Festival Hydro Inc.
Strategic Options Analysis
City of Stratford

June 24, 2014

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Purpose

- The City of Stratford (“**City**”) has received an unsolicited proposal from Hydro One Inc. (“**Hydro One**”) for the purchase of its Local Distribution Company (“**LDC**”), Festival Hydro Inc. (“**Festival**”) (the “**H1 Proposal**”).
- The City has also received an Expressions of Interest from Erie Thames Powerlines Inc. (“**Erie Thames**”) for a potential merger as well as interest from Toronto Hydro and Essex Power
- To assess the proposals, the City is currently considering three options (“**Strategic Options**”) going-forward for Festival:
  1. Status Quo;
  2. Merger; or
  3. Sale.
- The City has retained Deloitte LLP (“**Deloitte**”) to carry out an analysis of the various options under consideration (the **“Strategic Options Analysis**”) as well as a review of the H1 Proposal

Executive Summary

- The Strategic Options Analysis has been conducted through the evaluation of certain criteria that consider the qualitative and quantitative impact of the Strategic Options from both the ratepayers and taxpayers perspectives:

Evaluation Criteria	
1. Ability to Meet Service Quality Requirements Over Time	4. Strategic Importance to Local Community
2. Long-Term Rate Stability	5. Economic Factors
3. Value to the Shareholder	

Each of the criterion were allocated weights in terms of relative priority through consultation with various Council members

- The Strategic Options Analysis has been based on an evaluation framework that reflects the various risks and benefits to the City as the shareholders of Festival
- The results of the Strategic Options Analysis are provided below:

Evaluation Criteria	Status Quo Option	Merger Option	Sale Option (1.4x Premium)	Sale Option (1.6x Premium)
Total Score	**7.0**	**6.5**	**7.1**	**7.5**
Percentage of Available Points	**70%**	**65%**	**71%**	**75%**
Ranking	2	3	2	1

- For the Sale Option to rank higher than the Status Quo, the premium from the sale needs to be at least at 1.6x to overcome the negative impacts of a sale to the local community.
- The Merger Option ranks lower than the Status Quo as efficiencies and economic benefits are not sufficient enough to overcome negative impacts that would be caused by the dilution of local control.

Strategic Options Analysis Framework & Methodology

Methodology

Strategic Options Analysis

The Strategic Options Analysis is conducted based on certain evaluation criteria considering the impact of the Strategic Options from both **ratepayers**’ as well as **taxpayers**’ perspectives, based on the methodology below:

Qualitative Evaluation

Festival Hydro Financial Model

The Financial Model is developed to understand and analyze various strategic options, while at the same time assessing the current regulatory landscape. The Financial Model is constructed from a ***rate payers****’ perspective.*

Shareholder Analysis

The Shareholder Analysis utilizes results from the Financial Model to determine the long-term value to Festival’s shareholders (i.e. the City). The Investment Analysis is conducted from a ***tax payers’*** *perspective*

1. **Define Strategic Options under Consideration**
2. **Define Evaluation Methodology and & Evaluation Framework**
3. **Assessment of Strategic Options**

The Assessment would be conducted by ranking each of the Strategic Options for each of the Evaluation Criteria based on an Evaluation Scale that measures the benefits that each of the Strategic Options

Recommended Strategic Option

Strategic Options Analysis Framework & Methodology

Overview of Strategic Options

- The City is currently considering looking to evaluation the following Strategic Options:

1. **Status Quo Option:**
   - Festival to continue operations on an as-is basis
   - City would maintain local ownership of Festival over the long-term and control over utilities services
   - Possible future opportunities to collaborate with other LDCs for shared services that may lead to cost reduction
2. **Merger Option:**
   - The City to look to merge with other LDCs that may provide strategic value over the long-term through expansion of existing customer base as well as other economic or social benefits
   - City would retain part local ownership of Festival and control over utilities services
   - Opportunities to take advantage of merger synergies (cost savings) on a proportionate basis
3. **Sale Option:**
   - Sale of 100% shareholding in Festival by the City to another LDC through either going to market to seek bids or engaging in a sole sourced bid from an LDC
   - Sale Option may have the following impacts the long-term:
     - Upfront cash payment for shareholding in Festival leading to large increase in funds for the City
     - Possible impact to ratepayers and taxpayers through harmonization of rates to a larger LDC with either lower or higher overall rates and stability in long-term rates
     - Possible impact on customer service and reliability over the long-term as well as reduced regulatory risk on the taxpayers

Strategic Options Analysis Framework & Methodology

Evaluation Framework – Evaluation Criteria

Evaluation Criteria	Evaluation Factors
1. Ability to Meet Service Quality Requirements Over Time	
The extent to which the Strategic Option allows service quality requirements over the term of the analysis to be met thereby providing high quality service to the ratepayers.	Factors under consideration include the degree to which Festival can continue to meet OEB requirements on: • Service quality requirements • System reliability • Asset condition
2. Long-Term Rate Stability	
The extent to which the Strategic Option maintains stability in customer rates over the term of the analysis such that any corresponding rate increases are equal to or below the inflation rate.	Factors under consideration include: • Consideration of current rates in comparison to industry comparables • Total distribution revenue per customer over the term of the analysis • Forecast of customer rates over the term of the analysis • Control over rate setting policy
3. Value to the Shareholder	
The extent to which the Strategic Option provides the shareholders (the City or the taxpayers) the greatest value over the long-term.	Factors under consideration include: • Value of Festival's current and forecasted rate base • Cash proceeds to the tax payers under all Strategic Options as measured from dividends and / or proceeds from the demand notes

Strategic Options Analysis Framework & Methodology

Evaluation Framework – Evaluation Criteria

Evaluation Criteria	Evaluation Factors
4. Strategic Importance to Local Community	
The extent to which the Strategic Option provides the greatest contribution to the local community (including its ratepayers and taxpayers).	Factors under consideration include: • Importance of local ownership and control of utilities services • Maintenance / creation of local jobs • Contributions to community initiatives (support for local non profit organizations, sustainable development, etc.)
5. Economic Factors	
The extent to which the selected Strategic Option reduces economic risk and regulatory burden being borne by ratepayers which helps maintain rate stability	Factors under consideration include: • Growth of customer base through new customers • Stability of existing customer base and ability to retain over time • Diversification of customer base across municipal boundaries mitigating risk due to local economic factors

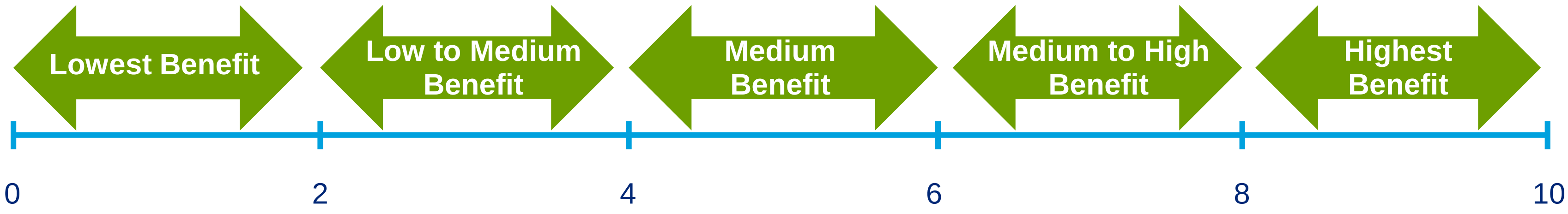
Strategic Options Analysis Framework & Methodology

Evaluation Framework – Weighting & Scoring Methodology

Evaluation Criteria	Totals		
	Maximum Raw Score	Category Weight	Maximum Category Score
1. Ability to Meet Service Quality Requirements Over Time	10.0	18.5%	1.9
2. Long-Term Rate Stability	10.0	17.5%	1.8
3. Value to the Shareholder	10.0	24.0%	2.4
4. Strategic Importance to Local Community	10.0	22.0%	2.2
5. Economic Factors	10.0	18.0%	1.8
Total Evaluation Score		**100.0%**	**10.0**

- Category weights for each of the Evaluation Criteria were finalized after feedback from Council members.

Evaluation Scale



Assessment of Strategic Options

Summary of Results

Criteria Evaluation Summary

1. Ability to Meet Service Quality Requirements Over Time

- The Sale Option ranked as the highest as it is assumed that the acquirer is a larger organization that would have higher efficiencies and scale to deliver service quality to the ratepayers.
- Status Quo Option ranked the lowest as Festival, in its current state, would have the smallest organization resulting in the lowest potential efficiencies and scale, exposing the ratepayer to service quality inefficiencies over the long-term.
- The Merger Option ranked between the Sale and Status Quo Options as it is assumed that the merger target would be of a sufficient size to provide incremental benefits (over the Status Quo) but not to the extent of the Sale Option.

2. Long-Term Rate Stability

- The Status Quo Option ranked the highest as Festival has demonstrated a track record of rate stability over the long-term.
- Although the Merger or Sale Option would add some efficiencies and scale that should be able to provide long-term rate stability, this benefit is mitigated by:
  - Loss of the shareholders' control over rate-setting policy; and
  - The fact that Festival's current rate structure is relatively efficient and the merger or sale target may be at a higher rate (i.e. in a Merger Option or Sale Option, Festival's rates may go up).

Assessment of Strategic Options

Summary of Results

Criteria Evaluation Summary

3. Value to the Shareholder

- The Sale Option (at 1.6x premium) ranked the highest as it delivered the greatest Net Present Value to the shareholders.
- The Sale Option (at 1.4x premium), Merger, and Status Quo Option all derived Net Present Value to the shareholders within an order of magnitude that was not significantly different and therefore were given the same score.

4. Strategic Importance to Local Community

- The Status Quo Options ranks the highest as the shareholders' control over Festival would ensure its ability to keep Festival's jobs local and to maximize re-investment in the local community.
- The Sale Option ranked the lowest as the loss of control would decrease the likelihood that jobs would remain local and decrease the incentive to reinvest in the local community. It is recognized that the Sale Option could provide proceeds that could be used towards local reinvestment; however, these proceeds are not significant enough to overcome the loss of control.
- The Merger Option ranked in-between as the City retains control but has some added risk as the merger entity may dilute the City's ability to focus on the local community.

Assessment of Strategic Options

Summary of Results

Criteria Evaluation Summary
5. Economic Factors

- The Sale Option ranked the highest as the shareholders / taxpayers would benefit from customer diversification and economic diversity across significantly larger municipal boundaries, thereby providing greater stability to future dividends.
- The Status Quo Option ranked the lowest as the shareholders / taxpayers do not benefit from any added diversification or economic diversity across municipal boundaries.
- The Merger Option ranked in-between as some additional diversification and reduction in economic risk across municipal boundaries but not to the same extent as the Sale Option.

Assessment of Strategic Options

Summary of Results

Evaluation Criteria	Weighting	Status Quo Option	Merger Option	Sale Option (1.4x Premium)	Sale Option (1.6x Premium)
1. Ability to Meet Service Quality Requirements Over Time	18.50%	4.0	6.0	10.0	10.0
		0.7	**1.1**	**1.9**	**1.9**
2. Long-Term Rate Stability	17.50%	8.0	6.0	6.0	6.0
		1.4	**1.1**	**1.1**	**1.1**
3. Value to the Shareholder	24.00%	8.0	8.0	8.0	10.0
		1.9	**1.9**	**1.8**	**2.4**
4. Strategic Importance to Local Community	22.00%	10.0	6.0	2.0	2.0
		2.2	**1.3**	**0.4**	**0.4**
5. Economic Factors	18.00%	2.0	6.0	10.0	10.0
		0.7	**1.1**	**1.8**	**1.8**
Total Score		**7.0**	**6.5**	**7.1**	**7.5**
Percentage of Available Points		**70%**	**65%**	**71%**	**75%**
Ranking		**2**	**3**	**2**	**1**

Score varies between the two Sale Options depending upon the sale premium of either 1.4x or 1.6x. A premium of 1.6x would provide significant additional benefit to the shareholders

Conclusion and Next Steps

Conclusion

- In order for the Sale Option to rank higher than the Status Quo, the premium from the sale needs to be at least at 1.6x to overcome the negative impacts of a sale to the local community.
  - If the City pursues with the Sale Option, it would entail the City receiving an upfront cash payment from the potential acquirer in exchange for annual cash flow stream (through interest revenue and dividends) that it would receive from Festival (under the Status Quo Option)
- The Merger Option ranks lower than the Status Quo as the efficiencies and economic benefits are not sufficient enough to overcome the negative impacts that would be caused by the dilution of local control