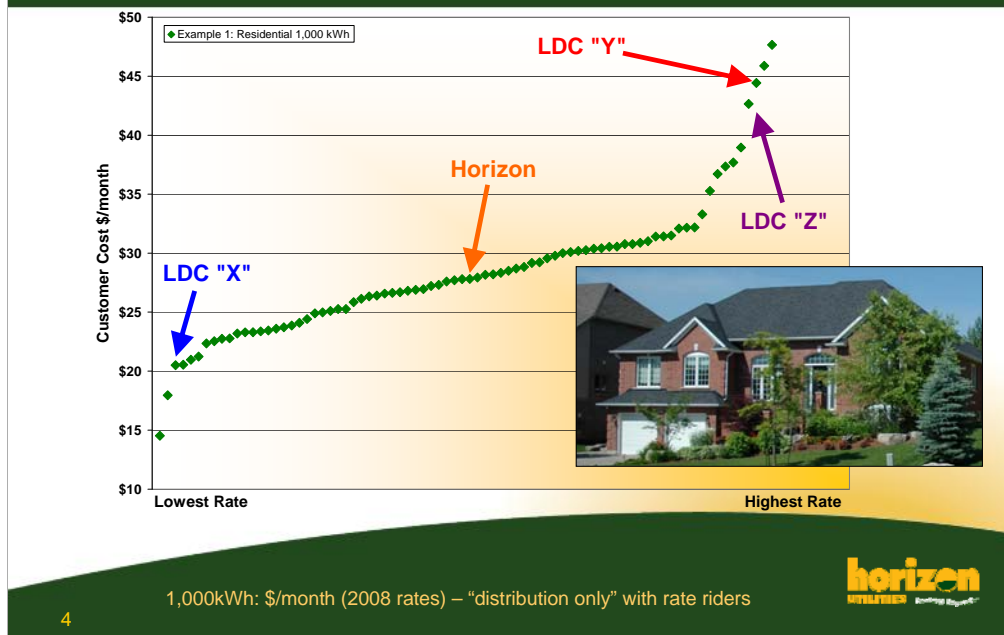
Secondly a quick cost comparisons – just how different the cost of operation can be from one utility to the next.

Thirdly, financial performance of LDCs, and how they differ and the role that scale plays in this performance.

Fourthly, I will share with you Horizon's experience and how, through its three merger initiatives, it has been able to keep its operating costs low, financial returns high, while maintaining low rates for all Horizon customers – residential and commercial.

Lastly, I will share with you my views on challenges that lie ahead that your utility will be facing and what you might have to start thinking about to ensure your "customers have low rates and shareholders have full returns".

Residential rates comparison (\$/month)



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As you will be aware, the rates of all electricity distribution companies are regulated by the Ontario Energy Board (OEB), but you likely are not aware how much rates differ from utility to utility.

This graph shows only the “distribution” portion of the bill for a typical residential customer for all Ontario LDCs – that is no energy, transmission, debt retirement, etc. are included – only distribution charges. A typical residential customer uses 1,000 kWh.

Most LDCs charge between \$20 and \$40 a month. That the rate can vary by more than 100% is a story in itself.

Please note Horizon’s placement in the middle of the pack at \$27 per month.

Please take note of where LDCs X and Y and Z are in relation to Horizon and where they end up as we move to commercial rates.

The point that I will be making in the next couple of slides is that many, if not most, Ontario LDCs cross-subsidize residential rates from commercial rates.

Small commercial rates (\$/month)



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This next graph shows a typical small commercial customer. We all have them – a large corner store with a lot of lighting and refrigeration. They typically consume around 13,000 kWh per month or 13 times more than a residential customer.

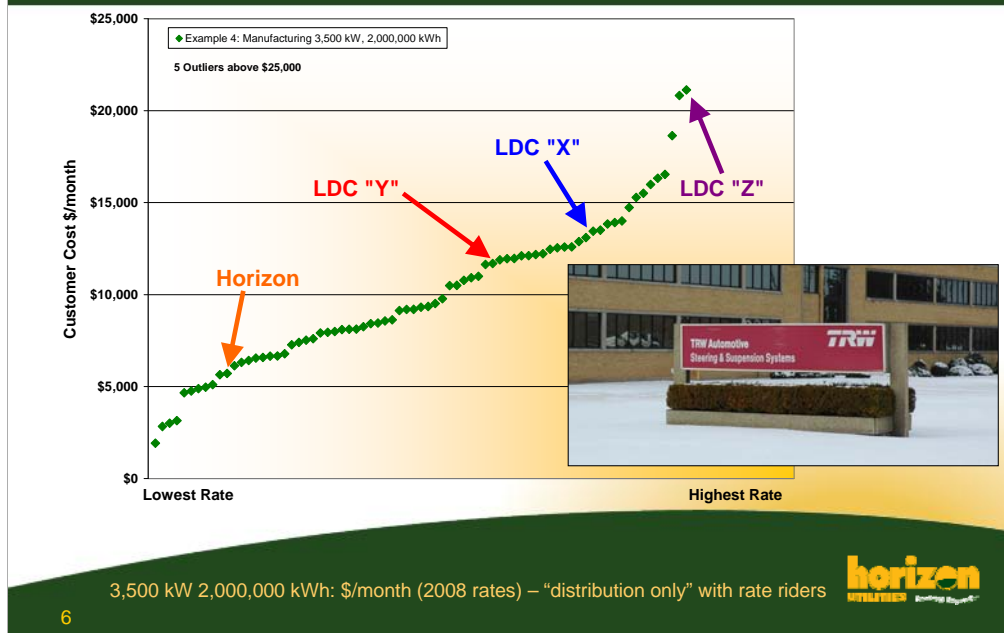
As you can see, most LDCs are charging between \$125 per month and \$275 per month. Imagine what you would think if you owned this “On the Run” business, which has locations in many jurisdictions, and you were paying such different rates.

At Horizon, the rate is \$127 per month, which means that customers in some other LDCs are paying more than twice as much for the same service.

Notice as well what happens to utilities X and Y and Z.

- X was among the lowest in Ontario for residential, but is now near the highest for small commercial.
- Z was high for residential and is still among the highest for small commercial.
- Y was the highest for residential and X was the lowest, but now they are both in the \$250 per month range for small commercial.

Large commercial rates (\$/month)



This last rate graph shows the case for a typical manufacturing business with large commercial rates, using 2 million kWh of energy and 3,500 kW of capacity.

As you can see, the bulk of the LDCs are charging between \$5,000 and \$16,000 for this same customer, with a few below and a few above.

Horizon's rate is slightly greater than \$6,000 per month, but look what happens to LDCs X and Y and Z.

- X, which had the lowest residential rate, is charging more than two times that of Horizon
- Y is now lower than X, but still about two times that of Horizon
- Z is still the highest of the sample and in fact the highest in Ontario

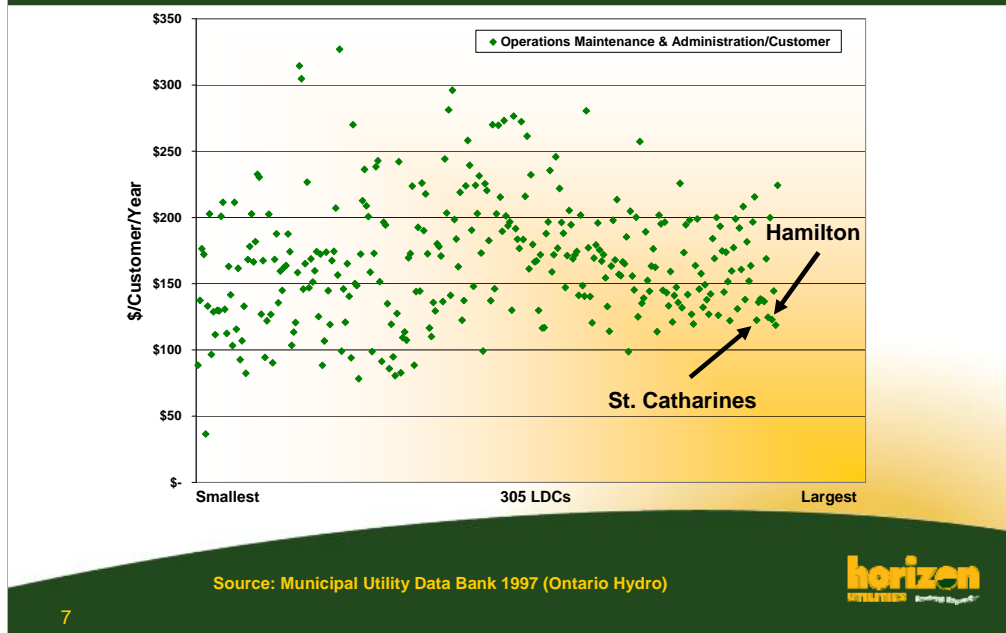
Let me conclude this observation with a key point.

These differences are mainly attributable to cross-subsidization issues.

The Ontario Energy Board has identified cross-subsidization across classes of customers to be something that it is setting out to fix.

There is actually little mystery as to how to get low rates for all customer classes – you need low operating costs from an efficient business.

Controllable costs – all MEUs 1997



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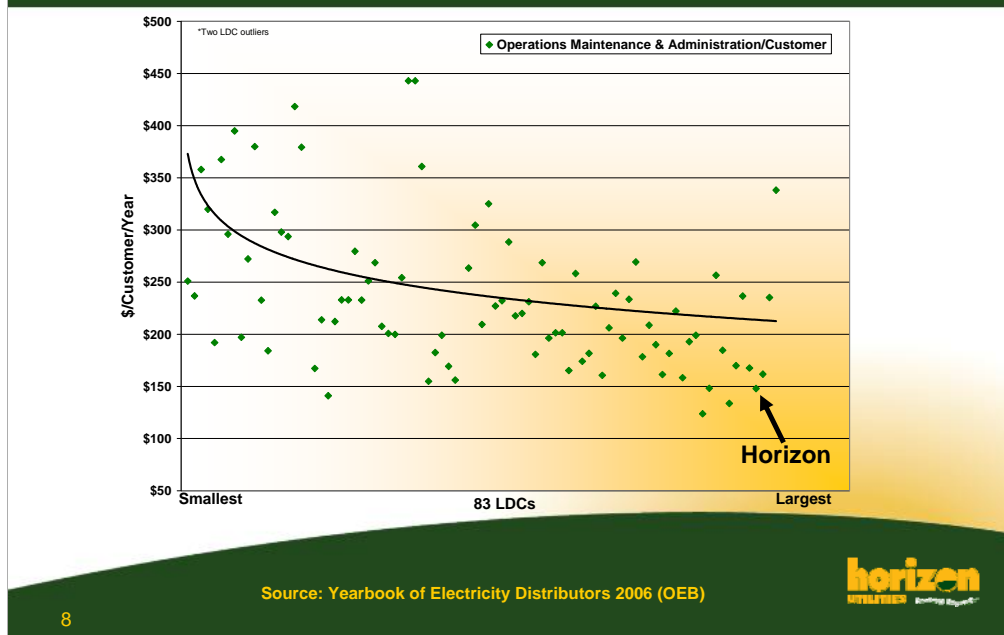
So you are able to see exactly how the industry has evolved on customer costs, I want to take you back to the situation in 1997 before all the industry change.

In 1997 LDCs were referred to as MEUs (municipal electric utilities) and 305 of them existed. This slide shows the controllable cost per customer per year for all 305 MEUs. Controllable costs are operation, maintenance and administration or “OM&A”. It is a standard measure of efficiency within our industry.

The X-axis maps utility size in customers from smallest to largest and the Y-axis is in dollars-per-customer-per-year. The results do not appear to have any particular pattern.

This is prior to incorporation of electric utilities and reporting methods and standards were less formal than today.

Controllable costs – all LDCs 2006



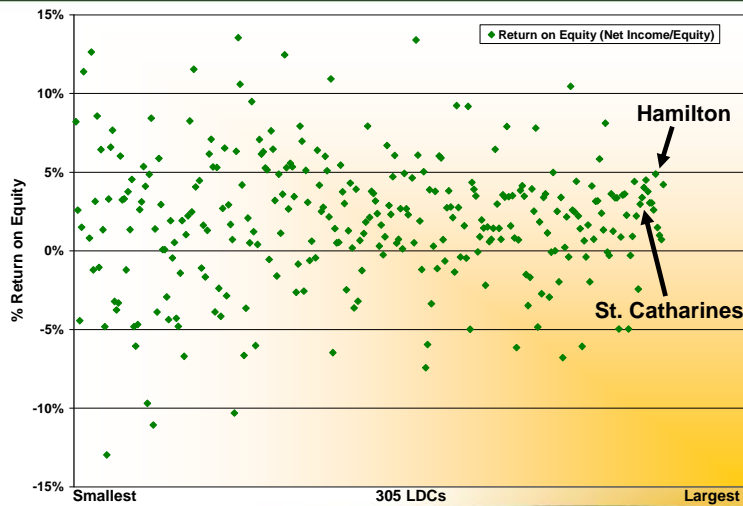
Now let's move forward in time to 2006. The number of utilities dropped from 305 to approximately 90. All utilities have had to incorporate greater standards in accounting, financing, and regulatory requirements were imposed on utility reporting making an "apples to apples" comparison possible. Now let's look at the contrast of LDC OM&A in 2006, which shows a clear correlation of scale and lower costs.

What is notable in the 2006 data, when compared to 1997, is that the OM&A for LDCs with more than 100,000 customers actually decreased 7% over the nine years since 1997. The average of all the other groupings increased, and in some cases substantially.

Adjusting for inflation, the decrease of 7% for large LDCs over this same period is more like a 25% improvement.

In the new regulatory environment what appears to be emerging is clear evidence that scale matters in delivering utility services to customers at the lowest possible rates.

Financial returns – all MEUs 1997



Source: Municipal Utility Data Bank 1997 (Ontario Hydro)

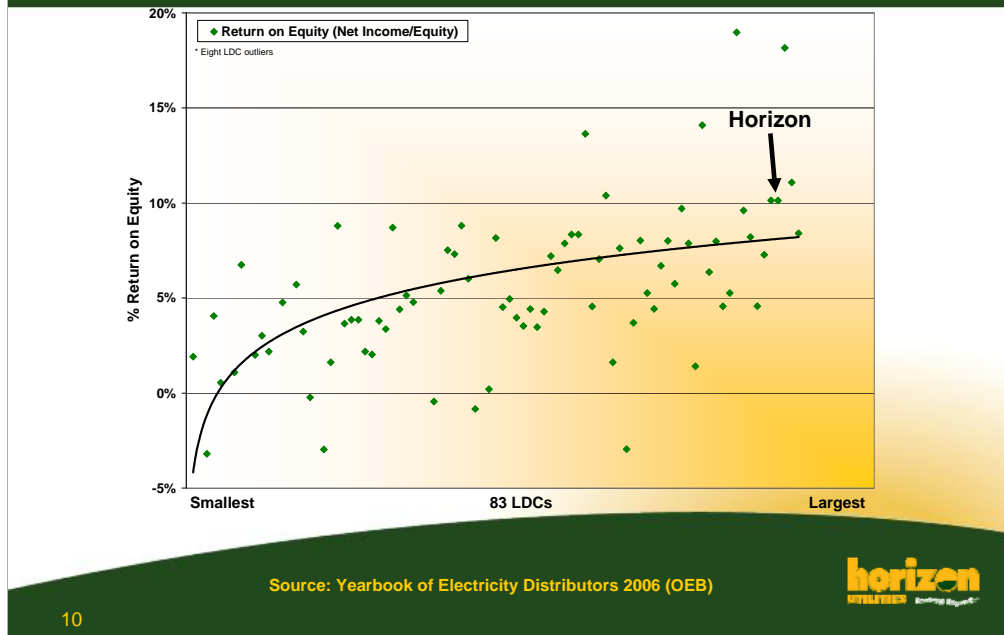


Now let's look at financial returns – return on the equity that municipal shareholders hold as investments in these businesses.

Back in 1997, these businesses were “not for profits”, so they were only supposed to keep their heads above water rather than to make commercial returns.

Like the controllable cost data for 1997 there appears to be no pattern other than a funnel with a wide range of returns at the smaller scale and a narrower range at the larger scale.

Financial returns – all LDCs 2006



When we turn to the 2006 data – the most recent year for published comparative data – there is a distinct correlation between large LDCs and high returns on the equity the shareholders have invested in the LDCs.

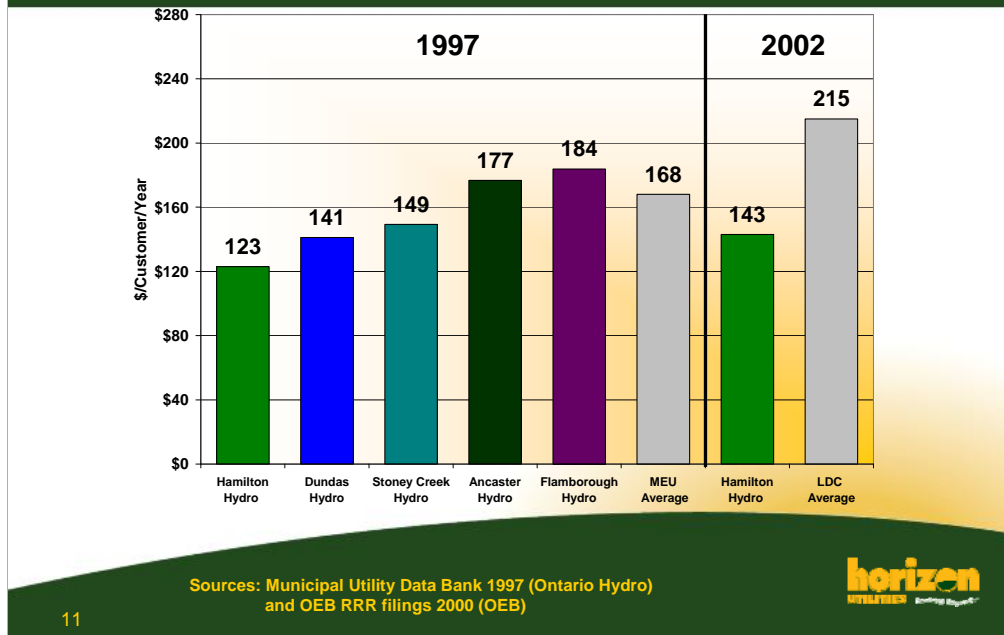
In this year, LDCs were permitted to earn a 9.88% ROE.

What is noticeable and evident in the trend line – is how the returns cascade downward as LDC size diminishes.

The simple message is that one can have low rates for customers and high returns for shareholders but it is much harder to do so in a smaller LDC.

Let me turn now to Horizon's experience with three mergers to show you how we have kept our costs down and returns up.

Horizon 2000 merger – controllable costs



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In this graph, I am showing the benefit of Horizon's first utility merger, which resulted from the municipal amalgamation in Hamilton-Wentworth Region on January 1, 2001.

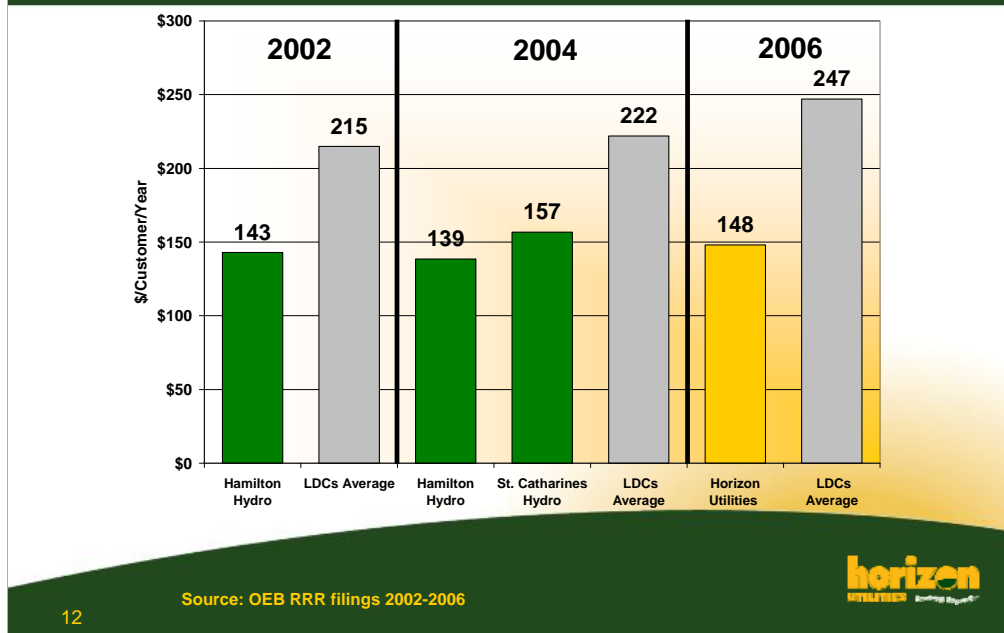
The last published data for all 305 municipal electric utilities – from 1997 – showed that the controllable cost average was \$168 per customer per year.

In Hamilton's case, three of the five merging utilities had below average costs and two had above average costs.

When you look at the 2002 numbers for all LDCs – the first ones published after the amalgamation of Hamilton Hydro in 2001 – the LDC average was now \$215, but the Hamilton Hydro controllable costs were kept down to just \$143.

The period from the passage of the Energy Competition Act in 1998 to market opening in 2002 was an extraordinary time for all utilities because of transition costs to becoming commercial utilities and preparations for competition, but Hamilton Hydro was able to keep costs down and below average, in my view, because of the merger.

Horizon 2005 merger – controllable costs



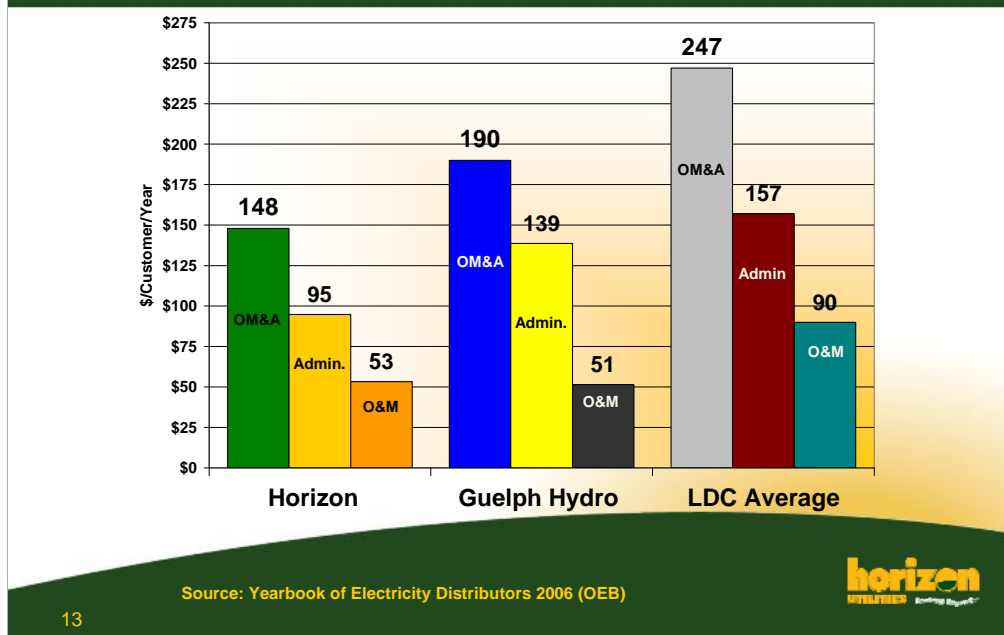
This graph demonstrates the benefit of the Horizon merger in 2005 between St. Catharines Hydro and Hamilton Hydro.

Where in 2002 we were \$143 per customer versus an industry average of \$215, by 2004, the year before the merger, we were \$139 in Hamilton and \$157 in St. Catharines compared against an industry average of \$222.

By 2006, in the first full year after the merger, we actually lowered our costs per customer to \$148 when the industry average increased to \$247. This is 40% lower than the industry average!

As a result, we were able to mitigate a great deal of pressure for rate increases while maintaining high returns for our shareholders.

Horizon & Guelph Hydro – controllable costs 2006



As some of you may be aware, Horizon is currently in merger discussion with Guelph Hydro.

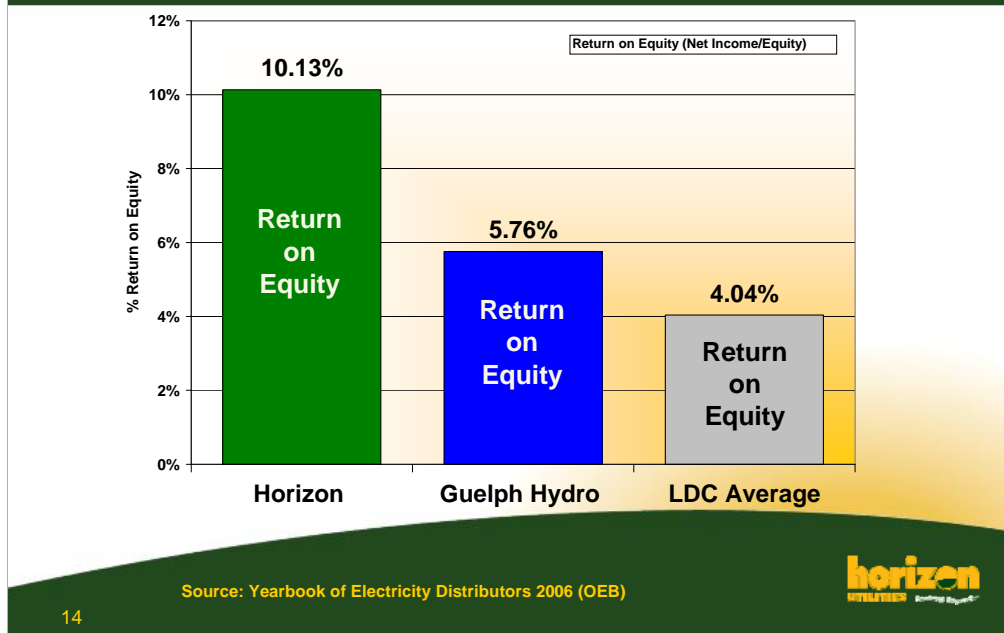
Both Guelph Hydro and Horizon are strong businesses with good operations and low rates, but Guelph Hydro has controllable costs per customer of \$190 compared to Horizon's costs of \$148. Note that the LDC industry average is \$247.

But notice, as well, that both LDCs have about the same unit costs for operations and maintenance. These are among the best "O&M" costs in Ontario, with Guelph Hydro at \$51 and Horizon at \$53. The industry average is \$90.

What this breakout shows is that the difference in the cost to serve customers is mostly in the cost of "administration". Reducing back office costs are the key.

The reason Guelph Hydro's administration costs are more expensive is simply a case for scale. Horizon with 232,000 customers can spread the fixed administration costs for billing systems; call centres, and such over a much larger base. This means Horizon can have a much lower unit cost per customer than Guelph Hydro can, with its 47,000 customers.

Horizon & Guelph Hydro – financial returns 2006



In 2006, the OEB permitted distributors to earn a 9.88% Return on Equity (ROE). As can be seen in the graph:

- Horizon was able to make 10.13%
- Guelph Hydro earned 5.76%, and
- The industry average was only 4.04%.
- Notably, Horizon exceeded the permitted return and is lowering rates in 2008 as a result

There are only two ways for a utility making less than the full return to increase its return: increase rates or decrease costs. Increasing rates is always a challenge to justify and would only serve to make Guelph less competitive with other areas. The solution then lies in decreased costs.

By coming together in a merger, the objective will be to get both utility's controllable costs down to lower than the present cost level of Horizon. The cost savings possible from the merger create the additional financial room to boost the return to the full financial return, with any excess going to customers in lower rates.

Consolidation drivers – societal

- Cost of living / cost of doing business
 - New power generation and transmission more costlier
 - Conservation also costs more than existing power supply
- Energy product and service offerings
 - Customers want products, services, and leadership
- Conservation initiatives and sustainable communities
 - Program design and delivery – scale matters
 - Reduce environmental footprint
 - Community energy management and planning
- Worsening economic conditions and high fuel price
 - Greater customer and public scrutiny

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Aside from the benefit of enabling your community to benefit from lower rates and ensuring that the municipality receives a fair return for its investment other factors are occurring within our industry that will place greater emphasis on consolidations.

Ontario is being faced with an infrastructure renewal problem. The electricity sector is not immune. In a few years we will see an unprecedented build in new power plants and transmission lines. The fuel will be more expensive as cheap coal is phased out and the rates will increase to pay for the new assets. The increases to the price of electricity and services in general will make customers less tolerant of inefficient and poor performing public businesses.

Customers will demand that their local utility deliver products and service offerings that lower their costs and help them conserve and be more competitive.

It will no longer be acceptable for a community owned utility to not contribute to lessen the environmental footprint of the community's energy needs.

We already see signs of progress in this regard. Leading edge communities, such as Guelph, want local energy plans. Communities like Hamilton and St. Catharines want industry leading conservation initiatives that deliver real results to customers.

And now that there is a great deal of public disclosure of LDC cost information – much of what I have used here is readily available on the regulator's website – there will be greater public scrutiny of LDC affairs.

In this sector scale matters.

Partnering with other communities – building scale through mergers – allows many of these important customer and environmental initiatives to become a reality and is the best defense in this rapidly changing environment. Not looking to other partners will ensure that many promising initiatives will never be realized.

Consolidation drivers – technology

- LDCs being remade by technology
 - Customer billing information systems – cost of administration usually higher than cost of operations
 - Electronic business information and planning tools
 - System automation for enhanced reliability
 - “smart meters” and “smart grids” = intelligent utilities
- New technologies require constant investment
 - Have high fixed cost / high depreciation character – scale lessens unit cost for customers
 - Increasingly complex – requires constant attention
 - Pace of change makes it easy to fall behind

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One of the more striking changes that have affected LDCs in recent years is how they are being remade by technology. This is a more complex business than it was in the past.

All LDCs have experienced the challenge of establishing new customer billing systems to meet the complex requirements of buying power in the new marketplace.

But this is only the beginning of where information technology is remaking the business. New business information planning tools are necessary if one is to manage the business effectively.

Technology is also making it possible to enhance system reliability through increased system automation. Our electric grids, that have been with us for decades relatively unchanged, are now going digital. When “smart meters” are layered on this capability, the future outlook will be one of “smart grids”.

The new demands will require capital – lots of it.

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.

The implication on rates will be that LDCs that do not have scale of operations to support these new required technologies will experience increasingly higher rates thereby increasing the gap between good and poor performing utilities.

Consolidation drivers – regulatory

- No longer a “cost-of-service” framework
 - Incentive rate making (IRM) has built-in revenue reductions
 - Meant as stimulus to find efficiency improvements – easy to fall behind and lose money
- Cross-subsidies between customer classes
 - Residential rates usually too low and commercial too high
 - Correct “cost allocation” now a requirement for future
 - Interventions by special interest groups likely only to increase
- Not the expected “light-handed” regulation
 - Expensive to file and defend rate applications
 - Special interests get paid to challenge application

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Probably the most important consolidation driver is the regulatory framework we operate in.

The biggest change is that this industry is no longer a “cost of service” business, as it was before, where whatever your costs were would drive your revenue requirements and rates for the next year ahead.

We are now in a regulatory framework of incentive ratemaking. Utilities are being required to achieve mandatory productivity improvements or suffer a reduction in returns and potentially dividends. We are expected to do as the old saying goes, more with less just to stay even.

On top of this, the new issue of cost allocation has been layered on. As I was showing you in the rates graphs, some LDCs have low residential rates at the expense of cross subsidies with other customer classes. This is now no longer permitted. LDCs must move towards removing these cross-subsidies with each rate filing.

I expect that many LDCs will not be able to address their cost allocation problems without significant increases to residential rates.

Another key factor is the “regulatory burden” itself. Today, the regulatory costs of filing and defending a rate application are substantial and onerous even for large, well-resourced LDCs. Not getting your rates approved satisfactorily is a big risk for a utility. Smaller may not mean less cost or even proportionately less cost. These are not simple matters to manage any longer. Resources to help you manage this area is required and they are expensive.

Worse still, the process is made more difficult because of public funding for special interests groups – paid for by the utility. Intervenors obviously deserve their due, but this does add to the cost and complexity of the approval process.

Concluding thoughts on LDC consolidation

- Pressures for improvement are real
 - Customer rates, operating costs, shareholder returns
 - Incentive rate making requires continuous efficiency gains
 - Local control not the same as in “cost of service” regulation
 - Poor performance may undermine business viability
- Reviewing your options is responsible
 - Hold, merge and sale can all make sense, depending on circumstance
 - Merger makes the most sense when shareholders want both the advantages of ownership and the benefits of good returns

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With all that said, I just want to leave you with two points.

First, I want to emphasize to you that pressures for improvements are real. By this I mean improvements in customer rates, operating costs and shareholder returns. If you have not heard from your utility lately on the financial pressures being faced you soon will be.

Probably the biggest change all of our utilities have faced is that our degree of local control has been severely diminished in the change from cost of service regulation to incentive regulation.

Where once we could tinker with rates and service, we are now under the direction of the Ontario Energy Board. Municipalities can provide little if any direction to LDCs.

My second point is that reviewing your options is the responsible thing to do. If you do not, you cannot know for sure you are doing the right thing.

Deciding to hold on, merge or sell can all make sense, depending on your circumstances.

What I can tell you, however, from the Horizon experience with two successful mergers and another merger negotiation under way, is that we have found mergers to be the sensible halfway house.

Mergers permit shareholders to continue with the advantages of ownership and enjoy the benefit of improved financial returns and low rates for customers.

Thank you for your attention.

I would be pleased to answer 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***

