City of
Ville d' Ottawa

Backgrounder

April 13, 1999 ACS1999-CO-CMG-0005

Ottawa Hydro Task Force - Task Force Recommendations

Groupe de travail d'Hydro Ottawa - Recommandations du groupe de travail

Issue

- on October 7, 1998, Council approved establishment of a joint Ottawa-Hydro\City of Ottawa Task Force to make recommendations to Council regarding the restructuring of Ottawa Hydro in accordance with the Energy Competition Act passed in late 1998.
- the Task Force examined five options of restructuring, each of which was assessed in light of Ottawa Hydro's internal and external environments and its shareholder requirements.

What's New

- the Task Force unanimously recommends that the City retain ownership of Ottawa Hydro. Two new companies would be established. One which would continue to operate as a utility, and the other which would provide competitive services, e.g., generation, water heaters, metering, dark fibre, etc.
- that a selection board of Council be set up to search for a board of directors, to be appointed no later than October 1, 1999.
- that the Task Force explore the business case for acquiring other electric utilities.

Impact:

- City may realize an extra $100 Million in new funds through restructuring.
- City retains ownership of this valuable asset.
- Electricity rates are expected to remain stable as a result of our restructuring.
- Ottawa Hydro will only control 13% of the cost of Hydro to our customers.
- Ontario Energy Board and the retail electricity market will control 87% of the cost of hydro to our customers.

Contact: John S. Burke,
Chief Administrative Officer
244-5300, ext. 5402

Lucian Blair,
Chief Communications Officer
244-5300, ext. 4444
pager 780-3310

City of Ville d'Ottawa

April 13, 1999

ACS1999-CO-CMG-0005
(File: ACS1300)

Office of the Chief Administrative Officer

Ward/Quartier
City Wide

- Policy, Priorities and Budgeting Committee / Comité des politiques, des priorités et des budgets
- City Council / Conseil municipal

Action/Exécution

Ottawa Hydro Task Force - Task Force Recommendations

Groupe de travail d'Hydro Ottawa - Recommandations du groupe de travail

Recommendations

1. That this report be tabled at the Policy, Priorities and Budgeting Committee of April 15, 1999 to be considered by the Policy, Priorities and Budgeting Committee at its meeting of May 13, 1999 and then City Council at its meeting on May 19, 1999.
2. That the City of Ottawa retain ownership of Ottawa Hydro and that Ottawa Hydro be operated as a utility regulated by the Ontario Energy Board (distributing electricity but retailing electricity only to satisfy its standard supply service obligation) and provide existing competitive services (e.g., generation, water heaters, metering, and dark fibre) [Option 3 reviewed by Task Force].
3. That the City of Ottawa incorporate by June 30, 1999 two or more Ontario Business Corporations Act ("OBCA") corporations through which it will operate the regulated utility and the unregulated competitive businesses upon the transfer of the assets and liabilities of Ottawa Hydro described in recommendation 6 below.
4. That the unregulated businesses providing competitive services (e.g., generation, water heaters, metering , and dark fibre) be established as subsidiary corporations of the utility corporation.
5. That the City retain "Ottawa Hydro" in the names of its successor corporations in a manner which complies with Ontario Energy Board approved codes.
6. That the existing Hydro Commission carry on its operations until December 31, 1999, at which time its assets and liabilities are to be transferred to the successor OBCA corporations.
7. That the Ottawa Hydro Task Force be appointed as the transition board of directors to coordinate the details of transferring assets and liabilities to the new corporations, including:
    a. drafting of the transfer by-law, which will authorize the transfer of assets and liabilities to the new corporations,
    b. recommending the price and form of consideration to the City which will include proceeds from about $100 Million of debt financing, and,

c. drafting of the shareholders agreement, including a dividend policy and risk management policy, which will constrain the amount of risk the board could assume without prior approval of City Council,

and that the by-laws, financing and agreements be subject to approval by Council.

8. That a selection committee comprised of two Councillors and two individuals from the business community be established, assisted by the transition board, to search for the end state board of directors using outside professional assistance if required.
9. That the end state board of directors for the regulated utility be comprised of five to seven members with one (1) position to be filled by the person holding the position of Chief Executive Officer (currently the General Manager and Chief Engineer) and that the end state board be appointed no later than October 1, 1999.
10. That the Ottawa Hydro Task Force be authorized to explore and report back on the business case for municipal acquisition of other electric utilities.

John S. Burke
Chief Administrative Officer

Carl F. Kropp
General Manager and Chief Engineer
Ottawa Hydro

Mona Monkman
City Treasurer

Wil Barber
Secretary-Treasurer
Ottawa Hydro

Jerald Bellomo
City Solicitor

Contact: John Burke - 244-5402
Carl Kropp - 738-6401

Policy, Priorities and Budgeting Committee Action - April 15, 1999

- The Committee tabled the submission until May 13, 1999.

Executive Report

Reasons Behind Recommendations

Background

At its meeting of October 7, 1998 Council approved the establishment of a joint Ottawa Hydro - City of Ottawa Task Force to make recommendations to Council on the incorporation of Ottawa Hydro as required by the Energy Competition Act, 1998.

This Task Force of five is composed of the General Manager and the Secretary-Treasurer of Ottawa-Hydro with the City being represented by the Chief Administrative Officer, the City Treasurer and the City Solicitor

In accordance with the Energy Competition Act, all local electric utility commissions will be replaced by one or more electricity corporations created under the OBCA no later than November 7, 2000. All monopoly businesses (i.e., utility distribution) must be separated from competitive businesses in separate corporations.

Upon incorporation, the City of Ottawa becomes the sole shareholder of Ottawa Hydro's successor entities. Accordingly, City Council needs to make important decisions respecting the structure, organization and business activities of the new corporations.

In keeping with the competitive focus of the new legislation, private sector companies may enter the electricity market to generate electricity, retail electricity and to provide ancillary electricity services.

Given the timelines prescribed by the legislation and the competitive imperatives of the deregulated market, it was agreed that the City should work expeditiously to undertake a financial and competitive review of Ottawa Hydro and make recommendations to Council as soon as practical.

The management consulting firm of Deloitte and Touche and the legal firm of Scott and Aylen were retained to provide advice to the Task Force.

In addition to stakeholder meetings, interviews and attendance at industry workshops, the Task Force has met regularly since the beginning of November 1998 and the minutes of those meetings have been distributed to the Mayor and Members of Council.

Goal of the Task Force

The mandate of the Task Force is to make the restructuring and strategic direction recommendations which best serve the interests of the City of Ottawa, Ottawa Hydro and its customers.

Structural and Business Activity Options

As a result of the new legislation, municipal electric utilities will have a range of business activities and structural options to consider. The new electric corporations may operate strictly as regulated utilities, which own and maintain the "poles and wires" and provide distribution services to all customers and Standard Supply Service for those customers who do not wish to purchase electricity from a competitive supplier. The utility part of the business remains a monopoly (similar to Bell Canada's maintenance of telecommunications infrastructure) which is regulated by the Ontario Energy Board. Affiliate companies separate from the utility must be established to operate in competitive markets (e.g., power generation, water heaters, electrical retailing, gas retailing, etc.).

Early in its mandate, the Task Force determined to evaluate a continuum of five possible options for City Council to consider:

- Option 1 Sell Ottawa Hydro's existing businesses;
- Option 2 Operate a Regulated Utility only (to provide distribution services and standard supply service under regulated rates);
- Option 3 Operate a Regulated Utility and provide existing competitive services (e.g., water heaters, metering , dark fibre and generation);
- Option 4 Operate a Regulated Utility and provide existing competitive services plus retail electricity in the competitive market; and,
- Option 5 Operate a Regulated Utility, provide other existing competitive services, plus retail electricity in the competitive market, plus retail gas in the competitive market and actively pursue district heating & cooling opportunities.

Evaluation Criteria

Each of the options was assessed in light of Ottawa Hydro's: internal environment; external environment; and, shareholder requirements.

The internal environment analysis focused on a review of Ottawa Hydro's: people (core competencies and culture); infrastructure (core processes, technology, and physical plant); and, products / services synergies (marketing, distribution, and brand equity). Information was accumulated through individual interviews and focus group sessions with key Ottawa Hydro staff as well as through a thorough review of Ottawa Hydro's annual reports, business plans, organizational charts and collective agreements.

The external environment analysis focused on a review of: the regulatory environment (Bill 35, Ontario Energy Board regulation licensing and Codes of Conduct, Market Design Committee Recommendations); the competitive environment (industry structure, products and services, competitor analysis); customers (large users, commercial clients, residents); and, the technological environment (alternative power sources, telecommunications). Information was gathered through documentation reviews such as regulatory pronouncements and papers as they became available (e.g., Ontario Energy Board statements on Affiliate Relationships, Market Design Committee technical papers) and secondary research in the areas of competition and technology. Customer input was obtained through six focus group sessions (2 with Ottawa

Hydro's commercial customers; 3 with Ottawa Hydro's residential customers; and 1 with non-Ottawa Hydro commercial customers) plus a random telephone survey of 500 Ottawa Hydro residential customers.

The shareholder analysis focused on a review of: shareholder value (risk and return) as well as public perceptions (perception of selling, perception of local control / accountability; and perceptions of supply and rate stability). Information was gathered through financial analysis of the business options being considered (e.g., regulated utility, generation, water heaters, metering, dark fibre, retail electricity, retail gas and, district heating and cooling). A comprehensive analysis of capital structure options and the impacts those structures would have on stakeholders was also undertaken. The public perception information was drawn from the consultation process referred to in the preceding paragraph.

Task Force members agreed on a number of "conclusion statements" emanating from the internal analysis, external analysis, and, shareholder requirements. All of the conclusion statements of the Task Force are provided in Document 1. Highlights of the financial implications of the options are provided in Document 2. Based on an in-depth review of the conclusion statements and accompanying analysis, the Task Force rated each of the five options as having either "high", "medium" or "low" desirability. The ratings received from each Task Force member were placed on an evaluation matrix to assist the Task Force in determining the preferred strategic option to be recommended to City Council (see Document 3). The pros and cons associated with each of the five options are provided in Document 4. Highlights of consultation are provided in Document 5.

Recommendation 1

The tabling of the report on April 15, 1999 to be returned to the Policy, Priorities and Budgeting Committee on May 13, 1999 is intended to provide Council members with the benefit of a careful review of the Task Force materials.

Recommendation 2

The Task Force unanimously agreed that the preferred strategic option is Option 3 which provides that the City of Ottawa retain ownership of Ottawa Hydro's successor entities one of which will operate as a utility regulated by the Ontario Energy Board. The new utility company will provide regulated distribution services to all customers and standard supply service for those customers who do not wish to purchase electricity from a third-party, competitive supplier. Ottawa Hydro's successor companies will continue to offer existing competitive services (e.g., water heaters, metering, dark fibre, and generation; including local sale of its generated output) through companies separate from but wholly-owned subsidiaries of the new utility company.

The main reasons why the retention of Ottawa Hydro to provide its existing utility and competitive services was unanimously endorsed by the Task Force are:

- it retains the value of the business for the shareholder;
- it is seen as the most acceptable option to the public;
- it maintains an opportunity for future growth;
- it represents the least change for both customers and Ottawa Hydro staff;
- it carries acceptable risk for the shareholder;
- it allows for a reasonable return to the shareholder;
- Ottawa Hydro has a proven track record in the businesses being recommended;
- it does not preclude the sell option at a future date; and,
- a sale at a premium is unlikely in current market conditions consisting of a high rate of transfer tax and many regulatory uncertainties.

The retention and continued operation of the existing utility and competitive business activities allows Ottawa Hydro to capitalize on its high brand equity by continuing to operate a low-risk regulated utility (which comprises 95% of its existing business) while allowing for some diversification of its operations (e.g., generation, water heaters, meters and dark fibre) in the competitive market.

The main reasons why Option 1, the sell option, was rejected by the Task Force are because:

- there would be a loss of control by the City;
- the City gains little at this time by selling the utility to the private sector compared to transferring the utility to Ottawa Hydro's successor entities on terms requiring the utility to finance the purchase of the assets from the City with long term debt amounting to about 60% of the value of the assets;
- the City would lose the opportunity to participate in the new electricity market and to grow its investment;
- there is a significant transfer tax of 33% which will apply to the sale proceeds if Ottawa Hydro is sold to the private sector; and
- the City would recover a larger percentage of the sale proceeds later as the transfer tax is reduced by payments made in lieu-of-taxes over the period that the utility is owned by the City.

Option 2, which limits the scope of business activities to utility activities only, was rejected primarily because it would have the utility exit competitive, medium risk, businesses (e.g., water heaters, metering, dark fibre, and generation) in which it is already successfully engaged .

Option 4, the existing operations plus "retail electricity" option, was rejected primarily because competitive retail electricity will be a high risk/low margin business with full competition from very large, established retail competitors.

Option 5, existing operations plus "retail electricity" plus "retail gas and district heating & cooling" was rejected primarily because retail gas is a high risk business with large established retail competitors.

Approval of Option 3 does not preclude the Hydro Corporation pursuing new businesses that hold some promise for enhancing shareholder value in the future. The Task Force determined that the utility could prepare business cases to evaluate possible entry into niche markets (e.g., district heating and cooling or a fixed fee retail offering). Those business cases would be submitted to the board of directors who could implement the proposals subject to compliance with the Shareholders Agreement (the Shareholders Agreement will be drafted and submitted to Council pursuant to Recommendation 7 to follow).

Fiscal Impact of Sale and Retention Options

Any of the options (2 through 5) under which the City retains ownership of the electric utility have financial implications associated with the operation of the utility and competitive businesses as companies incorporated under the OBCA.

Ottawa Hydro currently has an estimated maximum market value of $172-$255 Million and a maximum after transfer tax value of $115-$170 Million (note that no strategic pricing premiums which "special purchasers" may be willing to pay have been included in these values). The regulatory framework and the advice of our consultants support a debt/equity mix of 60/40 which would result in potential debt financing of approximately $100 Million. The actual cash transfer to the city will depend on the source of debt financing. There is also potential for an annual cash dividend. Details of an appropriate debt equity ratio and dividend policy have not been finalized at this time but are proposed to be pursued by the Transition Task Force pursuant to Recommendation 7 of this report.

In terms of impact on the ratepayer, the regulated utility has control over only 13% of the overall cost of electricity; the other 87% will depend on the costs of energy which will be driven by market forces, and the level of Ontario Hydro's regulated transmission charges. As such, the price impacts of the changes occurring in the industry are unknown. When factoring in potential changes to the portion of the overall price that is controllable by the utility/shareholder as well as the "new" rates estimated by Ontario Hydro (which represent the remaining 87% of the price), it is estimated that changes in rates could range from a possible slight decrease to an increase of 94 cents / month on an average residential customer bill (currently $53.72 per month).

The following table summarizes the financial impact on the City and Ottawa Hydro's utility customers of the various options.

	IMPACT ON	
	CITY - REVENUES FROM THE UTILITY	**UTILITY CUSTOMER BILLS** [Note: Distribution charges only 13% of overall cost of electricity - 87% dependant on factors beyond utility's control]
EXISTING SITUATION	Nil	$53.72/month for Average Residential Customer consuming 722/KWH/month
OPTION 1 City Sells to Private Sector	About $115 million + (Assumes minimum value of $172 million less transfer tax of 33% and transaction costs)	94¢/month increase in overall existing monthly bill
OPTIONS 2 TO 5 City Retains Equity Ownership	**A(i)** About $100 million cash **-** if Ottawa Hydro's successor obtains debt financing from a source other than the City OR **A(ii)** About $7 million per annum in interest if City provides the debt financing at 7% per annum **B)** plus (in both A(i) and A(ii) above) up to 9.35% return on equity with related potential annual cash dividends	Nil to 94¢ depending on the extent to which the City wishes to forego its return on equity

Recommendations 3 through 9 - Incorporation and Business Continuance Issues

Throughout the evaluation process the Task Force has been working with the legal consultants to work through the various legal issues associated with incorporating Ottawa Hydro's successor companies, including: selection of an appropriate corporate structure; selection of a "transition" board of directors; selection of an "end-state" board of directors; drafting of a transfer by-law to convey the assets and liabilities of Ottawa Hydro to the successor corporations; and, review of an appropriate shareholder agreement to place constraints on the authority of the directors including the amount of risk the boards of the successor OBCA corporations could assume without prior approval of City Council. Recommendations 3 through 9 deal with these important components of a business continuance plan which will facilitate Ottawa Hydro's transition from a municipal electric utility (MEU) to one or more corporations incorporated pursuant to the OBCA.

Options analysis memoranda and reports were used when considering the restructuring and "Business Continuance" issues pertaining to Incorporation, Corporate Structure, Corporate Governance, Company Names, Operational Leadership, Tax Planning, the essential terms of Transfer Agreements between the City and Ottawa Hydro's successor entities including Price, Financing Options, Share Issuance and the Terms and Conditions of a Shareholders Agreement between the City and Ottawa Hydro's successor entities.

Recommendation 3, 4 and 5

For Ottawa Hydro to carry on its existing business activities beyond November 7, 2000, requires the creation of at least two corporate entities to which the utility and competitive business activities of Ottawa Hydro will be transferred. Although the closing date for the transfer of assets and liabilities to the new corporations can be as late as November 7, 2000, preparations for the transfer of assets related to the utility and competitive business activities needs to be started now.

It is important to note, that any new corporations created by June 30, 1999 will not be "operating" corporations until the transfer of assets and liabilities from the existing Ottawa Hydro to the new corporations has been completed. As such, the new corporations will be "non-operating" companies prior to the effective date of the asset and liability transfer which is expected to be December 31, 1999. The transfer by-law, which is discussed further in Recommendation 7, will be submitted to Council for approval.

Since the utility business comprises 95% of Ottawa Hydro’s existing business activities it is proposed that the utility and non-utility corporations be structured so that the City’s direct relationship as shareholder is with the utility corporation. The corporations carrying on unregulated competitive business activities will be established as wholly-owned subsidiaries of the utility corporation.

Given that current Ottawa Hydro customers are very satisfied with the quality of service provided by Ottawa Hydro, it is important that the company capitalize on its high brand equity by retaining the name “Ottawa Hydro” in its successor corporation’s. The City will work to retain the name Ottawa Hydro in compliance with Ontario Energy Board approved codes.

Recommendation 6

As noted above, the new corporations will not be "operating" corporations until the closing date of the asset and liability transfer prescribed in the Transfer By-law to be approved by Council later this year.

It is proposed that the existing Ottawa Hydro Commission will continue to be responsible for the operations of Ottawa Hydro until the closing of the asset transfer transaction.

Recommendation 7

The City, as the first shareholder of the new corporations, will need to appoint a board of directors to manage the affairs of the corporations while they are in a "non-operating" mode until the effective date for the appointments to the end state Board.

Given that the Task Force has been working for the past six months to determine an appropriate strategic direction for Ottawa Hydro it is appropriate that the Task Force serve as the Transition board of directors, while the new corporations are in non-operating mode, to coordinate the details of transferring assets and liabilities to the new corporations.

Work to be undertaken by the Transition Board will include:

- the drafting of the transfer by-law which will authorize the details of the transfer of assets and liabilities to the new corporations.

- refining the details of the price and form of consideration to the City.

- drafting a shareholders agreement to constrain the amount of risk the board can assume without prior approval of the shareholder.

- drafting a dividend policy which describes how dividends will be determined annually.

A great deal of preparatory work has already been completed by the Task Force legal consultants, Scott and Aylen, to develop drafts of the above-noted documentation and the Task Force will benefit from that work in its capacity as the transition board of directors for the new corporations. All of the above-noted documents will be submitted to Council for approval prior to being executed.

Recommendations 8 and 9

As noted previously, the City, as the first shareholder of the new corporations, will also need to appoint the “end state” board of directors to manage the affairs of the OBCA corporations when they are in an “operating" mode, having acquired the assets and liabilities from the existing Ottawa Hydro Commission.

It is proposed that a selection committee comprised of two members of Council and two individuals from the business community be established as soon as possible to begin the search for the end state board of directors. The transition board and outside professionals, as required, will work to assist the selection committee in its mandate.

A great deal of preparatory work has already been undertaken by legal consultants to develop draft criteria to assist in the identification, evaluation and selection of appropriate candidates for the end state board of directors. That information will be furnished to the selection committee once it has been struck.

Work completed to-date indicates that a board of directors of five (5) members would be appropriate. However, to allow for some flexibility, it is proposed that the size of the board of directors for the utility company be initially five (5) directors with the board authorized to increase its size to a total of seven (7) directors. City council will make all appointment to an enlarged board.

It is proposed that the position of Chief Executive Officer of the utility corporation (now the General Manager of Ottawa Hydro) should be confirmed as a member of the end-state board as is commonly the case with private sector companies.

It is proposed that the selection committee be established as soon as possible and that the end state Board be appointed no later than October 1, 1999 to ensure that the new board has time to gain a full knowledge of the new Corporations before they become operational by the end of the year.

The selection committee's recommendations will be submitted to Council for approval.

Recommendation 10

The recently released regulations respecting the transfer tax make municipal acquisitions more financially attractive than sale to the private sector (i.e., the 33% transfer tax applies only to municipal electric utilities sold to the private sector). Although the Ottawa Hydro Task Force had no mandate to evaluate acquisition options, given the transfer tax regulations and the fact that the Task Force has recommended a retention option for Ottawa Hydro, it may be beneficial to review the business case for the municipal acquisition of other electric utilities.

Consultation

Consultation was undertaken with Ottawa Hydro customers who were segmented into three customer groups: large users; general rate users, and; residential customers. Information was obtained from interviews, focus groups and a random telephone survey of 500 Ottawa Hydro Customers. Highlights of the consultation findings are provided in Document 5.

Disposition

Task Force to coordinate implementation of all Recommendations approved pursuant to this report.

List of Supporting Documentation

Document 1 - Task Force Conclusion Statements [External Analysis, Internal Analysis, and Analysis of Shareholder Requirements]
Document 2 - Financial Implications
Document 3 - Evaluation Matrix
Document 4 - Pros & Cons of Evaluated Options
Document 5 - Consultation Details

Part II - Supporting Documentation — Document 1

Task Force Conclusions Statements
External Analysis, Internal Analysis, and Analysis of Shareholder Requirements.

External Analysis

Competition

- Competition in the area of retail electricity will be a reality once the market is opened.
- There are many players larger than Ottawa Hydro who have the resources and skill sets to be formidable competitors in the retail electricity market.
- In order to compete with these retail electricity competitors and do so profitably, Ottawa Hydro will have to offer many peripheral services, including energy consulting, in addition to the commodity alone.
- In certain public service-related niche markets within the retail electricity market (e.g. fixed prices to some small segments of the population) peripheral services may not be required. However, high profit should not be expected in these service-related niche markets.
- There are many smaller players who will compete in niche markets within the retail electricity market.
- There is a higher risk involved in entering the competitive retail electricity market, and losses are possible unless risk mitigation measures are put in place.
- Putting in place risk mitigation measures will most likely result in relatively small returns to Ottawa Hydro with respect to the related competitive retail electricity offerings.
- Retail electricity competitors will focus on large use and larger commercial customers rather than residential customers because this will minimize the required sales and marketing expenditures.
- Many retail electricity competitors will sell not only the electrons, but also natural gas and a host of other energy and non-energy related services.
- Initially, there will not be significant competition for the metering business in Eastern Ontario.
- The key competition for water heaters will come from the gas companies.
- Dark fibre will not have a lot of competitors (since the typical competitors in this area (Bell, Rogers, Metronet) are more interested in the relatively higher bandwidth revenues).
- There are many competitors in the retail gas market, who will likely attempt to enter the competitive retail electricity market as well. Should Ottawa Hydro decide to enter the retail gas market, a lot of competition already exists.

External Analysis

Regulation

- Performance based regulation will drive efficiencies through the use of incentives/penalties.
- The Standard Supply Services business is a relatively minor impact business that cannot be used to support competitive ventures.
- Regulated operations cannot assist or support non-regulated operations.
- Non-regulated operations cannot place a burden on regulated operations.
- Compliance and reporting requirements may create somewhat of a burden.
- The transfer tax of 33% will significantly impact the cash proceeds if the City decides to sell the utility to someone other than another other MEUs or Ontario Hydro successor companies.

External Analysis

Technology

- There are no new electricity technologies likely to impact the industry in the near future.

External Analysis

Customers

- There is a high level of satisfaction amongst Ottawa Hydro's customer group.
- The majority of large users are likely to switch to a competitive electricity provider within the first two years of competition in an attempt to save money.
- One third of commercial customers will likely switch to competitors within the first 2 years if they are satisfied that they can get better prices elsewhere.
- Most residential customers are unlikely to switch to a competitive electricity provider (this is accentuated by their bad experience with gas deregulation) until the market stabilizes and lower prices are shown to be a reality and that there is no impact to them on reliability of their electricity supply if they switch suppliers.
- Residential and commercial customers, other than large users, would require substantial savings to switch (10-20%).

- Residential customers did not demonstrate any clear consensus with respect to support or opposition to the privatization of Ottawa Hydro.
- Residential customers want Ottawa Hydro to be non-profit in nature.
- Ottawa Hydro is not seen as being a viable provider of gas and most customers will not switch to Ottawa Hydro for gas even if it provided the service.
- District heating & cooling is not a "top of mind" requirement for Ottawa Hydro large customers. If this is to be pursued, it needs to be very focused and business case driven.
- MEU amalgamation is viewed very positively by Ottawa Hydro and non-Ottawa Hydro customers and should continue to be pursued.
- Customers have not yet differentiated between the attribute of reliability and the purchase of the commodity from a retail electricity provider. However, competition will likely make this clear very quickly.
- Customers would like increased communication from Ottawa Hydro about various issues (deregulation, Y2K, environment, etc.).

Internal Analysis

People

- Ottawa Hydro’s workforce is very experienced and technically competent.
- While the labour-management relationship has shown signs of strain (e.g. 1994 strike), there is also evidence of a positive relationship. The state of the existing union-management relationship lends itself to open dialog.
- The management style at Ottawa Hydro is hierarchical and top-down controlled. Even though middle management and employees have been empowered to make decisions on their own, they often defer to senior management.
- To enter a competitive marketplace, Ottawa Hydro will be required to produce a cultural shift that will see employees embrace a more customer-focused, cost-effective, and adaptive environment.
- In conjunction with the OMERS pension offering, succession planning has been addressed by each of Ottawa Hydro’s departments. However, there is a need to define a succession plan around the position of General Manager/CEO.
- There is strong sense of pride and ownership for Ottawa Hydro at both the management and employee levels. There is an opportunity to leverage this sense of pride and ownership amongst employees during the change process.

- There is a high degree of expectation at all levels that change is imminent. Given the anticipation of change, employees may be more responsive to a proactive approach to managing the transition.

Internal Analysis

Infrastructure

- Like other monopolies, Ottawa Hydro is organized functionally which is seen as a major contributor to inefficient and ineffective internal communication.
- Ottawa Hydro has a large current infrastructure / cost base for its regulated and non-regulated business. Competitors will not have this cost base.
- Many of Ottawa Hydro's processes are not centered around the customer.
- Ottawa Hydro's physical plant is a strength.
- Ottawa Hydro needs to review the capability of its computer technology to determine if it meets the needs of the new environment.
- There are systems which require upgrades in order to meet industry requirements.
- Under a performance based regulatory scheme, which is expected to prevail, there will be continued downward pressure on costs. As a result, Ottawa Hydro must continue to look for opportunities to streamline processes and create operating efficiencies.

Internal Analysis

Products/Services Synergies

- It is expected that the regulations may eliminate any potential synergies between retail and regulated businesses.
- There are marketing and distribution synergies between retail electricity, gas, water heaters, and energy consulting.
- Other than for large customers, district heating & cooling and metering will likely have different marketing and distribution requirements thereby eliminating the potential for synergies related to these services.
- Ottawa Hydro's brand equity appears to be high. Ottawa Hydro needs to leverage its high brand equity to its advantage as much as possible in addressing the upcoming industry change.

Shareholder Requirements
Public Perception
• There is not a clear public consensus as to whether or not the City should own a profit-oriented business. Similarly, there is no consensus as to whether or not the City should sell Ottawa Hydro. • Most residents of Ottawa feel that local control and accountability is important, however, this is not one of the most important attributes that customers want in their electricity provider (e.g. other attributes such as reliability are more important). • Supply stability/reliability is the most important attribute to Ottawa residents. • Price stability is a concern for residents, however the concern is lessened by the fact that most customers do not feel that the price will be extremely volatile and the electricity bill for most customers is not a significant monthly expense. It is a belief of Ottawa Hydro, based on years of experience, that seniors and low income families view price stability as very important.

Shareholder Requirements		
Pricing		
Based on market research, it is estimated that the pricing of Ottawa Hydro would fall in the following ranges (note that no strategic pricing premiums which "special purchasers" may be willing to pay have been included in these values):		
	Including Contributed Capital	**Excluding Contributed Capital**
Book Value Multiple	**1 - 1.2**	**.81 - .83**
Applied to Current Book Value	**$212M - $255M**	**$172M - $176M**
Value after Transfer Taxes	**$141M - $170M**	**$115M - 117 M**
Value After Transfer Tax & Transaction Costs	**To be Determined**	**To be Determined**
* This assumes that all funds provided by customers towards the cost of installing facilities ("contributed capital") will be excluded from the investment base on which distribution rates are established. The probability is that the OEB will use the current net book value of the existing investment base for determining rates, and exclude any new contributed capital when determining regulated distribution rates in the future.		

Shareholder Requirements

Regulated Utility

- From a financial analysis perspective, the regulated utility is a low risk business.
- After deregulation, in order enhance the value of Ottawa Hydro to the City as shareholder, the business activities of Ottawa Hydro need to be financed by a reasonable mix of debt and equity.
- The OEB's decision with respect to including/excluding contributed capital from the investment base could have a significant impact on value.
- The market value of the regulated utility is not likely to vary significantly from the book value unless the OEB excludes contributed capital from the investment base.
- The loss of standard service supply customers will have a minimal impact on value.

Shareholder Requirements

Generation

- Generation is a medium risk business. This reflects Ottawa Hydro's belief that the likelihood of rate decreases is low, and their belief that annual production will remain close to the historical average.
- The value of the generation business is highly sensitive to the selling price of power and the production level of the plant

Shareholder Requirements

Water Heaters

- The water heater business is likely worth more than its net book value.
- The water heater business bears medium risk.
- Water heater rentals will require a rate increase after deregulation in order to maintain existing returns, because the introduction of financing and tax costs.
- Returns on the water heater business are very sensitive to price changes.
- The cost of acquiring new customers will not likely justify the benefits unless a significant premium is charged. The market may not accept the necessary premium if competitors are offering lower prices.

Shareholder Requirements
Metering
• The size of the metering opportunity is relatively small. The entire Eastern Ontario market size is less than $0.5M. • The metering business bears medium risk.

Shareholder Requirements
Dark Fibre
• Dark Fibre is a medium risk business. • Current dark fibre leases provide adequate returns to Ottawa Hydro, even when costs are fully allocated. • Ottawa Hydro's current dark fibre leases represent only a small portion of total market potential. However, partnering with other local utilities may be required to capitalize on some of the opportunities.

Shareholder Requirements
Retail Electricity
• Retail electricity is likely a very low margin business. • A large available customer base and high market share gains are required to be profitable. • Retail electricity is a high risk business, particularly when the expected price volatility of the electricity market is considered.

Shareholder Requirements
Retail Gas
• Retail gas appears to be a higher margin business than retail electricity. • A high market share and gross margin percentage are required to be profitable. • Retail gas is a high risk business. • When analyzing the possible venture of retailing gas, the concept of growing an "energy services" company (i.e. one-stop-shopping) in the future should be considered and included in weighing the pros and cons of this venture.

Shareholder Requirements
District Heating & Cooling (DH&C)
• If Ottawa Hydro can partner with the key players that could benefit from DH&C, there is an opportunity for it to be involved in the operation of the DH&C distribution system. • From the City’s perspective it could provide DH&C at a lower overall cost by offering the service through a non-taxable entity. • When analyzing the possible venture of DH&C, the concept of growing an “energy services” company (i.e. one stop shopping) in the future should be considered and included in weighing the pros and cons of this venture.

FINANCIAL IMPLICATIONS

Distribution Rate Regulation and its Impact

Distribution Charges a Small Percentage of Total Bill

Distribution charges will comprise only about 13% of the overall cost of electricity to consumers served by Ottawa Hydro. While Ottawa Hydro's successor can control the level of its distribution charges, it has no control over those costs which make up about 87% of the overall cost of electricity to its customers. The level of these costs will depend upon the operation of the electricity generation market and the level of regulated transmission charges.

The Return Component and Debt/Equity Ratio

The price charged for distributing electricity will now be regulated by the Ontario Energy Board ("OEB"). The regulated rates for distribution will include a return component in order to enable Ottawa Hydro's successor to access debt and equity capital on reasonable terms. The return component in regulated distribution rates, as determined by the OEB, will permit the utility company to recover in rates the costs of its debt financing and an after-tax return on equity at a current rate of about 9.35%. An expert retained by the OEB is of the opinion that a distribution utility of the size of Ottawa Hydro should be able to borrow about 60% of its capital requirements, with the remaining 40% to consist of equity.

The Return Component and its Impact on Customer Bills

If Ottawa Hydro's distribution charges are increased to include the full amount of the return component approved by the Ontario Energy Board and if Ontario Hydro's rate estimates for energy and transmission charges are accurate, then it is estimated that the monthly bill of $53.72 for an average residential customer consuming 722 KWH per month will increase by about 94¢ or about 1.7%.

If the City retains ownership of the utility company then it can, if it wishes, require the utility company to refrain from charging utility customers the full amount of the OEB-allowed return component. On the other hand, if the City sells its interests in Ottawa Hydro to the private sector, then the likelihood is that the private sector owner will charge the full amount of the return component allowed by the OEB. Accordingly, if the City retains ownership of the utility then the distribution charge increase, as a percentage of the total bill for an average residential customer, ranges between 0 and 1.7%. It should be noted however, that refraining from earning a reasonable return may impact Ottawa Hydro's successor's ability to access debt and equity capital on reasonable terms.

Comparison of Ottawa Hydro's Distribution Charges to Others

Ottawa Hydro estimates that the average distribution costs from 1992 to 1996 of utilities within the Ottawa Region are:

- Ottawa Hydro 0.75¢/KWH
- Nepean Hydro 1.07¢/KWH
- Gloucester Hydro 1.01¢/KWH
- Kanata Hydro 1.84¢/KWH

Ottawa Hydro estimates that its distribution cost would increase to about 1.05¢/KWH if it charges the full return component allowed by the OEB. The rates of the other utilities within the Region will be substantially higher if they decide to recover the full amount of the OEB-allowed return component in regulated distribution rates. Accordingly, it is to be expected that Ottawa Hydro's distribution charges will continue to be more favourable than the regulated distribution rates which other utilities within the Region may charge.

Financial Impact of Sale and Retention Options

The recovery of a return component in regulated distribution rates will allow the utility to obtain debt financing for about 60% of the value of its assets. If the City sells its interests in Ottawa Hydro to the private sector then its net proceeds of sale will be reduced by 33%, being the rate of transfer tax which the City must pay towards the stranded debt of Ontario Hydro on a taxable sale of the assets. The City gains little by selling the utility to the private sector compared to transferring the utility to Ottawa Hydro's successor entities on terms requiring the utility to finance the purchase of the assets from the City with long term debt amounting to about 60% of the value of the assets.

By retaining ownership of the utility the City receives the added benefit of any cash dividends paid to equity shareholders, along with control over the distribution component of electricity bills paid by customers of Ottawa Hydro. In addition, the "virtual" taxes paid by Ottawa Hydro's successor entities reduce the amount of any transfer tax payable if the City eventually sells its interests in Ottawa Hydro; so that the transfer tax deduction from the proceeds of a sale some time in the future will be less than the 33% reduction that applies to an immediate sale.

The following table summarizes the financial impact on the City and Ottawa Hydro's utility customers of the various options.

	IMPACT ON	
	CITY - REVENUES FROM THE UTILITY	**UTILITY CUSTOMER BILLS** [Note: Distribution charges only 13% of overall cost of electricity - 87% dependant on factors beyond utility's control]
EXISTING SITUATION	Nil	$53.72/month for Average Residential Customer consuming 722/KWH/month
OPTION 1 City Sells to Private Sector	About $115 million + (Assumes minimum value of $172 million less transfer tax of 33% and transaction costs)	94¢/month increase in overall existing monthly bill
OPTIONS 2 TO 5 City Retains Equity Ownership	**A(i)** About $100 million cash - if Ottawa Hydro's successor obtains debt financing from a source other than the City OR **A(ii)** About $7 million per annum in interest if City provides the debt financing at 7% per annum **B)** plus (in both A(i) and A(ii) above) up to 9.35% return on equity with related potential annual cash dividends	Nil to 94¢ depending on the extent to which the City wishes to forego its return on equity

Document 3

Evaluation Matrix

Desirability of Options H = high desirability M = Medium Desirability L = Low Desirability					
	Option 1	**Option2**	**Option 3**	**Option 4**	**Option 5**
Shareholder Requirements					
• Public Perception	L	H	H	M	M
• Shareholder Value	L	H	H	L	L
Internal Environment					
• People	L	H	H	L	L
• Infrastructure	H	M	M	M	L
• Products / Services	M	H	H	M	M
External Environment					
• Regulation	L	M	M	M	M
• Competition	H	H	H	M	L
• Customers	L	M	H	H	L
• Technology	L	M	M	M	M

Option 1: Sell;
Option 2: Regulated Utility
Option 3: Option 2 PLUS Other Current Competitive Services
Option 4: Option 3 PLUS Retail Electricity
Option 5: Option 4 PLUS Retail Gas and District Heating and Cooling

The Task Force determined that Public Perception, Shareholder Value, People and Customers were the four most important criteria to be considered when selecting the preferred strategic direction for Ottawa Hydro.

Document 4

Pros & Cons of Evaluated Options

Option 1 Sell Ottawa Hydro's Existing Businesses

Pros:

- City would get all cash available out immediately.
- They would be ahead of the market.
- The City doesn't need to be in a "non-core" business.
- By selling, all risk is eliminated.
- The transfer tax impact is eliminated if sold to another MEU or successor Ontario Hydro company.
- The regulator will still protect customers.

Cons:

- There would be a significant transfer tax impact on the current value.
- The City gains little by selling the utility to the private sector compared to transferring the utility to Ottawa Hydro's successor entities on terms requiring the utility to finance the purchase of the assets from the City with long term debt amounting to about 60% of the value of the assets.
- The City could get a better price later due to reduction in transfer taxes from payments made in lieu of tax.
- There would be a loss of control to the City.
- The City would lose the opportunity to participate in this market and to grow the investment.
- There may be a negative public reaction to selling.

Option 2 Operate a Regulated Utility Only (To Provide Distribution Services and Standard Supply Service under Regulated Rates)

Pros:

- They would be focusing on the lowest risk portion of the business.
- fully regulated business - i.e. no competition.
- This reflects the greatest core competency of Ottawa Hydro's people and the quality of Ottawa Hydro's infrastructure.
- There would still be a link between Ottawa Hydro and the customer base

Cons:

- There would likely be a transfer tax on the businesses that would have to be sold (i.e. generation, water heaters, dark fibre, and metering)
- This would limit shareholder value.
- They would have to exit current businesses which:
  - ✓ may result in the shareholder not getting full market value on sale (for instance, if there are limited buyers for these businesses);
  - ✓ could have a potentially negative impact on the Hydro employees.

Option 3 **Operate a Regulated Utility and provide existing competitive services (e.g., water heaters, metering , dark fibre and generation) - *Recommended Option***

Pros:
- This option represents higher shareholder value than option 2.
- Maintaining the status quo would likely receive positive public perception.
- Ottawa Hydro has a proven track record in these businesses.
- There is a market demand for the ancillary businesses in this option, and there is an opportunity to grow these businesses.
- This is the least change from the present which would be positive for Hydro employees.
- This option partially diversifies Ottawa Hydro and will give them some experience in a competitive market.
- The competitive businesses in this option represent lower risk than the competitive ventures in options 4 or 5.

Cons:
- There is somewhat greater risk than on just the regulated business.
- The utility is only giving itself limited exposure to new businesses (i.e. they are not fully diversifying themselves).

Option 4 **Operate a Regulated Utility and Provide Existing Competitive Services PLUS Retail Electricity in the Competitive Market**

Pros:
- There is an opportunity to leverage Ottawa Hydro’s brand equity and increase shareholder value.
- This option provides a broader platform for Ottawa Hydro to become an energy services provider.
- This would allow Ottawa Hydro to meet the needs of customers who did not wish to be served with standard service supply.
- This would allow Ottawa Hydro to explore the niche opportunity to provide a fixed price to customers (which may be at a premium rate).

Cons:
- There is unacceptably high risk in retail electricity.
- There is a low margin in retail electricity.
- Eastern Ontario does not have the critical mass required to carry on retail electricity.
- Ottawa Hydro does not have the required skill sets today for retail electricity.
- It would take an up-front investment in order to get into the retail electricity business.

Option 5	Operate a Regulated Utility, Provide Other Existing Competitive Services, PLUS Retail Electricity in The Competitive Market, PLUS Retail Gas in The Competitive Market And Actively Pursue District Heating & Cooling Opportunities.
Pros: • This is a migration towards a full energy services company. • There may be an market opportunity for district heating & cooling, which also brings with it environmental benefits.	
Cons: • Ottawa Hydro does not have the required skill sets for this option today. • This option carries with it the highest risk. • Retail gas is a difficult market to enter and compete in, and carries a relatively low margin.	

Document 5

Consultation Details

Consultation was undertaken with Ottawa Hydro customers who were segmented into three customer groups: large users; general rate users, and; residential customers. Information was obtained from interviews, focus groups and a random telephone survey of 500 Ottawa Hydro Customers.

The key objectives of the consultation were to obtain information from customers on their:
- key requirements as customers
- current perceptions of Ottawa Hydro
- awareness and understanding of the changes occurring in the industry
- views on the future roles and opportunities for Ottawa Hydro
- likelihood of switching providers, and
- views on the City of Ottawa owning a profit-oriented, competitive business

Residents ~ Key Findings:

- most concerned with reliability, speed of response, and, value for money
- significant majority are either satisfied or very satisfied with Ottawa Hydro
- majority are not very, or not at all likely to switch providers
- majority would require at least 10% savings in order to switch
- many do not believe that deregulation will have much impact on service or price
- 44% of telephone respondents either strongly or somewhat disagree with the City owning a profit-oriented business, while 47% either like the idea or don’t care
- at the same time, 43% of telephone respondents either strongly or somewhat oppose the sale of Ottawa Hydro to an alternative supplier, while 41% strongly or somewhat support this concept
- 63% of focus group participants opposed the privatization of Ottawa Hydro
- significant majority strongly or somewhat support the amalgamation of local Hydros

Commercial Users ~ Key Findings:

- also most concerned with reliability, speed of response, and, value for money
- many do not believe that deregulation will have much impact on service or price
- 35% were unsure whether or not they would switch providers - the rest were fairly evenly split between those that were somewhat likely and those that were not very likely to switch
- majority would require at least 10% savings in order to switch
- opinion was fairly evenly split on privatization of Ottawa Hydro (44% opposed; 34% supported; and, 22% didn’t care)
- 90% supported amalgamation of local Hydros

Large Users ~ Key Findings:

- most concerned with reliability, quality and low price
- large clients are looking for preferential rates
- most would consider switching if prices were 5% lower
- most large users have already been approached by potential competitors
- this group will likely obtain provider through an RFP process
- privatization of Ottawa Hydro is viewed positively
- amalgamation of local Hydros viewed positively
- large users are likely to prefer a full service energy provider