



Subject: Options for the Future of Tillsonburg Hydro Inc.

Report Number: HYD 23-01

Department: Hydro Operations

Submitted by: General Manager, Hydro

Meeting Type: Council Meeting

Meeting Date: Tuesday, April 11, 2023

RECOMMENDATION

THAT report HYD 23-01 titled Options for the Future of Tillsonburg Hydro Inc. be received as information; and

THAT Council recommends further investigation of the financial and operational impacts of options _____ for the future of Tillsonburg Hydro Inc. and to bring back a report to Council.

BACKGROUND

THI is in the process of preparing a cost of service rate application (CoS) to be filed on August 31, 2023 for rates effective May 01, 2024. Each year the Ontario Energy Board (OEB) publishes a list of key requirements (referred to as filing requirements) that must be included in a rate application for that year. In 2022, the OEB included a new item in the filing requirements for Utilities under 30,000 customers. Below is a copy of the filing requirements.

Distributors with less than 30,000 customers must file information on the extent to which they have investigated potential opportunities from consolidation or collaboration/partnerships with other distributors. This should be contained within a dedicated section of the application and include any conclusions resulting from any investigations, or plans to explore future opportunities.

At the November 29th, 2022 THI Board meeting the board requested that the General Manager bring forward a report containing recommendations with regards to the future of THI which includes: status quo, merger, and sale. The General Manager meet with

the CAO and the Mayor regarding the request from THI board and also referring to section 5.0 of the Memorandum of Understanding and Direction between the Town of Tillsonburg and Tillsonburg Hydro which is presented below.

5.0 TOWN APPROVAL:

The Board shall seek the approval of the TOWN in respect to each of the following matters prior to the BOARD undertaking or causing to undertake, authorizing or approving any of the following matters with respect to THI:

- a) Any changes or amendments to the share structure of THI
- b) Any changes to the business activities of THI as identified in Section 3.0
- c) Entering into any discussions or negotiations regarding a potential merger, amalgamation, divestiture or acquisition of THI or another corporation.

The Mayor, CAO and GM agrees that it would be appropriate to bring a report to council presenting the pros and cons of each of the options in regards to the future of THI.

DISCUSSION

The purpose of this report is to present to council the pros and cons of each of the options for the future of THI and seek feedback and direction from Council if they wish to explore any of these options. Below are the pros and cons of the following options;

- 1) Sale of Tillsonburg Hydro
- 2) Merger of Tillsonburg Hydro with another utility
- 3) Tillsonburg Hydro continuing operating as a virtual utility (Status Quo)
- 4) Separate Tillsonburg Hydro from the Town and operate as a separate entity.

Option 1 – Sale of Tillsonburg Hydro Inc.

The first option is for the outright sale of THI to a third party. It is the sale of one hundred percent of THI shares that the Town of Tillsonburg currently owns. THI is sold as a separate operating entity with the Town having no control over the future operation. Below are the pros and cons of this option.

Pros

- 1) The Town of Tillsonburg will not have any responsibility for the future operating of the utility as that would be solely the responsibility of the purchaser.
- 2) The Town would have available the net revenue from the sale that could be used to;
 - Finance current and future capital projects or use as operating cash.

- Invest in a long term financial instrument and having annual interest income as a replacement of the dividend income the Town currently receives from THI.
- 3) All hydro utility Mergers, Amalgamations, Acquisitions, or Divestitures (MAADs) transactions in Ontario have to be approved by the Ontario Energy Board (OEB). In reviewing the application the OEB will apply the no harm test to the proposed transaction. In applying the no harm test, the OEB primarily focuses its review on the impacts of the proposed transaction on the price and quality of service to customers, as well as the cost-effectiveness, economic efficiency, and financial liability of the electricity distribution sector.

The no harm test will provide some assurance that customers will not be negatively affected in terms of price, reliability and quality of service by the proposed transaction.

Cons

- 1) The Town will not have any control/influence on the operation of the utility which includes;
 - Capital and operating dollars to be invested in the distribution system to maintain and improve reliability.
 - The desired level of service THI customers is currently receiving taking into consideration the demographic of the customer base.
- 2) A sale transaction is subject to tax.
- 3) THI distribution system is in excellent condition. About 80% of THI system has been converted from 4 kV to 27.6 kV. Selling the utility would transfer the benefit of this capital investment to the purchaser.
- 4) The Town will not have control/influence on future rate increases.

Option 2 – THI Merge with another utility

The second option is the merger of THI with another utility. Under this option, the Town of Tillsonburg will have a percentage ownership in the merged company and will have representation on the merged company board of directors. Below are pros and cons of this option.

Pros

- 1) Merger can create synergies and efficiencies which may result from the elimination of duplicate positions or functions leading to lower operating costs such as;
 - Optimization and reduction of staffing levels, which can be achieved through planned retirements; maintaining vacant positions; and natural attrition;
 - Reduction in corporate governance costs, with the consolidation of two boards of directors into a single board of directors;
 - Reduction in information technology costs, such as hardware and software maintenance fees as a result of combining key information systems and reducing third party supports costs;
 - Reduction in future regulatory costs associated with fulfilling regulatory requirements, including the preparation and filing of regulatory applications, including Cost of Service applications;
 - Reduction in overall financing costs (IESO prudential and interest rates on credit facilities and long-term debt) as a result of a strong credit profile and capital structure of the merged LDC.
- 2) Larger utilities tend to have more staff expertise available in house than a smaller utility. E.g. regulatory, engineering, finance, etc.
- 3) The OEB have allowed merged utilities to defer rebasing for up to 10 years after consolidation so as to allow distributors to fully realize the anticipated efficiency gains and offset the costs of integration.
- 4) A larger utility will have the capacity to modernize and adapt to future changes in Ontario's electricity sector, and will have more resources to invest in innovation and new technologies that address the needs of customers.
- 5) A larger utility will have the ability to draw upon a much larger number of operations staff for responding to emergencies or storm restoration efforts.
- 6) Depending on the utility that THI merges with, it may have the benefit of a 24/7 System Control Centre and Outage Management System ("OMS"). Thus helping to improve reliability and quality of service by minimizing the duration of outages.

Cons

- 1) With a merger there are a number of different shareholders depending on the number of municipalities that owns the merged company. This would lead to reduce control/influence over the utility. E.g. If there are 3 or 4 municipalities that own the merged utility the seats on the board of directors will have to be allocated amongst the municipalities leading to reduced/loss of control.
- 2) A merger is a complex and time consuming transaction. It is costly in terms of lawyers, M&A consultants, accountants, etc. All transaction and integration costs associated with consolidation are not recoverable through rates. The transaction costs are the responsibility of each party and the integration costs are absorbed by the merged company.
- 3) Dividend payments to the shareholder could be affected in the first few years after the merger. The merged company will have to absorb all the integration costs while not realizing all the synergies from merger immediately.
- 4) THI is expecting significant customer growth over the next 5 years. If THI were to merge today with another company the shareholder would lose the benefit of the future growth as ownership percentage in a merged utility is based on existing customer counts at the date of the merger.
- 5) THI distribution system is in excellent condition. About 80% of THI system has been converted from 4 kV to 27.6 kV. Merging with another utility would transfer the benefit of these capital investment to the merged company.
- 6) Any saving from the synergies may not have a material impact on a customer's bill as the utility has control of only roughly 25% of a customer bill.
- 7) The level of service THI customers are currently receiving or expecting could be affected depending on the level of control the shareholder has in the merged company taking into consideration THI customer demographic.

Option 3 – THI Continue Operating as a Virtual Utility (Status Quo)

Under this Option, THI continues to operate as is, where THI continues to contract all of the services from the Town of Tillsonburg through the use of the master service agreement to manage the day to day operation of THI. This option is referred to as a virtual utility where THI has no employees. Below are pros and cons of this option.

Pros

- 1) THI is currently operating as a department of the Town and is staffed by Town employees. This model is referred to as a virtual utility. Under this model the Town would retain 100% control of THI via the board of directors and the CAO's office on a strategic, operational and administrative level. This includes operating and capital investment, customer service, etc.
- 2) THI continues to share resources with the Town. E.g. HR, Payroll, IT, Customer Service, Communications, etc. This leads to economies of scales and reduced costs for THI.
- 3) The Town will continue to have control over dividend payment it receives from THI.
- 4) A lot of the expertise and synergies that is achieved through a merger can be achieved through collaboration, shared resources or partnership. E.g. collaboration and shared resources with the Cornerstone Hydro Electric Concepts Inc (CHEC) Electricity Distributor Association, Utilities Standards Forum etc. Some of the items that THI collaborated on with the CHEC group are;
 - The Green Button All-Member Working Group educated members on the requirements, led the vetting and evaluation of third-party vendors, facilitated collaboration within members to save costs and planned the implementation. This resulted in cost savings for members, reduced effort and the assurance of knowing that the project will be guided by the experience and knowledge of the extended group.
 - A group purchase of services by 14 members for the biannual Customer Satisfaction Survey and ESA Safety Survey reduced the cost of the surveys and the standardization allows for easier comparisons between LDCs.
 - The shared training across all portfolios to reduce costs and ensure the courses are delivered professionally and staff are educated on the changes and requirements within the industry. A sample of recent training courses includes: Basic & Advanced Regulatory training, Leadership Training for Operations staff, Basics of Electricity and Electrical Safety Awareness I & II, Managing Customer Relationships, Effective Business Communication, Spring Safety Session and Privacy & Information Access Training.

Cons

- 1) THI is the last LDC in the province that is operating under this model as a virtual utility. All other LDC's have transitioned to separate operating entities from the municipality. Under the virtual model THI faces more scrutiny by the OEB and interveners at rate cases to ensure compliance with the Affiliate Relationship.
- 2) THI has to prove to interveners and the OEB that THI is not subsidizing any of the Town's cost under the virtual model. Thus leading to increase regulatory burden and costs for THI at rate case.
- 3) The OEB currently requires all LDCs in Ontario to work towards a 100% compliance with the OEB Cyber security framework. THI financial systems are integrated with the Town of Tillsonburg. With the virtual model it would make compliance more costly and difficult as the entire Town IT system would have to be in compliance before THI can achieve compliance. However, the costs can be shared with the Town and provides greater protection for the Town.
- 4) THI is required to keep two sets of books. One in accordance with the OEB Accounting Procedures Hand (APH) for regulatory reporting and the other in accordance with International Financial Reporting Standards (IFRS) for financial reporting. However, the Town as a municipal corporation is required to keep its books in accordance with the Public Sector Accounting Standards (PSAS) and as such the Town's financial system is configured in accordance to PSAS.

As a result, THI financial and regulatory reporting are maintained using excel spreadsheets and an access data base which not only increases the administrative burden for THI but is also prone to errors.

- 5) All staff currently working for THI are employees of the Town. This has created some moral issues with the staff as they see themselves as municipal employees performing hydro utility work which is not comparable to the hydro industry.
- 6) At times there are confusions at the THI board between the clear segregation of THI and the Town. E.g. what costs or duties are responsibility of the Town and what responsibility of THI.

Option 4 – THI separated from the Town and operate as a separate entity

Under this option, THI would be separated from Town and operate as a separate entity rather than as a department of the Town. THI would have its' own employees and also continue to contract some services from the Town.

Pros

- 1) With this model the Town would still maintain 100% control of THI via the board of directors. Currently, THI board consists of seven members which includes one shareholder member and six independent members. However, in accordance with the Affiliate Relationship Code the shareholder can have up to two thirds or four of the seven members on the board.
- 2) THI can continue to collaborate and share resources with the Town such as Customer Service, Communications, HR and payroll.
- 3) A lot of the expertise and synergies that is achieved through a merger can be achieved through collaboration, shared resources or partnership as mentioned above under option 3.
- 4) Most utilities in the province, including the smaller utilities, have unregulated affiliated companies that provide an additional dividend stream to their shareholders. With THI operating as a separate entity, it would make it easier for management to explore unregulated business opportunities such as;
 - Streetlight and traffic lights maintenance, sports fields and parks, industrial and commercial lighting services. The Town currently contracts these services to third parties. This is something that can be done through an unregulated company for the Town and other customers in Tillsonburg and surrounding areas.
 - Installing distribution systems for developers. Most of the developers in Tillsonburg contract out the installation of distribution systems in new subdivisions. With the expected residential and industrial growth over the next 10 years in the community, this a good business opportunity for an unregulated company.
 - Installation of EV Charges and other behind the meter electrical services. With the move towards electrification there is an opportunity to work with the residential and industrial customers to install EV charges at homes and work sites.

- 5) THI is required to keep two sets of book. One in accordance with the OEB Accounting Procedures Hand (APH) for regulatory reporting and the other in accordance with International Financial Reporting Standards (IFRS) for financial reporting. However the Town as a municipal corporation is required to keep its books in accordance with the Public Sector Accounting Standards (PSAS) and as such the Town's financial system is configured in accordance to PSAS.

As a result, THI financial and regulatory reporting are maintained using excel spreadsheets and an access data base which not only increases the administrative burden for THI but is also prone to errors. THI operating as a separate company would allow THI to utilize the financial system for reporting and rely less on excel thus reducing the risk of error.

- 6) THI operating as a separate entity would reduce the scrutiny from the OEB and interveners in terms of compliance with the Affiliate relationship code and reducing the regulatory burden and costs.
- 7) There are moral issues with the staff working for THI. They see themselves as utility employees working in a municipal setting which is not comparable to the utility industry. Having THI operate as a separate entity would help eliminate this.

Cons

- 1) The Town would not have the direct control it has today over THI via the CAO's office but would have control over THI through the board of directors.
- 2) Depending on how it structured, the Town could lose control over THI Board appointments.
- 3) THI would lose CAO expertise and oversight on a strategic, operational and administrative level.
- 4) THI would lose the expertise from the Town on strategic, operational and administrative matters.
- 5) The Town would have less authority to manage any mismanagement of the utility.
- 6) There would be administrative burden and costs associated with creating the new model.

CONSULTATION

SLT.

FINANCIAL IMPACT/FUNDING SOURCE

N/A

CORPORATE GOALS

How does this report support the corporate goals identified in the Community Strategic Plan?

- Lifestyle and amenities
- Customer service, communication and engagement
- Business attraction, retention and expansion
- Community growth
- Connectivity and transportation
- Not Applicable

Does this report relate to a specific strategic direction or project identified in the Community Strategic Plan? Please indicate section number and/or any priority projects identified in the plan.

ATTACHMENTS

N/A