

# Energy Bulletin

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## Chainsaw Don says “Tighten Your Belt”: The Drummond Report and LDCs

By Ron Clark

February 17, 2012

### Overview

On February 15, 2012, the Commission on the Reform of Ontario's Public Services released *Public Services for Ontarians: A Path to Sustainability and Excellence*, and known more commonly as the “Drummond Report” after the Commission's Chairperson. The Report delivered a blunt message: the provincial budget cupboard is bare. Doctors' wages, casinos, even full day kindergarten are all on the chopping block. Is there any reason to think the electricity distribution sector will be spared?

The answer is “no.” Drummond takes direct aim at LDCs. His recommendation is:

Consolidate Ontario's 80 local distribution companies (LDCs) along regional lines to create economies of scale. Reducing the \$1.35 billion spent on operations, maintenance and administrative costs for Ontario's LDCs would result in direct savings on the delivery portion of the electricity bill ... Larger regional entities might allow for economies of scope as well as scale, allowing greater participation in planning, design of conservation programs and expanding responsibilities to deliver other resources such as water.

Drummond also advocates the elimination of the punitive 33% transfer tax on sales of LDCs to the private sector. He advocates “a co-operative federal-provincial tax arrangement that returns to the province any federal corporate taxes paid by newly privatized electricity utilities.”

### Options for LDCs

How should LDCs respond? Clearly LDCs will need to continue to drive efficiencies. However, at a strategic level, they have a number of options:

- **Status Quo:** Hunker down and wait out the storm? This has worked before and it may work again. Many an LDC has been out in front of government policy, incurring time and

expenses to be among the first to implement new initiatives, only to find that a u-turn in government policy has meant that these investments have been wasted. This time, however, when the music stops, an LDC that has not been searching for synergies and economies of scale may find that others that have will have achieved the size and scale to dictate terms.

- **Merger:** Lessons from Barrie and St. Catharines, on the one hand, and Guelph and Haldimand County, on the other, show that the right process must be established or a merger will not receive shareholder approval, let alone achieve the desired synergies and economies of scale. Serious questions must be asked including:
  - i. How to ensure that the LDC and the municipality are on the same page?
  - ii. What is sought to be achieved by the merger?
  - iii. Who is the right partner in terms of size, proximity, corporate culture and goals?
  - iv. What protections are needed in relation to activities and jobs that should remain in the municipality?
  - v. What governance arrangements, board appointments and voting percentage are appropriate?
- **Sale:** Sale of a utility by a municipality will always be fraught with political repercussions, even more than a merger. While ratepayers could benefit, jobs and a company will likely be lost. However, for a municipality that wants to create synergies and no longer wishes to be in the electricity business, this could be the right decision. Once the political issues are overcome, a key consideration will, of course, be price. On the flip side, a purchaser will need financing, a good understanding of the company being acquired and an accurate way of calculating the right price.

- **Strategic Investor:** A very interesting new model involves Collingwood's approach. It recently approved the entry into an agreement to sell half of the shares in its LDC to PowerStream. This transaction represents an innovative structure, balancing acquisition of expertise, synergies and economies of scale with retaining the utility, and its assets, jobs and corporate identity, while still monetizing the town's investment in a significant way.

### Privatization?

Advocating elimination of the transfer tax is Drummond's early Christmas present to pension funds that love infrastructure, have long time horizons and are able to use tax advantages in these types of acquisitions. For example: Borealis' 10% holding in Enersource now looks like a potential beachhead for further

acquisitions. Other pools of capital, including private equity and large electricity players such as Brookfield and TransAlta may also start taking an interest in the sector. Corix' stake in Chatham-Kent (now Entegrus), also bears watching.

### The Biggest Challenges Yet?

In recent years LDCs have faced immense challenges around corporatization, regulatory changes, connection of new renewable energy facilities, smart meters and new CDM initiatives, to name a few. However, should the provincial government and the Ontario Energy Board fully adopt Drummond's recommendations, the coming years may see the greatest transformation yet of the electricity distribution sector in Ontario.

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