Report to: General Committee

Report Date: November 11, 2015
Recommendations updated November 19, 2015

SUBJECT: PowerStream Merger

PREPARED BY: Mark Visser, Senior Manager of Financial Strategy & Investments
Catherine Conrad, City Solicitor
Graham Seaman, Director, Sustainability Office

RECOMMENDATION:

WHEREAS Markham Enterprises Corporation ("MEC") and The Corporation of the City of Markham (the "City"), Vaughan Holdings Inc. ("VHI"), The Corporation of The City of Vaughan, Barrie Hydro Holdings Inc. ("BHHI"), and The Corporation of the City of Barrie, PowerStream Holdings Inc. and PowerStream Inc. are parties to the Unanimous Shareholders' Agreement for PowerStream Holdings Inc., dated November 1, 2013 (the "PowerStream Shareholder Agreement");

AND WHEREAS MEC owns 34.185% of the shares of PowerStream Holdings Inc.;

AND WHEREAS MEC is a wholly owned holding company of the City, incorporated under the provisions of the *Electricity Act, 1998 (Ontario)*;

AND WHEREAS the Board of Directors of PowerStream has approved and has recommended to its shareholders the approval of a merger of the local hydro distribution companies of PowerStream Holdings Inc. ("PowerStream"), Horizon Holdings Inc. ("Horizon"), and Enersource Holdings Inc., a holding company to be established by Enersource Corporation ("Enersource");

AND WHEREAS the Board of Directors of PowerStream has approved and has recommended to its shareholders the purchase of Hydro One Brampton Networks Inc. ("Brampton"), conditional upon the completion of both the Merger Participation Agreement and the Share Purchase Agreement, in accordance with the terms set out in both agreements;

AND WHEREAS the PowerStream Shareholders' Agreement requires unanimous approval by its Shareholders for transactions including the merger and the acquisition of Brampton;

AND WHEREAS the merger of PowerStream, Horizon, Enersource and acquisition of Brampton will form a new organization currently referred to as "MergeCo";

AND WHEREAS MEC, together with VHI and BHHI, retained independent consulting and legal services as follows:

- Navigant Consulting Ltd., on the proposed Transaction ;
- BDR NorthAmerica Inc., on the proposed Transaction;

- Gowlings LLP, on the proposed governance structure and the draft agreements:
    - Merger Participation Agreement;
    - Unanimous Shareholders' Agreement; and
    - Share Purchase Agreement

AND WHEREAS the City, at its General Committee meeting on October 7, 2015, received presentations and reports from:

- Navigant Consulting Ltd.
- PowerStream
- City Staff

AND WHEREAS the merger and the acquisition (the "Transaction") require a significant equity contribution of $43-47.3M, depending on the amount of closing costs and adjustments;

AND WHEREAS the City holds a promissory note in the amount of $67.9M and the interest rate approved by the OEB for shareholder promissory notes will be reduced from 5.58% to approximately 4.54%;

AND WHEREAS the dividends forecasted for the core business, are expected to increase;

AND WHEREAS the MergeCo dividend policy carries incremental uncertainty as compared to the PowerStream dividend policy;

AND WHEREAS under the proposed terms of the merger, dividend income and equity return from PowerStream's solar assets are segregated for the benefit of the shareholders of PowerStream, as set out in the draft PowerStream Solar Business Services and Indemnity Agreement Indicative Term Sheet;

AND WHEREAS the Net Present Value of the solar dividends in MergeCo will be decreased by approximately $1M;

AND WHEREAS the financial modeling and the analysis indicate a return on the incremental investment greater than 5%;

AND WHEREAS, although staff have negotiated significant amendments to the Transaction to reduce associated risks , the investment is not financially compelling given the remaining risk and the investment criteria of both MEC and the City of Markham ;

AND WHEREAS the Transaction can not be recommended by City staff solely on an investment basis;

AND WHEREAS the Transaction will deliver meaningful benefits to PowerStream customers beginning in year six after the merger, estimated at an average of $40/year for all customers and $25-$30 on the average residential utility bill (representing approximately 5% to 9% of the distribution portion of the utility bill), in the form of reductions in the cost increases on the distribution portion of such bills;

NOW THEREFORE, be it resolved:

1. **THAT** subject to conditions set out in clauses 1 and 2 hereof, The Corporation of the City of Markham, in its capacity as a shareholder of MEC, approves:
    a. the merger of PowerStream, Horizon and Enersource, substantially in accordance with the draft Merger Participation Agreement dated October 9, 2015 and the Unanimous Shareholders' Agreement dated October 9, 2015;
    b. The purchase of Hydro One Brampton Networks Inc., substantially in accordance with the terms of the Share Purchase Agreement dated October 8, 2015, between Her Majesty the Queen in Right of Ontario as represented by the Minister of Energy (the "Province") and Brampton Distribution Holdco Inc. as the vendor, and Horizon, Enersource and PowerStream as purchaser.

2. **AND THAT** the completion of the merger and the purchase of Brampton be conditional on the following:
    a. The terms of the Transaction being substantially as set out in the Merger Participation Agreement dated October 9, 2015, the Share Purchase Agreement dated October 8, 2015, the Unanimous Shareholders' Agreement dated October 9, 2015 and the draft PowerStream Solar Business Services and Indemnity Agreement dated October 5, 2015.
    b. Amendments to the agreements in a form satisfactory to the Chief Administrative Officer as follows:
        i. Unanimous shareholder approval required for mergers and acquisitions until 75% of the targeted synergy savings have been achieved;
        ii. Extension of the term of the Shareholder promissory notes for 20 years from 2016 with right to extend for a further 20 years, at the interest rate approved by the Ontario Energy Board;
        iii. Improvements to section 8.3 of the Unanimous Shareholders' Agreement to achieve clarity on the tax mitigation strategies for first and subsequent sales of shares in MergeCo that trigger departure and transfer taxes;

c. That a financial back stop be negotiated with one or more of the municipal partners participating in this Transaction, on terms satisfactory to the Chief Administrative Officer;
d. That the equity investment required to complete the merger and acquisition be no greater than $47.3M;
e. Confirmation from the Province of Ontario, satisfactory to the Chief Administrative Officer and the City Solicitor, with respect to the terms and rates of shareholder loans to LDC's;
f. Approval of the Strategic Plan by the Board of Directors of MEC.

3. **AND THAT** the City work with MEC staff and other shareholders, to reduce the equity contribution required for the Transaction to occur, including but not limited to a formal, municipally led sale of 10% of MEC's shareholding in PowerStream with consideration for MergeCo's value.

4. **AND THAT** in the event that the sale is not successful, staff shall report back with alternate funding options, including funding options that will not require funding from the City of Markham.

5. **AND THAT** the Mayor and Clerk be authorized and directed to execute the Merger Participation Agreement, the Unanimous Shareholders' Agreement and the PowerStream Solar Business Services and Indemnity Agreement based on the draft Indicative Term Sheet, subject to any modifications or amendments approved by the Chief Administrative Officer.

6. **AND THAT** the Mayor and Clerk be authorized and directed to execute and deliver all other documents, notices, articles, certificates to be signed and or delivered under or in connection with the Merger Participation Agreement, the Unanimous Shareholders' Agreement or Share Purchase Agreement or to take any action(s) required to give effect to the foregoing resolutions;

7. **AND THAT** staff be authorized to do and to take any action necessary to give effect to these resolutions, including the execution of any documents.

EXECUTIVE SUMMARY:

The proposed Transaction that the City of Markham is considering consists of the merger of PowerStream Holdings Inc. ("PowerStream") with Enersource Corporation ("Enersource") and Horizon Utilities Corporation ("Horizon") and the purchase of Hydro One Brampton Networks Inc. ("Hydro One Brampton") to create the second largest local distribution company ("LDC") and the largest municipally owned LDC in Ontario. The Transaction is a very complex decision with many financial and non-financial variables, risks and opportunities.

In April 2015, PowerStream, Horizon and Enersource announced they were working together to merge and then acquire Hydro One Brampton from the Province of Ontario for $607M (1.5x rate base multiple ($405M) or a $202M premium over rate base) (the "Transaction"). The Transaction to create "MergeCo" would establish the second largest electricity distribution company in Ontario with almost 1 million customers in York Region, Simcoe County, Peel Region, Hamilton and St. Catharines's, with $2.7 billion in assets and a $2.5 billion rate base.

Under MergeCo, the current PowerStream Shareholders would collectively own approximately 46% of MergeCo, Enersource 31%, and Horizon 23%.The City of Markham owns 34.185% of PowerStream via its holding company Markham Enterprises Corporation ("MEC"). Under the merger, the City's ownership of MergeCo will be approximately 15.7%.

The equity investment required from the three PowerStream Shareholders to complete the purchase of Hydro One Brampton is expected to be $125M, with Markham's share being approximately $43M to $47.3M, with closing costs and adjustments.

In order to assist in analyzing all the options available, the three Shareholders of PowerStream retained industry experts, Navigant Consultants Ltd. and BDR North America Inc., with Navigant spearheading the business case analysis and financial due diligence, and Gowlings LLP for legal advice. PowerStream has agreed to pay the consulting costs incurred.

The consultants mandate was to review the business case for the proposed Transaction, specifically they were asked to provide a valuation of PowerStream to ensure its Shareholders value is maximized; compare the future value and cash flows of an unmerged PowerStream with MergeCo; consider the proposed MergeCo dividend policy's cash flow and options for future equity calls whether to the Shareholders or a private source; partnership options and long term value; analyze and consider risks and industry trends and provide any other relevant information including impact on Markham electricity ratepayers.

The analysis of the different options looked at the preservation of principle/diversification, return on investment, liquidity/control and impact to Markham LDC rate payers.

Under all funding options considered, the analysis indicates a return on the incremental investment greater than 5%.

Investments in PowerStream account for half of the market value of the City's investments, with the core business (poles and wires) being the single biggest investment for the City (38%). To date, the PowerStream core business has been one of the City's top performing investments as it has seen a significant increase in value in recent years. If the MEC Board and Markham Council approve the Transaction, the MergeCo core business would account for approximately 45% of the City's investments. This could be reduced to 41% if MEC sold 10% of its shares in PowerStream (with MergeCo considered) to help fund the Hydro One Brampton purchase.

In order to achieve the goals of: 1) maintaining the current levels of portfolio diversification; 2) taking advantage of the current market multiple being paid for LDCs; and 3) retaining funds to invest in future MEC initiatives, staff's preferred funding option (if the MEC Board and Markham Council approve the Transaction) is to sell up to 10% of MEC's shares in PowerStream (with consideration for MergeCo) which is estimated to generate approximately $30M. It is also recommended that the remaining equity be funded from a combination of cash that is currently retained in MEC and potential borrowing through MEC. Staff does not recommend the conversion of any part of the promissory note as it provides a solid revenue stream into the City's Life Cycle Reserve.

Risks relating to MergeCo include:

- Reduction in and timing of dividends and cash flows;
- Failure to achieve targeted level of synergies;
- Potential for earlier rate application (rebasing) than planned;
- Impact of disruptive technology;
- Declining market value;
- Regulatory framework change; and
- Potential path to private equity for future growth investment.

Legal considerations for the proposed Transaction are significant. Due diligence conducted by the LDC's themselves spanned the whole business from corporate registration and equity, property, environmental and asset condition, labour and employment including post-retirement benefit obligations, intellectual property, litigation and insurance and claims. City staff have not verified the due diligence done by other parties to the Transaction.

There are three major agreements driven by the proposed Transaction to create MergeCo:

1. Unanimous Shareholders' Agreement which sets out the Shareholder structure, board member allocation, matters for Shareholder approval including unanimous and super majority (2/3) approvals, the structure of PowerStream Solar to protect Markham, Vaughan and Barrie's original investment and expected cash flows, dividend policy, liquidity provisions, Strategic Plan, capital calls and future reorganization to establish a limited partnership (if approved by the OEB and federal government) that will limit tax consequences for the sale of 10% or more of MergeCo to allow for private equity investment.
2. Merger Participation Agreement, among the six municipalities, their holding companies, BPC Energy Corporation (Borealis), and the three LDCs, sets out the process for and the obligations of each party in proceeding to a closing of the merger.

3. Share Purchase Agreement sets out the terms for the purchase of Hydro One Brampton Networks Inc. from the Province of Ontario at the price of $607M, plus adjustments for Working Capital and Net Fixed Assets Adjustment, as defined therein. This agreement will not be signed unless and until all of the parties agree to and execute the Merger Participation Agreement.

Prior to Closing, expected to be in the second quarter of 2016, a Transition Board is to be established, with the mandate to select the Executive Team for MergeCo, determine compensation, and other matters. This Board has not yet been established.

PURPOSE:

To provide Markham Council with recommendations regarding the proposed merger of PowerStream Holdings Inc. (“PowerStream”) with Enersource Corporation (“Enersource”) and Horizon Utilities Corporation (“Horizon”) and purchase of Hydro One Brampton Networks Inc. (“Hydro One Brampton”).

BACKGROUND:

<u>Opportunity</u>

On April 16, 2015, four of Ontario’s largest electricity distribution companies (LDCs) announced they would work together to form a new utility that would serve almost a million customers in York Region, Simcoe County, Peel Region, Hamilton and St. Catharines.

The proposed Transaction is comprised of a merger of the regulated and non-regulated business activities of PowerStream, Enersource, and Horizon and an acquisition of the regulated electricity distribution business of Hydro One Brampton Networks Inc. for gross proceeds of $607M, net of any purchase price adjustments.

The combined entities described above are referred to as “MergeCo” and the corresponding transactions are referred to as the “Transaction”. The creation of MergeCo must be approved by all Shareholders and is subject to regulatory approvals.

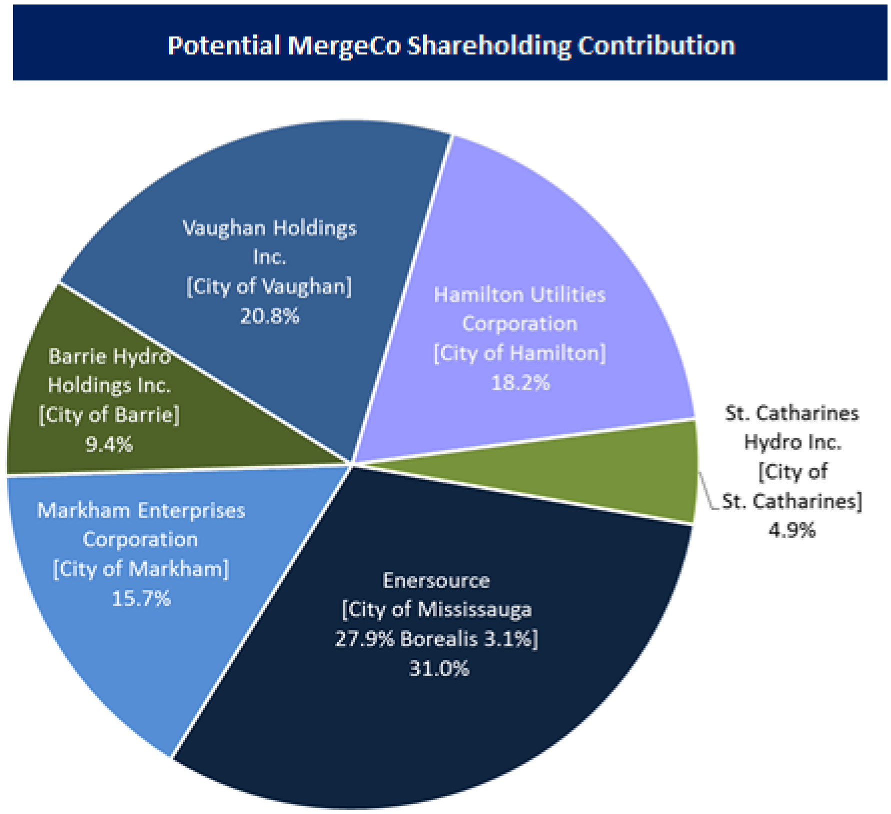
The Transaction will create the second largest LDC and the largest municipally owned LDC in Ontario with almost 1 million customers, $2.7 billion in assets, and $2.5 billion rate base.

The City of Markham owns 34.185% of PowerStream via its holding company, Markham Enterprises Corporation. The chart below illustrates the pre merger ownership shares:

Pre-Merger Shareholding		
Owner	**HoldCo**	
Enersource		
City of Mississauga	Enersource Corporation	90.0%
BPC Energy Corp. (Borealis)	Enersource Corporation	10.0%
		100.0%
PowerStream		
City of Barrie	Barrie Hydro Holdings Inc.	20.5%
City of Vaughan	Vaughan Holdings Inc.	45.3%
City of Markham	Markham Enterprises Corporation	34.2%
		100.0%
Horizon Utilities		
City of Hamilton	Hamilton Utilities Corporation	78.9%
City of St. Catharines	St. Catharines Hydro Inc.	21.1%
		100.0%

Through negotiations, the relative value of PowerStream was determined to be 49.1% of MergeCo. During these negotiations, the PowerStream Shareholders elected to retain the cash flows from the PowerStream Solar business, as both PowerStream and Navigant concluded that the valuation of the Solar business was "outside (below) the range of reasonable results provided by Navigant's independent valuation model, even under the most conservative assumptions and scenarios". By segregating the PowerStream solar assets and revenues from the Transaction, the relative valuation of PowerStream decreases to approximately 46%. Navigant's review indicates that this is reasonable, and that the Shareholders are receiving appropriate value for the assets they are contributing.

Under MergeCo, the former PowerStream Shareholders would own approximately 46%, Enersource 31%, and Horizon 23%. Under MergeCo, each Shareholder would now own the following proportion of the new company:



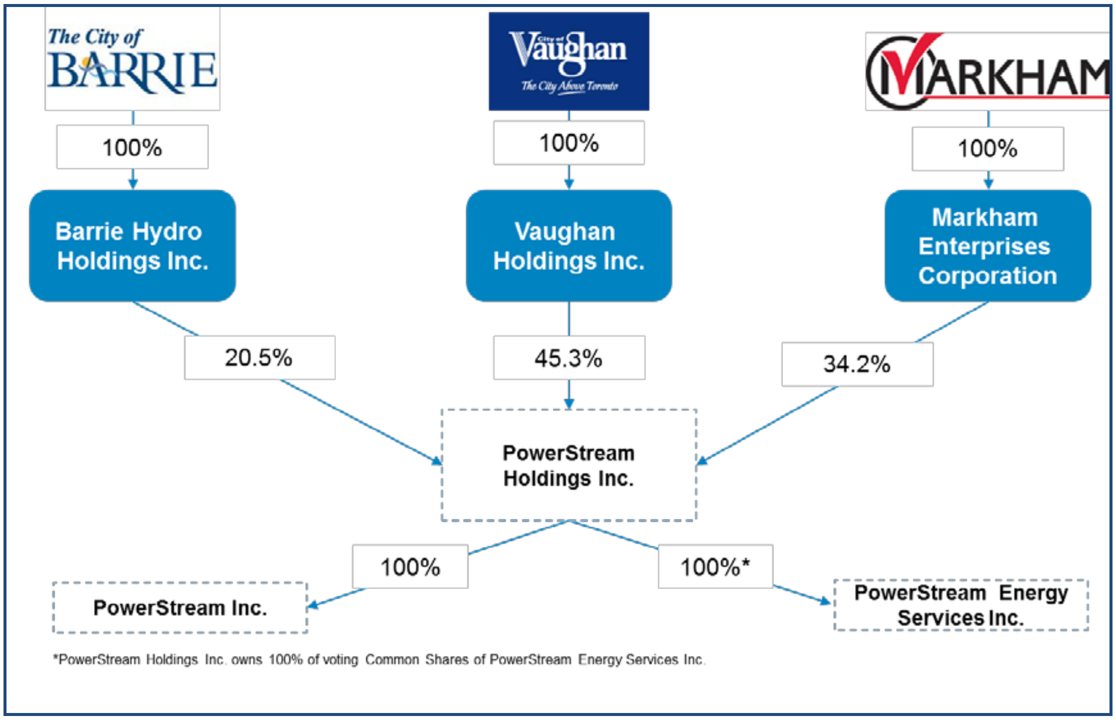
The equity investment required from the three PowerStream Shareholders is expected to be $125M, with Markham's share being approximately $43M (which could increase to $47.3M taking into account closing costs and adjustments). In 2013, Markham approved a $17.1M equity injection into PowerStream for core business to be provided between 2014 and 2016. If the Transaction is approved, Markham would not have to inject the final $5.1M in 2016. Therefore the total incremental equity injection for the Transaction would be between $37.9M to $42.2M ($43M to $47.3M less $5.1M).

Company Profiles

<u>PowerStream Inc.</u>

PowerStream Inc. (PowerStream) is the second largest municipally owned local distribution company (LDC) in Ontario, serving over 370,000 residential and commercial customers. PowerStream was formed in 2004, when Hydro Vaughan Distribution Inc., Markham Hydro Distribution Inc., and Richmond Hill Hydro amalgamated to form PowerStream Inc.

PowerStream is regulated by the OEB (Ontario Energy Board), and is jointly owned by the ccities of Barrie, Markham and Vaughan through their respective holding companies, Barrie Hydro Holdings Inc., MEC and Vaughan Holdings Inc." Markham, through MEC, owns 34.185% of PowerStream.



PowerStream Inc. operates the core distribution business, distributing electricity under a licence issued by the Ontario Energy Board. It also includes the PowerStream Solar and the Conservation Demand Management business units and a 50% ownership of the joint venture Collus PowerStream.

PowerStream Energy Services Inc. (PESI) was incorporated on July 25, 2013 to take advantage of opportunities in unregulated businesses, such as sub-metering. PESI began sub-metering operations in 2014, billing customers and securing contracts for new developments.

Enersource Corporation

Enersource Corporation serves over 200,000 residential and commercial customers across Mississauga. It is a diversified energy and technologies company that serves customers through the distribution of electricity and the delivery of services related to the design, operation and maintenance of electrical systems. Ninety per cent of Enersource Corporation is owned by the City of Mississauga, and 10 percent is owned by BPC Energy Corporation (Borealis), which is part of the Ontario Municipal Employees Retirement System (OMERS).

Horizon Utilities Corporation

Horizon Utilities Corporation provides electricity and related utility services to over 240,000 customers in Hamilton and St. Catharines. Horizon Utilities is wholly owned by Horizon Holdings Inc., a company jointly owned by the cities of Hamilton and St. Catharines through their holding companies Hamilton Utilities Corporation and St. Catharines Hydro Inc.

Hydro One Brampton Networks Inc.
Hydro One Brampton Networks Inc. was acquired by Hydro One from the City of Brampton in 2001. It has more than 150,000 residential, commercial and industrial customers and serves an area of 300 square kilometers.

Consultants

In order to assist in analyzing all the options available, the three Shareholders of PowerStream retained independent industry experts, Navigant Consulting Ltd. and BDR North America Inc., to spearhead the business case analysis and financial due diligence, and Gowlings LLP for legal advice. PowerStream has agreed to pay the consulting costs incurred.

Navigant (NYSE: NCI)
Navigant is a specialized, global professional services firm dedicated to assisting clients in creating and protecting value in the face of critical business risks and opportunities. Navigant's consulting services include a wide range of financial management services, investigation services, litigation support services, and business management consulting services, as well as software programs for use in database management, analysis and benchmarking.

Through senior level engagement with clients, Navigant professionals deliver expert and advisory work through implementation and business process management services. The firm combines deep technical expertise in Disputes and Investigations, Economics, Financial Advisory and Management Consulting, with business pragmatism to address clients' needs in highly regulated industries, including Construction, Energy, Financial Services and Healthcare.

BDR North America Inc.
BDR is a Toronto-based consulting firm of seasoned professionals specializing in the energy sector in terms of mergers and acquisitions, business and strategic planning and regulatory issues.

BDR has for many years managed and provided advice regarding the process of merger, acquisition and divestment of both generation and "wires" facilities in the electricity industry and related affiliates. Key to these assignments is the development of appropriate valuations for the businesses in the context of the relative risks.

Gowlings
Gowlings is a leading Canadian and international law firm, with over 700 legal professionals serving clients in 10 offices across Canada and around the world.

Gowlings has advised the City on all of the mergers and acquisition transactions undertaken by PowerStream, including the first merger of Markham Hydro Distribution Inc. with Vaughan's hydro company.

The consultants were hired to review the business case and provide analysis on legal and financial issues, including but not limited to the following matters:

1. An analysis regarding valuations and whether the PowerStream Shareholders are receiving an appropriate share of the merged company, taking into account items such as relative condition of assets, potential growth in customer bases, and involvement in unregulated businesses;
2. A analysis of the current and expected future value of PowerStream and the payouts to Shareholders (dividends and interest) compared to the expected value of the Shareholders interest in the merged company as well as the expected payouts to Shareholders;
3. A review of the proposed dividend policy and its impact on cash flows and the potential impacts either for future equity calls to Shareholders or the need to source private equity;
4. An analysis on how the Transaction(s) would impact the Shareholder's ability to divest their holdings (in whole or in part) taking into account tax implications and the political landscape;
5. Valuation of potential option of a new partner and the impact to cash flows (taking into account the premium and synergies) and long term value; and
6. An analysis of merger and acquisition benefits and risks, industry trends, and any other relevant information, including impact to ratepayers.

Decision Framework

When analyzing the different options, staff used the following criteria to determine the appropriateness of investment decisions and funding options:

Criteria	Ranking
Preservation of Principal	**1**
Diversification of investments	
Risk of loss of principal	
Return on Investment	**2**
Quantum of dividends and interest payments	
Risk of future unplanned equity injections	
Long term value/investment growth	
Liquidity/Control	**3**
Security of planned cash flow	
Future liquidity/ability to sell or extract value	
Impact to Markham LDC ratepayers	**4**

These criteria are, for the most part, aligned with the City's Investment Policy objectives.

The notable differences between the above Decision Criteria and the City's Investment objectives are that: 1) Return on investment is ranked higher than liquidity – this is because the City has sufficient liquid investments in the general portfolio to meet all operating and capital requirements for the foreseeable future, therefore this investment does not need to be as liquid, and 2) Impact to LDC ratepayers is not a consideration for other investments made by the City.

OPTIONS/DISCUSSION:

Numerous options have been analyzed over the past few months, the following three most viable options will be addressed in this report:

1) Do not merge (status quo)
2) Sell all, or portion, of PowerStream
3) The Transaction: 3-way merger (PowerStream, Enersource, Horizon) and purchase of Hydro One Brampton

The majority of the financial numbers in this document were provided by Navigant.

1) Status Quo

Preservation of Principal/Diversification

There is no additional investment to be considered under this option. MEC and the City did approve a $17.1M equity injection for PowerStream core business in 2013, of which $10.3M is still to be transferred to PowerStream in 2015 and 2016. While there are no immediate plans for any further equity injections past 2016, there does exist the possibility that PowerStream would make an equity call in the 2020-2025 time frame of approximately $10M to meet core business funding requirements. Forecasts indicate that this equity call would not be required under MergeCo.

Return on Investment

The City of Markham relies on the annual dividend and interest revenue earned from PowerStream; approximately $12 million in 2015 and expected to grow in future years. These cash flows are mostly the result of interest payments on a $67.9M promissory note (at an interest rate of 5.58%), dividends from PowerStream's core business, and dividends and equity repayment from PowerStream's solar business. The majority of these cash flows are transferred to the City's Life Cycle Replacement and Capital Reserve ("Life Cycle Reserve") to ensure the proper replacement of assets over the next 25 years.

It should be noted that, even under the status quo scenario, there are risks of receiving lower cash flows than forecasted (or PowerStream requesting additional equity injections) based on PowerStream being able to maintain its target debt/equity ratio each year.

<u>Liquidity/Control</u>
If MEC wanted to sell its investment in PowerStream, it would require the approval of both of the two PowerStream Shareholders. Any sale to the private sector for greater than 10% of the company would trigger significant departure and transfer taxes.

Under the Status Quo, MEC would maintain its 34.185% ownership of PowerStream and its influence with PowerStream management (through its 4 board members on the 13 member board).

<u>Impact to Markham LDC Ratepayers</u>
Under the status quo, there would be no merger synergies and therefore no potential distribution of cost reductions to LDC ratepayers in Markham. However, it is possible to achieve synergies in other ways, such as the consolidation of back office operations with other LDCs, although this would appear unlikely at this time. Maintaining the Status Quo does not preclude mergers with other LDC's in the future.

2) Sell All, or a Portion, of PowerStream

Under the existing Shareholder's Agreement, MEC would require the approval of both of the other two PowerStream Shareholders in order to sell any of their interest in the company. The following analysis assumes all existing Shareholders sell their shares in PowerStream.

<u>Preservation of Principal/Diversification</u>
By selling all, or a portion, of PowerStream, the Shareholders can capitalize on 1) historically high purchase multiples due to currently low interest rates (multiples tend to be highest when alternate investment opportunities are providing low yields) and 2) the upcoming 3 year tax holiday being offered by the Province which would significantly reduce the amount of taxes payable on a sale (of more than 10%) to the Private sector between January 1, 2016 and December 31, 2018. During the tax holiday, the Capital Gains Tax is eliminated, and the Transfer Tax is reduced from 33% to 22%. The Departure (Recapture) Tax remains at 26.5% during the tax holiday. The following table outlines the applicable taxes:

Tax		Current Rate	Tax Holiday Rate ('16-'18)
Recapture Tax	(Lesser of Sale Price or Book Value – Undepreciated Capital Cost) X Recapture Tax Rate	26.5%	26.5%
Capital Gain Tax	Sale price – (Book Value + Working Capital) X Capital Gains Tax Rate	9.5%	0%
Transfer Tax	Sale Price X Transfer Tax Rate – PILs (Payments in Lieu of Taxes already paid)	33%	22%

Even though the next three years provides a good window to consider selling the company, owning PowerStream provides for diversification of cash flows from MEC to Markham and acts as a hedge against low interest rates. By selling and reinvesting the proceeds in the bond market, Markham would be more negatively impacted in periods of low interest rates.

Return on Investment

If MEC sold all of its investment in PowerStream, it is expected the after-tax sale proceeds (and redemption of the promissory note) could net MEC and the City approximately $300-340M during the tax holiday, including redemption of the $67.9M promissory note. If these proceeds were to be invested in the bond market, the resultant annual interest earned would be approximately $9.0M to $10.2M/year (assuming a 3% rate of return), which is less than the $12M the City is receiving in 2015. Furthermore the bond interest amount would not grow each year as the PowerStream dividends would.

Therefore, selling PowerStream would result in lower cash flows to the City which would result in a shortfall in the City's Lifecycle Reserve, which would then require an alternate funding source (i.e. tax increase) to make it whole.

Liquidity/Control

If the Shareholders only sold a portion of PowerStream, they would have less control over the operations of the business.

Impact to Markham LDC Ratepayers

Unless PowerStream was sold to another LDC, there would be no merger synergies and therefore no rate reduction benefits to LDC ratepayers in Markham.

3) The Transaction: 3-Way Merger (PowerStream, Enersource, Horizon) and Purchase of Hydro One Brampton

The following analysis addresses the 3-way merger plus purchase of Hydro One Brampton ("the Transaction").

Hydro One Brampton has a Rate Base (or Book Value) of $405M and a purchase price of $607M (representing a 1.5X Rate Base multiple), which results in a $202M premium. Markham's portion of the purchase price would be approximately $43M (exclusive of closing costs and adjustments), calculated as follows.

Purchase price	$607 M	[A]
MergeCo debt financing	$202 M	[B]
Residual financing requirement	$405 M	[C] = [A] – [B]
PowerStream	$186	[C1] = 46% x [C]
Enersource	$126	[C2] = 31% x [C]
Horizon	$93	[C3] = 23% x [C]

Existing ‘debt capacity’	$223 M	[D]
PowerStream	$62	[D1]
Enersource	$61	[D2]
Horizon	$101	[D3]
Incremental equity investment	$182 M	[E] = [C] – [D]
PowerStream	**$125**	**[E1] = [C1] – [D1]**
Enersource	$65	[E2] = [C2] – [D2]
Horizon	($8)	[E3] = [C3] – [D3]
MEC Incremental Equity	**$43 M**	**[F] = [E1] x 34.185%**

Preservation of Principal/Diversification
PowerStream’s Vision is that “by 2020, (PowerStream) will build on (their) core electricity distribution business to become Ontario’s premier integrated energy services provider”. In essence, PowerStream’s vision is to grow the core business as well as increase the diversification of their portfolio. It is expected that the MergeCo vision will closely align with the current PowerStream vision. The Transaction will increase the Shareholders’ investment in their core LDC business (ie. “poles and wires”) but does not address diversification.

The intent of PowerStream’s diversification strategy is partially motivated as a defensive strategy against the potential for disruptive technology. However, by approving the Transaction, MEC and Markham could have limited funds remaining to participate in any of the future unregulated business investments. This may be rectified if the Province approves a Limited Partnership (LP) ownership structure that would allow for private investors to fund both core and unregulated investments without triggering the transfer and departure taxes. However the status of the LP structure proposal will not be known by the time the Transaction requires approval. As such, the decision to enter into the Transaction needs to be made as if the LP structure will not be approved and that Markham (and other Shareholders) may not be able to fund the diversification part of the strategy. In essence, the Transaction would further increase Markham’s exposure to the core LDC business and may leave limited funds to participate in other ventures.

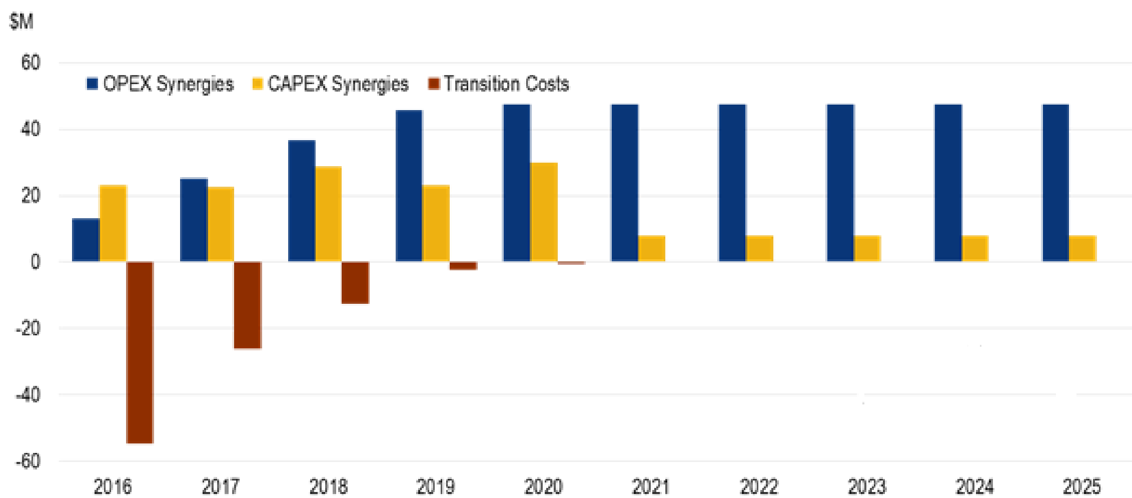
In terms of preservation of principal, while the Rate Base is expected to keep growing, there is risk that the current multiples will decline in future years as interest rates creep back up. Furthermore, the Shareholders could incur significant transfer and departure taxes should they decide to sell more than 10% of MergeCo.

Even if the equity value increases over time, it will be extremely difficult to extract this additional value from the business.

Return on Investment
The return on investment is impacted by a number of factors, most importantly the purchase price of Brampton, PowerStream’s relative valuation, the forecasted synergies, and the impact to the promissory note interest.

LDCs are allowed by the OEB to earn a return of 9.3% on their Rate Base. However, as Brampton's purchase price is 50% higher than its Rate Base, the actual rate of return that would be realized decreases. Navigant's opinion on the $607M price of Brampton is that it is "within, but at the high end of, market value".

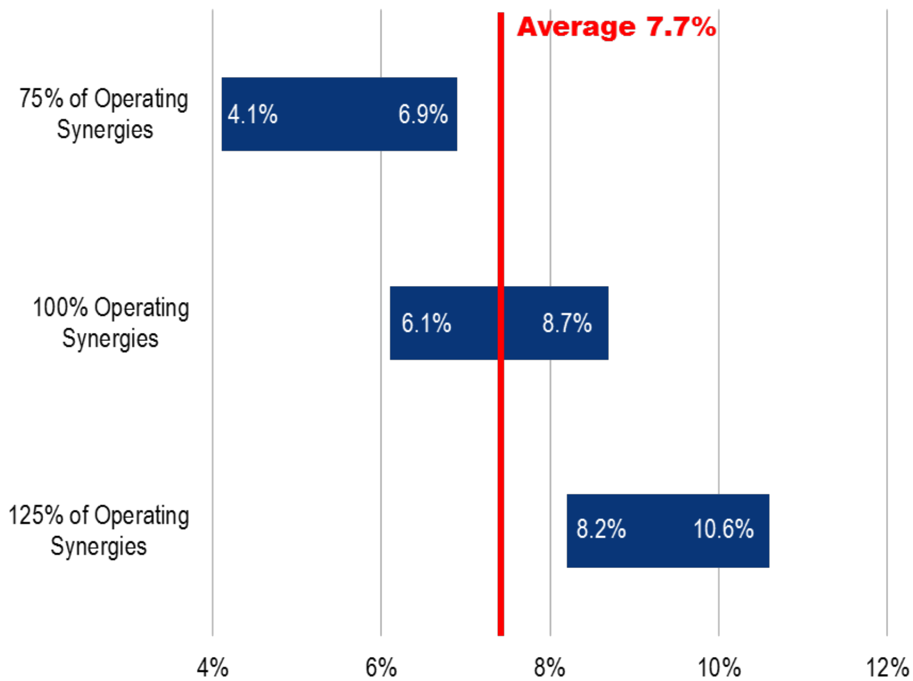
An offset to the premium is that the Ontario Energy Board now allows LDCs to retain the benefits of synergies for up to 10 years. Navigant have analyzed these potential synergies and estimate them to be approximately $310M in net operating savings and $110-170M in capital savings over the first 10 years. Navigant have concluded that the forecasted synergies are "reasonable and achievable". There is, however, a risk that MergeCo would need to rebase prior to 10 years which would reduce the rate of return. The following chart shows the timing of the expected synergies:



The transition costs exceed the projected synergies for the first two years, which Navigant believe is a reasonable assumption. The timing of the synergies has an impact on expected returns to the Shareholders. The quicker MergeCo achieves the synergies, the greater the return. At a high level, if $1M of synergies does not materialize in a given year, Markham's dividend would likely be reduced by $75-150k. Conversely, if $1M of synergies materializes a year in advance, Markham's dividend could increase by $75-150k.

A downside to the Transaction is that the promissory notes that the PowerStream Shareholders hold will have their interest rates adjusted downward from 5.58% to approximately 4.54%, in order to align with the allowable rate of return that LDCs can recover from rates, as mandated by the OEB. This would result in a decrease in interest income to the City of approximately $0.7M per year. This is largely offset by an increase in equity return (i.e. dividends and retained earnings), since regardless of the outcome of this transition, the OEB only allows cost recovery for up to the deemed interest rate.

Taking all these issues into account, it is estimated that the $43M investment is expected to result in an approximate 7.7% return on investment. Navigant have forecasted this range could change to between 4.1% and 10.6% depending on the successful achievement of synergies.



While these calculations are important to note, the more significant financial numbers for Markham and MEC are the actual cash flows they will receive, as they are used to maintain the City's Life Cycle Reserve to ensure there is adequate funding for the repair and replacement of City assets over the next 25 years.

Looking at the cash flows, the simple (undiscounted) payback period is approximately 10 years assuming no closing costs/adjustments.

These payback timeframes can be reduced by funding the Transaction through conversion of promissory notes or a sale of up to 10% MEC's shares of PowerStream (with consideration for MergeCo).

The return on investment is not as favourable to Markham as it may be for some of the other Shareholders for 3 main reasons: 1) the decrease in the promissory note interest rate only impacts the PowerStream Shareholders as St. Catharines, Hamilton and Mississauga do not have any promissory notes; 2) the dividends to MEC related to the PowerStream solar business are expected to decrease by $1M - $2M because of this Transaction, since MergeCo will be allocating higher interest charges (than would exist for the business under the Status Quo) and altering the dividend policy to delay cash flows to Shareholders, which impacts Markham, Vaughan and Barrie; 3) The PowerStream Shareholders are putting in $125M of equity, while the other Shareholders are putting in a combined $57M (Horizon Shareholders do not have to inject any equity into the deal). The relatively higher equity injection results in a less favourable return on investment.

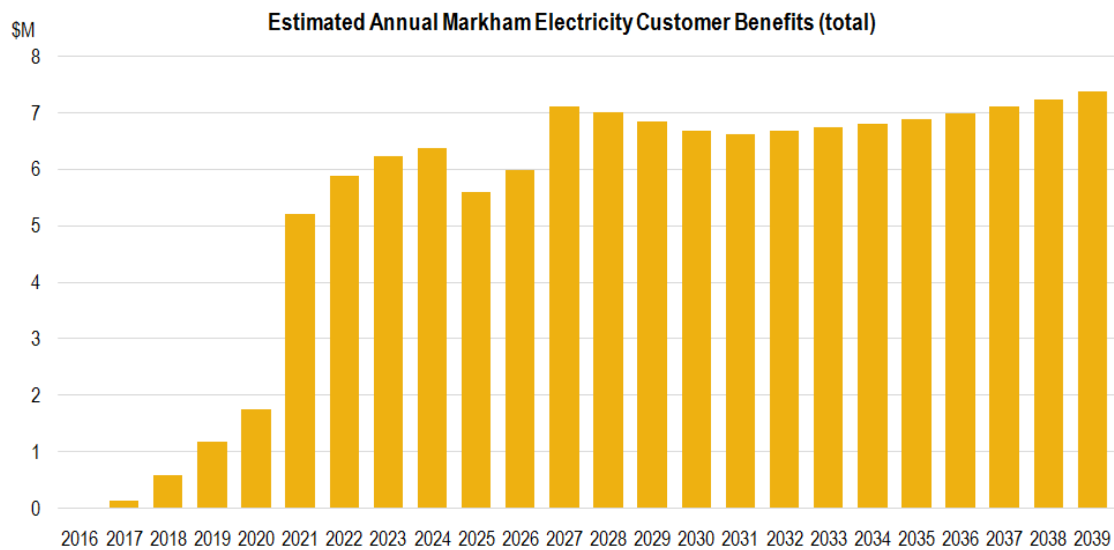
Liquidity/Control

If the Transaction occurs, MEC will have less control over the management of the business as more issues will only require Board, not Shareholder approval. MEC will only have two representatives on the 13 person Board. This may be reduced to one representative if MEC's share percentage drops below 15.38%.

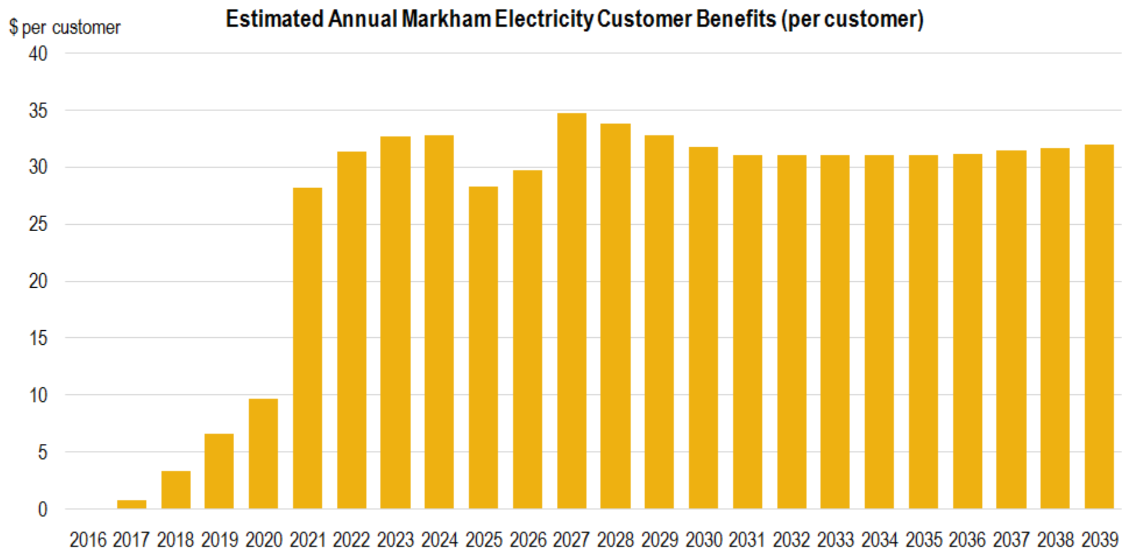
With respect to liquidity provisions, Navigant's view is that under MergeCo "..an exit from the PILs regime (is) at least no worse than the Status Quo, while providing that only a super-majority (two thirds) consent is required, as compared with unanimous consent today."

Impact to Markham LDC Ratepayers

The Transaction is forecasted to result in a favourable impact to Markham LDC ratepayers due to the operating and capital synergies in the amount of $64M (net present valued at a 5% discount rate).



Over the first 25 years, it is estimated that the Transaction could result in savings of approximately $40 per year (average) for each rate payer on the distribution portion of the electricity bill. However, as that figure includes non-residential and bulk-metered multi-residential accounts, the savings for an average resident is estimated to be approximately $24-30 per year, with the first significant savings occurring in 2021. The following chart shows the annual savings for the average residential customer in Markham:



It is important to note that hydro rates are expected to keep increasing over this period due to transmission, commodity, Global Adjustment, and debt portions of their bill, so the projected savings from the Transaction will only partially offset the expected increases.

The impact to Markham owned facilities are estimated to result in savings of approximately $60,000 per year.

FINANCIAL CONSIDERATIONS:

There are numerous complexities with each option given their unique positive and negative aspects, including the risk profile, impact on control, cash flow expectations, and benefits to ratepayers and other considerations, so that on balance, depending on one's perspective of the future of the utilities sector in Ontario, each option could be considered viable.

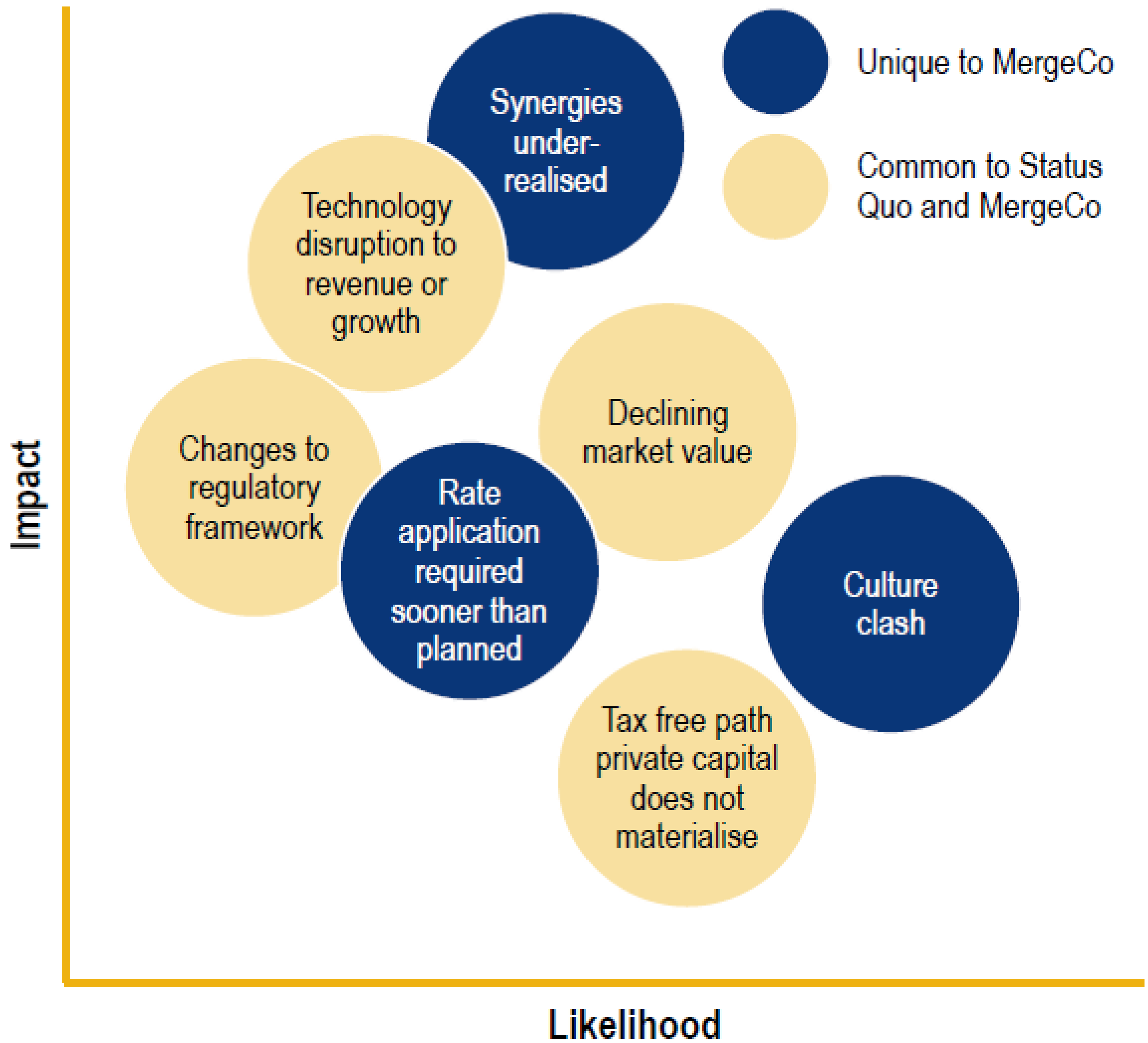
Risks

There are numerous risks involved in the proposed Transaction. The following charts (prepared by Navigant) summarize some of the risks to the forecasted return on investment (bolded items are unique to MergeCo):

Risk	Description
Culture clash	**Each of the four companies has a unique corporate culture. To the extent the new company is not effectively able to integrate the four cultures and retain PowerStream's strong innovation culture, the ability of the company to grow could be hindered.**
Synergies under-realised	**There is a risk that projected merger synergies are not realized. Navigant feel that the forecasted synergies are realistic. Note: the timing**

	of the synergies is important. MergeCo needs to be able to realize the savings early on during the first ten years while they can retain the benefits. After ten years, the benefits flow to the ratepayers.
Rate application required sooner than planned	**Significant value in the Transaction is predicated on effectively managing the regulatory framework and deferring a full rate application for the next ten years. Unforeseen events could force MergeCo to seek new rates sooner, thus transferring the benefit of operating synergies from the Shareholders to electricity customers sooner. Navigant has roughly estimated that rebasing one year earlier would reduce the value of the Transaction to the PowerStream Shareholders collectively by approximately $2M and would reduce the internal rate of return by approximately 0.2%. For Markham, this represents a risk of less than $700k. Navigant's view is that the management of the new company has a number of levers at its disposal to mitigate the early rebasing risk. For example, management could take more aggressive action to increase the synergies or defer capital projects until closer to the 10-year rebasing point. Navigant has characterized the risk as less than likely (i.e. less than 50%).**
Disruptive technology	Disruptive technologies could impact existing revenue and potential for core growth; conversely, these technologies could create new market opportunities for MergeCo. Navigant does not expect this risk to be impactful on the revenue/profitability of the poles and wires utility in Ontario over the next five to ten years.
Declining market value	Low interest rates and low yields are driving up transmission and distribution utility values; absent growth, utility valuations will likely remain stable or decline as interest rates normalize; Ontario's regulatory environment acts as a partial hedge, as the approved return on equity for electricity distribution utilities tracks changes in interest rates.
Regulatory framework change	The Ontario Energy Board has the ability to change the regulatory framework, in part or full, including the formula used to establish the approved return on equity.
Path to private equity does not materialise	Currently, there is a significant tax associated with accessing private capital to fund future growth; an alternative corporate structure that would reduce the impact of this tax was proposed, but a definitive decision from government will not be available prior to the Transaction approval date.

The following chart, prepared by Navigant, details the impact and likelihood of some of these risks:



Cash Flows/Return on Investment

The rate of return, risk profile and cash flows vary significantly depending on the funding source(s) being used to fund Markham's $43M-$47.3M investment. The following analysis is based on Navigant's cash flow model which incorporates the change in expected dividends, the reduction of the City's Promissory Note interest revenue (from 5.58% to 4.54%), and the impact of the Transaction on the projected dividends from PowerStream Solar.

Funding options include: 1) injection of equity from City of Markham, 2) debt (assuming a 4% borrowing rate), 3) conversion of promissory notes, and 4) a sale of up to 10% of PowerStream (with consideration for MergeCo) (it is estimated MEC could receive approximately $30M from the sale of 10% of PowerStream at a 1.5X multiple). The following table, provided by Navigant, outlines the forecasted net present value (NPV) of cash flows of each option (discount rate of 5%), taking into account the varying up front

Option	Funding Source	Cash flows Years 1-10	Cash flows Years 10-24	Cash flows Years 25+ (Terminal Value)	**Total**	**Change from Status Quo**
1 – Status Quo	N/A	$78M	$128M	$164M	**$370M**	
2 – Sell	N/A	$320M	-	-	**$320M**	**($50M)**
3 - Transaction	Equity	$66M	$134M	$179M	**$379M**	**$9M**
3 - Transaction	Debt	$87M	$117M	$179M	**$383M**	**$13M**
3 – Transaction	Promissory Notes	$94M	$122M	$166M	**$381M**	**$11M**
3 - Transaction	10% sale and Equity	$92M	$122M	$164M	**$378M**	**$8M**

outlay required to effect each:

The cash flow analysis indicates that, at a 5% discount rate, the Transaction generates an additional $8M-14M, depending on funding source.

There are many different ways to examine the relative cash flows and each Shareholder may have a different view on what is important based on how they utilize dividends and interest income in their respective budgets. For Markham, these income streams are allocated to the City's Lifecycle Reserve to ensure the repair and replacement of the next 25 years of City infrastructure given known inflows and outflows. Therefore, funding options that would reduce cash flows in the first 25 years (such as through borrowing or an equity injection) are less preferable since any change to the cash flows will have an impact on the reserve that could necessitate a tax rate adjustment.

Preferred Funding Option

Investments in PowerStream account for half of the market value of all the City's investments, with the core business ("poles and wires") being the single biggest investment for the City (38%). To date, the PowerStream core business has been one of the City's top performing investments as it has seen a significant increase in value in recent years. If Markham Council approves the Transaction, the MergeCo core business would account for approximately 45% of the City's investments (in terms of market value). This could be reduced if MEC sold 10% of PowerStream (with consideration for MergeCo) to help fund the Brampton purchase. However, Markham's exposure to the core LDC business would increase to over 40% under any funding scenario for the Transaction.

In order to achieve the goals of: 1) maintaining the current levels of portfolio diversification; 2) taking advantage of the high market multiple being paid of LDCs, 3) maximize cash flows in the first 25 years; and 4) retaining money to potentially invest in future MEC initiatives, staff's preferred funding option is to sell up to 10% of its shares in PowerStream (with consideration for MergeCo), which is estimated to generate approximately $30M. It is also recommended that the remaining equity to be funded come from a combination of cash that is currently retained in MEC. This option provides for an $8M uplift in net present value cash flows. Staff does not recommend the conversion of any of the promissory notes as they provide a solid revenue stream into the City's Life Cycle Reserve.

Proposed Funding

Equity Contribution for Transaction	$43.0M
Add: Closing Costs/Adjustments Contingency	$4.3M
Less: 10% sale of PowerStream	($30.0M)
Less: 10% reduction in Markham's share of Transaction	($4.3M)
Less: Equity already committed for 2016	($5.1M)
Remainder to be funded*	$7.9M

*through MEC debt or equity

It should be noted that selling 10% of PowerStream (with consideration of MergeCo) is estimated to generate approximately $30M assuming a 1.5X multiple. However, that price could prove to be optimistic since the selling of a minority interest has not been fully tested in the market. If the market does not meet these expectations, it may not be prudent for MEC to sell a 10% stake in PowerStream (with consideration of MergeCo).

Backstop

In order to protect against the risk of not being able to sell 10% of PowerStream (with consideration of MergeCo) at the forecasted 1.5X multiple, Markham is pursuing a backstop where one (or more) of the municipalities participating in the merger would fund Markham's $43M - $47.3M contribution in exchange for a prorated equity stake in PowerStream (which would reduce Markham's position in MergeCo from 15.7% to 13.5% -13.7%). If the 10% sale of PowerStream does not occur, staff will report back with alternate funding options which could include any of the aforementioned sources, including the backstop.

LEGAL CONSIDERATIONS:

Each of the LDC's retained legal counsel to complete legal Due Diligence on the parties as follows:

- PowerStream engaged Gowlings LLP to review Enersource
- Horizon engaged Stikeman Elliot LLP to review PowerStream
- Enersource engaged Borden Ladner Gervais LLP to review Horizon and Hydro One Brampton

The Business Plan prepared by the LDC's indicates that the scope of the legal due diligence included:

- Corporate registration and equity instruments;

- Financial matters, in particular credit agreements;
- Real property (owned/leased), as well as registered easements;
- Regulatory filings and orders;
- Distribution system plan and asset condition assessments;
- Labour and employment matters, including post-retirement benefits plans;
- Major contracts and commitments;
- Environmental matters;
- Intellectual property rights;
- Ongoing litigation; and
- Insurance coverage and claims.

MEC has not, nor has any of the other PowerStream Shareholders, duplicated this due diligence work. Our work has centered on the financial aspects and terms of the Transaction and the documents that are being drafted to implement the terms of the Transaction, if approved.

Unanimous Shareholders' Agreement ("USA")

This agreement establishes the governance framework for MergeCo and deals with matters including representation on the Board of Directors, sale of shares between Shareholders or third parties, items requiring unanimous or less consent of the Shareholders, etc. Attached as Appendix '1' to this report is a chart comparing the provisions of the existing PowerStream Unanimous Shareholders' Agreement (PSI USA) and the latest draft of the MergeCo Unanimous Shareholders Agreement (MergeCo USA). This section of the report deals mainly with those provisions that differ from the PSI USA.

Structure

The corporate structure on closing of the merger will be as shown on Appendix '2' hereto. On closing of the merger (and acquisition of Brampton), MergeCo, which will operate as a holding company, will be directly owned by:

- Markham Enterprises Corporation (MEC)
- Vaughan Holdings Inc. (VHI)
- Barrie Hydro Holdings Inc. (BHHI)
- Enersource Corporation (EC)
- Hamilton Utilities Corporation (HUC)
- St. Catharines Hydro Inc. (SCHI)

MergeCo will have three subsidiaries, namely:

- Horizon Solar Corp.
- LDC Co.
- Energy Services (ES) Co.

Horizon Solar Corp., with its own solar assets, will be the corporate vehicle to expand MergeCo's solar assets. PowerStream's existing solar assets will remain in MergeCo.

LDC Co. will operate the electricity distribution enterprise, and ES Co will operate the unregulated businesses.

The current proposal is to keep all of the LDC head offices for a minimum of ten years, during which unanimous Shareholder approval would be required for any re-location. The most recent version of the USA requires 66 2/3 approval (super majority) for any such relocation after ten years.

The corporate head office (Corporate Relations, General Counsel, Finance and Internal Audit) will be located in Mississauga at the Derry Road facility. The Utility Office (Network Service, Network Operations, Customer Service and M&A Business Development) will be located in Hamilton at the John Street Facility and the Sustainability and Innovation Office (Business Development, Technology, Renewable Generation, Energy Service and CDM) will be located in Vaughan at the Cityview Blvd. facility.

Relative Shareholding and Board Structure

The work done by Deloitte was the basis for the negotiation of the relative shareholdings of each of the Shareholders, and the number of directors to be nominated by each Shareholder, as follows:

Shareholder	**Ownership**	**No. of Appointees to Board**
EC	(31.0%)	4
VHI	(20.84%)	3
MEC	(15.72%)	2
HUC	(18.15%)	2
BHHI	(9.43%)	1
SCHI	(4.85%)	1

The initial allocation of Board representatives was negotiated by the parties to the merger. For a minimum of six years after the merger, Markham's number of representatives on the Board of Directors will not change, notwithstanding any changes in Markham's relative share. After the later of that initial six years, and the introduction of any new shareholders, Board representation will be based on the ratio of one representative for each 7.6923% ownership interest. Markham's ownership share will initially be 15.72% and even a small reduction in Markham's ownership interest would take Markham below the 15.3846% required to support two Board representatives. The USA also provides that the "founding" Shareholders will always, notwithstanding the amount of their ownership, be entitled to not less than one Board representative.

Board Members

The MergeCo USA requires that a majority of the Board be composed of Independent members: members who are not members of council or employees of municipal Shareholders, who are not and have not been, during the three years before his or her appointment, a Shareholder, an officer or employee of a Shareholder, a municipality or

MergeCo. The Chair and Vice-Chair of the Board are required to be Independent members.

Each municipal Shareholder may appoint up to one non-Independent Shareholder representative, even if it is the only Shareholder representative to which they are entitled. The municipal Shareholders may appoint more than one independent representative if their ownership share entitles them to more than one representative on the Board, but may not appoint more than one non-Independent.

The USA provides for a “Pre-Approved Shareholder”, in effect a new, permitted equity partner, defined to include the following and their affiliates:

- any public or quasi-public Canadian pension fund-with assets in excess of $5B;
- Canadian banks with assets in excess of $250B;
- Canadian life insurance companies with assets in excess of $10B;
- Credit unions with assets in excess of $5B; and
- Investment funds with assets in excess of $10B

Notwithstanding the above noted definition of Independent members, Pre-Approved Shareholders may appoint one of their directors, officers or employees as their Shareholder representative, if entitled and such appointee will be deemed to be an Independent member. BPC (Borealis) is specifically entitled to appoint a director, officer or employee, through MergeCo’s Shareholder, Enersource, who will be deemed to be an Independent member.

The Board may establish a Human Resources and Governance Committee (HRGC), who will make recommendations to the Board and its Shareholders~~,~~ with respect to candidates for the Board who have specified qualifications and experience~~,~~ in, for instance, corporate governance, human resources, mergers and acquisitions, finance, utility management, generation, etc. Shareholders are not required, however, to select their nominees to the Board from among the candidates recommended by the HRGC.

The Board may also appoint members to an Audit Committee. While the membership of the HRGC is prescribed (three Independent members), the composition of the Audit Committee is not.

Quorum for the Board is a majority of the Board. Any 7 members of the Board in attendance in person or by telecommunication facilities will constitute a quorum. In the PSI USA, there were requirements for members from each Shareholder to be present, for quorum.

<u>Matters for Shareholder Approval</u>

The existing PowerStream USA establishes 18 items that require Unanimous Shareholder Approval. All other matters may be decided by the Board. The MergeCo USA has only 8 matters that require Unanimous Shareholder Approval. In addition, there are 14 matters that require 66 2/3% approval by the Shareholders of MergeCo, a “super majority” or SM. All remaining items may be decided by the Board. The chart attached as Appendix “1” compares the items requiring unanimous Shareholder approval and super majority (“SM”) approval. The effect of the significant changes from the PSI USA is that the Shareholders lose a significant measure of control over material decisions (in fact, a veto in 18 matters) and their role moves to that of an investor rather than a shareholder in control. Overall, much more power will reside in the directors of MergeCo, than is the case with the directors of PHI. This is, however, not unusual in circumstances with more Shareholders having smaller ownership percentages in the corporation.

One of the more significant differences between the two agreements is that no Shareholder of MergeCo is required to contribute more funds to the corporation by way of debt or equity, however, the corporation may proceed with the other Shareholders contributing debt or equity and the shareholding of the Shareholder who does not so contribute will be reduced or diluted.

The MergeCo USA requires the initial Strategic Plan to be attached to the agreement, which effectively means that it requires unanimous Shareholder approval. Amendments to the Strategic Plan will require approval by a special majority of the shareholders or all of the directors. Staff have not seen a draft of this Plan. It will be developed by the Transitional Board (see below) and appended to the USA as a schedule.

Recent changes to the USA include a reduction in the threshold for Board – only approved acquisitions from $100M to $75M. Transactions above the $75M threshold require super majority approval of the shareholders. Markham has requested an amendment to the USA to require unanimous shareholder consent for all acquisitions and mergers of regulated businesses until the later of the third anniversary and achievement of 75% of projected synergies.

<u>PowerStream Solar Business</u>

The final relative shareholding in MergeCo for the PowerStream Shareholders was determined with the solar assets of PowerStream excluded, as discussed above, to achieve better preservation of the value of the assets and to preserve the cash flows from the solar business. To that end, the PowerStream Shareholders will receive additional “Class S shares”, which will pay dividends in accordance with the draft solar dividend policy, to stream the net income from the existing PowerStream solar operations and achieve the return of Shareholder equity to the former PowerStream Shareholders. The assets will be managed by MergeCo pursuant to the provisions of a Management Services Agreement, along with other existing and future solar assets. A draft of the term sheet for this agreement has been reviewed. A further draft was recently provided. These terms must be finalized before final approval of Transaction.

<u>Dividend Policy</u>

The initial dividend policy will be attached to the USA. The draft policy has been revised recently to address concerns expressed by Markham and the Shareholders, deleting criteria regarding “insufficient capital investment in electricity distribution infrastructure” and “impediment to growth”. In addition, MEC staff requested that the dividend policy for the Solar Shares be separated from the Common Shares policy, and this has also been addressed in the latest draft of the policy.

The Common Shares policy will have a target of 60% of net income to be distributed to Shareholders through dividends. Declaration of dividends is a discretionary matter for the Boards of corporations.

<u>Liquidity Provisions</u>
The liquidity restrictions operate at two levels: they apply to both the shares of MergeCo and the shares of the municipal holding companies (i.e., MEC). All transfers are prohibited unless they are expressly permitted, and the USA contain several express permissions.

Internal reorganizations (for example, if Markham wants to transfer its MEC shares to another holding company) are permitted without any approval requirements.

Pre-Approved Shareholders (the pension funds and other financial investors referred to above), and any other third party approved by all the MergeCo shareholders (a Pre-Approved Third Party), may buy up to 10% of MEC and the other municipal holding companies through the issuance of new shares without any approval requirements. This provision is intended to enable shareholders to fund, in part, their equity commitment to MergeCo needed to pay for Hydro One Brampton, although it is not restricted as to time. However, the USA contains terms providing Borealis with a first right to negotiate in good faith the purchase of these newly-issued shares for 20 days, based on a non-binding valuation done by an approved valuator. This provision is significantly better from MEC's perspective than a ROFO (Right of First Offer) as (i) the Offering Shareholder (MEC) and Borealis will go into the negotiation having a good sense of the value, (ii) there is no absolute commitment to sell to Borealis beyond the requirement to negotiate in good faith on an exclusive basis and (iii) if Borealis and the Offering Shareholder don't reach an agreement, the Offering Shareholder can then sell its newly-issued shares to a Pre-Approved Shareholder or Pre-Approved Third Party at whatever price it wants without any time constraints.

Any sale of shares of MergeCo itself is subject to a ROFO in favour of the other shareholders.

The first sale of 10% or more of MergeCo to a non-municipal shareholder will trigger a significant departure tax calculated on the full value of MergeCo. If a transfer of MergeCo shares to such a third party by one or more shareholders is approved by shareholders holdings at least 66.66% of the issued and outstanding shares, the Transferring Shareholders will remain responsible for the payment and indemnity of any tax payable by either MergeCo, the non-Transferring Shareholders or their Principals (municipalities). However, the non-Transferring Shareholders and their Principals must take all fair and reasonable steps to reduce this indemnity obligation and any taxes otherwise payable by the Transferring Shareholder. Additional negotiations on these provisions is required to ensure that, to the extent possible in the context of a changeable tax regime, all parties understand their obligations to mitigate taxes payable on the first and any subsequent sales of shares.

In the event that Markham sells up to 10% of MEC to Borealis or any other third party, some corporate reorganization of MEC will be required to ensure that the shares of Markham District Energy Inc. and the Class S (solar) shares are not held by the holding company in which a third party has invested equity. In this circumstance, a second holding company would likely be established.

All share Transactions are subject to the "anti-flip" provisions in the Hydro One Brampton Share Purchase Agreement which prohibits:

- Sale of more than 49% of MergeCo within three years after closing; and
- Sale of the Hydro One Brampton business within five years of closing

Financing (Capital Calls)

No Shareholder is required to respond to a capital call from MergeCo~~,~~; however, if MergeCo proceeds with the other Shareholders or third parties, the non-responding Shareholder's ownership interest will be reduced. As indicated earlier, Markham's ownership interest in MergeCo is very close to the threshold for two representatives on the Board. Not responding to a capital call could result in Markham's ownership share falling below that threshold and the loss of one board representative after the six year period referred to above.

Future Reorganization

The USA provides for a future re-organization, establishing Limited Partnerships for subsidiaries, if approval of the OEB and a favourable federal tax ruling can be obtained. The advantage of this alternative corporate structure is the elimination of the potentially adverse tax consequences for sales of more than 10% of MergeCo to non-municipal third parties.

The Merger Participation Agreement

This agreement is between the six municipalities, their holding companies, BPC Energy Corporation (Borealis), and the three LDCs and sets out the process and the obligations of each party in proceeding to a closing of the merger. It includes, among other provisions:

- The allocation of shares to each of the Shareholders
- Covenants by each of the parties for appropriate adjustments to be made on closing to ensure that each of the LDCs comes into the Merger with a prescribed level of "net working capital" (generally, current assets less current liabilities) and a prescribed ratio of net operating assets to total debt. If an LDC has more than the prescribed amounts, its Shareholders will be entitled to an adjustment payment and if an LDC has less than the prescribed amounts, the LDC will be required to fund the difference.

- The customary and negotiated representations and warranties, indemnities and other documents to be provided by each of the parties, primarily the LDC's, but including deliverables by MEC (and other Shareholders') officers on closing

This agreement must be signed in order for the Share Purchase Agreement to be executed.

Share Purchase Agreement
This agreement sets out the terms for the purchase of Hydro One Brampton Networks Inc. from the Province of Ontario at the price of $607M, plus adjustments for Working Capital and Net Fixed Assets Adjustment, as defined therein. This agreement will not be signed unless and until all of the parties agree to and execute the Merger Participation Agreement.

All three LDCs are parties to the Agreement, as well as Her Majesty the Queen in Right of Ontario as Represented by the Minister of Energy, Brampton Distribution Holdco Inc. and Hydro One Brampton Networks Inc. Upon closing of the Transaction, Hydro One Brampton Networks Inc. will become part of a wholly-owned subsidiary of MergeCo. The expected time for closing is the second quarter of 2016.

This agreement sets out the anti-flip provisions required by the Province of Ontario referred to above.

Prior to Closing
A Transitional Board is to be established, with the mandate to select the Executive Team for MergeCo, determine compensation, establish the Strategic Plan and possibly other matters. This Board has not yet been established.

Improvements to the Transaction

Over the past month, staff have requested the following improvements to the Transaction:

1) Staff requested that unanimous Shareholder approval be required for all mergers and acquisitions in the regulated business until achievement of the long term targeted annual OM+A synergies.

   The USA is being modified to add language that unanimous shareholder approval would be required until 75% of the synergies are achieved. Staff are satisfied with this outcome.

2) Staff requested that the founding Shareholders retain their original Board seat allocation for ten (10) years provided that they retain minimum of 75% of their original number of shares.

The most recent USA states that Markham shall be entitled to two board members until the later of: (A) the end of the sixth annual meeting of the Shareholders (six years from the date of this Agreement); (B) the end of the first annual meeting of the Shareholders after the introduction of a new shareholder; and (C) the end of the first annual meeting of the Shareholders after any Shareholder acquires the Voting Shares of another Shareholder. Staff are satisfied with this outcome.

3) Staff requested revisions to clause 8.3 of the USA to identify specific actions/obligations of Shareholders to reduce tax liability on sales of shares.

   An "aide-memoire" has been prepared to confirm the intent of Clause 8.3 and to provide examples of how any process to mitigate the tax liability would be applied to the first and subsequent movers under the current tax regime, although this document has no legal status. The City is looking for further wording in Section 8.3 on the objectives intended by this clause, as well as more clarity. Staff are not satisfied at the moment but recommend to make satisfactory amendments a condition of closing.

4) Staff requested that the City's promissory note with PowerStream that expires in 2024 be allowed to be extended.

   Staff have been advised that there is agreement among the merging parties that the Municipal Promissory Notes may be extended for a 20 year term from 2016, with an additional extension not to exceed a further 20 years, all at the interest rate permitted by the OEB. Staff are satisfied with this outcome.

5) Markham sought to get clarification for the province with respect to the potential of approving the Limited Partnership structure (to help reduce or defer future taxes).

   The Province responded with a letter dated October 6, 2015 addressing the issues, but they did not provide any firm commitments. As such, Markham must enter into the deal under the assumption Limited Partnerships may not be approved.

6) Successful negotiations of a municipal backstop can reduce Markham's equity commitment to the transaction should a 10% sale of PowerStream not prove to be successful. Negotiations on this continue.

ENVIRONMENTAL CONSIDERATIONS:

Corporate Sustainability

Staff are pleased to see Sustainability and Innovation as a key business area. This continues the sustainability leadership that PowerStream, Horizon, Enersource and Brampton have shown to date.

PowerStream has been recognized for its sustainability leadership numerous times. Horizon is a leader in sustainability and sustainability reporting using the Global Reporting Initiative. Enersouce supports a number of community programs to promote sustainability in their service territory. Horizon, Enersource and Hydro One Brampton are ISO 14001 registered, which means their environmental management systems consider issues relevant to their operation and promotes continual improvement in this area. It is anticipated that MergeCo will continue to demonstrate leadership in sustainability

Attachments:

Attachment "1" – Gowlings Chart comparing USA
Attachment "2" – Structure Chart

Trinela Cane, Commissioner, Corporate Services

Andy Taylor, Chief Administrative Officer