Energy Bulletin

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# LDC Consolidation and the 2015 Ontario Budget: Opening the Door to the Private Sector

By Ron Clark and Francesco Gucciardo

## Introduction

On April 23, 2015, the Ontario Finance Minister released the 2015 provincial budget ("Budget 2015"). Often a non-event from the perspective of Ontario's local electricity distribution companies (LDCs), this year there is much to consider.

## The Ed Clark Report: From Many to Few

On April 16, the Premier's Advisory Council on Government Assets, chaired by Ed Clark, released a report1 (the "Ed Clark Report") that, among other things, envisioned a reduction in the number of distribution utilities in Ontario from over 70 to "at least three or four financially strong distribution players." As an initial step, it recommended that Hydro One Brampton be used as a catalyst for consolidation. This would be accomplished by selling Hydro One Brampton to Enersource, PowerStream and Horizon, three large utilities, as part of a merger of those LDCs.

The Ed Clark Report also identified the tax regime as an obstacle to achieving efficiencies through consolidation.

## Budget 2015: Walking the Walk

Budget 2015 picked up where the Ed Clark Report left off, noting that:

> Moving forward with the proposed merger of Hydro One Brampton and three other urban LDCs would create one of the largest LDCs in the province by number of customers, and provide an additional catalyst for further consolidation in the provincial electricity distribution system.

## How We Got Here

Ontario's power sector was restructured around the year 2000, requiring, among other things, municipalities to "corporatize" their distribution assets. This resulted in a wave of mergers and sales, often to Hydro One.

By the end of 2000, Ontario's electricity distribution sector contracted from over 300 distributors to around 90. Since then, a continuing trend of mergers and sales has further reduced the number to a little over 70 today.

When the electricity sector was originally restructured, the Province introduced a transfer tax equal to 33% of the gross value of any electricity assets subsequently sold by a municipal electricity utility ("MEU") less any payments in lieu of (federal and provincial income) taxes (PILs) paid by the MEU up to the time of subsequent transfer. The transfer tax and PILs were imposed, in part, to compensate the Province for the initial "free" step-up in cost of such assets transferred by municipalities to MEUs under the initial transfer by-law in November 2000 and to level the playing field of the MEUs with taxable corporations.

Many have commented that the transfer tax effectively froze the private sector out of mergers and acquisitions with municipally-owned LDCs (which constitute the vast majority).

Energy Minister Bob Chiarelli had signalled his intention to accelerate the consolidation process in order to "bend the cost curve" of electricity. He even went so far as to deliver that message to the annual meeting of the Electricity Distributors Association held last March, hinting that many of the LDCs represented wouldn't be around in another few years.

## Opening the Door to the Private Sector

Recognizing that the transfer tax is an impediment to consolidation, Budget 2015 proposes to provide the following relief from the transfer tax for transfers occurring during the period beginning January 1, 2016 and ending December 31, 2018:

- Reduce the transfer tax rate from 33% to 22%; and
- Exempt MEUs with fewer than 30,000 customers from the transfer tax.

MEUs are generally exempt from federal and provincial income taxes. However, the *Electricity Act, 1998* imposes PILs on MEUs, which basically emulate federal and provincial income tax rules. One such rule provides that when an MEU ceases to be exempt from federal and provincial income tax (e.g. no longer owned 90% or more by municipal shareholders), the MEU is deemed to dispose of all of its assets for fair market value proceeds. The resulting gain is subject to PILs. Recognizing that consolidation might cause an MEU to lose its tax-exempt status, Budget 2015 proposes to exempt capital gains arising from such a deemed disposition from tax under the PILs regime. The exemption will apply for deemed dispositions that occur during the period beginning January 1, 2016 and ending December 31, 2018.

## Shifting Sands

According to Budget 2015, through these consolidation initiatives, Ontarians will benefit from a modern and more efficient electricity sector that will benefit ratepayers. In the past, most municipal owners of LDCs have resisted the urge to merge, wishing to preserve local control and identity and arguing that cost savings would be marginal.

[1]"Striking the Right Balance: Improving Performance and Unlocking Value in the Electricity Sector in Ontario," issued by the Premier's Advisory Council on Government Assets (made up of Ed Clark (Chair), David Denison, Janet Ecker, Ellis Jacob and Frances Lankin), dated April 16, 2015.

However, with the Horizon, Enersource and PowerStream transaction centered around the acquisition of Brampton Hydro, together with changes to the transfer tax and departure tax regimes, the issues around industry transformation will once again be front and centre for MEUs.

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