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Ontario Budget 2015 Setting the Stage for an Electric Atmosphere of Consolidation?

The 2015 Ontario Budget, released on April 23, includes proposed measures that are intended to set the stage for consolidation within Ontario's electricity distribution sector. At a high level, the measures are a limited-duration reduction of barriers to private sector investment in municipally owned electricity utilities (MEUs).

Background

The Ontario government launched a major restructuring of Ontario's electricity sector with the passage of the *Electricity Act, 1998* to create a more competitive market. As part of this restructuring, Ontario Hydro was broken up and municipalities were required to house their electricity distribution utilities in corporations.

In connection with the break-up of Ontario Hydro, Ontario Hydro's total debt and other liabilities stood at \$38.1 billion, whereas the fair market value of its assets (distributed to new entities) was \$17.2-billion market value. The resulting shortfall of \$20.9 billion was determined to be "stranded debt" that could not be serviced in the new competitive environment.

The government decided that the stranded debt would be paid by the electricity sector and ratepayers. Accordingly, the *Electricity Act* provides for revenue streams to service and ultimately retire the stranded debt. One of the primary revenue streams is a "payment in lieu of taxes" (PILs) regime, which includes PILs on profits, and payments in connection with transfers of assets and in connection with an MEU losing its tax exempt status (and thus departing from PILs regime).

Under the PILs regime, an MEU that is exempt from ordinary income tax is required to pay an amount that is intended to equal the income tax that it would have otherwise had to pay had it not been exempt. The regime also imposes a 33 per cent transfer tax on the fair market value of the MEU's electricity assets at the time those assets are transferred to an entity outside the PILs regime (the transfer tax is reduced by PILs paid by the transferor up to the time of the transfer) to compensate for the loss of future revenue from such assets. Where an MEU ceases to be exempt from ordinary income tax, the regime imposes a departure tax by deeming the MEU to dispose of all of its assets for fair market value.

It is widely accepted that the transfer tax and departure tax rules under the PILs regime discourage private sector investment and consolidation within the industry. It is also widely believed that such investment and consolidation can improve cost efficiencies and lead to other benefits within the industry.

Proposed Time-Limited Changes to PILs Regime

In light of the foregoing, the Ontario Budget proposed time-limited relief pertaining to transfers of electricity assets for all MEUs (or transfers of interests in the MEUs), including transfers to the private sector, for the period beginning January 1, 2016, and ending December 31, 2018, by:

- reducing the transfer tax rate from 33 per cent to 22 per cent;
- exempting MEUs with fewer than 30,000 customers from the transfer tax; and
- exempting capital gains from the departure tax.

The Budget also proposes to introduce measures to prevent the avoidance of PILs through dispositions of partnership interests made directly, or indirectly as part of a series of transactions, to a person who is not subject to the PILs regime or a partnership whose members are not all subject to the PILs regime.

Comments

The changes will reduce and, in the case of small MEUs, remove a major barrier to consolidation within Ontario's electricity distribution sector. However, whether the desired consolidation will occur will also depend on other factors. For example, although the measures are weighted to consolidating small MEUs, will any private sector participants be interested in smaller utilities or acquiring several small utilities to obtain sufficient scale? That remains to be seen.

Further, while capital gains will be exempt from the departure tax, it is important to note that income on recaptured depreciation is not so exempt. For example, assume at the time that an MEU is to lose its tax exempt status (because of private sector investment) it has an asset valued at \$1.2 million that it originally acquired for \$1 million and in respect of which it claimed \$400,000 of depreciation. Under the proposals, the departure tax would not apply with respect to the \$200,000 capital gain, but it would still apply in respect of the full income inclusion of the \$400,000 recaptured depreciation.

Municipalities and their MEUs will face difficult questions around whether to merge (and if so, with whom) or dispose of assets and how the assets of the MEUs should be valued. They will also have to address the impact of the merger on the assets, liabilities, rights and obligations of the merging entities and of the continuing entity formed by the merger. They will also face complex questions in the negotiation and finalization of the merger transaction and related documentation and concerning corporate governance, not just in the decisions related to the merger, but also in the post-merger governance arrangements. It will be essential that municipalities receive effective, independent advice about merger decisions.

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