Presentation to the Ontario Energy Network

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Good morning, everyone. When I first started working for Fortis back in 1998, Fortis' was a $700 million company, I remember meeting with our CEO, Stan Marshall at the time and he talked about his vision of becoming a major player in Canada and North America in the regulated utility sector. It seemed pretty exciting at the time so I jumped on board.

Fast forward to 2013, Fortis today is the largest investor-owned distribution utility in Canada:

- With total assets of more than $15 billion, serving more than 2 million gas and electricity customers, Fortis and its utilities have raised almost $4 billion in the capital markets since 2008.

- With regulated electric utilities in five Canadian provinces and two Caribbean countries and a regulated natural gas utility in British Columbia, Fortis is not just an investor, we are operators of these companies.

- Fortis has increased its common share dividend for 40 consecutive years, the longest record of any public corporation in Canada.

- Over the last decade, Fortis has invested almost $7 billion in its consolidated capital programs and in the next five years we will invest another $6 billion (6% annual growth in rate base).

In 2012, Fortis entered an agreement to acquire CH Energy Group for $1.5 billion with its main business being Central Hudson Gas & Electric a regulated utility serving 375,000 electric and gas customers in a region north of New York City. This deal is expected to close in the 2nd quarter of 2013.

Well, I have a confession to make. When we first established FortisOntario as a holding company in 2002, as a brand new wet behind the ears CEO, I was a bit naive to think that we would be able to acquire 500,000 customers by the end of the decade and become a utility similar in size to some of Fortis' larger LDCs in other Provinces.

Looking back on it now, what I failed to fully appreciate at the time was just how much of a detrimental impact the Province's 33% transfer tax would have on preventing private sector players like Fortis from making investments in Ontario's distribution sector.

The other fact that I didn't understand coming from a private sector utility in New York State, was the degree of sentiment for public ownership of hydro companies given the long history in the Province with a number of smaller utility commissions having existed for a long period of time (100 plus years in some cases).

FortisOntario has the distinction of being the only remaining investor-owned electric distribution utility in the Province of Ontario. We own and operate regulated electric T&D businesses through our wholly owned subsidiaries, Canadian Niagara Power, Cornwall Electric and Algoma Power. I should also point out that all three of these companies have been operating as privately owned utilities in the Province for over 100 years as well.

FortisOntario also owns regulated transmission assets in the Niagara and Cornwall areas; including an international transmission inter-tie between New York and Ontario as well a 10% strategic interest in three other electric distribution companies; Westario Power, Rideau St. Lawrence and Grimsby Power.

In spite of having both hands tied behind our back by the transfer tax, we have managed to acquire $175 million in new electricity assets and have invested over another $120 million in new capital upgrades to enhance safety and reliability of these power systems.

It's rather telling to note, however, that the majority of the assets we acquired were from other private sector owner/operators with the exception of Port Colborne Hydro, which was a 10 year operating lease, following which we acquired outright in April 2012; at the end of the lease period for a pre-determined amount.

Our team in Ontario is certainly proud of our accomplishments having transformed our business in Ontario from a legacy hydro generator; Canadian Niagara Power Company on the Niagara River (with water rights that expired by treaty in 2009), into the 12th largest electric distribution company operating in close to 50 communities in the Province.

The reality is, company's like Fortis want to invest in Ontario, but can't get their investment dollars into the Province. Fortis' investments in Ontario, relatively speaking, have been small when compared to the investments made throughout Canada and North America.

Most of these dollars fly over Ontario from our corporate office in Newfoundland landing in Alberta and BC where private sector investment in regulated utilities is welcomed.

As a former Director for FortisBC and a current Director on the Board of FortisAlberta, I've seen firsthand, the hundreds of millions of dollars being invested each year in these utilities to upgrade and expand their power systems, which are serving as a catalyst for these Provinces continued economic growth and prosperity.

I would like to see a lot more of that capital being put to work right here in Ontario**!**

The problem is that Ontario is essentially a **closed shop** when it comes to any material private investment in the electricity distribution sector.

The concern for the lack of private investment in Ontario becomes even more apparent when one looks at some of the findings highlighted in the Report of the Ontario Distribution Sector Review Panel issued at the end of 2012.

For those of you who may not be familiar, this report was prepared by a Bi-Partisan, three person panel; chaired by Murray Elston, along with former OEB Chair Floyd Laughren and David McFadden, partner at Gowling Lafleur Henderson, with support from staff at the Ontario Ministry of Energy.

In my opinion, it's no exaggeration to say that the Panel's work, which was focused on providing the government of Ontario with recommendations on improving overall efficiencies of the Distribution Sector, is the most extensive research done to date in Ontario since Bill 35 was first enacted in 1998. By my count the Panel met with over 85 different presenters and stakeholder groups over the course of many months before issuing their final report.

The Panel identified the transfer tax as a significant barrier to the consolidation of the distribution sector and recommended that the Province of Ontario enter into discussions with the Federal government on a tax agreement that would facilitate the removal of the transfer tax on the sale of LDC assets.

The need to reform the current tax policy was also addressed by C.D. Howe Institute's most recent report issued in March, which said, "The government's policy should be one of neutrality between private and public investment and that this neutrality can be achieved by eliminating taxes on sales of LDCs to private companies."

To provide some context around what the Panel and C.D. Howe are concerned about here, let me put a pencil to it for you. FortisOntario participated in an RFP to acquire 100% interest in a municipally-owned LDC. The sale process was opened up to a number of interested proponents since the seller wanted to ensure that they received the maximum FMV for the sale of their company.

On a no names basis, let's say the business could sell for $70 million as FMV of the enterprise. There were not one, not two, but three separate non-competitive penalties that Fortis would have had to pay; being a private sector company that Hydro One and the Municipal LDCs interested in acquiring this business would not have to pay.

Between the transfer tax, departure tax and a break free on retirement of Ontario Infrastructure (low interest) loans we would have had to overcome a $20 Million penalty in making our bid for the Company (almost 30%).

Said another way, if this were a 100 metre race, we would be spotting our competitors about 30 metres out of the gate.

So, if I'm a shareholder of an LDC in Ontario and I'm potentially interested in a divestiture or a merger of my assets, I have to ask the question; is there really a true competitive market for this kind of a transaction given the fact that at the present time, the private sector isn't able to make a bid on the same basis as the public sector due to the transfer tax and other non-competitive tax penalties? The obvious answer is No!

I'm sure that there are a number of private sector investors and operators, some of which are in this room today, which have access to capital with deep pockets who are very interested in participating in these kinds of transactions. It raises the legitimate question as to how much value is being left on the table if those shareholders can`t market their assets to the private sector.

It's like trying to sell your home to a limited set of buyers vs. having access to the MLS. Markets can and do work!

The irony here is that Ontario has encouraged private investment in the generation sector with Bruce Power being a great example. Also, as we speak there are a number of large private investors (including FortisOntario), competing for the construction of the East West Tie; a 400 km, 230 kV transmission line under the OEB's new competitive designation process. In fact, all of the players competing for designation are private companies with the exception of HydroOne (who has partnered with a private company).

It's time to open the distribution sector up for these same kinds of private investment opportunities.

When Tom Mitchell, The President & CEO of OPG spoke at the OEN in December, he stated that "He rejected the view that public business is always good; and a private one is always bad. He equally rejected the opposite view that only the private sector can get things done and the public sector is hopelessly inefficient."

He also pointed out the fact, that the Conference Board of Canada estimates that over the next two decades, renewal of Canada's electricity infrastructure will require an investment of nearly $350 billion.

There is no doubt that Ontario's distribution sector will need billions of dollars as well, in the next 20 years to maintain current networks, install smart grid technologies and service new customer requirements. Any estimates that I've seen are likely on the low side when one considers the dollars that will be required just to connect more distributed generation and renewables to the grid plus the future requirements for electric vehicles.

To further underscore this point, the Panel's Report referenced: *The Province's Task Force on Competitiveness, Productivity and Economic Progress* which stated: ***"Ontario businesses have under invested in machinery, equipment and software relative to their counterparts in the United States, so that the capital base that supports workers in Ontario is not as modern as that of their counterparts in the peer states."***

We also know that from various published data, Ontario has a significant deficit for its other infrastructure such as roads, bridges, water and wastewater. This situation is only magnified in the smaller communities who often don't get the same level of funding as the larger urban centres.

The reality here is that electric utilities are a critical part of the overall infrastructure that will be needed to support the future economic growth and viability of our province. With that in mind, doesn't it make more sense to increase the opportunities for new investment in the sector rather than to continue to hold it back?

The Electricity Distributors Association (EDA), which FortisOntario is a member, has recommended that the private sector be allowed to purchase up to 49% of a municipal LDC on a tax efficient basis. C.D. Howe in their recent report also identified a move to 49% private ownership as one of two possible options to increase private investment in the sector given the large spend that's looming on the horizon.

While, I would agree that this can be viewed as a step in the right direction, any new policies that place artificial caps that restrict the level of private sector ownership send a <u>conflicting</u> message to potential investors at a time when we should be encouraging more investments rather than setting new limits on the percentage of ownership.

By the way, I recently heard a good parallel of what it means to send a <u>conflicting message</u>. As the story goes, a young man decided to pursue a career as a Veterinarian. At the same time he also received his certification as a Taxidermist. When he opened his new office, the sign on the front door read, "Either way your pet goes home with you."

I agree with C.D. Howe when they said that government should be <u>agnostic</u> as to the size of utilities and should focus on enabling individual municipalities to seek amalgamations with other public utilities and private investors ranging from partial investments to outright sales. By not restricting the ownership level, you are creating a fully competitive market for distribution assets, which will in the long run lead to improved valuations and the free flow of capital in the sector.

I've been saying for a number of years that part of our future growth as a company will undoubtedly come in part, from forging successful public/partnerships like what we did with the City of Port Colborne. We entered into a 10 year operating lease with the City for their utility and this past April we acquired the utility for a predetermined amount.

When asked, Mayor Vance Badawey stated that:

"***The City of Port Colborne is undergoing the largest capital investment program in its history. Our strategic partnership with FortisOntario has allowed us to accelerate $65 million in capital projects over the last three years with no impact to our property taxpayers. FortisOntario's significant investments over the last 10 years have enabled our City to move forward with an updated and reliable electricity system in support of our current and future economic development."***

In the case of Port Colborne, there is another point that Mayor Badawey would want to make if he were here today, and that is around the issue of "risk transfer". In all businesses there is an element of risk. In the distribution business, for example there are a number of inherent risks such as system failures, major weather events, safety, environmental, regulatory and of course energy policy risk just to name a few.

When the private sector invests in municipally-owned distribution assets there is an inherent transfer of risk from the taxpayer (the underwriter of the public ownership) to private sector investors that takes place. Port Colborne made a conscious decision to off load that risk, which in turn freed up taxpayers' dollars for other important infrastructure investments. Other like minded communities might decide to use these dollars for things like transportation or water and sewer upgrades as an example.

I think we need to be concerned about whether Ontario could be a heading towards a two tier system with some regions and communities served by utilities that have modernized systems and those that are continuing to fall behind. The lack of investment in certain jurisdictions will make it extremely unlikely that our industry will be able to implement a regional and integrated approach to system planning and smart grid technology in a timely manner.

It's important to clarify, that from a regulatory standpoint, we do have a level playing field in Ontario since the electricity distribution sector is regulated by the Ontario Energy Board. As a result, every private or public utility, whether big or small, basically plays by the same rules. The revenue requirement, operating expenses and capital plans are approved by the regulator. Each LDC must go through a rigorous process to justify the prudency of their costs and operating plans before the regulator.

As a regulated LDC operator in Ontario, Fortis supports a commercial and voluntary approach to achieving consolidation of our industry. Minister Chiarelli's recent remarks and his March 19th letter to industry stakeholders have made it abundantly clear that our current Government will not legislate or force consolidation within the sector.

He also said that our industry must be focused on "bending the cost curve" through efficiencies and that part of the solution will be voluntary consolidations on a commercial basis.

The Minister also asked for our input on the Panel's report, as well what changes we would like to see in the sector to create and deliver more efficiencies and savings to our rate payers.

Well the first thing I would say to the Minister is that we don't need another study to tell us that it's time to take the shackles off private investment in the electric distribution sector in Ontario.

Secondly, I would offer a phase one solution assuming that it may take a little time to broker a deal with the Feds on a full 100% abolishment of the transfer tax.

This solution is not a new idea. It's been out there for some time and has had traction with a number of key staff and bureaucrats at Queen's Park in the past but we could never seem to get the ball over the line. I know this because we first brought this recommendation forward when my kids were still in high school. On the family front, I`m pleased to report that all three children, now graduated from university, are happily married and we have our fourth grandchild on the way.

All kidding aside, we are recommending that the Province, as a first step, eliminate taxes on the sales and mergers of municipally-owned utilities to the private sector, for those LDCs with a customer base of 25,000 and under, which represents close to fifty (50) of the remaining LDCs.

This move will remove some of the barriers to private sector investment in the distribution sector, and (as the C.D. Howe Institute suggested), facilitate the experimentation and trial and error that is required to separate successful mergers from unsuccessful mergers while taking place on a commercial and voluntary basis.

This policy will also help to encourage a number of other benefits including to:

- Support the achievement of improved scale economies where they exist through the merger of certain LDCs.
- Facilitate municipal shareholders greater flexibility to undertake a "portfolio review" of the same nature as what is occurring at the provincial level.
- Utilize a phased in approach to achieve momentum around consolidation in the sector.
- Provide for a tax efficient approach since the Payment in Lieu Taxes (PILs) historically paid by the LDCs with 25,000 customers and under is immaterial when compared to total provincial PILs collected (i.e., less than $10M).
- Ensure a time sensitive approach since this change in regulation doesn't require a special deal to be made with the Federal government, but a simple amendment to the existing regulations by Cabinet.

To my mind, this policy can be best characterized as empowering smaller municipalities with more options. If you open up Ontario's LDC sector to private investment, I predict that the amount of dollars that will flow into the sector and into the Province will be transformational.

I think, one of the best points that the Panel made in their final report was that, ***"Transforming the distribution sector from the status quo, if it wants to help and not hinder future economic success, will require a change in the attitudes and policies of a number of players currently involved in the sector. Everyone from the LDCs and municipalities to the provincial government and the OEB, must work together to ensure this new vision of distribution takes root and flourishes in Ontario."***

As an industry, we are at a defining period in our history and I feel strongly that we need to take the lead. There is no doubt our industry will be under the microscope now more than ever.

In addition to the huge capital spend that`s looming, finding ways to soften the impact for consumers of the rising cost of electricity, through energy conservation and operational efficiencies will be of paramount importance.

As well, the Ontario Energy Board's move to a more outcomes or performance based regulatory environment underscores the regulator`s expectations that LDCs must keep their eye on the ball when it comes to efficiency, quality and reliability of service.

But in order for us to take the lead we need the Province to implement a new tax policy that enables neutrality between private and public investments while also supporting the Province's electricity policy goals, such as new investments in smart grid technologies and improved efficiencies as Minister Chiarelli has highlighted.

In conclusion, it's my humble belief that if the Distribution Sector is opened up to more private investment, you will see a variety of transactions emerge in our sector. Not just outright sales, but also some new and innovative public/private partnerships structures, which can become a catalyst for major industry wide renewal and innovation.

I may still have a bit of that young, naive CEO left in me, but given the tools, I believe that our industry can and will take a leadership role in addressing the needed restructuring. Absent these reforms, private investment will continue to go elsewhere searching for a home.

One thing we can hopefully all agree on; the Status Quo is not an option!

Thanks again for the opportunity to be here today.