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BY E-MAIL

March 14, 2018

Ms. Kirsten Walli
Board Secretary
Ontario Energy Board
2300 Yonge Street, 27th Floor
Toronto ON M4P 1E4

Dear Ms. Walli:

Re: OEB Staff Submission

Application for Approval of Share Purchase, Amalgamation, and related matters – Newmarket-Tay Power Distribution Ltd. and Midland Power Utility Corporation

OEB File Number: EB-2017-0269

In accordance with the OEB's directions, please find attached OEB staff's submission with respect to the above referenced application.

Yours truly,

Original Signed by

Judith Fernandes
Project Advisor
Applications Division

Attachment

ONTARIO ENERGY BOARD

OEB Staff Submission

EB-2017-0269

March 14, 2018

1 INTRODUCTION

On June 1, 2017, Newmarket-Tay Power Distribution Ltd. (NT Power) and Midland Power Utility Corporation (Midland Power) entered into a share purchase agreement, whereby Midland Power agreed to sell, and NT Power agreed to purchase, all of the issued and outstanding shares of Midland Power. Once NT Power has acquired all of the shares of Midland Power, NT Power and Midland will amalgamate and continue as Newmarket-Tay Power Distribution Ltd.

On July 18, 2017, NT Power and Midland Power filed an application with the Ontario Energy Board (OEB) under section 86 of the *Ontario Energy Board Act*, *1998*, S.O. 1998, c. 15, (Schedule B) (Act), requesting approval for the:

- Acquisition of all of the shares of Midland Power by NT Power
- Transfer of Midland Power's distribution system to NT Power
- Amalgamation of NT Power and Midland Power, following the share purchase

The applicants also seek approval for:

- Transfer of Midland Power's rate order to NT Power, under section 18 of the Act
- Cancellation of Midland Power's electricity distribution licence, under section 77(5) of the Act
- Amendment of NT Power's electricity distribution licence, under section 74 of the Act
- A ten-year deferral period for the rebasing of Midland Power's rates and the rates of the consolidated entity
- A proposed Earnings Sharing Plan for years six to ten of the deferred rebasing period
- A variance account to track excess earnings in years six to ten of the deferred rebasing period
- Continuation with current rate riders approved by the OEB for NT Power and Midland Power
- Continuation with existing approved deferral and variance accounts for NT Power and Midland Power

2 RELEVANT REGULATORY PRINCIPLES

2.1 The No Harm Test

In its assessment of applications relating to consolidation transactions, the OEB has applied the no harm test. The no harm test was first established by the OEB in 2005 in the Combined Decision,[1] and has been considered in detail in several OEB decisions. The *Handbook to Electricity Distributor and Transmitter Consolidation* (Handbook) issued by the OEB on January 19, 2016 confirmed that the OEB will continue to apply the no harm test.

The Handbook states that the OEB considers whether the no harm test is satisfied based on an assessment of the cumulative effect of the transaction on the attainment of its statutory objectives. The statutory objectives considered are those set out in section 1 of the Act. If the proposed transaction has a positive or neutral effect on the attainment of these objectives, the OEB will approve the application.

The OEB recognizes in the Handbook, that while it has broad statutory objectives, in applying the no harm test, the OEB has primarily focused its review on impacts of the proposed transaction on price and quality of service to customers, and the cost effectiveness, economic efficiency and the financial viability of the consolidating utilities.

2.2 OEB Policy on Rate-Making Associated with Consolidation

To encourage electricity distributor consolidations, the OEB introduced policies that permit consolidating distributors to defer rebasing of the consolidated entity, thereby providing consolidating distributors with an opportunity to offset transaction costs with any achieved savings.

The OEB policies on rate-making associated with consolidation are set out in a report entitled *Rate-making Associated with Distributor Consolidation*, issued July 23, 2007(the 2007 Report) and a further report issued under the same name on March 26, 2015 (the 2015 Report). The 2007 Report permits a deferred rebasing period of five years. The 2015 Report extended the deferred rebasing period, permitting consolidating distributors to defer rebasing for up to ten years from the closing of the transaction.

Consolidating distributors are required to select a definitive timeframe for the deferred rebasing period. The OEB's expectation is that, when consolidating distributors select a

[1] RP-2005-0018/EB-2005-0234/EB-2005-0254/EB-2005-0257

deferred rebasing period, they have committed to a plan based on the circumstances of the consolidation and that, if an amendment to the selected deferred rebasing period is requested, the OEB will need to understand whether any change to the proposed rebasing timeframe is in the best interests of customers.

The OEB requires consolidating entities that propose to defer rebasing beyond five years to implement an earnings sharing mechanism for the period beyond five years to protect customers and ensure that they share in any increased benefits from consolidation during the deferred rebasing period.

3 SUBMISSIONS

3.1 The No Harm Test

OEB staff submits that it is not clear from the evidence and the interrogatory responses provided in support of the proposed consolidation transaction that the no harm test is met.

In the sections that follow, OEB staff has set out its submissions on each of the factors that the OEB has primarily focused its review on, namely, the impacts of the proposed transaction on: price, quality and reliability of service to customers, and the cost effectiveness, economic efficiency and the financial viability of the consolidating utilities.

Impact on Price, Economic Efficiency and Cost Effectiveness

Price

The Handbook states that a simple comparison of current rates between consolidating distributors does not reveal the potential for lower cost service delivery as these entities may have dissimilar service territories, each with a different customer mix resulting in differing rate class structure characteristics. For these reasons, the OEB has stated that it will assess the underlying cost structures of the consolidating utilities.[2] As distribution rates are based on a distributor's current and projected costs, the OEB has stated that it is important for the OEB to consider the impact of a transaction on the cost structure of consolidating entities both now and in the future, particularly if there appear to be significant differences in the size or demographics of consolidating distributors.

The Handbook sets out that to demonstrate "no harm", applicants must show that there is a reasonable expectation based on underlying cost structures that the costs to serve acquired customers following a consolidation will be no higher than they otherwise would have been. While the rate implications to all customers will be considered, for an acquisition, the primary consideration will be the expected impact on customers of the acquired utility.[3]

Currently, NT Power has its distribution rates set using the Annual Incentive Rate-setting (IR) Index methodology while Midland Power has rates set according to the Price Cap IR methodology.

[2] Handbook, p.6
[3] Handbook, p.7

The applicants have selected a ten year deferred rebasing period. The applicants have stated that the consolidated entity will rebase and harmonize rates in year 11. NT Power projects that at harmonization, residential customers of Midland Power will see a distribution rate reduction as a result of the lower residential distribution rates of NT Power and the efficiencies generated as a result of the contiguous service areas of Tay and Midland.

NT Power anticipates an increase in distribution rates for Midland Power's General Service (GS) customers when rates are harmonized in year 11. In response to interrogatories, NT Power provided an estimate of the quantum of the expected typical bill increases in rates) – for GS<50kW, $160/month (17%) and for GS>50, $1,730/month (15%).[4] NT Power noted that this calculation does not take into account the OEB mandated principles of revenue recovery, cost allocation and rate design nor the effects of a direct connection to the IESO grid that NT Power intends to propose, if the application is approved.

NT Power stated that it expects to mitigate any increases for GS customers by applying, in accordance with the OEB policies in place at the time of rebasing the consolidated entity, gains from efficiencies and lower cost structures expected as a result of the proposed transaction, as well as any overearnings recorded in the variance account for the Earnings Sharing Mechanism (ESM).

Economic Efficiency and Cost Effectiveness

The Handbook sets out that the impact that a proposed transaction will have on economic efficiency and cost effectiveness (in the distribution or transmission of electricity) will be assessed based on the applicant's identification of the various aspects of utility operations where it expects sustained operational efficiencies, both quantitative and qualitative.

NT Power asserted that the significant potential for economic efficiencies and cost effectiveness in the provision of electricity distribution service is precisely why NT Power is proposing to acquire Midland Power. NT Power has submitted that the consolidation of NT Power and Midland Power results in natural synergies due to NT Power and Midland Power's contiguous service territories.[5]

Cost savings are anticipated to arise from efficiencies in business operations – reductions in management and staff through natural attrition (retirement and employee departures), reduced governance costs,(i.e. single Board of Directors), the elimination of duplicate

[4] OEB Staff IR 1-Staff-5
[5] Application, pp. 24-25

memberships and professional fees, reduced fleet maintenance, and reduced consulting costs through redeployment of existing staff resources.

The applicants have estimated that cumulative efficiencies arising from the proposed consolidation transaction result in cost savings of $1.3 million by year 10.[6] The applicants claim that the efficiencies gained will decrease the revenue requirement of the consolidated entity at rebasing and rate harmonization.[7]

As stated earlier, NT Power indicated that it intends to use these efficiencies to mitigate any rate increases for Midland Power's GS customers. NT Power also indicated in response to interrogatories, that the same cost synergy savings of $1.3 million will be used to fund the purchase price premium of $11.9 million.[8]

The applicants have acknowledged that the purchase price premium will not be fully recovered from the efficiencies generated during the deferred rebasing period and will be recovered from the consolidated entity's earnings from year 11 onwards, and specifically from the consolidated entity's return on equity (ROE).

In response to OEB staff's supplementary interrogatories, the applicants submitted that the OEB imposes no requirement that a purchase price premium must be fully recovered from efficiencies generated during the deferred rebasing period and that the matter is a shareholder issue that does not impact electricity distribution ratepayers. The applicants stated that the residual amortization of the premium and transaction costs and expenses will be funded from net income (i.e. return on shareholders' equity) and that this treatment will ensure that ratepayers will pay no portion of the premium and the transaction costs and expenses.[9]

Electricity distribution service to the Tay and Midland areas is currently provided by Hydro One Networks Inc. (Hydro One) through shared 44kV feeders. The applicants' evidence claims efficiencies arising from a proposed future direct IESO grid connection for the Midland and Tay areas. NT Power has estimated that the elimination of losses related to embedded distribution could result in a three percent average savings on Midland Power customers' overall bills.

In response to interrogatories, however, the applicants acknowledged that this is a future project plan which would be included in the Distribution System Plan (DSP) that would be

[6] OEB Staff IR 2-Staff-4
[7] OEB Staff IR 1-Staff-5 (b)
[8] OEB Staff IR 1-Staff-12
[9] OEB Staff IR 2-Staff-5

subject to customer and stakeholder review and comment. The applicants also confirmed that the estimated cost savings from this planned future project have not been factored into the estimated cumulative efficiencies arising from the proposed transaction.[10]

The applicants have indicated that this planned project will either be financed by NT Power and recovered at rebasing, or an Incremental Capital Module (ICM) will be filed during the deferred rebasing period.

Continued Use of Midland Power Name and Branding

Section 6.16 of the Share Purchase Agreement contemplates the continued use of the Midland Power name and branding following the amalgamation.

The applicants indicated, in response to interrogatories,[11] that they intend to continue using the Midland Power name and its related branding in Midland Power's current service territory for during the selected deferred rebasing period of ten years following the closing of the proposed transaction, including on customer bills or invoices as well as maintaining signage existing as at the closing date. The applicants also indicated that they will maintain separate websites for each of the predecessor utilities.

As noted previously, the applicants have requested approval for the cancellation of Midland Power's electricity distribution licence, the amendment of NT Power's licence to incorporate the Midland service area and the transfer of Midland Power's rate order to NT Power.

OEB staff requested information[12] on why the applicants wish to continue to use the Midland Power name and related branding when Midland Power is no longer licensed by the OEB. OEB staff also asked the applicants to explain how the continued use of the Midland Power name and relating branding will not cause confusion for consumers and to comment on the foregone synergies from not being able to consolidate billing, maintenance of signage, etc.

The applicants indicated that "the continued use of the Midland Power brand is intended to be a transitional mechanism … to provide Midland customers with reassurance that, while ownership is changing, customers can expect to experience the same or improved quality

[10]OEB Staff IR-1-Staff-9
[11] OEB Staff IR 1-Staff-4
[12] OEB Staff IR 2-Staff-1

of service…”.[13] The applicants submitted that branding and licensing are mutually exclusive, with branding used to identify and distinguish an organization for its customers, while licensing is a legal requirement.[14] The applicants asserted that continuing the Midland Power brand for 10 years will not create confusion for customers as all bills, correspondence and the Midland Power website will contain a statement that Midland Power is owned and operated by NT Power.

In response to interrogatories[15], the applicants have claimed that no synergies are foregone from not consolidating billing, maintenance of signage, etc., as functions like billing and sign maintenance can be consolidated and that only printed consumer bills will use the Midland branding.

Submissions

Price, Economic Efficiencies and Cost Effectiveness

As stated earlier, the applicants selected a 10 year deferred period until rebasing and estimated that cumulative efficiencies will amount to $1.3 million over the ten-year period. The applicants indicated that these efficiencies will be used to address future rate mitigation that NT Power expects will be required for Midland’s GS customers and will also be used to finance the purchase price premium of $11.9 million.

The applicants indicated an expected rate increase for Midland Power’s GS customers. Their analysis is based on starting with the current rates for each of the consolidating distributors and applying the rate plan approved by the OEB for the deferred rebasing period. In OEB staff’s view, as NT Power’s rates for GS customers are currently higher than those for Midland Power, just the application of NT Power’s existing rate plan for the deferred rebasing period will magnify the rate differential in a dollar sense, although the gap would decrease percentage-wise.[16]

In OEB staff’s view, the efficiencies generated will be insufficient to mitigate rates as proposed by NT Power, particularly considering that NT Power anticipates using these efficiencies to also finance the recovery of the purchase price premium.

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[13] OEB Staff Supplementary IR -1 (a)
[14] *Ibid.*
[15] OEB Staff IR 2-Staff- IR 1 (c)
[16] This occurs because Midland Power’s rates are set under a Price Cap IR annual rate adjustment, with Midland Power in cohort 4 in recent years. As such, distribution rates are adjusted by IPI – 0.45% annually. Newmarket-Tay operates under the Annual IR Index, so rates are adjusted by IPI – 0.6%. All else being equal, the differential between GS rates between the two areas decreases by 0.15% annually.

OEB staff submits that the deferred rebasing period was permitted and the length extended by the OEB from five years to ten years to give utilities sufficient time to achieve savings and efficiency gains to enable recovery of transaction costs, including recovery of any premiums.

While the applicants have stated that the proposal for the recovery of the purchase price premium, transaction costs, and expenses will not impact ratepayers, OEB staff questions the applicants' proposal given the meagre economic efficiencies forecasted to being achieved through this consolidation over a period of ten years and the corresponding benefit to Midland Power's customers, relative to the overall transaction costs, expenses and the premium being paid.

OEB staff also notes that, by the time the consolidated entity rebases in 2029, NT Power will have gone 18 years between rebasings, while Midland Power will have gone 15 years between rebasings. In OEB staff's view, the applicants may see their overall proposal as risk-free, as any under-earnings in a given year could trigger an off-ramp for them to rebase.

The OEB defines the earnings off ramp as plus or minus 300 basis points from the deemed ROE.[17] OEB staff notes that both companies achieved ROEs in the neighbourhood of 9% on average over the past five years. OEB staff also notes that, for 2016,for example, NT Power reported a net income of $3.1M.[18] This represents an 8.01% ROE as reported on their scorecard with a 9.66% deemed ROE underpinning rates.

NT Power provided reassurances and explanations of how the new debt incurred to fund the transaction are being amortized and how ratepayers will be protected from bearing the cost of the debt financing the premium.[19]

Despite these explanations and reassurances, OEB staff notes that NT Power would still be accounting for all of its debt; i.e., all debt would be reported in Audited Financial Statements and reported through Trial Balances and other reporting requirements to the OEB. OEB staff is concerned that servicing of the new debt for financing the premium will decrease net income (return on equity) from what it would otherwise be.

Given that the premium is not allowed in rates, the debt incurred to fund the premium should be a shareholder issue that is not passed on to ratepayers or reflected in the realized (and reported) ROE for regulatory purposes. The ROE reporting is based on the distributors' last cost of service parameters inclusive of deemed ROE and debt in the "rate

[17] Handbook, p. 16
[18] OEB 2016 Yearbook of Electricity Distributors, p. 35
[19] OEB Staff Supplementary IR - 5

base" formula. As such, the "Interest Adjustment for Deemed Debt" in the calculation will affect the determination of the reported "actual" ROE.

To avoid this, there should be a requirement for the distributor to exclude the long-term debt interest expense in its ROE reporting. This would be done by the OEB, requiring as a condition of approval of this application, that NT Power establish sub-accounts (e.g. under long-term debt and interest expense) to record transactions for the long-term debt associated with the purchase premium, essentially separating this debt and interest expense from debt financing "used and useful" assets to provide electricity distribution services to ratepayers. In this manner, the financial amounts are "bifurcated" and not included in the reported ROE.

This requirement would serve two purposes:

1) It would ensure that the debt used for funding the premium is a shareholder responsibility and risk, and not borne by or affecting ratepayers.
2) It would enable calculation and reporting of achieved return on equity on a regulated basis unaffected by this new debt thus not perturbing any under or over earning results.

OEB staff also submits that if the consolidation application is approved, the OEB could also consider ordering NT Power to file a rate mitigation plan upon rebasing which would involve mitigating any cost increases to NT Power's GS customers by having NT Power's shareholders absorb more of the cost increase.

Future Grid Connection

The Midland and Tay areas are presently embedded to Hydro One. NT Power has indicated that it intends to undertake a project to establish a direct connection to Hydro One's transmission system for the Midland and Tay service areas if the consolidation transaction is approved. The applicants have indicated that this project will either be financed by NT Power and recovered at rebasing, or that an ICM will be filed during the deferred rebasing period.

OEB staff notes that the OEB's consolidation policies[20] extended the availability of the ICM for consolidating distributors that are on an annual IR index, thereby providing those consolidating distributors with the ability to finance capital investments during the deferred rebasing period without being required to rebase earlier than planned.

[20] 2015 Report, pp. 7-9 and Handbook, p.17

OEB staff submits that the contemplated direct connection to the IESO-grid is expected to eliminate, in whole or part, low voltage charges in addition to reducing line losses. While NT Power expects to recover the costs for undertaking this project from rate base, OEB staff considers that it is not unreasonable to expect that Midland and Tay customers would benefit from better reliability and lower losses. However, there is little evidence on the record of this application to determine the overall net impact on customer bills given the lack of information on costs and revenues.

Continued Use of Midland Name and Branding

Section 6.16 of the Share Purchase Agreement contemplates the continued use of the Midland Power name and branding following the amalgamation, but it is not clear to OEB staff that this is a critical component of the agreement.

The applicants claim that no synergies are foregone from not consolidating billing, signage maintenance. OEB staff has reservations about this claim and questions the cost effectiveness of the applicants' proposal, particularly given the length of time (10 years) that the applicants are proposing to continue with separate branding and websites. The applicants are proposing to become one entity legally, but are intending to be branded and operate as the predecessor utilities. OEB staff questions how this is reconciled with the OEB's expectations as outlined in the Handbook: "The OEB remains of the view that having consolidating entities operate as one entity as soon as possible after the transaction is in the best interest of consumers".[21]

OEB staff also does not understand how the applicants' plans to maintain separate branding is consistent with the plans for the Midland and Tay areas. These areas are contiguous and plans call for common operations, a direct connection to the grid, and for the Midland operations centre to be used to service Midland and Tay customers. It is unclear to OEB staff how the applicants intend to maintain separate branding given these plans.

OEB staff questions the impact of the applicants' proposals on economic efficiency and cost effectiveness, both of which are factors that are assessed by the OEB in a consolidation application.

OEB staff submits that, if the OEB approves the consolidation application, the OEB should not permit the proposed branding strategy as it is not consistent with the Handbook. OEB staff further submits that the applicants have not provided reasonable explanations for

[21] 2015 Report, p. 7 and Handbook, p.13

deviating from the OEB's policies. In OEB staff's view, the applicants' rationale, that is that the branding strategy avoids customer confusion, is not a good reason and in fact the proposed strategy may lead to more confusion, rather than less.

Earnings-Sharing Plan

The OEB requires consolidating entities that propose to defer rebasing beyond five years to implement an earnings sharing mechanism (ESM) for the period beyond five years to protect customers and ensure that they share in any increased benefits from consolidation during the deferred rebasing period.

The Handbook recognizes that there are numerous types and structures of consolidation transactions, and that there can be significant differences between utilities involved in a transaction.

The Handbook states that the ESM as set out in the 2015 Report may not achieve the intended objective of customer protection for all types of consolidation proposals. The Handbook then goes on to clarify that for these cases, applicants are invited to propose an ESM that better achieves the objective of protecting customer interests during the deferred rebasing period.

NT Power confirmed that as required by the OEB's consolidation policies[22], it plans to implement an ESM starting in year 6 of the deferred rebasing period to share earnings in excess of 300 basis points above the OEB's established regulatory ROE for the consolidated entity, on a 50:50 basis between the consolidated entity and its customers. However, NT Power's proposed ESM is not entirely consistent with the OEB's policy and it has therefore requested the OEB's approval of its proposed ESM.

The default policy is that where an ESM is proposed as part of consolidation, earnings will be assessed each year once audited financial results are available and that excess earnings beyond 300 basis points will be shared with customers annually.[23] However, the Handbook also states that:

> There are numerous types and structures of consolidation transactions, and there can be significant differences between utilities involved in a transaction. The ESM as set out in the 2015 Report may not achieve the intended objective of customer protection for all types of consolidation proposals. For these cases, applicants are invited to propose an ESM that better achieves

[22] 2015 Report, pp.6-7 and Handbook, p.16-17
[23] Handbook, p. 16

> the objective of protecting customer interests during the deferred rebasing period. For example, a large distributor that acquires a small distributor may demonstrate the objective of consumer protection by proposing an ESM where excess earnings will accrue only to the benefit of the customers of the acquired distributor.[24]

NT Power requested that the OEB approve a variance account (ESM Account) in which NT Power will place 50% of any earnings above 300 basis points in years six through ten of the deferred rebasing period.[25]

NT Power proposed that at the end of year 10, any amounts in the ESM Account first be used for any rate mitigation required for Midland Power's GS customers at the time of re-basing of the combined entity and that, if rate mitigation is not required, any amounts in the ESM Account be reimbursed to all customers. NT Power submitted that, in the circumstances of this transaction in which all the customers of the proposed combined entity are anticipated to benefit from consolidation, all customers should be considered to benefit from any amounts that have accrued in the ESM Account.

Submissions

OEB staff submits that NT Power's proposal to use any overearnings for rate mitigation is not consistent with the default policy position, but is instead tailored to respond to the bill impact analysis conducted by the utility for the post-deferral period.

NT Power confirmed in response to interrogatories[26] that, if there are overearnings in years six to ten, that NT Power would consider that they have arisen from the OEB-approved rates paid by all customers and that if rate mitigation for Midland's GS customers is required, the use of these over earnings would effectively result in inter-class subsidization.

However, in OEB staff's view, NT Power has attempted to propose a remedy to deal with the rate differentials between utilities. On its face, OEB staff is not opposed with this approach. However, it is an indication in OEB staff's view of the less than ideal analysis and planning conducted for how NT Power, as consolidated entity, would achieve savings

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[24] *Ibid*., pp. 16-17
[25] OEB staff considers that the possibility of NT Power achieving overearnings on a regulated basis due to, for example, cost efficiencies, remains plausible with the OEB staff recommendation for separation of the debt and associated interest expense in sub-accounts of the established USoA accounts for debt and interest, from the debt and interest expense components associated with debt financing of normal physical assets.
[26] OEB Staff IR 2-Staff-10

over the deferral period. OEB staff notes that the merged company would have a combined OM&A envelope of approximately $10M (based on 2016 data). A forecast of savings in the order of $1.3M represents approximately 1.3% of OM&A over the 10-year period. OEB staff observes that other recent merger applications that have been approved included forecast savings in the order of 11-18% of the total OM&A envelope of the consolidating entities.[27] OEB staff recommends that the OEB could deal with this matter as it relates to the ESM by implementing the recommendations put forth on ROE reporting as set out by OEB staff earlier in this submission.

NT Power was asked to explain why the ESM account is being requested in this application instead of at the time the account is needed in year six and was requested to provide a draft accounting order for the requested account. In its response,[28] NT Power stated that it understood that the OEB would consider and render approval of the ESM account as part of its approval of NT Power's proposed earnings sharing plan but that it seeks the OEB's direction on the appropriate timing to set up the ESM account and will provide a draft accounting order once it is determined that the ESM account is considered part of this proceeding.

OEB staff submits that NT Power can be required to establish the ESM account closer to year six of the deferred rebasing period and provide a draft accounting order at that time.

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[27] Based on Cambridge and North Dumfries Hydro's acquisition of Brant County Power (the amalgamated utility now known as Energy+) (EB-2014-0217/EB-2014-0223) and the acquisition of Hydro One Brampton Networks Inc. by Horizon Utilities, PowerStream and Enersource Hydro Mississauga (the amalgamated utiuility now known as Alectra) (EB-2016-0025/EB-2016-0360).

In the case of Energy+, forecasted savings were estimated to be in the range of $1.2M to $1.5M per year (Decision and Order EB-2014-0217/EB-2014-0223, October 30, 2014, p.5), over the five year period. Based on a 2016 OM&A of $11.759,032 (from the 2016 Electricity Distribution Yearbook) and average estimated savings of $1.35M, this would equate to savings representing 11.5% of OM&A.

In the case of Alectra, estimated savings net of transaction costs were estimated at $426M over the 10-year deferred rebasing period (Decision and Order EB-2016-0025/EB-2016-0360, December 8, 2016, p.9). Relative to an annual consolidated OM&A of $247,668,429 (2016 Electricity Distribution Yearbook), this would equate to savings representing about 17.8% of average annual OM&A pre-merger.

Each utility's circumstances differ. Through its acquisition and amalgamation, Alectra has become the second largest municipally-owned utility in North America. However, Energy+'s situation may be more comparable to that of NT Power's proposed acquisition of Midland Power.

[28] OEB Staff IR 1-Staff-19

Impact on Service Quality and Reliability

The Handbook requires consolidating utilities to indicate the impact that the proposed transaction will have on consumers with respect to reliability and quality of electricity service. The Handbook also sets out that in considering the impact of a proposed transaction on the quality and reliability of electricity service, and whether the "no harm" test has been met, the OEB will be informed by the metrics provided by the distributor in its annual reporting to the OEB and published in its annual scorecard.[29]

The 2015 Report sets out the OEB's expectations that while consolidating distributors can extend the rate rebasing period, all other regulatory requirements, including the requirement to file DSPs every five years remain in effect.[30]

The applicants provided a comparison of SAIDI and SAIFI statistics for NT Power and Midland Power. OEB staff observed that from 2014 to 2016, the SAIDI and SAIFI statistics for Midland Power were lower, indicating better performance than those shown for NT Power. OEB staff also observed that in 2016, NT Power's statistics were at their highest and asked NT Power to explain how the "no harm" test is satisfied with respect to the expected reliability for Midland Power customers in light of the statistics provided.[31]

In its response, NT Power has stated that its SAIDI and SAIFI statistics were better than Midland with the exception of 2014 and 2015 where Midland had exceptionally good reliability. NT Power has also stated that the amalgamation will provide opportunities to implement best practices from both NT Power and Midland Power.

NT Power has stated that it is committed to retaining all of Midland Power's staff members, as well as continuing the existing level of operational capability in the Midland and Tay communities, in order to continue providing the best possible service levels and quality standards to Midland Power's customers. The applicants submitted that this local knowledge, in combination with NT Power's Tay area operations and staff, will allow NT Power to operate the distribution system in a manner that is expected to maintain or improve reliability.[32]

As mentioned previously, NT Power has stated in its application that it sees an opportunity for improving reliability through the direct connection to the grid that it expects to establish for the Tay and Midland areas, if the proposed amalgamation is approved. NT Power

[29] Handbook, p.7
[30] Report of the Board, p.7
[31] OEB Staff IR 1-Staff-10
[32] Application, pp. 22 and 24

submitted that the direct IESO-grid connection enables the consolidated entity to use local resources to service certain outages instead of waiting for Hydro One to address an issue with its system. NT Power anticipates that a direct IESO-grid connection would lead to measurable improvements in outage durations due to loss of supply.

According to the application, the Tay and Midland Power operations and administrative facilities will be consolidated which is expected to result in cost savings. In response to interrogatories,[33] the applicants clarified that Midland Power's existing operation centre will serve Tay and Midland Power customers. The Tay operations centre consists of a yard, shop and administrative building. The shop and yard will be used for vehicle and material storage, while the administrative building is proposed to be leased to a third party at prevailing market rates. The applicants also note that no new operations centre is contemplated.

The applicants submitted that these proposed changes make the most efficient use of the facilities with minimal transition costs and that there will be minimal impact on Tay and Midland Power customers and others that need or desire in-person contact with the distributor as the facilities are within six kilometers of each other.

The applicants were asked to comment on their plans for filing a DSP following the consolidation. In response, the applicants confirmed that NT Power filed a DSP on December 2015, that a DSP will be filed for the Midland rate zone after the proposed consolidation closes, and that a DSP for the consolidated entity will be filed by December 2020.[34]

Submissions

OEB staff submits that based on the evidence and interrogatory responses provided, the amalgamated entity can reasonably be expected to meet service quality and reliability standards currently provided by each of the amalgamating distributors. OEB staff also submits that the OEB is able to monitor performance of the amalgamated entity through performance scorecards as well as the OEB's *Electricity Reporting and Record Keeping Requirements* (RRR).

OEB staff submits that the applicants' proposals for the filing of the DSPs for the Midland rate zone and for the consolidated entity are reasonable.

[33] OEB Staff IR 1-Staff-8
[34] SEC IR 15(d) and 20; OEB Staff IR 2-Staff-14

Impact on Financial Viability

The OEB sets out in the Handbook that the impact of a proposed transaction on the acquiring utility's financial viability for an acquisition, or on the financial viability of the consolidated entity in the case of a merger will be assessed. The OEB's primary considerations in this regard are:

- The effect of the purchase price, including any premium paid above the historic (book) value of the assets involved
- The financing of incremental costs (transaction and integration costs) to implement the consolidation transaction[35]

The purchase price that has been agreed to by the consolidating distributors is $27.7 million. This purchase price includes a premium of $11.9 million. NT Power has indicated that the transaction costs and expenses amount to $1.2 million, which includes $0.2 million that NT Power has agreed to pay Midland Power in respect of Midland Power's transaction costs and expenses.[36]

NT Power explained that it is financing the acquisition cost consisting of Midland Power's book value, premium and transaction costs and expenses through cash (10%) and new term debt (90%). The debt will be amortized over twenty-five (25) years. The cash portion of the acquisition cost will be used to partially fund the premium and transaction costs and expenses. NT Power will account for the debt in two components: a premium and transaction costs and expenses component and a book value component.

NT Power has stated that during the deferred rebasing period, efficiencies will increase the applicants' ROE and this increase will be used to fund the amortization of the premium and transaction costs and expenses component. The residual amortization of the premium and transaction costs and expenses component from year 11 onwards will continue to be funded from ROE. This accounting treatment will ensure that ratepayers will pay no portion of the premium and the transaction cost and expenses.

OEB staff asked the applicants to clarify how the applicants' proposal to recover the premium from the consolidated entity's return on equity beginning in year 11 is consistent with the OEB's expectation that the transaction costs, including the premium, is recovered from efficiencies generated during the deferred rebasing period.

[35] Handbook, p.8
[36] OEB Staff IR 2 -Staff -3 a)

The applicants have responded stating that in their view, the OEB imposes no requirement that a premium paid must be fully recovered from efficiencies generated during the deferred rebasing period, asserting that this is a shareholder issue and does not impact electricity distribution ratepayers.[37]

The applicants submitted that the consolidated entity has ample financial capacity to fund the new term debt (up to $50 million of financing capacity available) over the 25-year amortization period.

Submissions

As stated previously, the efficiencies gained from the proposed consolidation amount to a total cost savings of $1.3 million over the 10 year deferred rebasing period. While the applicants have stated that the recovery of the purchase premium will be accomplished from the estimated synergy savings, there will be an outstanding amount of approximately $10 million that NT Power will be recovering from its return on equity from year 11 onwards.

Although the applicants have stated that the purchase premium will not be recovered from ratepayers, OEB staff submits that if the proposed consolidation is approved by the OEB, the OEB should make clear in its decision that it expects NT Power to track recovery of the acquisition premium, given that a large proportion of the premium is expected to be recovered after the rebasing of the consolidated entity occurs.

OEB staff can accept the applicants' assertion that the consolidated entity has ample financial capacity to fund new term debt, noting in particular, the applicants' interrogatory responses that existing NT Power shareholder debt is being subordinated and postponed.[38] The applicants stated that this results in NT Power's 2016 third party debt to capital ratio being 6.7%, although OEB staff could not verify this ratio for either of the predecessor utilities or the consolidated entity.[39]

OEB staff submits that the confirmation by the applicants that the financial projections and financial ratios for the consolidated entity incorporates the new term financing of the proposed transaction and that NT Power has secured financing for the proposed

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[37] OEB Staff IR 2-Staff-5
[38] OEB Staff IR 2-Staff-7
[39] OEB Staff IR 2-Staff-5

acquisition provides assurance of NT Power's capacity to undertake the proposed acquisition.[40]

The pro forma statements for first year following the merger show no immediate concerns (positive net income). OEB staff has some reservations, however, with 90% debt financing of the purchase. NT Power will be paying (debt) interest to pay off the loan underpinning the purchase, which increases the gearing (debt leveraging). If banks, other financial communities and credit rating agencies consider that the company is over-leveraged, the cost of borrowing, or the ability to borrow, could be negatively impacted in the future.

OEB staff acknowledges that these are hypothetical circumstances, and while there is no evidence of this being the case here (based on the pro forma statements filed), this is a potential risk given the deferred rebasing period of 10 years.

OEB staff does not recommend any further actions or conditions if the amalgamation is approved as the OEB will be in a position to monitor the consolidated entity's financial position during the deferral period.

3.2 Other Requested Approvals

As part of the proposed consolidation transaction, the applicants have requested the OEB's approval for:

- Transfer of Midland Power's rate order to NT Power
- Cancellation of Midland Power's electricity distribution licence
- Amendment of NT Power's electricity distribution licence
- Continuation with current rate riders approved by the OEB for NT Power and Midland Power
- Continuation with existing approved deferral and variance accounts for NT Power and Midland Power

Submissions:

OEB staff does not have any concerns with the approval of these requests if the application is approved. However, OEB staff is of the view that approval to continue with rate riders is not required as rate riders are part of the rate orders.

[40] OEB Staff IR 2-Staff-6

3.3 Conclusion

OEB staff supports the notion of consolidations in the electricity distribution sector. The concerns outlined in this submission may relate more to the quality of the application than the underlying business case for the transaction. It is not clear either way as the onus is on the applicants to demonstrate that the no harm test has been met.

While OEB staff are generally supportive of distributors merging, the business case underpinning that merger must contain sufficient rationale to provide a level of comfort that the applicants have considered and rationalized all aspects of the MAADs policy carefully. In this instance, it appears the applicants are relying on the existence of the policy and the option to elect a deferred rebasing period, on which the OEB should base its approval.

OEB staff notes that the deferred rebasing period was permitted and extended by the OEB from five years to ten years to give utilities sufficient time to achieve savings and efficiency gains to enable recovery of transaction costs, including recovery of the premium.

OEB staff questions the degree of analysis conducted by the applicants given the meagre savings being achieved through this consolidation and the corresponding benefit to Midland Power's customers relative to the overall transaction costs, expenses and the premium being paid.

OEB staff reiterates that the efficiencies generated will be insufficient to mitigate rates as proposed by NT Power, particularly considering that NT Power anticipates using these same efficiencies to also finance the premium. OEB staff also submits that, for the reasons set out in this submission, NT Power's proposal to use any overearnings (if realized) for rate mitigation should require revisions to the reporting methodology used for its ROE and as it will relate to the ESM calculation.

The applicants have indicated an expected rate increase for Midland Power's GS customers. OEB staff submits that there could be harm to these customers, if the cost of serving these customers is higher than the status quo beyond the deferred rebasing period, which appears to be the case based on the bill impact analysis provided. OEB staff acknowledges that the applicants' have made a proposal in this regard, but questions the likelihood that the applicants will realize over earnings at all given their forecast of savings over the deferral period. In OEB staff's view, the recommendation on the parameters to use for the ROE reporting put forth by OEB staff is consistent with the spirit of the applicants' proposals.

OEB staff questions the applicants' proposals for the continued use of the Midland name and branding for 10 years in terms of economic efficiency and cost effectiveness, both of which are factors that are assessed by the OEB in a consolidation application. OEB staff submits that the applicants' proposals are not consistent with the OEB's consolidation policies, i.e. having consolidating entities operate as one entity as soon as possible after the transaction is in the best interest of consumers.

If the OEB approves the application, OEB staff provides the following recommendations for the OEB's consideration:

- Require NT Power to establish sub-accounts of Long-term Debt and Interest Expense accounts to separate the long-term debt and interest expense associated with the debt incurred to fund the purchase price premium from other debt, and associated interest expense, incurred for financing assets used to provide electricity distribution services to ratepayers, and to report RRR and other reporting requirements, including the achieved ROE on a regulated basis absent the impact of the debt incurred to finance the purchase price premium

- Order NT Power to file a rate mitigation plan upon rebasing which would involve mitigating any increases to Midland Power's GS customers by including a sharing plan with the shareholder (i.e. for NT Power's shareholders to absorb more of the cost increase if the ESM is insufficient)

- Reject the applicants' proposed branding strategy

All of which is respectfully submitted