MARKHAM

Report to: Council

Report Date: September 24, 2008

SUBJECT: PowerStream merger with Barrie Hydro

PREPARED BY: Catherine M. Conrad, Town Solicitor
Donald Taylor, Director of Strategic Initiatives
Barb Cribbett, Treasurer

RECOMMENDATION:

THAT the report entitled "PowerStream merger with Barrie Hydro" be received;

THAT the terms of the Transaction contemplated by the Merger Agreement, substantially in the form presented to the Town Council, subject to any modifications or amendments approved by the Chief Administrative Officer or Commissioner of Corporate Services of the Town, be and are hereby approved and that PowerStream and Markham Enterprises Corporation be authorized to enter into and deliver the Merger Agreement and the Shareholders Agreement, in a form satisfactory to the Chief Administrative Officer, or Commissioner of Corporate Services and perform, observe and comply with its obligations under the Merger Agreement.

THAT the Mayor and Clerk are hereby authorized and directed to sign the Merger Agreement and the Shareholders Agreement and in doing so agree to and approve any amendments to the Merger Agreement and the Shareholders Agreement subsequent to the date of this resolution;

THAT the Mayor and Clerk are hereby authorized and directed to sign and/or dispatch or deliver all other documents, notices, certificates to be signed and/or dispatched or delivered under or in connection with the Merger Agreement or the Shareholders Agreement or to take any action deemed necessary by the Chief Administrative Officer or Commissioner of Corporate Services.

THAT the Chief Administrative Officer, or Commissioner of Corporate Services is hereby authorized and directed to sign and/or dispatch or deliver any other documents, notices, certificates required to be signed and/or dispatched or delivered under or in connection with the Merger Agreement and the Shareholders Agreement and take any other action necessary to give effect to the Merger Agreement.

THAT the Town of Markham approves a Dividend Policy for the merged corporation to be incorporated into the proposed Shareholders Agreement, generally in the form attached hereto. (See below)

THAT the Town of Markham approves an amendment to Section 2.06 of the proposed Shareholders Agreement to require unanimous shareholder approval, in all circumstances, for each of the items listed in Section 2.06(1).

EXECUTIVE SUMMARY:
Not applicable

PURPOSE:
The purpose of this report is to obtain Council approval to the merger of PowerStream Inc. and Barrie Hydro.

BACKGROUND:
The provincial government supports consolidation of local power distribution companies (LDCs) as a method of increasing efficiencies and lowering costs to consumers. The Ontario Energy Board (OEB) has openly stated it wants to regulate fewer LDCs. A transfer tax holiday is in place until October 17, 2008 as a merger/acquisition incentive.

OEB's Incentive Regulation requires LDCs to meet aggressive minimum productivity targets each and every year, and will penalize LDCs who cannot achieve efficiencies. To realize economies of scale and achieve those productivity targets, LDCs must consolidate, either through merger or acquisition. PowerStream has been actively pursuing merger and acquisition opportunities over the past year.

In the summer of 2007, Barrie Hydro management approached PowerStream management to discuss a potential merger of the two utilities. The management teams from both corporations worked together to develop a preliminary business case which outlined potential synergies and relative value ranges that could result from a merger.

A letter of intent, establishing the principles of the proposed transaction and the process for negotiations, was executed by Vaughan Holdings Inc., Markham Enterprises Corporation and Barrie Hydro Holdings Inc., on June 12, 2008 and subsequently amended to extend the period for exclusive negotiations.

OPTIONS/ DISCUSSION:
In order to proceed with the negotiations towards a possible merger, PowerStream's Board of Directors established a Joint Steering Committee comprised of members of PowerStream management as well as external legal counsel Frank Callaghan, to represent PowerStream. Similarly, Barrie appointed a team to act on their behalf in the negotiations.

KPMG was appointed by both parties to prepare a market valuation of the combined entity to determine the relative fair market value of shares for PowerStream and Barrie. Based on KPMG's discounted cash flow analysis and Rate Base analysis, the relative share value range was confirmed at 79 – 82% for PowerStream and 18 – 21% for Barrie. The negotiated shares, taking into account concerns about 2008 projections and PowerStream's next rate filing for 2009, are 79.5% for PowerStream and 20.5% for Barrie. Of that, Markham Enterprises' share of the amalgamated corporation will be 34.19% (43% of 79.5%). Markham Enterprises Corporation hired BDR Energy to advise it on financial matters related to the valuation.

Based on the shareholdings set out above, the Board of Directors will be composed of 13 members, distributed as follows:

Vaughan	6 of 13 directors
Markham	4 of 13 directors
Barrie	3 of 13 directors

The Draft Shareholders Agreement is based on the PowerStream Shareholders Agreement and includes many of the protections for shareholders in that agreement. There are a significant number of items requiring unanimous shareholder consent, including:

- The carrying on of any business or activity other than the business of MergeCo;
- Taking steps to wind-up, dissolve or terminate MergeCo.;
- Mergers or acquisitions other than Board Approved Transactions;
- The admission of new Shareholders or the issuance of any shares or any other change in the issued outstanding share capital;
- The disposition (other than in the ordinary course of Business) of the assets of MergeCo, having a value of (i) 5% or more of the Asset Value in the case of assets forming part of the "rate base" for OEB rate hearing purposes or (ii) 9% or more of the Asset Value in the case of any other assets;
- Change of Auditor;
- Approval of the dividend policy;
- Any name change from "PowerStream Inc.". However, for a period of one (1) year after merger, MergeCowill co-brand itself "PowerStream Inc. Barrie Hydro Distribution" within the Barrie service territory;
- Transactions with Shareholders;
- Any change in the articles or By-laws;
- Entering into any agreement other than in the ordinary course of Business;
- Making any capital expenditure in excess of 9% of the Asset Value or (ii) the making capital expenditures which, in the aggregate, exceed 20% of the Asset Value;
- Swap or derivative transactions not in accordance with the swap and derivative transaction policy approved by the Board;
- Any change of the head office or the closing of any operations/administration centres;
- The making of a Capital Call by the Shareholders;
- The establishment of a subsidiary, other than in connection with a Board Approved Transaction;
- The approval of the initial strategic plan, and updates on a three year cycle.

The draft Shareholders Agreement does not contain the shotgun provision that was in the PowerStream agreement, however, it does contain provisions permitting sales of shares to third parties, with tag along rights, and will also contain provisions permitting first right of refusal for internal sales of shares, with tag along rights.

If approved by the Shareholders, the approval of the Ontario Energy Board is also required, and if granted, the transaction should close on the first day of the month following the date that is 14 days after the OEB approval is obtained.

FINANCIAL TEMPLATE

Relative Valuation Report

As noted above, KPMG was appointed as an Independent Financial Advisor by both PowerStream and Barrie Hydro to determine the relative fair market value of shares for PowerStream and Barrie. Markham Enterprises Corporation hired BDR Energy to complete a peer review of KPMG's relative valuation work.

Overall, BDR was generally in agreement with the use of the discounted cash flow valuation approach which KPMG used to determine relative share value range of 79 – 82% for PowerStream (mid-point of 80.5%) and 18 – 21% for Barrie (mid-point of 20.5%). BDR pointed out that the KPMG's forecast period of 10 years for the Discounted Cash Flow analysis did not fully reflect PowerStream's higher forecasted growth and capital expenditures. BDR also pointed out that KPMG's use of the "Multiple Rate Base Approach" as a second valuation methodology was not generally used for valuation purposes, as it is based on a snapshot in time, and does not consider future growth and subsequent cash flows. BDR's analysis based on their variations to the KPMG approach results in a mid-point closer to 81.5%

KPMG noted in its analysis that there is considerable uncertainty regarding the accuracy of managements projections for 2008, and the potential impact of an unfavourable rate decision on PowerStream's next rate filing in 2009, in terms of certain capital expenditure items not being allowed in the ratebase. It was estimated that the impact of these risks could reduce PowerStream's relative ownership by 0.5% to 1.5%. As a result, the negotiated shares are 79.5% for PowerStream and 20.5% for Barrie. Of that, Markham Enterprises share of the amalgamated corporation will be 34.19%.

Synergy Savings

The Joint Steering Committee estimates that the merger will result in synergy savings of $5M to $5.5M for five years, 50% of which is projected to be distributed to the MergeCo shareholders as a dividend for the first 5 years (to 2013), after which synergies are passed on to customers (service levels will be maintained). The cost of the merger will be equivalent to approximately one year's projected savings.

Capital expense savings averaging approximately $850,000 annually will also be realized over the 10 year period.

Cash Flows to Shareholders

PowerStream provided a forecast of the total net increase in dividends to the shareholders (Markham Enterprises Corporation and Vaughan Holdings), resulting from the merger based on 79.5% PowerStream relative value:

	2009	2010	2011	2012	2013
Increase in Dividends (1)	803,201	506,363	108,079	261,717	112,858
Additional Cash Flows (2)	(644,551)	1,354,510	1,498,089	1,555,314	1,597,387
Total Increase in Dividends Attiributed to Merger	158,650	1,860,873	1,606,168	1,817,030	1,710,245
PV of Increase in Dividends	150,379	1,671,906	1,367,835	1,466,737	1,308,567
NPV of Increase in Dividends	**5,965,424**				

(1) Increase in dividends is due to PowerStream contributing less in net income as compared to Barrie than its relative ownership in MergeCo. in the first 5 year period.

(2) Additional Cash Flows to Shareholders are PowerStream's share of the synergy savings from the business case which can be kept for 5 years. It is expected that the additional cash flows will cease in 2014, although a forecast beyond 2013 was not provided.

MEC's share of the increased dividends over the first 5 year period, as per the PowerStream forecast is:

2009	$68,219
2010	$800,176
2011	$690,652
2012	$781,323
2013	$735,406

As noted above, projected dividends beyond 2013 were not provided, although PowerStream indicated that the additional dividend resulting from the synergy savings can only be retained for 5 years. It is therefore expected by MEC staff that the increased dividends resulting from the synergy savings will be reduced significantly starting in 2014. Future mergers and/or acquisitions could, however, affect these forecasts. In any event, the projected increased dividends to MEC over the first 5 year period, totaling $3.1M, would not be received without the Barrie Hydro/PowerStream merger.

Rate Harmonization

The rate departments from Barrie Hydro and PowerStream anticipate that, based on OEB policy, rate harmonization will occur over a 3 to 5 year timeframe. For PowerStream's customers, the projected magnitude of these long-term changes due to rate harmonization and flow-through of the merger synergy savings (after 5 years) by customer class is as follows:

- Residential rates increasing between 0.8% and 1.8%
- General service (up to 50 KW) changing by -0.5% to +0.4%
- General Service (greater than 50 KW) increasing between 0.3% to 0.8%

ALIGNMENT WITH STRATEGIC PRIORITIES:
Not applicable.

DEPARTMENTS CONSULTED AND AFFECTED:

RECOMMENDED BY:

Catherine M. Conrad Town Solicitor	Don Taylor, Director of Strategic Initiatives
Barb Cribbett Treasurer	John Livey Chief Administrative Officer

ATTACHMENTS:
Appendix A - Dividend Policy

Appendix A

Dividend Policy

PURPOSE

Consistent with the Objectives and Guiding Principles, the corporation will endeavor to earn the maximum rate of return allowable by the Ontario Energy Board. The purpose of this policy is to provide shareholders with a steady income stream from dividends while providing the corporation with an appropriate capital structure and working capital level in order to operate as a viable business.

DETERMINATION OF DIVIDENDS

Dividend amounts will be determined as follows:

- The Corporation shall pay a minimum of 50% of net income with consideration given to the following:

    - Cash position at the beginning of the current year;
    - Working capital requirements for the current year; and
    - Net capital expenditures required for the current year.

CRITERIA FOR DETERMINATION OF DIVIDENDS

Dividends will be declared after due consideration is given to the following:

- All financial covenants on any debt issued by the corporation
- Qualifications to meet external bond rating services to maintain an "A" rating
- Cash requirements of the corporation to meet working capital requirements and short-term (5 year) plans of capital expenditures