Speech to the CCRE Conference on Governance Issues for Municipally–Owned Electricity Distribution Utilities

"To Own or Not to Own"

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by

David McFadden, Q.C., Partner

Gowling Lafleur Henderson

In preparing my remarks, I looked at the topic of our conference from my experience in three capacities:

- as a member of the Board of Directors of an LDC and of business corporations and funds;
- as counsel to municipal governments and LDCs on structuring, corporate governance and mergers and acquisitions;
- as a member of the Smart Grid Forum and as a member of the Distribution Sector Review Panel which reported in December 2012.

I found my experience in each of these three roles useful in considering the topic of owning or not owning.

To start with, it is useful to remember that effectively the modern era in electricity distribution in Ontario started when the Harris Government in the late 1990's conferred ownership of electricity distribution in Ontario on municipal governments outside of distribution assets owned by Hydro One. Prior to this, it was legally unclear who actually owned the electricity distribution utilities in Ontario. In giving ownership of electricity distribution to municipalities, the Electricity Competition Act required incorporation of the distribution entities under the Ontario Business Corporation Act.

Over the past 14 years, LDCs have been the gift which has kept on giving to municipalities, either through dividends or through the sale of LDCs.

Now the winds of change are blowing again and getting a lot stronger. From my work on the Distribution Sector Review Panel and on the IESO's Smart Grid Forum, it has become clear, at least to me, that a number of key drivers are coming to bear which will fundamentally change the LDC sector. Those drivers include:

- The development and implementation of smart grid technology which is requiring and will require both new investment and more sophisticated skills. I should point out that the deployment of smart grid is mandated by the Ontario Government under the Green Energy Act.

- At the same time as smart grid is being deployed, the Ontario Government is pushing ahead aggressively with conservation and demand management programs which inevitably reduce the amount of electricity sold through the wires of LDCs. As a consequence, the income for LDCs is inevitably going to be reduced by the reduction in electricity.

- On top of this, we can expect to see a rapid growth in the deployment of distributed generation which could see a reduction in the amount of demand of power through the wires and could even see substantial numbers of users moving away from wires as they become self generators without reliance on outside power.

- Offsetting some of the loss of load would be the widespread use of electric cars in the years to come. However, to cope with the new load created by electric cars and the pattern of use, significant investment in our distribution systems are likely going to be required.

- To add to all of this, we are now seeing the entry of new competitive players who are offering a range of services in such areas as electricity management

> which will reduce or potentially even eliminate a promising source of new revenue for LDCs. Companies such as Rogers Communications are already moving into the electricity sector and are simply providing electricity services as an extension of their ongoing telecommunications capabilities.

A dramatic illustration of where things are going was found last month with the announcement that Google is acquiring NEST for $3.2 billion. What does NEST do? It manufactures programmable thermostats, smoke alarms and other internet connected devices for the home. So now, Google has moved into the electricity management business.

The challenges which are arising for the Electricity Distribution Sector is reflected in PWC's latest Global Power & Utility's Survey which states:

> "Many in the industry expect the existing power utility business model…to transform or even be unrecognisable in the period between now and 2030. Decentralised generation is already eating into revenues and partly marginalising conventional generation. Ultimately it could shrink the role of unwary power utilities to operators of back-up infrastructure…The Industry is increasingly coming to recognise that to stay profitable and to succeed in the period ahead, companies will need to adapt their business models to respond to a power environment that could be transformed by changes such as decentralised power, technological changes and a very different customer outlook."

What we are seeing is that technology companies, telecommunications providers and even retailers are moving into the electricity space essentially at the distribution level.

Think about our situation in this light. Smart grid, demand management, distributed generation and new competitors have started to move in and represent a significant threat to the revenue base of LDCs. If this isn't bad enough, notwithstanding the revenue challenge, new investment will be required by the shareholders to keep LDCs in the game and competitive. But here lies the dilemma. Relatively few municipal owners are willing or able to invest substantial new equity in their LDCs.

In this environment of potentially highly disruptive change, it will be critical for LDCs to have the right governance model supported by a capable board of directors with the appropriate mix of skills and experience.

In looking at the boards of directors and even LDC management teams, there are effectively three scenarios which need to be considered.

First, if a municipality is intending to sell its LDC in the near term, the Board of Directors should be populated by directors who understand and support this goal and have the right skill mix to assist in securing the best possible price for the benefit of municipal shareholder and the municipality's tax payers.

Second, if the decision has been made to continue to hold the ownership of LDC over the long run, then you will need to focus on directors with solid experience in asset management as well as a track record of working in a changing business environment. Having directors who have a successful record of dealing with business change management will be invaluable.

Third, if you are intending to acquire or merge with other LDCs, it will be particularly valuable to have directors with experience in mergers and acquisition as well as in change management.

The worst thing is to have a misfit or a breakdown in goals and objectives between the shareholder and directors which will lead almost inevitably to resentment and confrontation and, all too often, to public controversy. I have lived through that on more than one occasion. For example, it doesn't work if a board of directors feels that it is in the best interest of the company to grow through acquisitions or mergers while the municipal owner likes everything exactly the way it is.

Alternatively, you can have a situation where a board of directors wants everything to remain the same while the municipality is anxious to sell the LDC either with or without the board's knowledge or consent. This has happened and is happening now much to the outrage often of long time directors.

At the end of the day, in considering whether to own or not to own, it is important to remember that perhaps the most potent determinant is embodied in a five letter word – M-O-N-E-Y. Whether to invest or not invest: Whether to keep, sell or buy.

In the past week when I was thinking about what I would say today, I ran across a quotation of the great American jurist, Oliver Wendell Holmes, who said:

"I find the great thing in this world is not so much where we stand, as in what direction we are moving...we must sail sometimes with the wind and sometimes against – but we must sail, and not drift, nor lie at anchor."

In a period of technological and economic change, we can't afford to drift or stand still. It is all the more essential to have a governance model which fits the times and allows the distribution sector to make the right decisions to bring value to municipal owners as well as to consumers and tax payers.