

# **Managers' Reports**

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# Request for Recommendation Priorities Committee



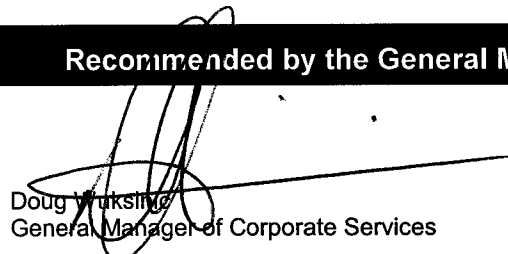
Type of Decision									
Meeting Date	February 12 <sup>th</sup> , 2003				Report Date	February 7 <sup>th</sup> , 2003			
Recommendation	<input checked="" type="checkbox"/>	Yes		No	Priority	<input checked="" type="checkbox"/>	High		Low
	Direction Only				Type of Meeting	<input checked="" type="checkbox"/>	Open		Closed

Report Title
Bill 210 - Electricity Pricing, Conservation and Supply

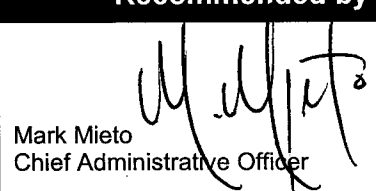
Policy Implications + Budget Impact	
<input checked="" type="checkbox"/>	This report and recommendation(s) have been reviewed by the Finance Division and the funding source has been identified
<input checked="" type="checkbox"/>	Background attached

Recommendation
<p>WHEREAS Section 142(1) of the Electricity Act, 1998 required municipalities to convert their existing electricity businesses into corporations incorporated under the Business Corporations Act within two (2) years of its entitlement; and</p> <p>WHEREAS on December 9<sup>th</sup>, 2002, Bill 210 - The Electricity Pricing, Conservation and Supply Act, 2002 received Third Reading and Royal Assent; and</p> <p>WHEREAS Bill 210 amends the Electricity Act, 1998 by adding Section 159.1 to require a municipality that beneficially owns voting securities in a corporation incorporated under Section 142 of the Electricity Act, 1998, to pass a resolution affirming that the</p>
<input checked="" type="checkbox"/> Recommendation attached

**Recommended by the General Manager**

  
 Doug Wukslin  
 General Manager of Corporate Services

**Recommended by the C.A.O.**

  
 Mark Mieto  
 Chief Administrative Officer

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**Report Authored By**

Doug Wuksinic  
General Manager of Corporate Services

**Division Review**

**Recommendation (Cont'd)**

Corporation should continue to be incorporated under the Business Corporations Act within ninety (90) days of Bill 210 receiving Royal Assent; and

WHEREAS Bill 210 also provides several consequences for failure to pass the required resolution and submit the necessary Certificate certifying the passing of the resolution, it is hereby recommended that the Corporation of Greater Sudbury Hydro Inc./Hydro Du Grand Sudbury Inc. (GSHI) should continue to be incorporated as a Business Corporations Act company as provided in Sub-section 142(1) of the Electricity Act, 1998; and

THAT the City Clerk be requested to prepare and file with the Minister of Energy the necessary Certificate required under Section 159.1 of the Act; and

THAT the Mayor and City Clerk be authorized to execute same.

**Background**

The purpose of this Report is to recommend that Council confirm the status of Greater Sudbury Hydro Inc./Hydro Du Grant Sudbury Inc. (GSHI) as a "For-Profit" Corporation, as required by Bill 210 - Electricity Pricing, Conservation and Supply Act, 2002, which received Royal Assent on December 9<sup>th</sup>, 2002. Council must confirm the status of the GSHI within ninety (90) days (March 10<sup>th</sup>, 2003) from the date Bill 210 receives Royal Assent.

In 1999, Provincial Legislation mandated that all municipalities review options for the future of their Hydro Electric Commissions (Bill 35 - Electricity Competitions Act). Ultimately, the Transition Board and the Council of the City of Greater Sudbury made the decision to operate the Hydro as a "For-Profit" Corporation.

The recently introduced Bill 210 requires that Council confirm the decision to operate the distribution services (GSHI) on a "For-Profit" basis within ninety (90) days of Royal Assent (March 10<sup>th</sup>, 2003).

For your information, I have attached recent documentation provided to the Board of Directors of the Greater Sudbury Hydro Inc. on this matter; specifically:

- ▶ A Memorandum dated 2003-01-27 to the Board of Directors from Mr. Doug Reeves, President & Secretary and Mr. S.A. Pawlowicz, Vice-President of Greater Sudbury Hydro Inc./Hydro Du Grand Sudbury Inc. entitled "*For Profit vs Non-Profit*"
- ▶ A Report dated January 24<sup>th</sup>, 2003 from Macquarie and Ogilvy Renault entitled "*Legal and Financial Analysis of For-Profit and Zero-Return LDCS*",

Date: February 7<sup>th</sup>, 2003

And a Letter dated 2003-01-29 to Mr. Mark Mieto, Chief Administrative Officer of the City of Greater Sudbury from Mr. Doug Reeves, President/CEO and Secretary of Greater Sudbury Utilities Inc./Services Publics Du Grand Sudbury Inc. outlining the recommendation of the Board; specifically, the Board has passed the following Resolution:

*"THAT the Board recommend to the Corporation's Shareholder, that Greater Sudbury Utilities Inc. subsidiary, Greater Sudbury Hydro Inc. continue as a "For-Profit" Corporation as required by Bill 210, The Electricity Pricing, Conservation and Supply Act, 2002."*

An Executive Summary of the information provided outlines the following benefits of passing a Resolution to operate the distribution company, Greater Sudbury Hydro Inc./Hydro Du Grand Sudbury Inc. as "For-Profit" as:

- 1) The Utility is a valuable asset in excess of \$70 million to the City of Greater Sudbury. Operating on a "For-Profit" basis, maintains and will increase its value for both the retention and re-capitalization or possible sale or merger;
- 2) The City is able to utilize any future dividends and interest from the Promissory Note in order to address capital financing requirements for infrastructure renewal, and in this manner is providing direct benefit from returns on this investment to the taxpayers;
- 3) The valuation of GSHI is based on both the present net value of its future cashflows based on distribution rates and a multiple of book value of its assets. The valuation of the asset in a "For-Profit" exceeds that of a "Not-For-Profit";
- 4) The City's 2001, 2002 and Draft 2003 Current Budgets have received the benefit of funding from the Utility as a result of implementing the "For-Profit" model. This funding is equivalent to a tax rate increase of approximately 2 percent in 2003;
- 5) The City of Greater Sudbury has invested significant time and resources to implement the "For-Profit" model. Reversing this will be time-consuming and costly.

On the other side, the implications of not passing a Resolution to operate GSHI as a "For-Profit" are:

- a) If the City does not pass a "For-Profit" Resolution, the electricity company would not be able to declare dividends or increase its debt obligation either through creating new debt or expanding existing debt to the Shareholder;
- b) The ability to sell the distribution company is eliminated as Bill 210 specifically prevents a Shareholder from disposing of its share interest in the company if it does not pass a resolution to continue to operate the company as a "For-Profit" Corporation;
- c) The Ontario Electricity Board (OEB) will deem an application to have been made for a rate order that incorporates a zero percent return on common equity, which effectively converts the Corporation into a "Not-for-Profit" business, without the benefits of a "Not-for-Profit" status.

Based on all of the foregoing, it is recommended that Council of the Greater City of Sudbury accept the recommendation of the Board of Directors of Greater Sudbury Hydro Inc./Hydro Du Grand Sudbury Inc. and declare the distribution company as a "For-Profit" Corporation, as required by Bill 210 - The Electricity Pricing, Conservation and Supply Act, 2002.

**MEMORANDUM TO THE BOARD OF DIRECTORS**

2003-01-27

MEMBERS OF THE BOARD OF DIRECTORS:

**"FOR PROFIT VS NON-PROFIT"**

REQUEST  
FOR  
APPROVAL:

That the Board recommend to the Corporation's Shareholder, that Greater Sudbury Utilities Inc. subsidiary, Greater Sudbury Hydro Inc. continue as a "For Profit" Corporation as required by Bill 210 – Electricity Pricing, Conservation and Supply Act, 2002.

REMARKS:

In 1999, Bill 35 – Electricity Competition Act mandated that the City of Sudbury review options for the future of the Sudbury Hydro Electric Commission, Capreol Hydro Electric Commission and Nickel Centre Hydro Electric Commission. Ultimately, Council through the Transition Board made the decision to operate Greater Sudbury Hydro Inc. as a "For Profit" Corporation as provided in Subsection 142(1) of the Electricity Act, 1998. The recently introduced Bill 210 requires that the Council of the City of Greater Sudbury confirm the decision of operating the distribution utility on a "For Profit" basis prior to March 10, 2003.

Should the City not pass a "For Profit" resolution the distribution utility will not be able to declare dividends or alter its debt structure either through creating new debt or amending existing debt to the Shareholder.

The OEB will deem an application to have been made for a rate order that incorporates a 0% return on common equity which effectively converts the Corporation into a not for profit business, however without the benefits of not for profit status. The Corporation will continue to be liable for PIL taxation including its obligation to pay tax on the Corporation's capital. Furthermore, the ability to sell or modify the ownership structure of the distribution company is eliminated as Bill 210 specifically prevents the Shareholder from disposing of its share interest if the City does not pass a resolution to operate the company as a "For Profit" Corporation.

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The valuation of Greater Sudbury Hydro Inc. is based on both the net present value of its future cash flows based on distribution rates and a multiple of book value of its assets. On this basis, the valuation of the Corporation as a "For Profit" far exceeds that of a "Not for Profit". Access to this value must be preserved in order to keep both sales and refinancing options open for the long term.

The City of Greater Sudbury has built the net interest payment that it receives from the Utility into its financial operating plans. The Utility had the ability to make these payments without passing on a rate increase to its customers. The Utility could have increased its rates to reflect a prescribed market adjusted rate of return but decided against such an option. If the City does not pass a "For Profit" resolution it appears with a higher degree of certainty, that distribution rates would be reduced by a rate order that would claw back earnings before interest. Such an action would result in negative financial implications to the City.

Because the Utility has a 0% market adjusted rate of return incorporated in its rates, any negative aspects of a "For Profit" designation can be effectively managed, we have been good corporate citizens and have not "gouged the consumer".

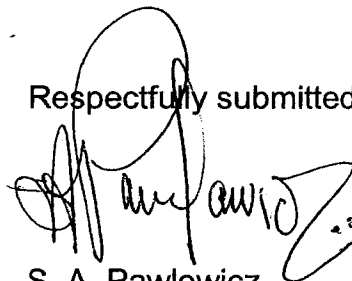
In conclusion, "For Profit" designation preserves the status quo and a significant number of potential opportunities for the future. It is management's unequivocal recommendation that the City pass a resolution that Greater Sudbury Hydro Inc. continue as a "For Profit" Corporation.

Recommended for Approval,



Doug Reeves, P. Eng.,  
President & Secretary.

Respectfully submitted,



S. A. Pawlowicz,  
Vice President.

TO: The Chair, and  
Board of Directors



MACQUARIE



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**LEGAL AND FINANCIAL ANALYSIS OF FOR-PROFIT  
AND ZERO-RETURN LDCS**

COMMISSIONED BY THE ELECTRICITY  
DISTRIBUTORS ASSOCIATION  
JANUARY 24, 2003

## EXECUTIVE SUMMARY

The recently enacted Electricity Pricing, Conservation and Supply Act, 2002 ("Bill 210, the EPCS Act") fixes the commodity price for electricity payable by certain customers at 4.3 cents per kilowatt hour and caps distribution rates until at least May 1, 2006. This legislation also requires the municipal shareholder(s) of a local distribution corporation ("LDC") to decide whether to affirm the current commercial status of the utility or, alternatively, have it revert to an entity which cannot earn a profit and is prohibited from exercising many of the rights associated with commercial enterprises (referred to herein as a "Zero-Return LDC").

In making this decision, the municipal shareholder(s) of the LDC will have to consider the impact of the decision on the financial viability of its utility. While all LDCs will be affected by the freeze on distribution rates, the Zero-Return LDC will additionally be impacted by the many statutory restrictions which will apply as a result of assuming the Zero-Return status. In assessing the financial viability of its utility, the municipal shareholder will also have to consider the provisions of the Municipal Act which may affect the manner and the extent to which the municipality can financially support the utility, a concept commonly referred to as "bonusing".

This report has been commissioned to identify the legal and financial issues imbedded in the For-Profit and Zero-Return models.

From a legal perspective, this Report summarizes the regulatory regime in place prior to the introduction of Bill 210, the EPCS Act, describes the distribution-related aspects of Bill 210, the EPCS Act, and discusses the relevant provisions of the Municipal Act, 2001, in particular, the provisions on bonusing. The question of whether the municipal shareholder is legally permitted to infuse capital or increase lending to the LDC is raised. The Report then turns to an analysis of the financial implications of the new legal framework for the LDC, depending upon whether its current commercial status is affirmed (that is, it remains a "For-Profit LDC") or whether it becomes a Zero-Return LDC.

The key financial implications of Bill 210, the EPCS Act, on LDCs are grouped into three categories: operations, capital funding and shareholder return. In order to analyze and illustrate the financial implications for LDCs under the For-Profit and Zero-Return scenarios, a financial model was created to simulate an LDC with a fixed asset base size of \$100 million and an assumed allowance for working capital, to derive its rate base. The implications of the distribution rate regime beyond 2006 are also considered.

### *Assumptions and Findings*

The key factor determined to affect an LDC's ability to withstand the financial impacts of Bill 210, the EPCS Act, is **growth**, which will impact revenues, expenses, working capital, expansion capital and shareholder return. Secondary factors are also identified and addressed in the report. The analysis in Sections 7 and 8 of the Report considers three different growth scenarios under both the For-Profit and the Zero-Return cases:

- Zero Growth LDC: an LDC with zero growth in its rate base;
- Low Growth LDC: an LDC with 2% annual growth in its rate base; and
- High Growth LDC: an LDC with 6% annual growth in its rate base.



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***Financial Implications – For-Profit LDCs***

The analysis indicates that a For-Profit LDC should be able to continue to pay for its operating expenses and taxes in all growth scenarios.

There is no requirement to finance capital in the zero growth LDC since it is assumed that in this scenario, incremental capital expenditures are equal to zero. However, LDCs in the low and high growth scenarios do require funding of capital expenditures. The analysis indicates that the low growth LDC should be able to fund capital expenditures without borrowing; it may encounter problems with lenders if it wants to borrow enough to optimize cash flow and maintain its capital structure. The high growth LDC would not be able to fund capital expenditures without borrowing but should have access to external debt markets provided that the municipal shareholder infuses additional equity capital.

If the municipal shareholder holds existing LDC debt, there are measures which can be taken to enhance the LDC's ability to access the external debt market.

Enterprise value of the For-Profit LDC has been reduced by the passing of Bill 210, the EPCS Act, and is highly dependent on the regulatory regime applicable after 2006. Most significantly, in the high growth (6%) scenario, assuming a constant capital structure (debt and equity split), there is a need for shareholders to infuse equity capital into the LDC.

***Financial Implications – Zero-Return LDCs***

The analysis indicates that the Zero-Return LDC should be able to continue to pay for its operating expenses and taxes in all growth scenarios, but margins between revenue and operations, maintenance and administration expenses are smaller than for a For-Profit LDC.

After taking into consideration interest expense on initial capitalization and (if applicable) incremental capital expenditures, the Zero-Return LDC would have negative free cash flow in all cases and it would be virtually impossible to source external financing for capital expenditures. Thus, cash injection by the shareholder is necessary under both the low growth and high growth scenarios in order to fund capital expansion obligations of the LDC (assuming replacement capital is funded by the depreciation expense recovered in rates). Additional cash could potentially be sourced from the forgiveness of interest expense on existing municipally held debt, to the extent this is legally permissible. Depending on the specific situation of each LDC, this may or may not be sufficient to finance the required capital expenditures going forward.

If the LDC has external debt in place, it is likely that the existing debt would go into default and would require concessions/support from the municipal shareholder.

Enterprise value for the Zero-Return LDC would be even more severely reduced than that of the For-Profit LDC in all growth scenarios.



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**APPENDICES**

**Appendix A – Sections 159.1 and 159.2 of the Electricity Act**

**Appendix B – Model Assumptions**



## 1. INTRODUCTION

Bill 210, the EPCS Act received Royal Assent on December 9, 2002. Bill 210 was introduced in the legislature by the Government of Ontario in response to a period of high electricity prices following the opening of the electricity market in May of 2002.

From the perspective of the LDCs, Bill 210, the EPCS Act, amends the Ontario Energy Board Act, 1998 (the "OEB Act") and the Electricity Act, 1998 (the "Electricity Act") in fundamental ways. Bill 210, the EPCS Act, also amends the Assessment Act, the Corporations Tax Act and the Retail Sales Tax Act to meet energy conservation and environmental goals by providing incentives to generate electricity from alternative or renewable sources of energy and to use energy-efficient household appliances.

New OEB Act provisions fix the commodity price for electricity payable by certain consumers to 4.3 cents per kilowatt hour (or such lower price as may be determined by regulation) and cap the distribution rates which LDCs can charge to all customers at their current levels or lower until at least May 1, 2006.

The new section 159.1 of the Electricity Act requires the municipal shareholder(s) of each LDC to make a decision whether or not to pass a resolution to affirm the current commercial status of the LDC. If a resolution is not passed and a certificate to that effect forwarded to the Minister of Energy by March 8, 2003, specific statutory restrictions are placed upon the LDC affecting its operations, rates, financing and earnings.

For each municipal council, the question of whether to affirm the LDC's current status will necessarily involve political considerations of local importance. The decision, however, also has significant legal and financial implications which must be understood and addressed by LDC management and its municipal shareholder(s) as part of the decision-making process. The Electricity Distributors Association has commissioned this Report by Ogilvy Renault and Macquarie North America Ltd. in order to provide the decision-makers with the legal and financial information required to make an informed decision as to how to respond to section 159.1 of the Electricity Act (see Appendix A).



## 2. LEGAL CONSIDERATIONS

### 2.1 Historical Legal Context

Prior to the enactment of the Energy Competition Act, 1998, all LDCs (then referred to as municipal electric utilities or MEUs) were public, non-profit bodies which obtained their powers and obligations under the Public Utilities Act (or under special legislation which mirrored the Public Utilities Act) and were governed by publicly elected or appointed commissioners. As an adjunct to local government, the LDC shared certain privileges with the municipal corporation, such as the right to tax-roll hydro arrears.

Bill 35, the Energy Competition Act, 1998, received Royal Assent on October 30, 1998 and fundamentally changed the structure of the municipal electric utilities. The Energy Competition Act, 1998 was composed of several schedules, most notably, the Electricity Act and the OEB Act. Municipal corporations were given two years after section 142 of the Electricity Act was proclaimed into force (on November 7, 1998) to incorporate a corporation under the Ontario Business Corporations Act (the "OBCA") through which to distribute electricity. While there would continue to be municipally-owned electricity distribution companies, they would no longer be commissions established pursuant to the Public Utilities Act or special legislation, but ordinary business corporations established and functioning in the same manner as private sector corporations, subject to restrictions laid out in the OEB Act (for example, pursuant to section 70 of the OEB Act, a distributor could only carry on the business of generating or retailing electricity through an affiliate).

Each newly-incorporated LDC obtained its assets by way of a transfer by-law passed by the local municipality. The asset transfer constituted payment for the shares and the promissory notes issued to the municipality upon incorporation. While the municipality was to be the initial shareholder of the LDC, the legislation placed no restrictions on the power of the municipality to sell some or all of its shares to someone else. Indeed, private sector shareholders of LDCs emerged in some cases.

### 2.2 New Legal Framework

Pursuant to Bill 210, the EPCS Act, unless a municipal shareholder passes a resolution which affirms the current status of the LDC and delivers to the Minister of Energy a certificate confirming the passage of the resolution within 90 days of section 159.1 of the Electricity Act coming into force (amounting to a deadline of March 8, 2003), a host of consequences will follow which have legal and financial implications.

The legislated consequences of failing to pass an affirming resolution (referred to, for convenience, as the "Zero-Return consequences") are the following:

- (a) An application based on a projected revenue requirement that incorporates a 0% return on common equity shall be deemed to have been made, and the Ontario Energy Board ("OEB") shall make an order to replace each existing applicable rate order. The OEB order shall incorporate a 0% return on common equity and shall not increase any of the other components of the revenue requirement or increase the rates set out in the existing order;
- (b) No dividends can be declared;
- (c) The LDC cannot sell, lease or otherwise dispose of all or substantially all of its assets, liabilities or obligations, and cannot dismiss all or substantially all of its employees;
- (d) A municipal shareholder cannot dispose of any of its interest in the LDC. A non-municipal shareholder can dispose of its interest where the OEB has made a rate order incorporating a 0% return on common equity, but only in accordance with section 159.2 of the Electricity Act (see Appendix A), which sets up a



mechanism through which the private shareholder's interest is valued as of November 8, 2002, before the current rate freeze was announced;

- (e) The LDC cannot increase the amount of LDC debt held by the municipality, whether directly or indirectly through a non-municipal shareholder; and
- (f) The LDC cannot enter into an agreement for goods and services with an affiliate, shareholder or a municipality other than in the ordinary course of business for fair value, and cannot amend any existing agreement with an affiliate, shareholder of the LDC or a municipality that increases the financial obligations or liability of the LDC.

Pursuant to section 159.1(6) of the Electricity Act, the above consequences apply despite the articles of incorporation, the by-laws of the corporation, any shareholder agreement or resolution or direction of shareholders, any other instrument or agreement, and the OBCA or any other act or law.

While, strictly speaking, the OBCA continues to apply to a distributor who fails to pass the confirming resolution, the operations and financing of the corporation are severely affected by the above restrictions.



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### 3. RIGHTS OF A FOR-PROFIT LDC VS. A ZERO-RETURN LDC

The following is an overview of the rights and governance structure of an OBCA corporation, with a focus on the comparison between the particular rights of an LDC where a confirming resolution is passed (referred to, for convenience, as a "For-Profit LDC") and the rights of an LDC where a confirming resolution is not passed (referred to, for convenience, as a "Zero-Return LDC"). It is important to note that while the Zero-Return LDC is often described colloquially as a "not-for-profit" company, it is **not** a not-for-profit corporation in the legal sense in that it continues to be governed by the OBCA rather than the statute which governs most not-for-profit corporations.

#### 3.1 Rights of a Person

While a business corporation is an artificial entity, subject to certain restrictions, a corporation has all the same powers and rights as a natural person to carry on business, sign contracts, own property, borrow money, start lawsuits, be at the receiving end of law suits and do just about everything else that an individual can do legally.

The OEB Act imposes some restrictions on the business which an LDC may be engaged in, and such restrictions are equally applicable to the For-Profit LDC and the Zero-Return LDC. For example, an LDC can undertake no electricity-related function other than distribution unless it does so through an affiliate, ensuring that the monopoly and non-monopoly functions are divided. Further, so long as more than 50% of the voting shares of the LDC are owned by one or more municipalities, the LDC cannot engage in any business other than the electricity business or a business which enhances the LDC's electricity business.

Clearly, section 159.1 of the Electricity Act further restricts the Zero-Return LDC's rights. Indeed, the fundamental rights of a corporation to sign contracts, own or dispose of its property and borrow money are severely restricted.

#### 3.2 Constatting Documents

The articles of incorporation is the document which, once filed, creates the corporation. The articles set out the basic structure and features of the corporation and typically state the name of the corporation, the number and classes of shares the corporation is authorized to issue, the numbers of directors the corporation will have and any restrictions on the types of business that the corporation may carry on in addition to those restrictions prescribed by statute.

Section 159.1 affects the authorized capital, in particular the shares, of the Zero-Return LDC. Shares are ownership interests in the corporation which give certain rights to the holders, such as the right to vote on certain matters affecting the corporation, the right to receive dividends and the right to share in its property upon dissolution. Section 159.1 clearly states that no dividends can be declared and that the Zero-Return LDC cannot dispose of substantially all of its assets, for distribution to shareholders or otherwise, despite anything in the articles.

The directors pass the by-laws of the corporation. The first by-law of the corporation will typically set out a framework for the internal governance of the corporation's affairs. For example, it will stipulate how a shareholder can convene a meeting of shareholders and how a director can convene a meeting of directors. It will stipulate how contracts or other instruments are to be signed on behalf of the corporation. It will say when shareholders' and directors' meetings are called and where they are held.



The For-Profit LDC's ability to borrow and enter into contracts is governed by such a by-law passed by its directors. The Zero-Return LDC, however, is severely restricted in its ability to borrow regardless of what the by-laws say in terms of the powers of the LDC to borrow and enter into contracts. As stated above, the Zero-Return LDC cannot increase the amount of debt held by a municipality, it cannot enter into an agreement for goods or services with an affiliate, shareholder or municipality other than in the ordinary course of business and for fair value, and cannot amend an existing agreement with an affiliate, shareholder or municipality to increase the financial obligations of the LDC.

### 3.3 Management and Governance

Under the OBCA, the directors of the corporation are responsible for managing its business and affairs. Practically speaking, directors usually do not run the day-to-day operations of a corporation; instead, they delegate responsibility for managing the ongoing operations of the corporation to officers designated by them. The director's role in practice is usually restricted to approving or rejecting proposals that originate with management.

Under the OBCA, directors can declare dividends or authorize any distribution of a corporation's property to the shareholders. In addition, under the OBCA, directors can authorize transactions which are out of the ordinary course of business, such as the sale of assets.

General principles of corporate law impose a high standard of care on directors. They must use due diligence in discharging their duties; that is, they must take reasonable steps to inform themselves concerning the affairs of the corporation and must make their own assessment of the proposals presented to them by management. As well, they must always act in the best interests of the corporation, which may not always be consistent with the best interests of the shareholders, or even with the best interests of the customers.

Although the shareholders elect the directors, they cannot directly tell the directors what to do, as managing the corporation is the responsibility of the directors. If the shareholders are not satisfied with the decisions the directors make, they can convene a meeting to remove them or wait until they come up for re-election.

There are two important exceptions to the general rule that the shareholders cannot interfere in the directors' management of the business and affairs of the corporation. The first is that the OBCA permits the shareholder or shareholders of a corporation to execute a document which is called a unanimous shareholder declaration (if there is just one shareholder) or a unanimous shareholders agreement (if there are two or more shareholders). In such a document, which must be executed by all of the shareholders of the corporation, the shareholders can take away all of the powers and duties of the directors and place them with the shareholders directly, and can provide for specifics as to how the corporation is to be managed.

The other important exception to the rule that shareholders cannot interfere in the directors' management of the corporation is that the OBCA says that certain fundamental changes require shareholder approval. These would include things like selling all of the corporation's assets, merging the corporation with another corporation, or amending the corporation's articles of incorporation.

Many of these standard governance mechanisms are impacted by Bill 210, the EPCS Act:

- (a) The Board of Directors of a Zero-Return LDC is prohibited from declaring or paying dividends;
- (b) A Zero-Return LDC is prohibited from selling, leasing or otherwise disposing of all or substantially all the assets, liabilities, rights or obligations of the corporation and from dismissing all or substantially all of its employees;



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- (c) Section 159.1(6) of the Electricity Act provides that the Zero-Return LDC operates with the restrictions of the Zero-Return consequences despite the articles of incorporation, by-laws, any shareholder agreement or resolution or direction of shareholders, any other instrument and any other law. Therefore, any provision of any of the Zero-Return LDC's governing documents which conflicts with the Zero-Return consequences will be without effect.

The high standard of care and the duty to act in the best interest of the corporation will continue to apply to the directors of the Zero-Return LDC. However, the behaviour of the Zero-Return LDC's directors will be judged against the backdrop of the additional specific limitations of the Zero-Return consequences on the LDC's activities.

### 3.4 Finances of the LDC

Broadly speaking, there are three ways in which an OBCA corporation can raise funds: through cash from operations, through borrowing or through the issuance of equity (shares).

In terms of revenue generation, Bill 210, the EPCS Act, places a restriction on both For-Profit and Zero-Return LDCs. Specifically, neither the For-Profit nor Zero-Return LDC can raise rates until at least after May 1, 2006, barring exceptional circumstances which remain within the discretion of the Minister of Energy. An application to the OEB for a rate order may only be made with the written approval of the Minister of Energy, who may only grant approval where the rates proposed are lower than the rates in effect, there is no order under section 78 of the OEB Act in effect, the LDC has incurred extraordinary costs or the Minister of Energy is of the opinion that "other circumstances justify the giving of approval" having regard to the interests of consumers with respect to prices and reliability and quality of electricity service. It remains to be seen what circumstances, if any, will persuade the Minister of Energy to allow an application for a rate increase.

As for borrowing, in general terms, borrowing can be done in one of three ways. First, the corporation can borrow money from its shareholders. Second, the corporation can borrow money from a financial institution such as a bank. Alternatively, a corporation can borrow funds from a broader group of lenders by issuing bonds or debentures or similar instruments of indebtedness pursuant to which the corporation promises to pay a stipulated sum to the holder of the instrument plus interest (referred to herein as "Bonds"). If the corporation issues Bonds to a broad group of people, the corporation will likely be required to comply with the requirements of provincial securities legislation.

Finally, a corporation can raise funds by selling shares in itself. The benefit of doing this is that the corporation does not bring any additional indebtedness onto its balance sheet, and does not incur any additional borrowing costs. The down side of selling common shares, at least to the current common shareholders of the corporation, is that it dilutes their ownership interest in the corporation.

The restrictions imposed on a Zero-Return LDC by Bill 210, the EPCS Act, with respect to financing are numerous and important and will be dealt with in detail in the sections which follow. In summary, the key Zero-Return consequences for the financing of the Zero-Return LDC are the following:

1. A municipal shareholder of a Zero-Return LDC is prohibited from selling any of its interest in the LDC and, therefore, it cannot sell all or a portion of its shares to the private sector to raise funds for itself, which might affect the municipality's ability to financially support the LDC;
2. No dividends can be declared nor can the Zero-Return LDC earn a return on common equity, thus impeding the ability to attract private sector investment in the LDC by way of a new share issuance;
3. The Zero-Return LDC cannot increase the amount of debt held by the municipality;



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4. The Zero-Return LDC is not entitled to enter into contracts with the municipal shareholder on uneconomic terms; that is, all agreements for goods and services with the municipality must be for fair value; and
5. The Zero-Return LDC cannot amend any existing agreement with the municipality or other shareholder or affiliate that increases the financial obligations of the LDC.

Items 3 through 5 are clearly intended to prevent municipal shareholders of Zero-Return LDCs from replacing the dividend income taken away by Bill 210, the EPCS Act, with other sources of returns such as interest payments.

### 3.5 Impact of the Municipal Act, 2001 on LDC Finances

The availability of municipal financing for municipalities to assist in the financing of both the For-Profit LDC and the Zero-Return LDC is affected by any additional limitations placed upon municipalities to issue debt, make investments and provide grants under the Municipal Act. As well, the overall financial health of the municipality can affect its ability to support its LDC in the ways permitted by the Municipal Act and the OEB Act. The new Municipal Act, 2001 came into force on January 1, 2003. This section summarizes the aspects of the Municipal Act, 2001 which could affect the municipal shareholder's financial support of the LDC.

#### 3.5.1 Bonusing

The new Municipal Act contains a provision similar to the old Municipal Act regarding a prohibition on bonusing to commercial enterprises. Specifically, the new Municipal Act provides as follows:

106 (1) Despite any Act, a municipality shall not assist directly or indirectly any manufacturing business or other industrial or commercial enterprise through the granting of bonuses for that purpose.

(2) Without limiting subsection (1), the municipality shall not grant assistance by,

- (a) giving or lending any property of the municipality, including money;
- (b) guaranteeing borrowing;
- (c) leasing or selling any property of the municipality at below fair market value; or
- (d) giving a total or partial exemption from any levy, charge or fee.

(3) Subsection (1) does not apply to a council exercising its authority under subsection 28(6) or (7) of the Planning Act.

107 (1) Despite any provision of this or any other Act relating to the giving of grants or aid by a municipality, subject to section 106, a municipality may make grants, on such terms as to security and otherwise as the council considers appropriate, to any person, group or body, including a fund, within or outside the boundaries of the municipality for any purpose that council considers to be in the interests of the municipality.

(2) The power to make a grant includes the power,

- (a) to guarantee a loan or to make a grant by way of loan or to charge interest on the loan;
- (b) to sell or lease land for nominal consideration or to make a grant of land;
- (c) to provide for the use by any person of land owned or occupied by the municipality upon such terms as may be fixed by counsel;
- (d) to sell, lease or otherwise dispose of at a nominal price, or make a grant of, any personal property of the municipality or to provide for the use of the personal property on such terms as may be fixed by counsel; and,
- (e) to make donations of food stuffs and merchandise purchased by the municipality for



that purpose.

The impact that the Municipal Act's prohibition on bonusing to commercial enterprises will have on the legal means by which the municipal shareholder can give financial assistance to either the Zero-Return LDC or the For-Profit LDC is uncertain. Some have expressed the view that any financial assistance to either form of LDC would breach the Municipal Act. This issue has never been considered by the courts.

### **3.5.1.1 Bonusing to the For-Profit LDC**

Considering first the For-Profit LDC, one view is that the granting of assistance by lending or otherwise to the LDC, from and after the initial capitalization of the LDC, is prohibited by virtue of the fact that an LDC is a "commercial enterprise". Under the Electricity Act and the OEB Act, distribution is clearly considered to be a commercial service.

A less conservative view is that the giving of financial assistance by way of lending or otherwise to an LDC, even if it is a For-Profit LDC, is permitted because such financial aid does not violate the intent of the unlawful bonusing provisions. Historically, unlawful bonusing has been prohibited for essentially two reasons:

1. to avoid competition amongst municipalities attempting to attract industry to locate within their own limits; and
2. to prevent a municipality from favouring a particular business over another.

It can be argued that the prohibition against unlawful bonusing does not apply to the municipality giving aid to the For-Profit LDC because any commercial activities of the For-Profit LDC are ancillary to its main, public service objective, which is to ensure the delivery of electricity to residents of the municipality.

The Government of Ontario seems to support this view as it has, to date, not challenged any of the loans that municipalities have made to their LDCs, and Bill 210, the EPCS Act, expressly acknowledges the existence of those loans. However, there may be some constituencies who might contemplate a court challenge.

Accordingly, any municipality considering granting a form of financial aid to a For-Profit LDC should seek a legal opinion with respect to the particular action being considered as to whether it will run afoul of the unlawful bonusing provisions.

### **3.5.1.2 Bonusing to the Zero-Return LDC**

With respect to the Zero-Return LDC, there are additional arguments that providing financial assistance to a Zero-Return LDC is permissible. The fact that the Zero-Return LDC has been stripped of many of the characteristics of OBCA corporations, such as the ability to earn a profit and the ability to dispose of substantially all of its assets, would indicate that the Zero-Return LDC may have lost its commercial character. Even if this view is correct, it must be borne in mind that the form of financial assistance granted must not violate the other restrictions on Zero-Return LDCs. In particular, it is clear by virtue of section 159.1(5) of the Electricity Act that the Zero-Return LDC cannot increase the amount of debt owed to the municipality and that the Zero-Return LDC cannot enter into an agreement for goods and services with the municipality other than in the ordinary course of business for fair value.



### 3.5.2 Finances of the Municipalities

The new Municipal Act does not provide new revenue sources to the municipalities. While there are some refinements in the areas of user fees and financial accountability, there are no significant changes to tax policy. The new Municipal Act does, however, expand the range of financing vehicles available to municipalities. While none of these directly impacts the LDC, they may affect the ability of the municipality to raise the funds it may require for injection into its LDC, to the extent it is determined that an injection of funds is permitted by the Municipal Act.

The new Municipal Act contemplates a mechanism to improve cash flow through a concept known as asset securitization. Previously, municipalities could not sell their receivables. Section 305 of the Municipal Act, 2001 provides that any municipality may sell any prescribed debt payable to the municipality (for instance, parking fees, licensing fees, water and sewage receivables and property tax revenues) to any other person and the person who acquires the debt has the priority of the municipality with respect to the debt. The Minister of Municipal Affairs and Housing may prescribe a debt or classes of debt for the purposes of the section. It remains to be seen how the section will be applied through the regulations. To the extent asset securitization improves the financial health of the municipality, it might affect the financial support which can be provided to the LDC.

Similarly, municipal participation in public/private partnerships through the ownership of shares in a corporation was generally prohibited under the Municipal Act. Section 203 of the new Municipal Act permits the making of regulations which will allow municipalities to hold shares in "prescribed corporations". The scope of permissible investments under this section cannot be determined until the regulations under section 203 have been filed. Again, any positive change to municipal finances might translate to better funding of the LDC.

Under the new Municipal Act, municipalities' right to grant security and incur debt have been expanded. Municipalities are now permitted to incur debt not only by borrowing money but in "any other way", and are permitted to issue "prescribed financial instruments" and to enter into "prescribed financial agreements for or in relation to the debt". The scope of these financial instruments and agreements will be set out in regulations yet to come under section 401 of the new Municipal Act, and therefore any impact on the financial health of municipalities is not clear.

The new Municipal Act also gives expanded powers to municipalities to enter into investment arrangements with other municipalities, public hospitals, universities, colleges or school boards, or additional persons or bodies prescribed in regulations. Section 421 of the new Municipal Act will continue to allow municipalities to lend their securities as long as the loan is fully secured by cash or securities, subject to regulations. Without the regulations being available, it is difficult to assess the real impact of these changes on municipal finances.



## 4. FINANCIAL CONSIDERATIONS

The objective of Sections 4 through 8 of this report is to analyze the financial issues associated with a municipality's decision to either pass a resolution to operate as a For-Profit LDC or not pass such a resolution and operate as a Zero-Return LDC, pursuant to Bill 210, the EPCS Act.

### 4.1 Key Financial Implications

The key financial implications of Bill 210, the EPCS Act, on LDCs can be grouped into three categories: operations, capital funding and shareholder return. This report will discuss the criteria used to evaluate key financial implications, provide some background on the regulatory regime and its financial components prior to the introduction of Bill 210, the EPCS Act, discuss general financial impacts of Bill 210, the EPCS Act, on LDCs and lastly, analyze and illustrate these impacts on the operations, capital funding and shareholder return for a For-Profit and Zero-Return LDC, respectively.

#### 4.1.1 Operations

The primary objective of LDCs, municipal shareholders, regulators, consumers and government is to continue to allow an LDC to provide efficient, reliable delivery of electricity to its customers. The supply and distribution of electricity is an essential service.

The ability of an LDC to continue to operate efficiently and reliably depends on its ability to generate sufficient revenue to pay operating, maintenance and administrative costs and taxes. An inability to cover these costs would compromise the quality of the electricity supply and distribution service.

#### 4.1.2 Capital Funding

The LDC's ability to operate efficiently and deliver quality, reliable distribution service also depends on its ability to:

- finance short term liquidity (working capital); and
- finance capital expenditures for the replacement and expansion of the distribution network.

The ability to obtain and service (i.e. pay interest on debt and a return to equity) capital for short term liquidity is critical to the ongoing sustainability of the LDC. The experience of LDCs since the opening of the competitive electricity market in Ontario has been that working capital requirements have proven to be quite onerous compared to pre-market opening requirements.

LDCs must also be able to either fund internally or attract external capital to pay for the replacement of a depreciating distribution system and, if necessary, fund the growth of the system. The ability to access this capital is key to the viability of the LDC.

#### 4.1.3 Shareholder Return

Utility regulators recognize that a balance needs to be found between securing affordable rates and ensuring that shareholders are compensated for their investment in an LDC via a return on equity ("ROE"). This ROE level should reflect the operational and financial risks of the business and provide incentives for future reinvestment.



As a shareholder of a commercial entity, municipal shareholders should have an ability to earn a fair, risk-adjusted return on their investment in LDCs. This rate of return will affect the enterprise value of the LDC.



## 5. FINANCIAL IMPLICATIONS ANALYZED

Section 5 provides a summary of the rate making methodology for LDCs in Ontario as background to the analysis of the financial impact of Bill 210, the EPCS Act, on LDCs.

### 5.1 Performance Based Rate Making

Prior to the introduction of Bill 210, the EPCS Act, the OEB had adopted performance based regulation ("PBR") as the rate regulation regime for LDCs in Ontario. First generation PBR had been implemented through the OEB's Electricity Distribution Rate Handbook ("Handbook"), which established what rates LDCs may charge their customers. The Handbook was initially meant to provide the foundation for first generation PBR rate adjustments for the years 2000 to 2003 inclusive, with first generation PBR ending on March 1, 2004.

For the period of first generation PBR, the OEB set rates for LDCs under a "price-cap" mechanism. The Handbook set out the procedure to determine the initial distribution rates which a utility may charge through the establishment of 1999 as the base year to determine the efficient level of operating costs and depreciation for each utility, and the appropriate commercial rate of return on capital invested. Once these initial rates were established, they were to be adjusted annually to reflect inflation, a productivity adjustment of 1.50% and an extraordinary event adjustment factor, which utilities must apply for if they believe they should be able to recover the costs associated with an extraordinary event.

On October 19, 2002, the OEB announced its decision to provide a one year extension to first generation PBR until March 1, 2005. Under the extension, the March 1, 2004 electricity distribution rate adjustments were to be calculated using the current price adjustment mechanism. A second generation PBR plan was expected to commence on March 1, 2005, but the passing of Bill 210, the EPCS Act, has made these dates irrelevant. It is unclear whether or when second generation PBR will commence.

### 5.2 Theory of Rate Making

To determine the appropriate return on capital for each utility, the OEB had to establish what amount of capital was invested in the utility (i.e. the rate base), what an appropriate capital structure would be (i.e. amounts of debt and equity to finance the rate base) and the appropriate rate of return that both debt and equity investors should receive from that investment (i.e. interest rate for debt and rate of return on equity). The OEB set the following parameters for rate base and rate of return:

- **Rate base:** the rate base for first generation PBR is defined as the 1999 year end fixed asset base (distribution wires and infrastructure) plus a working capital allowance. The working capital allowance is equal to 15% of the annual cost of power and controllable expenses (operations and maintenance, Billing and collection, and administration); and
- **Rate of return:** the deemed capital structure and rate of return are based on the following regulatory assumptions for utilities of varying sizes.

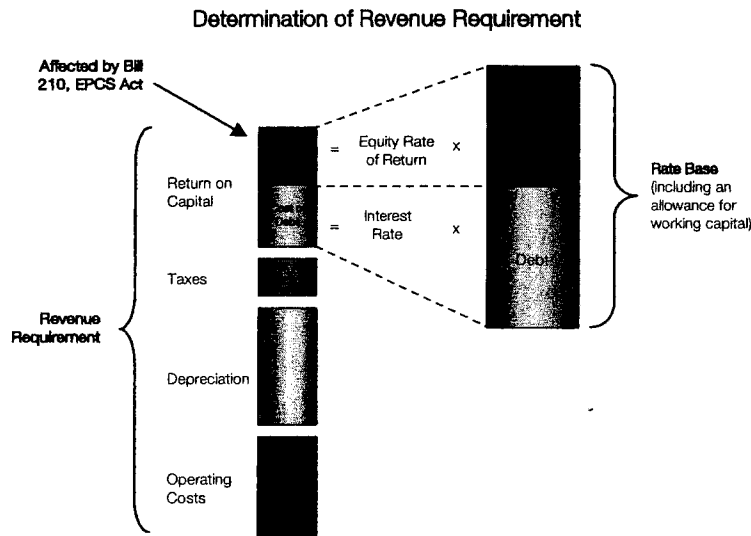


Size of Utility Rate Base	Common Equity Ratio (CER) %	Debt Ratio (1-CER)%	Debt Interest Rate	ROE*
Greater than \$1 Billion	35%	65%	6.80%	9.88%
Between \$250 million and \$1 Billion	40%	60%	6.90%	9.88%
Between \$100 million and \$250 million	45%	55%	7.00%	9.88%
Under \$100 million	50%	50%	7.25%	9.88%

\*Maximum allowed ROE before the introduction of Bill 210, the EPCS Act.  
 Source: OEB Distribution Rate Handbook

Unlike unregulated businesses which generate revenues, incur costs and accept the resultant return on equity, regulated utilities such as LDCs are allowed to receive revenue based on a target return on equity (or net profit). The revenue requirement consists of a return on equity, a recovery of deemed debt interest expense on debt, recovery of taxes, an allowance for depreciation and recovery of operating costs.

Thus, the initial revenue requirement for an LDC was set as follows:



The revenue requirement, once determined, was then allocated to the various customer classes to determine maximum rates that an LDC could charge for customers within that class. These rates consist of two components: a fixed charge and a variable charge dependent on consumption. Effectively, a per customer price cap was established.

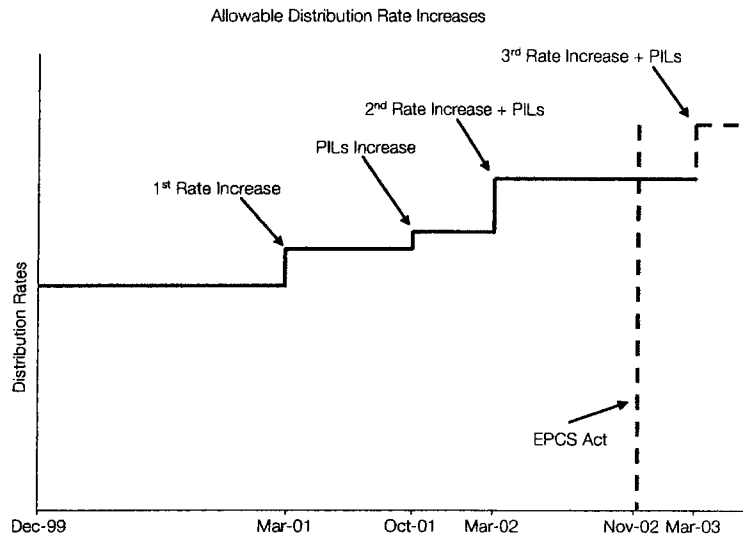
Although the Handbook sets out the maximum rates LDCs can charge for first generation PBR, LDCs were not able to charge these rates immediately. As many LDCs historically operated on a non- or low-profit basis, if they had immediately increased their rates to reflect the full equity rate of return and applicable taxes, there would have been the potential for large rate increases. To address concerns of the Province over the potential for large rate increases to customers, outlined in the Minister's Directive of June 7, 2000, the OEB mandated a phase-in of rate increases over the duration of first generation PBR, driven by a phase-in of the return on



equity portion and applicable taxes portion of the revenue requirement. Increases in distribution rates to move to the full 9.88% equity rate of return and applicable taxes were to be phased-in evenly over the three years of first generation PBR on March 1, 2001, 2002 and 2003.

Note that, rates began to reflect a recovery of payments in lieu of taxes ("PILs") once LDCs became liable for these payments. This occurred on October 1, 2001.

The graph below shows the progression of permitted rate increases from 1999 to the present.



### 5.3 Implications for LDC Operations

As discussed above, the revenue requirement established for each LDC is based on a rate application using 1999 operating costs (as adjusted for inflation and a productivity index). The key issue facing LDCs is the potential for erosion of the margin between revenues and operating costs over time should operating costs increase above levels recoverable through permitted rates. Some potential reasons for higher costs could be due to new call centres and Billing systems etc. In a growing LDC, this risk is reduced because rates are subject to a price cap rather than a revenue cap so that as the number of customers (and consumption) increases, the revenue of the LDC increases. In theory, operating expenses will increase at a lower growth rate than revenue because some costs are fixed and do not increase with customer growth (otherwise known as economies of scale).

### 5.4 Capital Funding

In addition to the payment of LDC operating expenses, regulated rates are designed to allow for the financing of working capital, replacement capital and expansion capital for the LDC.

#### 5.4.1 Initial LDC Capitalization

It is important to differentiate between the initial capitalization established upon incorporation of Ontario LDCs and ongoing requirements to add debt and equity to an LDC's balance sheet to fund capital requirements.



On incorporation, the majority of LDCs were financed with debt and equity capital, both of which were held by the municipal shareholder. That is, municipalities took back debt and common shares as consideration for the transfer of LDC assets into an OBCA corporation. The municipally-held debt is typically in the form of a promissory note that tends to be flexible, with limited terms and conditions and financial covenants.

Since incorporation, a number of LDCs have either refinanced all or part of the initial debt with bank or capital markets debt or simply added externally sourced debt to the initial capitalization.

#### **5.4.2 Working Capital**

Since Market Opening on May 1, 2002, working capital requirements have proven to be quite onerous for LDCs in Ontario. This is primarily due to the fact that LDCs are in essence collection agents for the entire electricity Bill, including cost of power, transmission charge, etc. The LDCs are charged with the collection of the entire Bill and must remit to the Independent Market Operator ("IMO") all amounts other than the distribution charge. This flow-through mechanism coupled with the requirement to post prudential requirements has resulted in significant working capital requirements.

Generally, the need for working capital will arise from the following:

- timing differences between the requirement to pay the IMO and other suppliers and the collection of revenue e.g. payments to IMO are on a monthly basis while the collection of a portion of revenue can be on a bimonthly basis (obligation to pay before collection occurs);
- financing of various short term deferral accounts reflecting charges that the LDC was unable to collect from customers (increases payment default risk to LDC); and
- posting of prudential requirements and potential margin calls to the IMO.

To date, LDCs have sourced liquidity needs from either internal cash balances, short-term bank financing or a combination of both. The OEB allows the recovery of the carrying cost of working capital, which is deemed to be 15% of controllable expenses and 1999 cost of power. The key issue facing LDCs is the potential mismatch between actual and allowed carrying costs. Another important consideration is the potential for changes in working capital and how these increases will be financed, given that the rate allowance is based on 1999 expense levels and may not reflect growth or expenditure increases incurred since.

#### **5.4.3 Replacement and Expansion Capital**

For long-term sustainability of an LDC, the LDC must invest sufficient capital to both replace assets that have reached the end of their useful life and add assets to accommodate system growth. The fact that electricity distribution assets generally cost more in nominal terms today than, for example, 20 years ago makes the cost of simply replacing LDC assets greater than the original cost accounted for on the balance sheet. Consequently, an LDC that spends the same amount of capital as its yearly depreciation expense is in real terms contracting its asset or rate base.

Because 1999 level depreciation expense is allowed to be recovered through distribution rates, a significant portion of replacement capital can be funded through the depreciation charge allowed in revenues. In theory, only the difference between the replacement capital expenditure and the depreciation charge is required to be financed with additional capital. Additional capital is also required to fund system expansion.



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Traditionally, the LDC would expect to recover the carrying cost of this incremental capital annually as the rate base is recalculated to account for incremental assets ("rebased"). Under PBR, the rebasing of the LDC's assets occurs less frequently, perhaps every three or four years. Consequently, LDCs are not able to immediately adjust rates to recover the carrying cost of this additional capital financing.

In order to maintain the existing or deemed capitalization of an LDC, capital expenditures incremental to the depreciation charge, should be financed with both debt and equity capital, in roughly the same proportions as the deemed capital structure.

The debt portion of the capital is typically sourced from banks or the debt capital markets. Alternatively, the municipal shareholder could contribute this capital to the utility as consideration for additional indebtedness. As discussed, there are complications associated with the latter option related to whether bonusing is permissible (see Section 3.5.1).

The equity portion of the capital required will generally take the form of earnings which are reinvested in the LDC rather than being paid out as a dividend.

Typically, LDCs have a requirement to invest in expansion capital to either maintain, improve and potentially expand their system. The various sources available for debt and equity capital for this purpose are discussed below.

#### 5.4.4 Bank / Debt Capital Markets Financing

Regulated distribution utilities typically have ready access to bank financing, and to debt capital markets financing depending on the size of the utility. Because regulated rates are designed to recover interest expense and interest is paid in priority to returns to equity holders (thus making the full amount of interest and ROE allowance available to lenders first), a "buffer" is provided for the payment of interest on debt. This buffer is measured by various forms of interest coverage ratios, which are ratios of cash available for servicing interest (numerator) to interest expense (denominator).

Any debt issued in the bank or capital markets will generally be subject to a number of financial covenants including timely payment of interest and principal, satisfaction of financial tests e.g. interest coverage ratios and maximum debt to capitalization ratios, maintenance of a credit rating, etc. Failure to fulfil covenants can lead to default on the part of the LDC borrower, which would trigger a number of lender remedies including mandatory debt repayment and measures permitting the lender to take control of LDC operations.

The following table summarizes typical financial tests utilized for both bank and capital markets investment grade debt:

Financial Tests	Potential Range
EBIT Interest Coverage Ratio	2.0x – 2.5x
Debt To Total Capitalization	70% - 75%

Theoretically, as long as actual leverage and associated cost of debt for an LDC is close to the OEB-deemed capitalization and OEB-deemed debt cost, the LDC should continue to be able to service its obligations. With time, however, there is a risk that net cash flow margins in the LDC could erode or that a deterioration in credit rating quality can increase the interest expense associated with any floating rate debt so that financial benchmarks imposed by external lenders are not met.



## 5.5 Shareholder Return

Once operating expenses and taxes are paid and working capital facilities and long term debt are serviced by an LDC, shareholders are then compensated with surplus cash flow. The unique situation in Ontario is that municipalities often have an interest in the LDC via both debt and equity that was established upon incorporation. In these circumstances, a municipality's total return from the LDC is comprised of both interest income and equity returns (dividends and any increase in enterprise value of the LDC).

## 5.6 Impact of Bill 210, the EPCS Act

### 5.6.1 Distribution Rates

The primary financial impact of Bill 210, the EPCS Act, on LDCs is on revenue and allowed distribution rates.

If a municipality **does** pass a resolution affirming the commercial status of their LDC, Bill 210, the EPCS Act, requires a distribution rate freeze at current levels. The legislation dictates that "*orders made by the OEB that approved or fixed electricity rates and that were in effect on November 11, 2002 will apply to electricity used on or after December 1, 2002, unless replaced or amended*". A For-Profit LDC is required to maintain these rates until at least May 1, 2006.

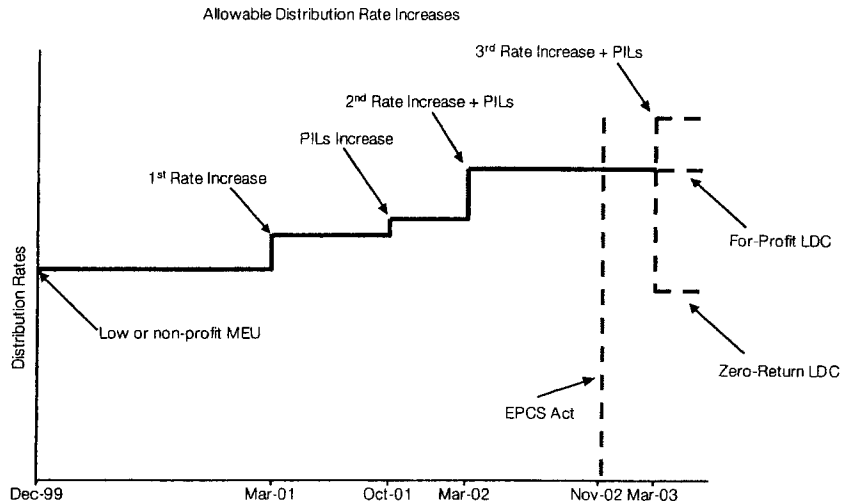
Currently, most LDCs have implemented two of the three rate increases allowed as part of the phase-in to reach a 9.88% return on common equity and applicable taxes. It is difficult to make a general comment as to what return level each LDC is currently operating at because LDCs have different starting points (i.e. the 1999 return on equity level). Each LDC was allowed to phase-in their return on equity from their starting point, based on their own timetable, to reach the full market-based rate of return ("MBRR") on equity of 9.88% by March 1, 2003. In addition, actual achieved return on equity can also vary from the deemed amount due to varying interest costs, capitalization, tax rates etc. from those initially used in the rate applications (which were based on 1999 data). LDCs, however, should currently be at a level well above 0% ROE.

If a municipality does not pass a resolution, under Bill 210, the EPCS Act, an application to set distribution rates shall be deemed to have been made to the OEB on the basis of a 0% ROE. The OEB is required to make an order that incorporates the 0% ROE. In addition, the OEB is not allowed to increase any other components of the revenue requirement or increase any rates in effect at the time. A Zero-Return LDC is required to maintain these rates until at least May 1, 2006.

For a Zero-Return LDC, an OEB order incorporating a 0% return on equity would result in a reduction in the revenue requirement and distribution rates from current levels. In effect, LDCs lose the ability to recover through rates the ROE component and income taxes.



This is illustrated graphically below:



Opportunities to increase distribution rates above levels set by legislation are limited. The legislation allows an application for a new rate order to be made only with the approval of the Minister of Energy who must consider the interests of consumers with respect to prices and the reliability and quality for electricity service. The Minister of Energy may only give an approval if:

- proposed rates are lower than those in effect;
- the LDC has incurred extraordinary costs; or
- the Minister of Energy is of the opinion that other circumstances justify the giving of approval.

There has been no indication as to what regime will be instituted after May 1, 2006 for the setting of the revenue requirement and distribution rates.

Consequently, both the For-Profit and the Zero-Return scenarios introduce a distribution rate cap, for the first at rates in effect in November 2002 and the latter at rates calculated to yield a 0% ROE for the LDC. In effect, growth in customers served and/or consumption is the only way an LDC can grow its distribution revenue without special approval from the Minister of Energy.

### 5.6.2 Working Capital

There are three key areas of potential increases to working capital requirements resulting from Bill 210, the EPCS Act, including:

- potential timing issues related to the payment of market prices for electricity by the LDC, collection of a fixed price for electricity from many of the LDC's customers and collection of the make-whole payments from the Ontario Electricity Financial Corporation;
- prohibition on disconnecting customers until March 31, 2003, at the earliest, for failure to pay their electricity Bills; and



- funding of one-off costs such as new Billing system changes, Bill simplification, demand side management, metering, etc.

It is difficult to quantify the potential increases in working capital for LDCs on the basis of the regulations to Bill 210, the EPCS Act. However, this is uncertain because working capital requirements have the potential to be increased. For purposes of the analysis which follows however, it is assumed that working capital levels are not affected by the introduction of Bill 210, the EPCS Act.



## 6. SCENARIO ANALYSIS

In order to analyze and illustrate the financial implications for LDCs under the For-Profit and Zero-Return scenarios, a financial model was created to simulate an LDC with a fixed asset base size of \$100 million and an assumed allowance for working capital, to derive its rate base.

As discussed, the impact of Bill 210, the EPCS Act, will be analyzed in three areas: operational revenues/expenses, capital funding and shareholder return. As an allowance for operating costs and servicing existing capital is recovered through distribution rates regardless of LDC size, the key factor affecting an LDC's ability to withstand the financial impacts of Bill 210, the EPCS Act, is **growth**, which will impact revenues, expenses, working capital, expansion capital and shareholder return. The analysis in Sections 7 and 8 of this report considers three different growth scenarios under both the For-Profit and the Zero-Return scenario cases:

- Zero Growth LDC: an LDC with zero growth in its rate base;
- Low Growth LDC: an LDC with 2% annual growth in its rate base; and
- High Growth LDC: an LDC with 6% annual growth in its rate base.

Contributed capital is loosely defined as assets or capital provided by developers to assist with the cost of expansion of the electricity distribution system, utilized especially in high growth areas. For purposes of this analysis, the expansion capital is assumed to be net of contributed capital, and is required to be financed by the LDC. Obviously, increased amounts of contributed capital collected would reduce the capital expenditure and financing requirements of an LDC. The implication, however, is the exclusion of these assets in the LDC's rate base and reduction of enterprise value over the long term.

The implications of the distribution rate regime beyond 2006 will also be considered through two possible scenarios: i) continuation of Bill 210, the EPCS Act, regime; and ii) a resumption of the pre-Bill 210, the EPCS Act, regime (see Appendix B).

Assumptions used in developing the financial model are listed in Appendix B.

The primary differentiating component used to "stress test" the financial model is growth. However, it should be mentioned that additional assumptions such as operating expenses, interest expense, capital structure, customer growth and return on equity also have the potential to affect the financial results of an LDC. Each LDC has, of course, its own set of unique circumstances and challenges. The analysis in this report is designed to help the reader easily identify the implications of variations to these secondary levels of assumptions and be able to put place them in the context of the analysis.



The table below provides guidance on potential impacts for each assumption.

Assumption	Impact
Operating expenses (e.g. labour, administration, maintenance)	Net operating cash flow, free cash flow, EBIT coverage and enterprise value e.g. if operating expenses are higher, then cash flow and coverages are reduced.
Interest expense (e.g. debt costs)	Free cash flow (before and after debt financing), EBIT coverage and enterprise value e.g. if interest expense is higher, then cash flow and coverages are reduced.
Capital structure (e.g. actual debt levels that deviate from the deemed debt level)	Free cash after debt financing, EBIT coverage, debt to total capitalization ratio and enterprise value e.g. if capitalization ratio is higher (i.e. more debt than deemed), then cash flow and coverage are reduced. Capitalization ratios and enterprise value are increased.
Customer growth (e.g. new connections and disconnections)	Revenue and net operating cash flow, free cash flow, EBIT coverage and enterprise value e.g. if customer growth is lower, then cash flow, coverages and enterprise value are reduced.
Assumed return on equity (e.g. 6.59% return on equity)	Revenue and net operating cash flow, free cash flow, EBIT coverage and enterprise value e.g. if actual return on equity recovered through rates is lower than 6.59%, then cash flow, coverages and enterprise value are reduced.

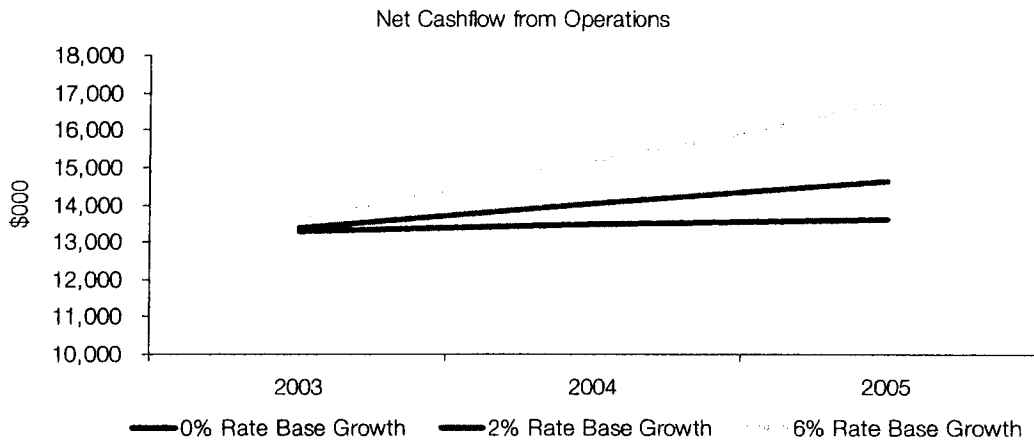


## 7. FINANCIAL IMPLICATIONS - FOR-PROFIT LDCS

### 7.1 Operations

As a result of the implementation of Bill 210, the EPCS Act, the For-Profit LDC is required to freeze its distribution rates at existing levels. The resulting ability of the For-Profit LDC to fund day-to-day requirements and maintain operations is shown in the diagram below under each growth scenario.

In each case, net cash flow from operations has been calculated as revenue less operating expenses and taxes.



Net cash flow remains constant in the zero growth scenario because the model assumes that revenues and operating expenses remain constant. Net cash flow would increase/decrease if operating expenses decreased/increased over time. The reason for the gradual increase in net cash flow in the latter two scenarios is that the model assumes revenue growth is equal to rate base growth, while operating expenses only grow at 75% of this rate. Similarly, net cash flow would increase at a slower rate if operating expenses grow at a faster rate, or vice versa if operating expenses grow at a slower rate.

Generally, though, under all three growth scenarios, it is reasonable to expect that the For-Profit LDC can operate on a day-to-day basis as revenues exceed operating expenses and required tax payments.

### 7.2 Capital Funding

The analysis calculates the free cash flow position of the For-Profit LDC under the low growth and high growth scenarios to determine its ability to fund capital expenditures. The issue of capital funding is not relevant in the zero growth scenario since depreciation and capital expenditures are equal (or expansion capital is zero). Free cash flow is defined as cash available after paying all operating expenses, taxes, interest expense, changes in working capital and capital expenditures.

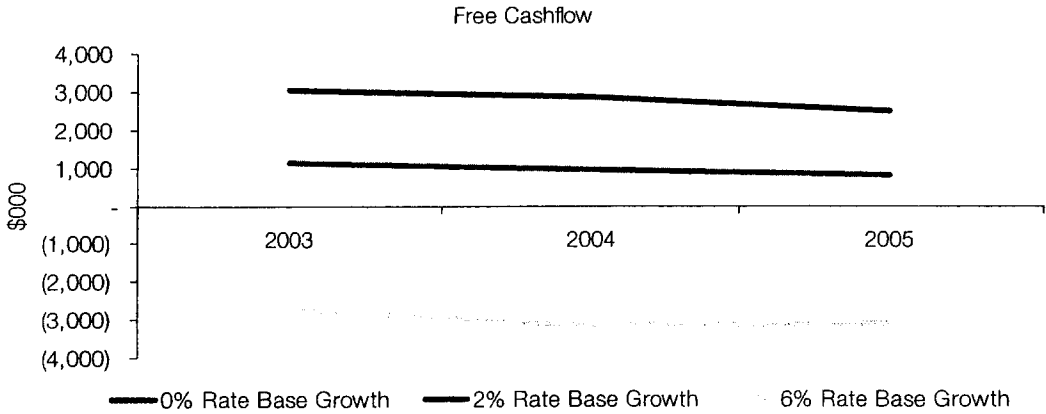
Firstly, free cash flow is calculated assuming no incremental debt financing of changes in working capital or capital expenditures. Secondly, free cash flow is recalculated assuming the use of external debt financing in proportion to the existing capital structure. This borrowing will increase the cash available for distribution to the



municipal shareholder, provide for the most efficient capital structure and maximize the value of the LDC. Finally, the LDC's ability to borrow such incremental debt from external sources is reviewed.

For the zero growth scenario, since incremental debt is not required to finance expansion capital, free cash flow in both charts below is equal and represents the ROE of the LDC.

**7.2.1 No Incremental Debt Financing**



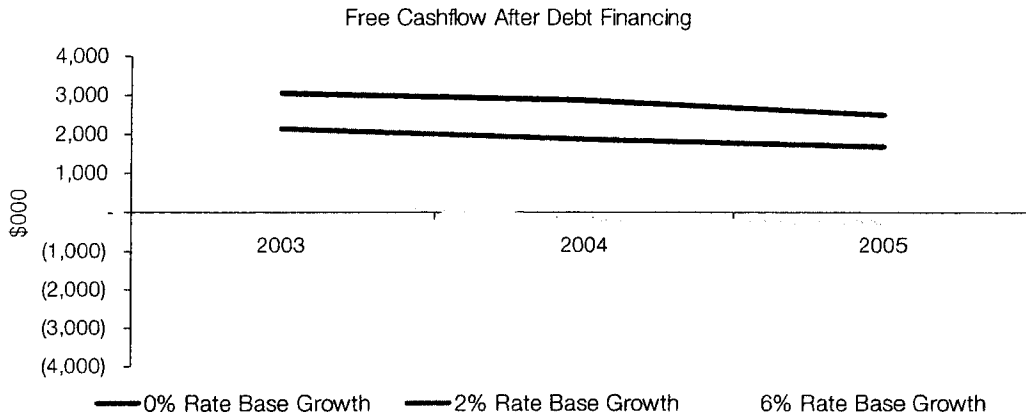
In the low growth scenario, there is sufficient cash flow to support the growth of the LDC over the next few years. The LDC can continue to operate with little or no additional capital, as internally generated cash flow is enough to meet the For-Profit LDC's requirements. However, with no incremental debt used to finance expansion growth, the capital structure of the LDC will begin to deviate from the most efficient mix of debt and equity.

The high growth LDC would be unable to fund capital expenditures out of free cash flow without incremental borrowing or other financial support. This is not a surprising result, as distribution rates are designed assuming external borrowing for capital expenditures.



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**7.2.2 Incremental Debt Financing**



In the low growth scenario, after assuming that external debt capital is sourced to finance a portion of the expansion capital, the future cash flow profile improves. However, in the high growth scenario there is insufficient cash flow generated internally to reinvest the equity portion of the expansion capital starting in 2004. Between now and 2006, shareholder infusion may be required for high growth LDCs. This equity capital required to be infused by the shareholder in the 6 % growth scenario will likely raise concerns about bonusing (see Section 3.5.1).

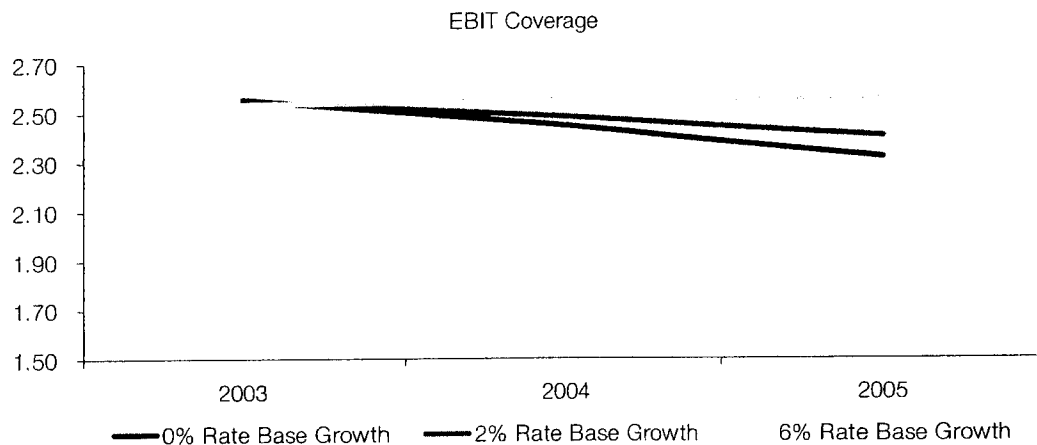
As illustrated in both charts, the high growth scenario has the greatest potential for cash flow shortfalls due to the cash requirements to fund expansion capital. Should the rate freeze and growth in rate base continue beyond 2006, a high growth LDC will continue to face cash flow issues and require funding by its shareholders, which might raise concerns about bonusing (see Section 3.5.1).

**7.2.3 Sourcing of External Debt**

The ability to source external debt is subject to criteria imposed by the third party lenders. The main criteria to enable the For-Profit LDC to borrow additional debt will be the interest coverage provided to the lenders, which is measured through various financial ratios, and the ability of lenders to recover their principal. Section 5.4.4 outlined some financial covenants utilized in both the bank and capital markets.

The resulting EBIT to interest ratios for the For-Profit LDC are shown in the graph below. The financial ratios assume that the LDC borrows additional debt to fund the expansion capital in order to maintain a capitalization ratio in line with the OEB-deemed capitalization ratio. The assumed cost of this debt is 7.0% (as deemed by the OEB).





In the high growth scenario, the coverage profile suggests that the LDC would have ongoing access to external debt financing provided that the shareholder continues to fund the equity portion of capital expenditures. The deterioration of coverage in the low growth scenario would become a concern if there was not some anticipation of a change in rate regulation e.g. a return to full equity MBRR after 2006.

#### 7.2.4 Existing Municipal Debt

In the situation where the municipal shareholder has existing debt which the LDC is currently servicing, in order for external lenders to provide additional financing to the LDC in the current environment, it is very likely that at a minimum, subordination of municipally held debt will be required from lenders. Such subordination would allow an external debt provider to have first priority to cash flows.

If external debt is not available, there are a number of alternatives the municipal shareholder has to enhance the **credit capacity** of the LDC and increase the potential of the LDC to access the external debt market and improve cash flow. These alternatives include: interest forgiveness, interest rate reduction, an equity for debt swap or provision of a municipal guarantee. These alternatives are described in further detail in Section 8.2.4. Under a For-Profit scenario, the municipal shareholder may or may not encounter bonusing issues (see Section 3.5.1) if it provides financial support to the LDC through these options.

Due to the legal complications and uncertainties that arise when municipal shareholders provide financial support to the For-Profit LDC, it is critical that access to the external funding market be maintained.

### 7.3 Shareholder Return

A For-Profit LDC is allowed to make equity distributions to its shareholders. The potential equity returns generated by the For-Profit LDC until May 1, 2006 are restricted by the rate freeze in place and as a result, would not be as high as they would have been in the absence of Bill 210, the EPCS Act. As the equity value of the LDC to the shareholder is determined by the present value of expected return, enterprise values under Bill 210, the EPCS Act, have been substantially reduced. The extent of the value reduction, however, is dependent on the regulatory regime and profit level assumed after May 2006.



The following table outlines the value reductions to the shareholder as a percentage of enterprise value of the LDC prior to the implementation of Bill 210, the EPCS Act, for each LDC growth scenario, under the two rate scenarios assumed post May 2006.

The enterprise value of an LDC is calculated as follows.

$$\text{Enterprise Value} = \text{Total Debt} + \text{Equity Value}$$

Where:

Total Debt is debt owed to the municipality only and external parties; and  
Equity Value is the present value of the all future cash distributions to equity holders.

**Reduction in Total Enterprise Value**

	0% Growth	2% Growth	6% Growth
Indefinite Continuation of Current Rates	19%	26%	> 100%
Reversion to Regime Allowing Full Return on Equity	5%	5%	9%

In all cases, the equity in the LDC is earning suboptimal returns for either a finite period of time or indefinitely while it is assumed that the municipal shareholders should be earning a 9.88% return on equity (also referred to as the applicable discount rate).

Scenarios which assume continuation of current rates post 2006 show a greater value reduction than those where reversion to full equity rates of return post 2006 occurs. It is under the high growth scenario with a continuation of current rates that value is most severely reduced. The reason for this is that, under a high growth scenario, the municipality will be forced to inject capital to provide the equity portion of expansion capital even though the equity capital is earning suboptimal regulatory returns.

**7.4 Conclusion**

In summary, the For-Profit LDC should be able to continue to pay for its operating expenses and taxes in all growth scenarios.

With respect to capital funding, the low growth LDC should be able to fund capital expenditures without borrowing; it may encounter problems with lenders if it wants to borrow enough to optimize cash flow and maintain its capital structure. The high growth LDC would not be able to fund capital expenditures without borrowing but should have access to external debt markets provided that the municipal shareholder infuses additional equity capital, as required.

If the municipal shareholder holds existing LDC debt, there are measures which can be taken to enhance the LDC's ability to access the external debt market.

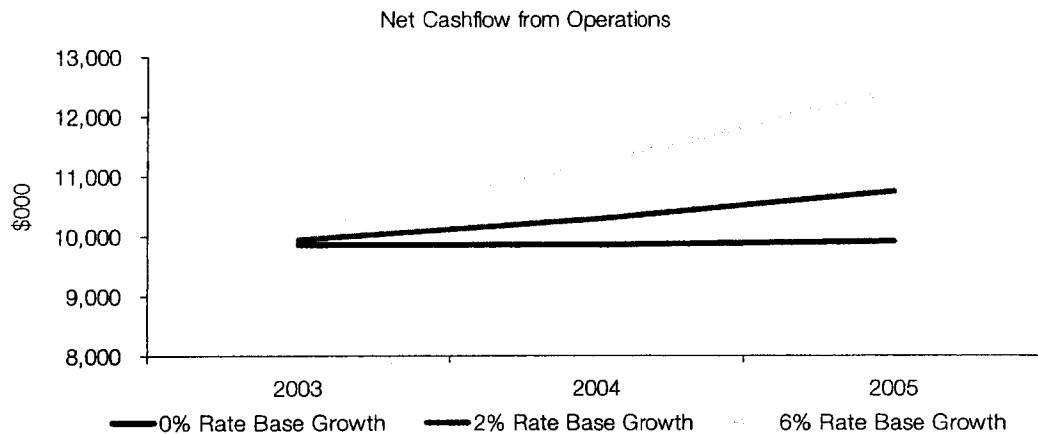
Enterprise value of the For-Profit LDC has been reduced by the passing of Bill 210, the EPCS Act, and is highly dependent on the regulatory regime applicable after 2006. Most significantly, in the 6% growth scenario assuming a constant capital structure (debt and equity split), there is a need for shareholders to infuse equity capital into the LDC.



## 8. FINANCIAL IMPLICATIONS - ZERO-RETURN LDCS

### 8.1 Operations

As a result of the implementation of Bill 210, the EPCS Act, the Zero-Return LDC is required to freeze its distribution rates at levels that incorporate a 0% ROE. For the Zero-Return LDC, a reduction in return on common equity to 0% would result in a significant reduction in the revenue requirement to reflect this reduced return and a reduction in PILs recovery. The resulting ability of the Zero-Return LDC to fund day-to-day requirements and maintain operations is shown in the diagram below under each growth scenario.



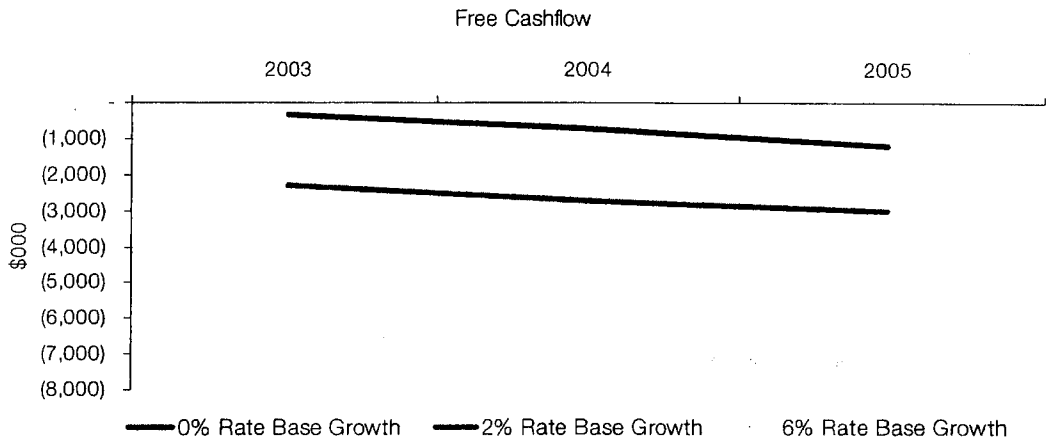
Under all three growth scenarios, it is reasonable to expect that the Zero-Return LDC can operate on a day-to-day basis as revenues exceed operating expenses and required tax payments. However, the margin between revenues and operating expenses is substantially narrower than in the For-Profit case. Maintenance of this margin by careful operating cost control measures is more critical in the Zero-Return scenario.

### 8.2 Capital Funding

#### 8.2.1 No Incremental Debt Financing

The chart below illustrates the free cash flow position prior to any additional debt financing of the Zero-Return LDC under each scenario.



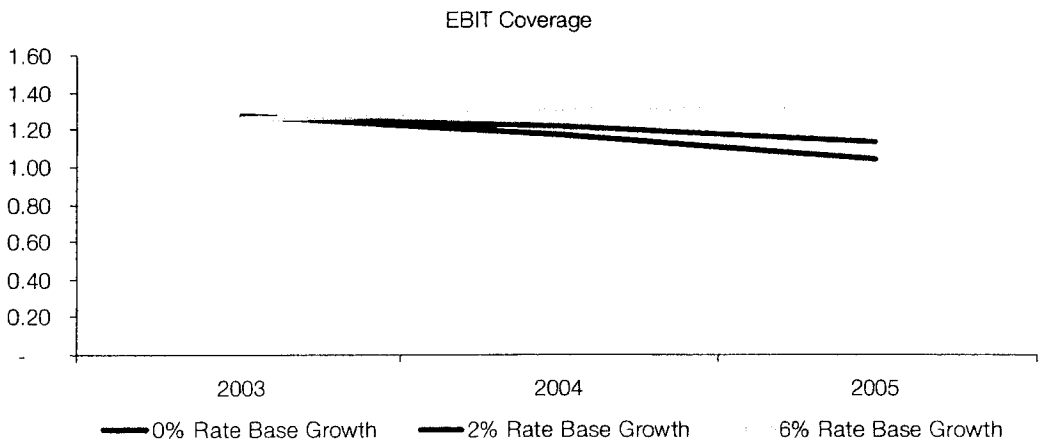


As can be seen from the diagram above, cash flow shortfalls are experienced under all three growth scenarios. Thus, in order for the Zero-Profit LDC to continue to operate it will require external capital. The zero growth scenario results in negative cash flow, even though it is assumed that replacement capital is equal to depreciation, as the deemed tax recovery does not exactly match the actual taxes paid. Deemed taxes are the amount of taxes payable by LDCs and allowed to be recovered through rates. This is due to the mismatch between the deemed tax recovery calculation (using accounting depreciation) and the actual tax calculation (using capital cost allowance). The high growth scenario results in the largest cash shortfall due to the requirements to fund expansion capital expenditures.

**8.2.2 Sourcing of External Debt**

As discussed, the ability to source external debt is subject to criteria imposed by the third party lenders.

The resulting EBIT to interest ratios for the Zero-Return LDC under each of the scenarios are shown in the graph below. The financial ratios assume that the LDC is able to borrow additional debt to fund the expansion capital in order to maintain a capitalization ratio in line with the OEB-deemed capitalization ratio.



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The financial ratios indicate that, firstly, given the levels indicated and secondly, given their decreasing profile, it would be virtually impossible for the Zero-Return LDC to obtain external financing to meet its funding requirements. Thus, the capital to finance all expansion growth of the LDC would have to be provided by the municipality, which might raise concerns about bonusing (see Section 3.5.1).

### 8.2.3 Implications for Existing External Debt

In addition to difficulties in sourcing incremental debt, it is likely that any existing external indebtedness would be in default under current financial covenants due to breaches in the financial tests or the inability to fully pay interest or principal. The external lenders would most likely demand repayment of the principal. In this situation the municipality would have a number of options:

- repay the external debt lenders;
- guarantee the external debt;
- subordinate any municipally-held debt, if applicable; or
- swap municipally-held debt for equity (principal forgiveness), if applicable.

Each of these options would require the municipality to financially support the LDC either through immediate cash payments (repayment of external debt), ongoing cash payments (supporting ongoing external debt payments of interest and principal), or forfeiting future cash receipts (interest and principal payments on municipally-held debt). External lenders would have to approve the implementation of these options otherwise they are entitled to a repayment of their debt principal.

### 8.2.4 Financial Support from Municipal Shareholder

The last financing option available to a Zero-Return LDC is to rely on the municipal shareholder to provide financial support. The key requirement for a Zero-Return LDC is access to cash to finance expansion capital and changes in working capital. Available alternatives to municipalities are:

- Interest forgiveness on municipal debt, if applicable; and
- Injection of additional capital by the municipal shareholder.

Assuming that the municipality holds the initial debt established on incorporation, the total annual interest expense paid by the LDC to the municipality would be approximately \$4.4 million. In the 0% and the 2% growth scenarios, forgiveness of the interest payment would provide sufficient cash to support the required growth. However, this is not the case for the 6% growth scenario where forgiveness of interest is insufficient. The municipality would then need to inject additional capital into the LDC.

Since increasing the existing level of municipal debt is not allowed pursuant to Bill 210, the EPCS Act, all new cash provided by the municipality will be in the form of equity capital. Bonusing may not be such a significant hurdle in the Zero-Return model due to the loss of commercial focus of the LDC (see Section 3.5.1).

Should the Zero-Return LDC be allowed to move to distribution rates that incorporate a full 9.88% ROE beginning May 2006, the LDC may become a financially sustainable operation once again able to support its own ongoing obligations without the assistance of the municipality. On the other hand, should the Zero-Return LDC continue indefinitely, there would not be any relief in the future and the municipality would face the prospect of having to continue to financially support the LDC indefinitely.



### 8.3 Shareholder Return

A Zero-Return LDC is not allowed to make equity distributions (dividends) to its shareholders. Due to the 0% ROE requirement and the associated revenue reduction for the LDC, the total reduction in equity value is substantially greater than in the For-Profit scenario. Similarly, the extent of the value reduction in the Zero-Return LDC is dependent on the regulatory regime and profit level assumed after 2006.

The following table outlines the value reductions to the shareholder as a percentage of enterprise value of the LDC prior to the implementation of Bill 210, the EPCS Act, for each LDC growth scenario under the two rate scenarios assumed post May 2006. Although not entirely improbable, the reversion back to a full MBRR in 2006 for a Zero-Return LDC will imply a significant increase in rates and therefore is not a likely scenario.

**Reduction in Total Enterprise Value**

	0% Growth	2% Growth	6% Growth
Indefinite Continuation of 0% ROE	58%	78%	>100%
Reversion to Regime Allowing Full Return on Equity	16%	16%	29%

In all cases, the equity in the LDC is earning suboptimal returns (i.e. 0% ROE) at least until May 1, 2006, while it is assumed that the municipal shareholders should be earning a 9.88% ROE (also referred to as the applicable discount rate).

In all cases, the model illustrates that the shareholder is required to inject capital into the Zero-Return LDC to maintain operations and fund necessary expansion, even though the equity capital is earning suboptimal returns. As is the case for the For-Profit LDC, scenarios which assume continuation of current rates post 2006 show a greater value reduction than those where reversion to full rates of return post 2006 occurs. It is under the high growth scenario with a continuation of current rates (incorporating a 0% return on equity) that value is most severely reduced, once again, since shareholder(s) are required to invest greater amounts of capital which yield a zero rate of return.

### 8.4 Conclusion

The Zero-Return LDC should be able to continue to pay for its operating expenses and taxes in all growth scenarios, but margins are smaller than for a For-Profit LDC.

After taking into consideration interest expense on initial capitalization and (if applicable) incremental capital expenditures, the Zero-Return LDC would have negative free cash flow in all cases and it would be virtually impossible to source external financing for capital expenditures. Thus, cash injection is a requirement under the low growth and high growth scenarios in order to fund capital expansion obligations of the LDC (assuming replacement capital is funded by the depreciation expense recovered in rates). Additional cash could potentially be sourced from the forgiveness of interest expense on existing municipally held debt. Depending on the specific situation of each LDC, this may or may not be sufficient to finance the required capital expenditures going forward.

If the LDC has external debt in place, it is likely that the existing debt would be in default and would require concessions/support from the municipal shareholder.



Enterprise value for the Zero-Return LDC would be even more severely reduced than the For-Profit LDC in all growth scenarios.



## 9. DECISION IMPLEMENTATION

If the result of the municipal shareholder's analysis is a determination that the LDC's status as a For-Profit LDC should be maintained, the following information is important:

1. The certificate which certifies that a confirming resolution has been passed must be received by the Minister of Energy by March 8, 2003. The certificate should be precisely in the form posted on the Minister of Energy's website at [www.energy.gov.on.ca](http://www.energy.gov.on.ca).
2. Where the LDC is owned by more than one municipality, each municipality may pass the resolution. However, to be effective, the resolution need only be passed by the municipality or municipalities which together own, directly or indirectly, a majority of the voting shares of the LDC.
3. The following are guidelines for what should be included in the confirming resolution:
  - A statement that Bill 210, the EPCS Act, received Royal Assent on December 9, 2002;
  - A statement that Bill 210, the EPCS Act, amongst other things, amended the Electricity Act by adding section 159.1;
  - A statement that section 159.1 of the Electricity Act provides that a municipality which has an interest in an LDC, as defined in subsection 159.1(3), may within 90 days after section 159.1 comes into force, pass a resolution providing that the municipality affirms that the LDC should continue to be incorporated as provided in subsection 142(1) of the Electricity Act;
  - A statement that section 159.1 of the Electricity Act provides that if the Minister of Energy does not receive a certificate certifying the passing of the resolution to continue to be incorporated as provided in subsection 142(1) of the Electricity Act within 90 days of section 159.1 coming into force, the consequences as laid out in subsections 159.1(5), (6) and (7) of the Electricity Act will follow;
  - A statement that the municipal shareholder has resolved that the LDC should continue to be incorporated as provided in subsection 142(1) of the Electricity Act;
  - A statement that the municipal shareholder has resolved to direct an appropriate representative to file with the Minister of Energy a certificate as contemplated in subsection 159.1(4) of the Electricity Act certifying the passing of the resolution to continue to be incorporated as provided in subsection 142(1) of the Electricity Act; and
  - Any other points of detail or conclusions of council on the topic which council wishes to include.



## APPENDIX A - SECTIONS 159.1 AND 159.2 OF THE ELECTRICITY ACT

### Resolution

**159.1** (1) A municipality which has an interest described in subsection (3) in respect of a corporation that was incorporated as provided in subsection 142 (1) and that is licensed under the Ontario Energy Board Act, 1998 to distribute electricity may, within 90 days after this section comes into force, pass a resolution providing that the municipality affirms that the corporation should continue to be incorporated as provided in subsection 142 (1).

### Where more than one municipality

(2) Where an interest described in paragraphs 1 or 2 of subsection (3) is held by more than one municipality, or where two or more municipalities together have the rights described in paragraph 3 of subsection (3), each of those municipalities may pass the resolution described in subsection (1).

### Interests in corporation

(3) The following are the interests in a corporation for the purposes of subsection (1):

1. Direct or indirect beneficial ownership or voting control of all or a majority of the voting shares of the corporation.
2. Direct or indirect beneficial ownership of all or a majority of the voting shares of a corporation that owns all or a majority of the voting shares of the corporation.
3. Any other form of corporate organization that gives the municipality rights or entitlements similar to those of a person who owns all or a majority of the voting securities in a corporation incorporated under the Business Corporations Act.

### When subsections (5) and (7) apply

(4) Subsections (5) and (7) apply if, within 90 days after this section comes into force, the Minister does not receive a certificate or certificates certifying the passing of the resolution in the form provided for in the regulations from the clerk or other appropriate official of the municipality or municipalities that alone or together,

- (a) directly or indirectly beneficially own a majority of the voting shares of a corporation described in subsection (1);
- (b) directly or indirectly beneficially own a majority of the voting shares of a corporation that owns all or a majority of the voting shares of a corporation described in subsection (1); or
- (c) with respect to a corporation mentioned in subsection (1), have the rights or entitlements similar to those of a person who owns all or a majority of the voting securities of a corporation incorporated under the Business Corporations Act.

### Consequences of failure to pass resolution

(5) If the Minister does not receive the certificate or certificates within the time set out in subsection (4), the following apply:



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1. The board of directors of the corporation described in subsection (1) shall not declare, and the corporation shall not pay, dividends for the benefit of any person.
2. The corporation described in subsection (1) shall not sell, lease or otherwise dispose of all or substantially all of its assets, liabilities, rights or obligations, and shall not dismiss all or substantially all of its employees.
3. A shareholder of the corporation described in subsection (1) shall not sell, convey, transfer, assign or otherwise dispose of any of its interest in the corporation except as provided in section 159.2.
4. The corporation described in subsection (1) shall not increase the amount of an obligation to a shareholder that is a municipality provided for in a debt obligation within the meaning of the Business Corporations Act, either by creating a new debt obligation or amending an existing debt obligation, and where such a debt obligation was created or amended after November 25, 2002, the increased amount of obligation shall be deemed not to exist.
5. If the corporation mentioned in subsection (1) increases the amount of an obligation to a shareholder other than a municipality that is provided for in a debt obligation within the meaning of the Business Corporations Act or in a contractual obligation, either by creating a new debt obligation or contractual obligation or amending an existing debt obligation or contractual obligation, that shareholder shall not increase the amount of its obligations to a municipality, and where such an obligation was created or amended after November 25, 2002, the increased amount of obligation shall be deemed not to exist.
6. A corporation described in subsection (1) shall not enter into an agreement for goods or services with an affiliate, a shareholder of the corporation or a municipality other than in the ordinary course of business for fair value of the goods or services provided under that agreement and where such an agreement was entered into after November 25, 2002, the agreement is void.
7. A corporation described in subsection (1) shall not amend or cause to be amended any existing agreement for goods or services with an affiliate, a shareholder of the corporation or a municipality that increases the financial obligations or liability of the corporation and where such an amendment was made after November 25, 2002, the amendment is void.

Non-application of articles, etc.

- (6) Subsection (5) applies despite,
  - (a) the articles of incorporation of any corporation;
  - (b) the by-laws of any corporation;
  - (c) any shareholder agreement or resolution or direction of shareholders;
  - (d) any other instrument or agreement; and
  - (e) the Business Corporations Act and any other Act or law.



Additional consequences of failure to pass resolution

(7) If the Minister does not receive the appropriate certificate or certificates within the time set out in subsection (4), an application shall be deemed to have been made to the Board under section 78 of the Ontario Energy Board Act, 1998 to replace each order made by the Board under section 78 of that Act with respect to the corporation.

Authority for deemed application

(8) Section 79.6 of the Ontario Energy Board Act, 1998 does not apply to an application that is deemed to be made under subsection (7).

Contents of application

(9) An application described in subsection (7) shall be deemed to be based on a projected revenue requirement that incorporates a 0 per cent return on common equity.

Board must make order

(10) The Board shall, upon giving notice to the corporation, make an order that incorporates a 0 per cent return on common equity despite section 78 or 79 of the Ontario Energy Board Act, 1998 and in making the order shall not increase any of the other components of the revenue requirement or increase any rates set out in any order that is in effect at the time that the deemed application is made.

No hearing

(11) The Board shall make the order described in subsection (10) without holding a hearing.

Effectiveness of order

(12) An order described in subsection (10) shall be deemed to have come into force 90 days after this section came into force.

Regulations

(13) The Minister may make regulations governing the form and content of the certificate for the purposes of subsection (4).

Compensation for certain shareholders

**159.2** (1) A shareholder of a corporation to which an order described in subsection 159.1 (10) applies or of a corporation that beneficially owns, directly or indirectly, all or a majority of the voting shares of a corporation to which an order described in subsection 159.1(10) applies is entitled to be paid by the municipality or, if voting shares in the corporation are beneficially owned, directly or indirectly by more than one municipality, by the municipalities, the fair value of all or part of its voting securities in the corporation of which it is a shareholder, determined as of the close of business on November 8, 2002, if the shareholder is not,

(a) a municipality; or

(b) a corporation of which a municipality beneficially owns, directly or indirectly, all or a majority of the voting shares.

Demand for payment of fair value



(2) A shareholder who is entitled to be paid under subsection (1) and who wishes to exercise his or her entitlement shall deliver to the municipality or municipalities, within 30 days from the making of the order described in subsection 159.1 (10), a written notice containing,

- (a) the shareholder's name and mailing address;
- (b) the number and class of securities in respect of which the shareholder is claiming payment;
- (c) a demand for payment of the fair value of the voting securities; and
- (d) the name of a valuator designated by the shareholder from a list of valutors set by the Minister.

Valuation by mutual agreement

(3) The shareholder and the municipality or municipalities, as the case may be, may enter into any agreement or arrangement to determine the fair value of the shareholder's voting securities, the timing and method of the payment to the shareholder of the fair value, the transfer of the voting securities to the municipality or municipalities, as the case may be, or any other related matter.

Same

(4) Where the shareholder and the municipality or municipalities, as the case may be, enter into an agreement or arrangement described in subsection (3), subsections (5) to (13) do not apply or shall cease to apply, as the case may be.

Valuator chosen by municipality

(5) Where the shareholder and the municipality or municipalities, as the case may be, do not enter into a written agreement or arrangement described in subsection (3), the municipality or municipalities shall, within 45 days of receiving the notice under subsection (2), designate a valuator from a list of valutors set by the Minister that is not the valuator designated by the shareholder.

Designation of valuator

- (6) The following rules apply to the designation of a valuator:
1. If the shareholder or the municipality or municipalities have not designated a valuator or if paragraph 2 applies, the Lieutenant Governor in Council shall designate a valuator for the shareholder or municipality or municipalities from the list of valutors set by the Minister.
  2. A valuator is not eligible to be chosen by the shareholder or the municipality or municipalities, as the case may be, if the valuator has provided any service to either the shareholder or the municipality or municipalities in the prior 12-month period.
  3. If more than one municipality beneficially owns, directly or indirectly, voting shares in the corporation, all the municipalities must agree on the valuator, and if they cannot agree on the valuator, the valuator shall be designated as under paragraph 1.
  4. The reasonable remuneration and expenses of the valuator shall be paid by the party who designated the valuator, or for whom the valuator was designated.



Report

(7) Within 90 days from the day that the second valuator is designated, each valuator shall deliver to the municipality or municipalities and to the shareholder a report,

- (a) determining the amount of the payment to which, in the opinion of the valuator, the shareholder is entitled under subsection (1); and
- (b) setting out, in detail, the basis upon which the valuator determined the amount.

SPPA

(8) The Statutory Powers Procedure Act does not apply to the determination of an amount by a valuator under this section.

Criteria

(9) The Minister may establish criteria to be applied by valutors in determining amounts under subsection (7).

Not regulations

(10) Criteria established by the Minister under subsection (9) are not regulations for the purposes of the Regulations Act.

Payment of fair value

(11) The municipality or municipalities shall pay a shareholder who is entitled to be paid under subsection (1) the arithmetic mean of the two amounts determined by the valutors within six months after both reports of the valutors have been delivered.

Where more than one municipality

(12) If more than one municipality beneficially owns, directly or indirectly, voting securities in the corporation whose voting securities are being valued, the amounts that they are liable to pay shall be determined and the deemed transfer under subsection (13) shall be made on a proportional basis in accordance with the extent of their ownership in the corporation.

Claims nullified

- (13) Where payment has been tendered under subsection (11),
- (a) the voting securities shall be deemed to be transferred to the municipality or municipalities; and
  - (b) the shareholder shall be deemed to be fully compensated for its voting securities in the corporation, and shall have no claim or cause of action for any further compensation or payment in relation to anything done in accordance with this section or section 159.1.



## APPENDIX B – MODEL ASSUMPTIONS

The base assumptions used in the report are an LDC with the following characteristics:

- Opening fixed asset base of \$100 million;
- Rate base is the sum of the fixed assets plus an allowance for working capital (calculated as 15% of cost of power and controllable expenses);
- Deemed capital structure of 55% debt and 45% equity;
- Deemed debt cost of 7.00% p.a.;
- Opening capitalization equal to the deemed capital structure of 55% debt and 45% equity;
- Revenue during the rate freeze period (until May 1, 2006) increases or decreases with rate base growth or decline respectively at a rate equal to change in the rate base;
- The two regulatory scenarios assumed post May 1, 2006 are:
  - Continuation of current ROE assumption – 0% for Zero-Return LDC and 6.59% for For-Profit LDC
  - Increase to full 9.88% ROE for both Zero-Return LDC and For-Profit LDC

In all cases, it is assumed that a rebasing of revenue requirement is allowed from May 1, 2006. That is, the OEB is assumed to take into account the operating costs, depreciation expense and rate base current at that time when determining the allowable revenue requirement and distribution rates. It is assumed that annual rebasing occurs thereafter.
- Opening operating, maintenance and administration expenses equal to 9% of rate base. As the rate base increases/decreases, these expenses will increase/decrease at a rate of 75% of rate base growth;
- The growth scenarios used in the analysis (0%, 2% and 6% growth rates) are net of any contributed capital received by the LDC i.e. 0%, 2% and 6% are the amounts of growth funded by the LDC itself.
- All growth capital expenditure requirements are funded proportionately with debt and equity in line with the deemed capital structure of 55% debt and 45% equity;
- Actual debt interest cost of 7.00% p.a. used for existing and new debt;
- Annual asset depreciation of 6% of rate base;
- Average CCA rate of 4%;
- The LDC will continue to be liable for PILs;
- Total customers of 40,000;
- Total consumption of 1,000,000,000 kWh; and
- Equity discount rate of 9.88%.



***Greater Sudbury Utilities Inc./  
Services Publics Du Grand Sudbury Inc.***

500 Regent Street / rue Regent, PO Box 250 / CP 250, Sudbury, ON P3E 4P1  
Telephone (705) 675-7536 Fax (705) 675-0539

2003-01-29

Mr. Mark Mieto  
Chief Administrative Officer  
City of Greater Sudbury  
Tom Davies Square  
P.O. Box 5000, Station "A"  
Sudbury, Ontario  
P3A 5P3

Dear Mr. Mieto:

The Board of Directors of Greater Sudbury Hydro Inc., at its "In Camera" concurrent meeting of January 27, 2003, passed the following resolution:

"THAT the Board recommend to the Corporation's Shareholder, that Greater Sudbury Utilities Inc. subsidiary, Greater Sudbury Hydro Inc. continue as a "For-Profit" Corporation as required by Bill 210, The Electricity Pricing, Conservation and Supply Act, 2002."

The above recommendation follows a valuation review whereby a "For-Profit" Corporation far exceeds that of a "Not-for-Profit" Corporation. Supporting documentation is outlined in attached Memorandum to the Board of Directors of Greater Sudbury Hydro Inc. dated 2003-01-27.

For your information, also attached is a "confidential" report on the "Legal and Financial Analysis of "For-Profit and Zero-Return LDCs" dated January 24, 2003. This was commissioned by the Electricity Distributors Association to identify the legal and financial issues imbedded in the For-Profit and Zero-Return models.

As you are aware, Bill 210 requires that the Council of the City of Greater Sudbury confirm the decision of operating the distribution utility on a "For Profit" basis prior to March 10, 2003.

Sincerely yours,



Doug Reeves, P. Eng.  
President/CEO & Secretary

:tt  
Attach.

c: Doug Wuksinic, General Manager – Corporate Services