

# MEMO

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**TO**                   **Members of City Council**

**DATE**               September 25, 2008

**FROM**               Mayor Karen Farbridge

**SUBJECT**           **GHESI /Horizon Merger**

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## **Position on merger recommendation**

As the Shareholder Representative on the Guelph Hydro Inc. (GHI) Board of Directors, I support the recommendation to merge Guelph Hydro Electric Systems Inc. (GHESI) with Horizon Utilities Corp. (Horizon).

## **Context**

Industry consolidation is being driven by regulatory pressures, the capital needs of utilities and increased consumer advocacy (e.g. industrial and commercial sectors seeking rate harmonization).

The GHI Board of Directors has been delegated the responsibility by Guelph City Council to manage the business and to “enhance the value of the Corporation (GHI) and its subsidiaries (GHESI & Ecotricity)”. The GHI Board unanimously recommends the merger with Horizon to respond to industry changes being driven by the Province of Ontario and the Ontario Energy Board (OEB), as the regulator.

Industry changes present both risks and opportunities for GHESI. Council’s role as stewards of this valuable public asset is to separate potential risks from fear and to understand how those potential risks can be effectively mitigated. Equally, Council must also consider opportunities for maintaining or enhancing the value of this public asset for the benefit of the community.

The role of Council is to provide strategic leadership based on the best available information. Critical to fulfilling this role must be an understanding that a decision to take no action at this time will not alter the course of industry change and comes with its own set of risks that must be well considered.

## **Due diligence**

Council and the citizens of Guelph can have confidence that the due diligence process has been robust.

**City Hall**  
59 Carden St  
Guelph, ON  
Canada  
N1H 3A1

T 519-822-1260  
TTY 519-826-9771

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The due diligence process is a process of discovery for the shareholder (Guelph City Council) with respect to the merging entities (Horizon and GHESI). This process is designed to assist Council in the assessment of the risk and opportunities with respect to the proposed merger.

The strength of the due diligence process is demonstrated by the significant resources that have been assembled to consider the proposed merger. They include:

- Council's appointment of a skills-based Board of Directors for GHI comprised of members with extensive industry and business expertise
- a GHESI Management Team with substantial industry knowledge and experience
- retaining Borden, Ladner and Gervais LLP for GHESI/Horizon to conduct the legal due diligence

The scope of the work included:

- corporate organization
  - financial matters
  - real property, plant and equipment
  - technology and intellectual property
  - regulatory matters
  - material contracts and commitments
  - management and employees
  - benefit plans
  - insurance
- retaining Deloitte & Touche LLP for GHESI/Horizon to conduct the financial due diligence

The scope of the work included:

- valuation of each merged entity (including relative contribution of each party to the merged entity, value of each entity on a stand alone basis, and the value of the merged entity)
- retaining Kinetrics Inc. for GHESI/Horizon to conduct the operational due diligence

The scope of the work included:

- asset verification
  - asset condition assessment
  - comparison of observed asset value with book value
  - review of capital expenditure
  - operation and maintenance programs and budgets
  - review of reliability statistics and planning
  - identification of any technical issues leading to financial risk
- retaining of Gowlings LLP for GHI/GHESI to provide independent legal advice

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- retaining BDR for the City of Guelph to conduct an expert, independent options analysis
  - retaining BDR for the City of Guelph to conduct an expert, independent peer review of the merger business case and accompanying analysis performed by Deloitte
  - the engagement of Aird & Berlis LLP as independent legal advisors to the City of Guelph to assist in its review of legal documentation concerning the proposed merger
  - the review of all documentation by the City of Guelph's Chief Administrative Officer, City Treasurer and City Solicitor
  - significant opportunity for the public to provide input and questions
  - significant access of Council to resources and expertise

## **Strategic benefits & timing**

In considering the available options, merger makes the most sense when shareholders want both the advantages of ownership and the benefits of good returns.

Many merger discussions only focus on potential financial savings. The comprehensive "Merger Principles" adopted by GHI at the outset have both informed the process and expressed a commitment to achieving a broader set of community benefits. The success in achieving these principles is reflected in the choice of merger partner and the breadth of benefits achieved.

There are several compelling reasons why moving forward with a merger at this time, rather than holding, is in the best interest of customers, employees, the community and the shareholder.

GHESI is entering the merger discussions from a position of strength. This is reflected in the strong ownership proportion identified for Guelph in the business case. As consolidation continues, Guelph's relative size and position in the industry will decrease. The number of potential merger partners will decline and our strategic options along with our ability to set the terms of a merger in the future will be diminished.

## **Customers**

All customers will benefit from lower rates (20% reduction in distribution rates after rate harmonization; lower distribution rate increases over time) and improved service (extended customer service hours; enhanced local emergency response). Lower distribution rates can only be achieved through a merger. Ongoing reliability of service is ensured not only by the past performance of both utilities but also regulation. The OEB regulatory environment protects customer and shareholder interests.

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## Employees

If we hold, our ability to negotiate as strong a transition package for GHESI employees will be compromised along with our ability to negotiate a significant level of local business presence as many of these opportunities will be locked in by other merger agreements.

Horizon and GHESI have complementary not competing human resource strengths which has facilitated the development of the human resources strategy.

The particular commitment of the GHI Board of Directors to the employee community is consistent with the City of Guelph's corporate values.

## Community

Horizon's undeniable commitment to conservation and demand management (C & DM), their strong voice at the provincial level and the designation of Guelph as the Centre of Excellence for C & DM for the merged entity will leverage substantial new resources and partnership opportunities for the implementation of Guelph's Community Energy Plan (CEP).

Lower industrial and commercial rates will give Guelph a competitive advantage. The merger will result in \$40 million of savings for ratepayers over the next 10 years. This money will stay in the community having a positive economic impact.

## Shareholder

BDR's conclusion, after thorough analysis, is that the business case is fair and reasonable from a financial point of view.

A merger will mitigate impacts of new regulatory requirements that would otherwise be felt by the customer through increased rates and by the shareholder as a decline in asset value and dividends. It is anticipated that the OEB will adopt performance based regulation (IRM) that will reward actions of those entities that merge to find cost efficiencies.

The strength and size of Horizon will bring many operational benefits to the merged entity including:

- a stronger credit rating
- new systems and technologies to enhance operational efficiency that would have been cost prohibitive for GHESI to implement (i.e. the high fixed costs and rapid depreciation of these new systems and technologies can be spread over a larger customer base)

The electrical distribution industry is highly regulated. Local boards and shareholders have limited control over the business. The legal agreements that have been negotiated preserve one important area of control - influence over the strategic direction of the merged entity

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(i.e. future mergers or acquisitions). Should we hold, our ability to negotiate a merger agreement in the future, that allows the same level of influence over future strategic business decisions, will be diminished.

Finally, increased dividends will assist the City of Guelph address the infrastructure deficit and CEP implementation.

## **Conclusion**

I recognize the magnitude of this decision. I want to thank members of Council for the significant amount of time you have committed to understanding the recommendation that has been put before you and your participation in the due diligence process. We are fortunate that we have an engaged citizenry. Their input and questions have contributed immensely to strengthening the process of discovery required to understand the risks and opportunities associated with a merger.

**Karen Farbridge**  
Mayor

59 Carden Street  
Guelph, Ontario  
N1H 6T1

T 519-837-5643  
F 519-822-8277  
E [mayor@guelph.ca](mailto:mayor@guelph.ca)

**City Hall**  
59 Carden St  
Guelph, ON  
Canada  
N1H 3A1

T 519-822-1260  
TTY 519-826-9771