OEB Approves Consolidation of Enersource Hydro Mississauga, Horizon Utilities, PowerStream And Hydro One Brampton Networks

December 28, 2016

Introduction

In April of this year, Enersource Hydro Mississauga Inc. ("Enersource"), Horizon Utilities Corporation ("Horizon"), and PowerStream Inc. ("PowerStream"), three of the largest municipally owned local electricity distribution companies ("LDCs") in Ontario, applied to the Ontario Energy Board requesting approval to amalgamate to form a new utility (named LDC Co for the purposes of the application, but to be formally named at a later date) and for LDC Co to purchase and amalgamate with Hydro One Brampton Networks Inc. ("Hydro One Brampton"), currently owned by the Province of Ontario, under section 86 of the Ontario Energy Board Act, 1998 (the "OEB Act"). Among other matters, the applicants also requested the issuance of a Distributor Licence to LDC Co and the transfer of the current distributors' rate orders to LDC Co.

On December 8, 2016, after a process that included a presentation of the application to the OEB panel and intervenors representing various customer groups; written interrogatories; a transcribed Technical Conference; a five-day oral hearing; and written argument, the OEB issued its Decision and Order approving the consolidation and Licence applications and the transfer of the rate orders to LDC Co. The consolidation of the four distributors will create the largest municipally-owned LDC in Ontario (BPC Energy Corporation [Borealis], which owns 10% of Enersource, will continue to own a small portion of the consolidated utility) by customer numbers and the second-largest licensed electricity distributor in Ontario, serving almost one million customers, with a total rate base of approximately $2.5 billion. The purchase of Hydro One Brampton, for a price of approximately $607 million, is the largest electricity distributor acquisition to date in Ontario. The OEB also observed that the LDC Co application was the first involving multiple distributors coming together to form a single utility, and the first merger application since the release of the OEB's *Handbook to Electricity Distributor* and Transmitter Consolidation in January 2016 (the Handbook). James Sidlofsky, of BLG's Electricity Markets Group, acted as counsel to the applicants.

Key Aspects of the Decision – The "No Harm Test"

The OEB's policies on merger, acquisition, amalgamation and divestiture (MAADs) applications, and more particularly its use of the "no harm test" in considering those applications, were established in the OEB's 2005 decision in a Combined Proceeding in which the OEB considered the principles to be applied to MAADs applications. Since that decision, the OEB has set out and refined its policies on rate-making associated with consolidation in 2007 and 2015 reports (the Reports) entitled *Rate-making Associated with Distributor Consolidation*. The OEB's January 19, 2016 Handbook provides guidance on the process for the review of an application, the information the OEB expects to receive in support of an application, and the approach it will take in assessing whether the transaction is in the public interest.

As the OEB discussed in its Decision, in reviewing an application, the OEB applies a no harm test. That test considers whether the proposed transaction will have an adverse effect on the attainment of the OEB's statutory objectives as set out in section 1 of the OEB Act. If the proposed transaction has a positive or neutral effect on the attainment of these objectives, the OEB will approve the application. In applying the no harm test, the OEB's review primarily focuses on the impacts of the proposed transaction on price and quality of service to customers, and the cost effectiveness, economic efficiency and financial viability of the consolidating utilities. In this case, the OEB found that it "has considered the specific facts in this application and is of the view that the features of this transaction are anticipated within the framework of the OEB's policy and the outcomes are aligned with the articulated policy objective of improving the efficiency of electricity distribution. The OEB finds that the scale enhancements of service delivery embedded in this transaction can be expected to result in long term benefits to customers." Having determined that the proposed consolidation meets the no harm test, the OEB approved the transaction, the LDC Co Licence application and the transfer of the rate orders for each of the applicants and Hydro One Brampton to LDC Co.

Price, Cost Effectiveness and Economic Efficiency, and the Rebasing Deferral Period – benefits for rate payers and incentives for consolidation

In this area, the OEB observed:

The Handbook states that to demonstrate no harm, applicants must show that there is a reasonable expectation based on underlying cost structures that the costs to serve customers following a consolidation will be no higher than they would otherwise have been. The Handbook also states that the impact the proposed transaction will have on economic efficiency and cost effectiveness will be assessed based on an applicant's identification of the various aspects of utility operations where it expects sustained operational efficiencies, both quantitative and qualitative.

In this case, the applicants submit that the effect of the consolidation on underlying cost structures will be positive, that costs to serve customers will not be higher as a result of the consolidation and that the consolidation will have a positive effect on economic efficiency and cost effectiveness.

The 2015 Report established a policy under which a consolidating distributor may choose to defer its next rebasing application (in which the distributor's rate base and costs of providing distribution services are updated) for up to 10 years. The deferral period allows for recovery of costs related to the consolidation and creates an incentive for consolidation. Earnings in years 6-10 that are greater than 300 basis points above the applicable OEB-approved rate of return are to be shared on a 50/50 basis with customers.

In its Decision, the OEB advised that its "incentive framework is intended to provide sufficient financial gains over and above the status quo to incent utilities to seek out merger or acquisition efficiency gains opportunities. The incentive framework is also intended to have customers share in large savings through earnings sharing beyond the 5 year deferred rebasing period."

The applicants selected a 10 year deferral period, and submitted that customers were expected to benefit from the consolidation with regard to the price for distribution service, in that revenues would be lower during the 10 year deferral period relative to the status quo, in which the individual utilities would be rebasing sooner. The OEB agreed, and found that "customers will be not be harmed by the proposed transaction in the short term, and will, in fact, be better off and will likely benefit from the enduring benefits of scale in the long term."

Reliability and Quality of Electricity Service

The OEB stated that

"The Handbook sets out that under the OEB's regulatory framework, consolidating utilities are expected to deliver continuous improvement for both reliability and quality of service performance to benefit customers. The applicants submit that they are committed to maintaining the quality, reliability, and adequacy of electricity service for customers, stating that they currently have a total of six service centres across their service areas which will continue to be used for decentralized functions such as construction and maintenance, trouble response, logistics, fleet services, and metering, such that the adequacy, reliability, and quality of electricity service will be maintained. The applicants further expect LDC Co to maintain and improve upon the five-year average reliability indices and the OEB customer service standard metrics for its customers."

The OEB concluded that no issues of concern were raised by the intervenors regarding the transaction resulting in a potential deterioration of overall reliability. The OEB noted that it "has the ability to monitor the reliability performance of licensed entities on an ongoing basis and also has the authority to intervene and impose corrective action where a licensed entity does not meet established performance expectations."

Financial Viability

The Handbook sets out two primary considerations in this regard – the effect of the purchase price, including any premium paid above the historic (book) value of the assets involved; and the financing of incremental costs (transaction and integration costs) to implement the consolidation transaction. In this case, as is common in MAADs transactions, a premium is being paid for the shares of Hydro One Brampton, and the OEB's policy is that any premium is not recoverable through rates. A combination of debt financing and shareholder contributions is being used to fund the purchase. The OEB was satisfied that "the evidence relating to the proposed financing of the Hydro One Brampton acquisition and the premium to be paid will not impact the applicants' financial viability and finds that the proposed transaction therefore meets the no harm test with respect to financial viability."

LDC Co Distributor Licence and transfer of Rate Orders

The OEB approved the issuance of the new Distributor Licence to LDC Co and the transfer of the existing rate orders to LDC Co. The Licence will be effective (under the new corporate name for LDC Co) when LDC Co is incorporated, and the transfer of the rate orders will take place after notice of the completion of the consolidation has been given to the OEB.

Conclusion

This case represents a landmark decision by the OEB in the largest amalgamation and purchase transaction it has reviewed to date, and the first application to be considered under the January 2016 Handbook. In its Decision, the OEB has clearly articulated its approach to the no harm test and has again recognized that LDC consolidations can benefit rate payers and shareholders alike.

By

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