CCRE Commentary

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Ensuring Customers Benefit when Electric Utilities Combine

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Council for Clean & Reliable Electricity
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Disclosure

The author is not and currently does not expect to be retained by any participant in the Ontario electricity distribution sector.

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Ensuring Customers Benefit when Electric Utilities Combine

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Ontario's Distribution Sector Review Panel estimated that electricity distribution costs could be lowered by as much as $1.2 billion over 10 years through the effective consolidation of the existing 80 local distribution companies (LDCs) into eight-to-12 much larger regional distributors (Elston et al 2012).

The panel contemplated that cost savings and greater efficiencies achieved through consolidation would be passed on, in part, to Ontario ratepayers. It is, therefore, disappointing that the first proposed subsequent consolidation involves Hydro One buying Norfolk Power's utility assets at an approximate 70 per cent premium over the depreciated original cost or net book value. If this proposed $93 million sale is approved by the Ontario Energy Board (OEB), Norfolk Power ratepayers will see their rates reduced by only one per cent—and frozen at that level for five years, at which time their rates will be harmonized with those of Hydro One, which are currently higher than Norfolk Power's (OEB 2013).

"Other regulators have demanded much greater ratepayer savings than Ontario's"

In neighbouring jurisdictions, regulatory authorities have demanded much greater ratepayer savings before approving such consolidations. For example, the June 2012 combination of Vermont's two largest electricity distributors into one company serving approximately 250,000 customers is estimated to save ratepayers US$144 million over 10 years, a 5.8 per cent reduction over the long term (Vermont PSB 2012).

REGULATORY AND MARKET DEFICIENCIES

In Ontario, market inefficiencies and regulatory gaps have prevented the hoped-for technical innovations, increased efficiencies and cost savings that were policy objectives in the 1998 corporatization of the distribution sector. Indeed, comparison of the 1996 Macdonald Committee recommendations to government (Macdonald et al 1996) with the more recent Distribution Review Panel highlights the lack of progress in the electricity distribution sector over the past two decades.

Meanwhile, as shown in Table 1, a review of public sector utility sales in Ontario since 2005 suggests that municipalities that have sold their electricity distribution systems have reaped significant premiums above book value (40 per cent on average), somewhat at the expense of ratepayers whose rates have not declined materially.

Table 1 - Recent Ontario LDC Sales

Utility Acquired	Purchaser	date	purchase price ($million)	book value debt+ equity ($million)	purchase price to book value (ratio)	rate change
Gravenhurst Hydro	Veridian	Sep-05	11.7	7.5	1.56	0
Aurora Hydro	PowerStream	Sep-05	34.5	26.5	1.30	0
West Nipissing	Sudbury Hydro	Sep-05	6.4	5.0	1.28	0
62% of ELK	Town of Essex	Jan-09	12.8	10.9	1.17	0
50% of COLLUS	PowerStream	Jan-12	22.0	15.2	1.45	0
Norfolk Power [1]	Hydro One	Mar-13	93.0	56.4	1.65	-1%
				mean	**1.40**	

Sources: Ontario Energy Board;, company reports

"Transfer tax and Hydro One's dominant financial advantages are distorting prices"

Currently, the LDC market has a number of major imperfections and inefficiencies affecting mergers or acquisitions, including:

1. A 33.33 per cent transfer tax payable by the seller, if the LDC is transferred to a private sector buyer. This tax virtually eliminates the participation of large equity capital pools, in the form of ownership by private sector utilities or pension funds, thereby denying the LDC sector extremely important drivers of innovation, efficiency and lower service costs.
2. By eliminating the private sector, there is no true market test of LDC sale transaction values. LDC buyers are government-owned utilities that rely on low-cost debt financing rather than new private sector equity financing that would be priced to reflect the transaction's fair market value. Quite possibly, the recent reliance on low-cost debt financing as the primary funding source for utility acquisitions may have created a bubble in LDC selling prices that will not be sustainable when interest rates return to more normal levels.
3. The existence of one dominant buyer, Hydro One, which can offer higher prices than competing bidders because:
   - it has access to attractively priced low-cost debt financing;
   - nearly two-thirds of its net income before financing charges and payments in lieu of taxes (PILs)[2] are provided by its cost-of-service transmission business;
   - its extensive distribution network (approximately 1.2 million retail customers); and
   - provincial rather than municipal ownership.

While these market imperfections have created significant opportunities to crystallize value for utility asset sellers, customer rates have not been materially reduced. The buyers of potentially overpriced LDCs must divert savings from consolidation and efficiencies to service the debt incurred to finance the purchase price, including the premium over book value and significant transaction costs. [3]

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[1] Proposed and awaiting regulatory approval.

[2] If an LDC is at least 90 per cent municipally owned, it is not subject to corporate taxes under the federal Income Tax Act. Ontario established PILs to create a "level playing field" between publicly and privately owned utilities. They are calculated in the same way as federal and Ontario corporate taxes such that amounts payable by LDCs as PILs are approximately the same as taxes paid by a private sector utility.

[3] Transaction costs are those fees paid to third-party advisers, providers of financing and legal firms as well as the 33.33 per cent transfer tax, if applicable.Ontario corporate taxes such that amounts payable by LDCs as PILs are approximately the same as taxes paid by a private sector utility.

REALIZING VALUE FOR CUSTOMERS

The process outlined below may achieve more material rate savings for Ontario electricity distribution customers along with a simplified, more rapid negotiation of consolidation transactions.

Under this proposal, electricity policymakers and the OEB would temporarily[4] introduce new measures, as follows:

1. For three years, transactions that offer material customer rate reductions when LDCs are merged into a larger more efficient utility would be exempt from OEB review. However, LDC purchase transactions would face full OEB review in which the primary issues would be the allocation of expected efficiency benefits and an associated schedule of guaranteed rate reductions for customers of both the acquired and the acquiring utility.
2. Following the initial three-year period for mergers, the OEB would set all LDCs customer rates no greater than the similar customer class rates of the most efficient utilities in each LDC's operating region. This would incent less efficient utilities to merge.
3. Consolidation transactions would be based on formulaic OEB approved book values, with the equity of the participating LDCs earning a slight premium based on their efficiency and reliability. No utility would be valued at less than book value. Following the initial three-year consolidation period, the utility book value floor would be removed so that the value of less-efficient utilities could decline below book value.
4. The OEB would publish a schedule of equity values for each LDC, thereby reducing the time and cost required for merger negotiation. The premium could increase as consolidation proceeds, such that an early adopter that has consolidated a number of other utilities may have a higher efficiency and reliability premium.
5. Consolidation transactions would consist of a share exchange in which the owners of the existing utilities would receive the common shares of a new company (Newco), comprised of the consolidating utilities' regulated operations.
6. Newco would assume the debt and other obligations of the regulated operations of each LDC involved in the consolidation.
7. Shareholdings in Newco would reflect the equity value contributed by each of the consolidating utilities, adjusted for efficiencies.

"Utility mergers offering customer savings would not require regulatory approval"

ADDRESSING THE VALUE CONCERNS OF MUNICIPAL UTILITY OWNERS

Some sellers of LDCs may object to the process outlined above on the assumption that it would reduce the value of their utility investment. However, it should be noted that:

1. A municipal shareholder will likely achieve a higher premium to book value for its equity stake in a larger, more diversified, more efficient distribution utility than it would for its current stake in a smaller, less efficient LDC.
2. Municipal shareholders inherited their LDCs at book value in 1998 and few if any have invested new capital, yet most, if not all, have received dividends and required the LDCs to fund capital projects from internal cash flow or new borrowings supported by customer rates.
3. As a matter of economic fairness, LDC ratepayers, who provide cash flow and stability, should be treated as major stakeholders in any re-organization and be rewarded with materially lower rates if consolidation savings are achieved.
4. The increased value and higher premiums paid for LDCs are largely attributable to the current low interest rate and cost of capital environment, a factor not influenced by the LDC or its ownership.

[4] These measures (Points 1 and 2) would likely be in force for at least six years, depending on the rate of consolidation. Following this period, the current regulatory regime would be reinstated.

The result of the foregoing merger transactions would be that each municipal shareholder would maintain a proportionally reduced stake in Newco while having direct input into Newco's efficiency and cost-reduction initiatives. Shareholders' cash flow from dividends would remain approximately the same. The risk profile of the shareholders' investment would be lower due to Newco's increased size, scope and more efficient operations. The larger, more diversified, more efficient utility would have greater access to external capital.

The financial position and cash-flow coverage of Newco's debt obligations would reflect a pooling of the utility operations and capital structure. As transaction-related debt would be virtually eliminated, Newco's debt leverage and EBITDA coverage of total interest would remain at appropriate utility levels,[5] transaction costs should be significantly reduced and savings from consolidation would be available to ratepayers rather than being allocated to debt service.

CONCLUSION

Since 2005, there have been few LDC merger transactions. Purchases of LDCs have led to insignificant, if any, customer savings. At the same time, selling shareholders have received significant premiums over their utilities' book value.

"Municipalities would own a proportional share in a more cost-effective larger utility"

The LDC market is inefficient due to the transfer tax that severely restricts the participation of private capital and Hydro One's dominance based on its financial position, which is stronger than other LDCs by provincial design. If policymakers are unwilling to remove these impediments, they should promote revised market and regulatory systems that:
• emphasize much greater customer rate savings,
• speed up utility consolidation by encouraging share exchanges at OEB approved book values rather than negotiated sales, and
• include economic incentives for less efficient LDCs to consolidate.

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[5] Debt leverage and EBITDA (Earnings Before Interest Taxes Depreciation and Amortization) coverage of interest charges are commonly used measures of the fundamental operational and financial health of a business.