DECISION SUPPORT WITH RESPECT TO THE PROPOSED MERGER BETWEEN POWERSTREAM, ENERSOURCE and HORIZON AND THE ACQUISITION OF HYDRO ONE BRAMPTON

Submitted to
The Corporation of the
City of Markham
October 3, 2015

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Table of Contents

SUMMARY OF KEY FINDINGS 3

RETAINER AND SCOPE OF WORK 3
RELATIVE OWNERSHIP PROPORTIONS 3
VALUATION OF HYDRO ONE BRAMPTON 4
SYNERGIES 5
EFFECTS OF TAX ON THE VALUE THAT CAN BE REALIZED FROM SALE 6
SOLAR PORTFOLIO (CLASS S SHARES) 6
VALUE CREATED BY THE TRANSACTION 7
Total Cash Flow Basis 7
Incremental Approach 7
PLATFORM FOR FUTURE GROWTH 8
BENEFITS TO CUSTOMERS 8

1 INTRODUCTION AND SCOPE OF THIS REPORT 10

2 DECISION FACTOR #1 – FINANCIAL VALUE TO THE SHAREHOLDER 12

2.1 MEASURING SHAREHOLDER VALUE 12
2.1.1 *Components of Shareholder Value* 12
2.1.2 *Alternative Approaches to DCF Valuation* 13
2.2 RELATIVE OWNERSHIP PROPORTION 15
2.2.1 *Why Proportion is Important* 15
2.2.2 *Standard of Fairness* 16
2.2.3 *Measures of Relative Value* 17
2.2.3.1 *Rate Base Multiple* 17
2.2.3.2 *Deloitte Market Methodology* 18
2.2.3.3 *Discounted Cash Flow Modeling* 19
2.2.4 *The Relative Value DCF Model* 20
2.2.4.1 *Model Description* 20
2.2.4.2 *Data for the Model* 20
2.2.4.3 *Discount Rate and Terminal Value* 21
2.2.5 *Findings on Ownership Proportion* 21
2.3 VALUATION OF HYDRO ONE BRAMPTON 21
2.3.1 *Absolute vs. Relative Valuation* 21
2.3.2 *Comparable Transactions and Stock Market Analysis* 22
2.3.3 *DCF Analysis* 23
2.3.4 *Findings as to Valuation of Hydro One Brampton* 23
2.4 THE MERGECO BUSINESS CASE 24
2.4.1 *Modeling the Mergeco Business Case* 24
2.4.1.1 *Scope of Mergeco's Business* 24
2.4.1.2 *The Mergeco Model and Assumptions* 24
2.4.1.3 *Synergies – Importance and Risks* 24
2.4.2 *Hold or Sell?* 26
2.4.2.1 *Holding in Perpetuity* 26
2.4.2.2 *What is Liquidity?* 26
2.4.2.3 *Tax Regime* 27
2.4.2.4 *Effects of Tax on Proceeds of Sale* 28

2.4.2.5 Whether to Sell if Others are Not Selling 28
2.4.2.6 Findings and Conclusions Related to Tax Provisions 29
2.5 POWERSTREAM SOLAR 30
2.5.1 Separation of Solar from the Mergeco Analysis 30
2.6 FINDINGS AS TO THE MERGECO BUSINESS CASE 31
2.6.1 Selection of a Basis for Evaluation 31
2.6.2 Comparison of Overall Cash Flows 32
2.6.3 Comparison of Net or "Incremental" Cash Flows 32
2.6.4 Immediate Cash Flows 33

3 DECISION FACTOR #2 -- MERGECO AS A PLATFORM FOR FUTURE BUSINESS GROWTH 34

4 DECISION FACTOR #3 -- BENEFITS TO CUSTOMERS 36

4.1 HOW AND WHEN CUSTOMER BENEFITS ARE CREATED BY THE TRANSACTION 36
4.2 MAGNITUDE OF BENEFITS 38
4.3 TIMING AND AMOUNT OF TOTAL BENEFITS 39
4.4 FINDINGS AS TO CUSTOMER BENEFITS 39

SUMMARY OF KEY FINDINGS

Retainer and Scope of Work

This is the report of BDR NorthAmerica Inc. ("BDR") to the Corporation of the City of Markham ("Markham") with respect to a proposed Transaction that, if approved, will result in the merger of PowerStream, Enersource and Horizon (the "Companies") to form a Mergeco, and the acquisition from the Province of Hydro One Brampton Networks Inc. ("HOBNI"). Markham, through its holding company Markham Enterprises Corporation ("MEC") is one of three municipalities with an existing ownership interest in PowerStream. The PowerStream Shareholders retained Navigant Consulting ("Navigant") to provide decision support as to whether the Transaction is in the best interest of the Shareholders, and also retained BDR NorthAmerica Inc. ("BDR") as a source of additional independent advice.

Based on its review of documentation, BDR has prepared this report. It is intended to support an informed decision by MEC and the City of Markham as to whether to enter into the Transaction. This report sets out the results of analysis made by BDR on the basis of the documentation provided.

It is noted that BDR had no mandate in its assignment to perform independent financial modeling, data collection, assessment of synergies or other due diligence. Its report is therefore based on a review and consideration of documentation prepared by others.

Issues include:

- Will the Transaction increase shareholder value? Given the alternative ways possible to quantify value, what approach is most consistent with the needs of MEC and the City?
- How will the value be impacted by the tax provisions that may be triggered on sale?
- What are the risks associated with the Transaction? How are these risks as compared with the risks already inherent in MEC's existing investment in PowerStream?
- What benefits are created for electricity customers by the Transaction?

Relative Ownership Proportions

If the Transaction proceeds, the PowerStream Shareholders together will own 46% of Mergeco if they do not divest any part of their equity investment. Based on the existing ownership of PowerStream, Markham through MEC will own 15.7% of the common

shares of Mergeco. This amount was set by negotiation, based on the results of quantitative analysis, and is important because it means that the values being compared in deciding whether to approve the Transaction are the relative values of the present ownership share of 34.2% in PowerStream, and 15.7% of Mergeco.

BDR reviewed the analysis carried out first by advisors to PowerStream and then by Navigant, and also compared the relative rate bases of the three Companies to provide a benchmark of reasonableness.

Relative rate base, which is generally a high level indicator of relative value for regulated electricity distributors, shows that on the basis of 2015 and 2016 forecast, PowerStream's rate base is between 45% and 46% of the total of the three merger participants. No analysis available for review indicates reasons why long term relative value is expected to be significantly different.

Navigant reported, and BDR confirmed through a high level review of the Navigant model, that most of the alternative approaches from DCF modeling gave results within a tight range around the proposed PowerStream ownership share of 46% (excluding Solar).

Navigant concluded that 46% is within a reasonable range of relative values for PowerStream, when the Solar shares are excluded. BDR, based on its own review, within the limitations stated, concurs with Navigant.

Valuation of Hydro One Brampton

The purpose of the review was to determine whether a price of $607 million is reasonable to purchase Hydro One Brampton from the Province.

BDR had no mandate to undertake an independent analysis. In drawing a conclusion, BDR has drawn on its own experience in conducting similar valuation analysis, and on its review of the methods and data as documented by Navigant.

BDR concludes that the valuation approaches used by Navigant are reasonable, and that the conclusion drawn by Navigant based on the results is reasonable: i.e. that the purchase price of $607 million for HOBNI is within a reasonable range.

BDR also notes that in valuing HOBNI through a DCF approach, Navigant has not factored in two variables which a purchaser other than Mergeco might consider in formulating a bid for HOBNI. These are the benefits of low-cost capital to fund the purchase (which would probably be the case for a very large utility or fund), and the strategic value of a business platform in Ontario. These factors might mean that other

prospective purchasers might well value HOBNI at an enterprise value of $607 million, or higher.

While PowerStream, Horizon and Enersource do not themselves require a new platform in the Ontario market, they may consider ownership of the service territory in Brampton by other competitors as negative to their own future strategic position in the marketplace.

Based on the synergies available from the merger, Mergeco can afford the acquisition without a negative effect on shareholder value, according to the modeling carried out by Navigant, as long as the forecast level of synergies can be achieved.

No potential for negotiation on the price appears to be available.

Assuming a continued environment for high values in utility investments, and the precedent established by this Transaction, the PowerStream Shareholders can reasonably expect the same multiples to be available to them as sellers, in the medium term, i.e. during the payback period for the investment in Mergeco.

Synergies

The ability of the Transaction to increase value for Shareholders and to control rate increases for customers is based the premise that the costs of providing service through Mergeco will be lower than the total cost of providing service to the customers separately through PowerStream, Horizon, Enersource and Hydro One Brampton. The Companies' management teams, working together, have created plans to reduce duplication in various areas of the operation. Significant levels of synergy savings are necessary to create the net cash flow increases that will repay the initial incremental investment in Mergeco. Only synergies realized in the first 10 years after the merger flow to the benefit of Shareholders; thereafter, under the regulatory approach mandated by the OEB, the savings are applied to reduce (or perhaps more accurately to reduce increases in) bills to customers.

Navigant concluded that the estimate of synergies made by the Companies, and included in valuation modeling, is reasonable, and that while there is certainly risk that the synergies may be lower, there is also potential for them to be higher, thereby increasing the value of the Transaction.

BDR accepts the reasonableness of the Navigant review, and notes that of the scenarios modeled, even the least favourable results in an increase in value, relative to the range of incremental investment ($38 million to $47 million) that can be assumed to be invested by Markham in Mergeco.

Effects of Tax on the Value that Can be Realized from Sale

BDR reviewed public documents as to the applicability of Transfer Tax and Departure Tax, performed high level analysis, reviewed analysis carried out by Navigant, and consulted with Navigant to refine its understanding of the intentions of the Companies with regard to the issue of taxes on sale. BDR has concluded that:

- If all of the municipal shareholders intend to sell their interest in the near term (3-5 years), they will incur a significant loss of value as compared with the hold option;
- If a sale is intended in a 3-5 year time frame, it should be done within the tax holiday timeframe (i.e. by the end of 2018); and
- There does not appear to be any gain in after tax value resulting from the Transaction, if the Shareholders exit their positions in the short to medium term.

A second and related concern is about the allocation of tax responsibilities and offsetting benefits, if different shareholders are selling at different times. The issue results from the fact that Departure Tax, in the full amount related to the company, is triggered at the time that more than 10% of the ownership moves into non-tax exempt hands. The effect of this provision on the selling shareholder and the other shareholders at the time of sale and beyond are being considered with a view to negotiating an equitable arrangement.

BDR concludes that the issue of tax liability is a very significant factor, reducing the desirability of selling to realize value, even with expectation of high premiums. The highest value is obtained, whether from the existing investment in PowerStream or from Mergeco, by continuing to hold and receive annual cash flows over the long term.

A priority for MEC if the Transaction is approved, is to gain understanding of the effects of tax responsibility sharing provisions as they are drafted, from the standpoint both of being the triggering seller, and of not selling when the Departure Tax is triggered. This will inform MEC's strategic decisions with regard to its investment in the next several years.

Time is an important factor in this decision since lower Transfer Tax rates apply in the years 2016-2018.

Solar Portfolio (Class S Shares)

BDR has done no independent analysis but is aware of on-going discussions between the Companies as to restructured arrangements and the expected cash flows to the Class S shareholders.

BDR accepts as reasonable the conclusion of Navigant that the Transaction may well result in reduced cash flows to MEC from the solar shares.

Value Created by the Transaction

Value was compared on a total cash flow basis, and on an incremental cash flow basis.

Total Cash Flow Basis

Assuming that the investment to be made by MEC at the time of closing is the currently estimated amount of $43 million, and that in the absence of the Transaction, there would have been an investment of $5 million, so that the net additional amount is $38 million, Mergeco results in an increase in value (over and above the investment), of about $6 million, or 1.55%. It is possible that when recalculated at the time of closing, the actual investment will be different, either higher or lower. Any additional investment will reduce value, while a reduction in the required investment will increase value correspondingly.

On the basis of these figures, it is reasonable to say that there is positive value to the transaction, but that the amount is not "compelling". If the amount of required investment were to increase by, for example, $3 million, an amount that is within a reasonable range of possibility, the value increase would be reduced to $3 million. Furthermore, risks such as the ability to realize synergies affect the results. An improvement in the realization of operating synergies of 25% above forecast could add about $6 million to the net value of Mergeco; but if synergies are 25% below forecast, all of the value gain would be eliminated.

Incremental Approach

In the incremental approach, the computation is of the internal rate of return that is considered to be generated if the new capital is considered the investment, and the change in annual cash flows is assumed to be the return from that investment. In this case, the results are sensitive to the approach used to estimate value beyond the period that is forecast in detail.

On this basis, Navigant shows that, assuming the investment is never sold and continues to generate income at the forecast levels, MEC would earn a return ranging between 6% and 9%. This rate of return is higher than a long term low risk interest-bearing investment (3-4%), but of course, carries a variety of business risks that are common to the electricity sector, as well as risks from the transaction in Mergeco.

The question then becomes, is this range of rates acceptable, given the risks. It is lower than the OEB-allowed return on equity for electricity LDCs, which is currently 9.3%. However, the willingness of investors to purchase Ontario LDCs at premium prices, and the fact that other utility stocks in the market trade at premiums to book value, indicate

that the market considers rates of return somewhat below 9.3% (perhaps in the 6% to 8% range) as commensurate with the risk. And, as any given new acquisition taken as an alternative to the Transaction would likely take place at a premium, the ability of MEC to make an investment at the same risk, with a better return, is expected to be limited.

Given the uncertainties of the future, and the fact that after 10 years the value-creating power of synergies will be redirected to customers, an alternative approach is to look only at cash flows to 2026.

The gradual recovery of a $38 million net investment (the difference between $43 million expected to be required on closing by Mergeco and a $5 million that will otherwise be made in PowerStream), will take place over 10 years through increased dividends on common shares, net of reductions in interest on the Shareholder note and in dividends on the solar shares. Once rebasing has taken place, the incremental cash flow to the Shareholders is reduced. Additional value after that point is considered to accrue, but more slowly.

Again, from this standpoint, the Transaction is neither strongly positive, nor strongly negative. The investment is forecast to be recovered in 10 years, but additional value is realized only in the very long term. If the investment on closing is higher than a net of $38 million, the payback period would be significantly longer.

Platform for Future Growth

A larger entity has a number of scale and other competitive advantages for growth, but also potentially may sacrifice the benefits of focus, unity, and existing position of trust and leadership with stakeholders. In a large measure, the outcome will depend on the ability of decision-makers in the new organization to build on strengths in a timely manner.

Benefits to Customers

The ability to realize benefits to customers is dependent on the synergies created by the merger. If cost reductions can be achieved, rates can be reduced, or at least, the upward pressure on rates can be mitigated.

It was not within BDR's scope of work to review these plans and estimates, but Navigant has done so, and has concluded that the forecast is reasonable. Markham decision-makers can, in BDR's opinion, give credibility to this independent review, and to the fact that PowerStream management has a successful record of managing the integration of LDC operations before.

On this basis, as an average over the long term, a typical residential customer of PowerStream with a monthly electricity bill of about $113 would benefit from synergy savings by, on average over time, about two dollars per month.

The implementation of the synergies represents probably the most significant risk faced in the transaction. The amount of benefits to customers depends entirely on realization of synergies. However, customers are less “at risk” than the shareholders in the sense that there is no time limit to customers in participating in synergy benefits. Customers will benefit from synergies even if the time needed to implement them is longer than forecast.

Markham decision-makers will need to explicitly consider the degree to which they want to take customer benefits into account in deciding whether to approve the Transaction.

1 Introduction and Scope of this Report

This is the report of BDR NorthAmerica Inc. ("BDR") to the Corporation of the City of Markham ("Markham") to support informed decision-making as to a transaction (the "Transaction") consisting of:

- The merger of PowerStream with Horizon Utilities and Enersource to form a new company ('Mergeco") providing electricity distribution and related services primarily in the areas now licensed to and served by PowerStream, Horizon and Enersource, and
- The acquisition of the shares of Hydro One Brampton ("HOBNI") from the Province of Ontario. The consideration for the acquisition is to be $607 million (as adjusted for working capital).

PowerStream is owned directly by three holding companies, which in turn are wholly owned by the Cities of Barrie, Markham and Vaughan respectively. The term "PowerStream Shareholders" in this report refers to the holding companies or the Cities directly, as appropriate. Markham's interest in PowerStream is held through a holding company called Markham Enterprises Corporation ("MEC").

In the spring of 2015, PowerStream, Horizon and Enersource (collectively, "the Companies" or the "merger participants") each retained legal and financial advisors with respect to the Transaction. It was determined among them that Deloitte Canada ("Deloitte") would develop financial models of the Companies and of HOBNI, and of Mergeco, for use by the Companies in negotiating terms among themselves for the merger, and with the Province of Ontario in respect of the acquisition. Deloitte did produce such models and analysis, and shared them with others including with advisors retained separately by the PowerStream Shareholders.

PowerStream staff also prepared certain analysis and a Business Case (the "PS Business Case"), which was also made available to the PowerStream Shareholders and their advisors.

The PowerStream Shareholders decided to retain a name-brand consulting firm to provide a comprehensive report as decision support in the Shareholders' determination (jointly and severally) as to whether the merger and HOBNI purchase option is in the Shareholder's best interests, again jointly and individually.

In addition, the PowerStream Shareholders decided to continue with the retention of BDR as a source of independent advice to the PowerStream Shareholders.

In April 2015, with BDR's support, the Shareholders issued an RFP and subsequently selected Navigant Consulting Inc. ("Navigant") as the primary Consultant.

The PowerStream Shareholders requested Navigant to provide confirmation of the models and analysis carried out by Deloitte. To satisfy this request, Navigant developed its own model. Navigant utilized which had been provided through joint consultation among the Companies, but developed an independent analysis in accordance with its own professional judgment. The Navigant models were also provided to BDR.

Navigant received access to some detail of the data supporting the modeling, and specifically, to detail supporting the Companies' conclusions with respect to the operating and capital cost synergies achievable as a result of the Transaction. BDR did not receive the same level of access, but did receive information as conclusions of Navigant, based on Navigant's review.

Over the course of the negotiation and review period, which lasted from April, 2015 through September, 2015, Navigant reported back at intervals to MEC in meetings, and issued a Final Report in September, 2015.

In mid-August, 2015, BDR was asked to assist by identifying the key areas of focus for their review. BDR prepared an Excel form due diligence checklist. The checklist was based on BDR's experience as an advisor to energy and utility sector parties in mergers, acquisitions and divestitures, and included nearly 200 items and issues.

Subsequent to issuing the checklist, BDR received copies of the PS Business Case and a various reports prepared for the Shareholders by Navigant. BDR also had opportunity to review current versions of the main legal documents and to receive material from the Shareholders' legal advisor (Gowlings) on some of the key issues.

Based on its review of documentation, BDR has prepared this report. It is intended to support MEC in making an informed choice as to whether to enter into the Transaction. Greatest emphasis was placed by BDR on the financial and regulatory aspects of the businesses.

The Transaction is being proposed by the Companies to their shareholders as a source of three types of potential community benefits:

- An increase in shareholder value, net of any required additional investment, based on the scope of business now carried out by the Companies and HOBNI and the service territories now served by them. Since the Shareholders are municipalities, any net increases in value would benefit the communities through either improved services, or improved control of property tax increases, or both.

- Further increases in shareholder value, based on increased capacity of Mergeco (as compared with PowerStream separately) to take advantage of opportunities for further mergers and acquisitions in the regulated LDC sector and/or in the unregulated energy sector, to the degree that such opportunities are shown to have a positive business case.
- Relative reductions in electricity rates to customers in the communities, as compared with the rates forecast to be in effect if the Transaction does not take place.

Each of these types of potential benefit is addressed in this report, to the degree that information was made available to BDR.

It is noted that BDR had no mandate in its assignment to perform independent financial modeling, data collection, assessment of synergies or other due diligence. Its review is therefore based on a review and consideration of documentation prepared by others.

2 DECISION FACTOR #1 – FINANCIAL VALUE TO THE SHAREHOLDER

2.1 *Measuring Shareholder Value*

2.1.1 *Components of Shareholder Value*

Shareholder value, or Fair Market Value ("FMV") when associated with a business or income-producing asset, is based on the expected future cash flows that the business or asset will produce for its owners during the term of ownership. Potential buyers of a business asset focus on how much the asset will earn for them in deciding how much they are willing to pay for it; conversely, potential sellers focus on the earnings they will forego by selling, when deciding what price they are willing to accept. The cash flows that are included in determining the value, and therefore the ultimate price at which a transaction can be consummated, include cash flows from the on-going operation of the business asset (revenues less any expenses and requirements for further investment over time), plus the amount that might return to the owner if and when the asset is eventually sold.

If the owner intends to operate the asset to the end of its life, or at least for an indefinite (but long) period, instead of an eventual sale price, the value includes the present value of expected future cash flows, to the end of the asset life or in perpetuity if the asset does not have a known finite life (or, as in the case of a utility, if there is continuous reinvestment in order to sustain the assets). This final sale or perpetual income value is called a Terminal Value by professionals in the area of valuation.

Even though the Terminal Value may be far in the future in terms of being created by annual operating income, the owner can[1] monetize the Terminal Value by selling the asset. A buyer who shares the seller's opinion about the future ability of the asset to produce income will be willing to pay somewhere near the Terminal Value to purchase the asset.

While FMV is by definition the price at which a willing buyer and a willing seller will close the deal, the value of a business asset can be different for different owners. The same asset may produce better cash flows in the hands of one owner than another, if one owner can, for example, reduce the costs of operation or increase revenues in a way that is not available to the other.

In summary, the components of shareholder value for an asset or business with a long life is the combination of

- some number of years' revenues, less expenses and additional capital expenditures; and
- a Terminal Value, which consists of the estimated future earnings in the time after the number of years for which annual cash flows have been estimated; or the estimated amount at which the asset can be sold at that time.

To make comparable the values of cash flows occurring at different times, valuators discount the future cash flows to compute their value at the present time. The discounted annual cash flows and terminal values can then be added together to compute total value. This is called a Discounted Cash Flow ("DCF") approach to valuation, and is a standard and well-accepted approach to valuation of businesses and income-producing business assets.

The approaches used in comparing the value that would be produced from the merger and acquisition Transaction with the value expected to be produced without the Transaction was compared by Navigant and other advisors retained by the Companies using a combination of:

- the DCF approach, and
- other approaches that seek to estimate what a purchaser might be willing to pay, based on what purchasers have paid for similar assets or businesses in the recent past.

2.1.2 *Alternative Approaches to DCF Valuation*

DCF valuation can be applied to different cash streams to compute value, depending on which measure is most relevant to the business decision at hand.

[1] Subject to tax that might be attracted by the sale.

Valuations from the standpoint of the entire business entity use **"enterprise unlevered free cash flows".** This approach starts with revenues and subtracts cash operating expenses, capital expenditures, and net changes in cash working capital. Unlike the computation of an income statement, depreciation is not subtracted, because it is not a cash expense. As well, interest is not subtracted in this method, so that the method ignores the financial structure of the company. Tax expense is computed as if there were no deduction for interest expense.

The terminal value component of the enterprise approach can be computed in several ways. The most common are:

- to assume a regular pattern of growth in the EBITDA (earnings before interest, depreciation and taxes) will continue forever, and compute its continuing value by dividing by the discount rate less a growth factor; or
- to apply a factor to the asset base as an estimate of what a purchaser might pay for the future cash flows.

The enterprise free cash flow method is suitable for comparing the values created by cash flows in a company, or the total value of a company, without considering how much of the company is funded by debt.

Alternatively, the analysis might take the viewpoint only of the equity investor, who regards debt as a cost assumed to increase the value of the equity. In this "**Free Cash Flows to Equity"** approach, the equity investor is assumed to be mainly interested in income net of interest, but is indifferent as to whether that income is paid out as a dividend or reinvested for growth in the company. The cash flows analyzed are therefore the revenue, less cash expenses, less interest, less actual taxes, less capital expenditures, plus net borrowings, plus or minus the net changes in cash balances. No assumption is made about the portion that will be paid out as dividends – it is counted as a cash flow when the cash is earned by the company, whether it is paid out or held in retained earnings.

For this method, the Terminal Value component considers interest in using the perpetual growth method, and subtracts debt from the asset base if using the asset base method.

The Free Cash Flows to Equity method is appropriate when the equity investor is relatively indifferent as to dividend policy or prefers a "growth" (i.e. no dividend) investment, and when the equity investor is not also a lender, because this method does not consider any effects of the investment on debt holders.

The final method used in the analysis is called the **"Dividend Growth"** method. This method considers cash flow as it arrives in the hands of the equity investor as a dividend.

Income held for reinvestment as retained earnings in the company is not a cash flow in this method.

For this method, the Terminal Value is assumed to be a growing dividend, received in perpetuity. The value of the perpetuity is computed by dividing the dividend amount by the discount rate less the growth rate.

This method is applicable when dividend policy is important to the investor (i.e. the ability to receive a payment from the investment without selling any shares). It also allows several streams of dividends from different share classes, or an income stream from interest, to be added together, if all of the streams are relevant to the price or investment decision.

These methods are each used for different purposes in the analysis of the Transaction.

To compare two different investments, or two different choices (such as to accept the Transaction or continue with PowerStream on a “status quo” basis), it is possible to include all of the cash flows for comparison, thereby comparing the aggregate value of two options. It is also possible to take an “incremental” approach, subtracting one set of cash flows from the other, so that the focus is on the total difference and, if relevant, and the timing of differences between the two options. Essentially, without looking at totals, this approach answers the question “How much more money needs to be invested, and how much more income will be received as a result?”

The incremental approach has also been used in analyzing the Transaction.

2.2 *Relative Ownership Proportion*

2.2.1 Why Proportion is Important

A key output of the detailed financial modeling exercise conducted for the Transaction is to determine the fair proportion that each of the merger participants (PowerStream, Horizon and Enersource) should own of Mergeco, and by extension, the proportion that each of the shareholders of those entities (including the City of Markham, through MEC) should own. The ownership proportion, determined on the basis of the value contributed by each shareholder (i.e. its ownership share in one of the merging Companies, plus cash if any) will determine the proportion of common shares, and therefore of dividends from the common shares of Mergeco that each shareholder is ultimately eligible to receive if the Transaction proceeds.

A similar exercise was carried out years ago, when the Markham and Vaughan LDCs were merged to create PowerStream, and later when Barrie Hydro was merged with

PowerStream. The ownership proportions of each of the PowerStream Shareholders today reflect the analysis done at that time to determine relative values of the merging LDCs within a range, with the final figures determined by agreement.

2.2.2 Standard of Fairness

In order to be fair to all the shareholders of Mergeco, their contribution of investment in Mergeco needed to be valued. For this reason, several methodologies were used to estimate the FMV of each of the Companies. The ownership share would then be determined by dividing the FMV of each Company by the total value of the three Companies.

Valuation of a going concern business is carried out by experts in valuation, and in a specialized industry like electricity distribution, the valuator needs to understand the industry and the regulatory regime, as well as the principles of valuation. Nonetheless, the information on which a valuation is based consists of forecasts, sampled statistics, and estimates. If several methodologies are used, which is often the case, the result is a range of values.

In the case of the Transaction, the task of performing the relative valuation of PowerStream, Horizon and Enersource was first conducted by Deloitte, resulting in a value range. The final relative values were then negotiated among the Companies.

In order to be fair, the final ownership proportion should have a basis in the relative values determined by the qualified valuator(s), and be set so that each merger participant shares equitably in the benefits of the Transaction.

Following completion of the valuation analysis, the ownership proportions for the common shares were fixed through negotiation at 46% for PowerStream, 31% for Enersource, and 23% for Horizon.

Assuming that none of the PowerStream Shareholders divests any of its ownership interest, this will result in MEC, which today owns 34.2% of PowerStream, owning 15.7% (46% x 34.2%) of the Mergeco common shares.

The original ownership interest for PowerStream was indicated to be about 49%, on the basis that all of the merger participants would receive an interest in the PowerStream solar portfolio. However, it was subsequently negotiated that the PowerStream Shareholders would retain full ownership of the benefits of the solar portfolio. On this basis, the ownership proportions for the common shares were established excluding the PowerStream solar portfolio and its cash flow stream from the computations. This resulted in a proposal that the ownership share of the

PowerStream shareholders would be 46%, in addition to which they would own 100% of the "Class S" solar shares.

The Class S shares are discussed in Section 2.5 of this report.

2.2.3 Measures of Relative Value

2.2.3.1 Rate Base Multiple

A simple approach to determining the relative values of regulated Ontario electricity distributors is to look at the rate base of each. "Rate base" is the regulatory term for a combination of net plant and working capital which constitute the assets funded by shareholders and lenders, and placed in the service of electricity customers. The Ontario Energy Board ("OEB") determines the amount that shareholders are allowed to earn from electricity rates, by applying a predetermined allowed equity rate of return to 40% of the rate base. The OEB-allowed net income of distribution utilities is therefore directly related to their rate bases, although individual distributors may earn slightly more or slightly less than the allowed amount in a particular year, depending on how actual spending compares with the levels approved by the OEB.

Table 1 computes the portion that the rate bases of each of the Companies represents of the total, using the forecast rate base values that were used by Navigant in its financial model of the transaction. The resulting proportions are very close to the negotiated ownership proportions for the transaction. This simple approach ignores different levels of future growth, and other differences that would contribute to relative value in the long term, and it also excludes the value of unregulated businesses (other than the PowerStream solar portfolio) that will be part of the merger.

However, this measure provides a high level indicator that the recommended proportions are within a band of reasonableness. If more detailed methodologies had provided a significantly different result (which they did not), it would be appropriate to require explanations of those differences.

Table 1: Relative Rate Base Values of Merger Participant LDCs

Relative Rate Base ($ millions)			
	2015	**2016**	**Avg**
PowerStream	990,434	1,013,921	
Enersource	698,478	755,718	
Horizon	479,779	497,783	
Total Rate Base	2,168,691	2,267,423	
Indicated Relative Values			
PowerStream	45.7%	44.7%	45.2%
Enersource	32.2%	33.3%	32.8%
Horizon	22.1%	22.0%	22.0%
Total	100.0%	100.0%	100.0%

Deloitte refined this approach slightly, and produced very similar results.

2.2.3.2 Deloitte Market Methodology

Deloitte, in preparing its material on relative values, applied an approach that takes the view of a potential purchaser of PowerStream, Horizon or Enersource, and uses a cash flow analysis to estimate the premium that such a purchaser might be willing to pay, assuming that the investment provided both financial and operating synergies, and that the purchaser would require pay-back on its investment over a ten-year period.

The analysis showed almost no difference among the Companies in the premium to rate base that the theoretical purchaser should be willing to pay, under the model's assumptions.

While this method is not one that is often encountered in valuation analyses, it can be viewed in the context of regulated LDCs as confirming that relative rate base is a good high level indicator of relative value for the Companies, within a band of reasonableness.

2.2.3.3 Discounted Cash Flow Modeling

The most common, and also the most detailed, methodology for determining value is DCF modeling. DCF modeling was carried out by Deloitte and by Navigant. Navigant's modeling confirmed the relative value ranges that were computed by Deloitte.

In DCF modeling, annual cash flows are forecast and modeled for some period of time. To the annual cash flow (enterprise free cash flows, free cash flows to equity, or dividends, depending on the methodology chosen (see Section 2.1.2)), the model adds a Terminal Value representing cash flows beyond the modeled period of time. In order to model cash flows, a forecast of revenues, operating, maintenance and administrative ("OM&A") expenses, depreciation expense, taxes, financial expenses, capital expenditures, new borrowings, and payment of dividends is required. The level of detail included in a DCF model provides opportunity for differences in the relationship of levels of revenues and costs to the rate base, and changes in these variables over time, to be taken into account in establishing value. This is in contrast with the rate base approach, which provides a "snapshot" of value at a point in time and assumes a consistent relationship between the rate base and cash flows, both amongst the Companies and over time.

DCF analysis is a very well established tool for valuators, and incorporates certain fairly standard methodologies. However, the methodology also requires the valuator to make certain choices on the basis of knowledge of the industry and expertise as a valuator. In considering the results of a DCF valuation, it is very important to understand:

- The modeling inputs to create annual cash flow calculations are always a forecast, and therefore subject to judgment. The longer the forecast modeling period, the less certainty can exist as to the reasonableness of the forecast. The forecast will necessarily assume decisions of management as to the way the business is operated, and business, legal and economic factors. In modeling an LDC, assumptions about the way that revenue is established in the regulatory regime (i.e. by the OEB) are important, as well as factors such as growth in customers and loads, and changes in the price of inputs such as labour and materials.
- The valuator has at least three key methodology choices to make in the valuation: what cash flow approach to use, what method to use in estimating Terminal Value, and what discount rate or range of rates to apply. In modeling LDCs, it is not unusual for Terminal Value (beyond a modeled time period, which in this case was 25 years) to represent about half of the total value, and therefore the method selected is very important to the overall result. Selection of a discount rate is also very important, because selection of the rate is primarily a matter of expert judgment (there is no "correct" rate). Use of a lower discount rate will increase the resulting total value, whereas use of a higher discount rate will reduce it.

In modeling the Companies for relative valuation purposes (i.e. for ownership share), getting the “right” absolute value is less important than getting a reasonable relationship among the values of the Companies. This provided Deloitte and Navigant with the opportunity to make the simplifying assumption that the Companies are all essentially the same kind of business, and will therefore be affected by financial, economic, technological and regulatory variables in essentially the same way. Most important is to take a consistent approach in modeling each Company. For the relative modeling, therefore, while using the individual financial and operating information of each Company, Navigant applied the same alternatives in choice of cash flow, Terminal Value approach, and discount rate to each one to obtain the results.

2.2.4 The Relative Value DCF Model

2.2.4.1 Model Description

Navigant’s model creates 25 years of forecast financial statements (i.e. for 2015 to 2039). Each of the Companies, and HOBNI, are modeled separately. The separate statements for each of the Companies are used to establish the relative valuation. The separate statements for HOBNI are used to consider the reasonableness of the purchase price of $607 million (see Section 2.4). All of these are then used as the basis a forecast for Mergeco. The model includes separate analysis of PS Solar.

Each Company model applies assumptions and computes revenues based on the application of the Ontario regulatory regime.

The Mergeco model (which is not relevant for purposes of the relative values of PowerStream, Enersource and Horizon), aggregates rate base and revenues from the four LDCs (i.e. including HOBNI), and applies assumptions as to regulatory treatment and synergies achieved. As will be discussed in Section 2.4, the assumption of synergies in operating and capital cost, while holding revenue unaffected (i.e. not rebased) for 10 years, provides the cash flows that enable the premium paid on HOBNI to be recovered by the shareholders and creates the relative savings for customers on their bills.

2.2.4.2 Data for the Model

Data for the model includes financial projections, economic variables such as inflation, and assumptions as to growth in number of customers in each Company. The data is all forecast, developed by staff teams in the Companies and accepted among them for inclusion in modeling.

2.2.4.3 Discount Rate and Terminal Value

The model enables testing of the relative values using different discount rate assumptions and three Terminal Value approaches. The discount rates in the model are, in BDR's opinion, a reasonable range of alternatives, based on BDR's knowledge of the industry and capital markets. The Terminal Value approaches used are not the only ones available, but are ones commonly used by valuators in the sector.

Navigant reported, and BDR confirmed, that most of the alternative approaches gave results within a tight range around the proposed PowerStream ownership share of 46% (excluding Solar).

2.2.5 Findings on Ownership Proportion

It is proposed that for purposes of the formation of Mergeco, the PowerStream Shareholders together receive a 46% interest in the common shares, in exchange for their interest in PowerStream and cash.

Relative rate base, which is generally a high level indicator of relative value for regulated electricity distributors, shows that on the basis of 2015 and 2016 forecast, PowerStream's ratebase is between 45% and 46% of the total of the three merger participants. No analysis available for review indicates reasons why long term relative value is expected to be significantly different.

Navigant reported, and BDR confirmed through a high level review of the Navigant model, that most of the alternative approaches from DCF modeling gave results within a tight range around the proposed PowerStream ownership share of 46% (excluding Solar). One Terminal Value method resulted in slightly higher relative value for PowerStream.

Navigant concluded that 46% is within a reasonable range of relative values for PowerStream, when the Solar shares are excluded. BDR, based on its own review, within the limitations expressed in Section 1, concurs with Navigant.

2.3 *Valuation of Hydro One Brampton*

2.3.1 Absolute vs. Relative Valuation

As explained in Section 2.2, DCF modeling was used to prepare valuations of the merger participants and HOBNI. In each case, the DCF summary value was computed by applying a discount rate to a stream of annual cash flows, plus a Terminal Value intended as an estimate of on-going cash flows, beyond the 25 years actually modeled. Also as

explained, the choice of discount rate and Terminal Value approach can have the effect of changing significantly the value produced by the calculation.

For purposes of the ownership proportions, the absolute value of each Company, as determined by the DCF method, is less important than the relative value. On that basis, different assumptions within reasonable limits can be accepted without serious concern, as long as they have a similar effect on the valuation of each Company. For example, a reduction in discount rate will increase the resulting value for all of the Companies, but may have little or no impact on relative value, if the change is applied consistently to the valuation of each one and the timing of cash flows is relatively consistent among the Companies.

However, in the case of HOBNI, the objective of the valuation is to test how the DCF valuation compares with a specific proposal as to purchase price, namely $607 million. The assumptions used therefore require a much higher degree of review as to reasonableness.

To make a test of reasonableness of the ratio between purchase price and the rate base (book value of plant and working capital), Navigant also looked in the marketplace for indications of the premiums that investors have been willing to pay for companies in the same sector. This is generally termed a “market” or “comparable transactions” approach, and serves as an additional confirmation of the reasonableness of a purchase price, just as the sale prices of similar homes in an area provide a benchmark price in real estate transactions.

2.3.2 Comparable Transactions and Stock Market Analysis

The challenge in this type of analysis is finding a sufficient sample of data that is both relatively recent and composed of companies with a similar business and degree of risk.

In order to obtain sufficient data, Navigant looked at:

- Transactions where the whole, or a significant interest, in one company was purchased by another, and data are available as to the price and cash flow or asset base; and
- Prices in the capital market, where investors of all types are making decisions as to the value of equity in a company, in a liquid and current environment.

Limitations on the data include, in the case of transactions, the time duration (about 5 years), different circumstances, different parts of the world, and the inclusion in the sample of companies of businesses other than distribution “wires”. In the case of stock market comparisons, Navigant made effort to secure a sample of companies that excluded merchant generation businesses and were relatively small in terms of number of

customers. However, this sample includes US companies, and typically regulated rates of return in the US are somewhat higher than those in Canada.

BDR concludes that these samples would tend to include transactions with premiums at the high end; nonetheless, the premium is not out of line as compared with fairly recent Ontario sector transactions, including the purchase by PowerStream of 50% of COLLUS. BDR also concludes that the approach and sample used were reasonable given the structure of the industry, number of transactions taking place, and availability of data.

This analysis by Navigant indicates that the purchase price for HOBNI is at the high end, but within the range indicated by the market.

2.3.3 DCF Analysis

In considering the results of its analysis, Navigant reported that in order to obtain a valuation of $607 million, it was necessary to apply assumptions that were not conservative, but which, in Navigant's opinion, are not outside the range that a purchaser might apply in valuing the company.

Of three terminal value methods tested by Navigant, $607 million is within the range produced by two methods, when a reasonable range of discount rates is also tested.

2.3.4 Findings as to Valuation of Hydro One Brampton

BDR had no mandate to undertake an independent analysis, and did not do so. In drawing a conclusion, BDR has drawn on its own experience in conducting similar valuation analysis, and reviewing the methods and data as documented by Navigant.

BDR concludes that the valuation approaches used by Navigant are reasonable, and that the conclusion drawn by Navigant based on the results is reasonable: i.e. that the purchase price of $607 million for HOBNI is within a reasonable range.

BDR also notes that in valuing HOBNI through a DCF approach, Navigant has not factored in two variables which a purchaser other than Mergeco might consider in formulating a bid for HOBNI. These are the benefits of low-cost capital to fund the purchase (which would probably be the case for a very large utility or fund), and the strategic value of a business platform in Ontario. These factors mean that other prospective purchasers might well value HOBNI at an enterprise value of $607 million, or higher.

2.4 *The Mergeco Business Case*

2.4.1 Modeling the Mergeco Business Case

2.4.1.1 Scope of Mergeco's Business

All of the comparative valuations and financial modeling carried out and described in Section 2 are based on the existing scope of business of the component Companies, i.e.:

- That the service territory of Mergeco will be the combined existing service territories of PowerStream, Enersource, Horizon and HOBNI, including any customer growth in those territories, but not assuming the addition of service territory through subsequent merger and/or acquisition; and
- Only solar installations "grand-fathered" in 2015 will be part of PowerStream Solar portfolio (i.e. the Class S shares); and
- That the other affiliate businesses included in the Transaction will not experience any significant change in nature, scope or volume of business.

However, PowerStream has a Board-approved strategic mandate for growth, and it is assumed that growth opportunities forecast to meet appropriate profitability and risk criteria, would also be sought by Mergeco. The relative values of Markham's 34.2% ownership in PowerStream and a 15.7% ownership in Mergeco, as compared in the available analysis, thus do not consider in any way the changes (positive or negative) that may affect the Shareholders' potential to participate in business growth opportunities as a result of the Transaction.

2.4.1.2 The Mergeco Model and Assumptions

The Mergeco model was built by Navigant based on the individual models of the Companies and HOBNI. However, certain changes were made to address the ways in which Mergeco would be different from the simple sum of the individual component companies. Of most import is that the expected operating and capital synergies were computed and subtracted from the Mergeco sum, to enable the assumption that the synergies provide value to the Shareholders over the first 10 years. Also interest on Shareholder loans was reduced, based on terms proposed as part of the Transaction.

The model calculates Terminal Values by the same methods incorporated and applied to the Companies individually. Cash flows are discounted to compute total value.

2.4.1.3 Synergies – Importance and Risks

The base case of synergies was developed by teams of management of the Companies, and reviewed for reasonableness by Navigant. Navigant concluded that the estimate of

synergies is reasonable in aggregate, and potentially underestimated in some specific areas. In making its assessment, Navigant noted

- Ability to achieve synergies is a risk factor in terms of the ability of the Shareholders to gain value from the Transaction; and
- PowerStream has a track record of effective integration of merged and acquired LDCs and the achievement of synergies.

Navigant has rated the under-realization of synergies as medium probability and high impact, as compared with other risks specific to Mergeco. In order to test the impact of different levels of achievement of synergies, Navigant conducted sensitivity modeling. In the base case (synergies as forecast), the value of the Transaction to MEC is $72 million as the average of a range of $61 million to $84 million. If only 75% of operating synergies are realized, the range of values is reduced to between $51 million and $74 million. If Mergeco management is able to achieve a 25% increase in operating synergies as compared with the forecast, the value of the Transaction is increased to a range of $71 million to $95 million.[2]

BDR accepts the reasonableness of the Navigant review, and notes that of the scenarios modeled, even the least favourable results in an increase in value, relative to the $43 million[3] that can be assumed to be invested.

In considering the risks associated with the achievement of the synergies, BDR notes:

- Synergy risk affects the potential benefits of the Transaction both to the Shareholders and to customers.
- Allocation of synergy benefits between customers and shareholders depends on the type of synergies (capital or operating) and the timing when they are realized (before or after rebasing. Rebasing will reassign all future synergy benefits to customers; in order to benefit Shareholders, the savings must be achieved in the 10-year period prior to rebasing.)
- These estimates do not include any changes, positive or negative, that might result from further mergers and acquisition that occur after the Transaction.
- The Status Quo (no Transaction) case may overstate costs, by not considering potential savings that might be achieved over time through means other than the Transaction.
- Integrating four of the largest municipal LDCs in Ontario is a complex and challenging task that should not be underestimated.

[2] All values result for the use of a 5% discount rate. The range results from inclusion of different Terminal Value estimation methodologies in the computation.
[3] Plus or minus certain adjustments.

- PowerStream cannot achieve success alone. The effort, dedication, flexibility and cooperation of the entire management and work force will be required to achieve the forecast results.

2.4.2 Hold or Sell?

2.4.2.1 Holding in Perpetuity

The value of a business can be realized by its owners in one of two ways: either by selling the business and receiving its value as cash (or other considerations); or by retaining ownership, in which case the cash flows from operating the business continue into the long term. Unless the business or business asset has a known limited life (such as the solar assets, which are estimated to be productive for 20-25 years and whose revenue source is a 20-year contract), it is assumed that unless sold, the cash flows from the business will continue forever. The value of the business continuing forever is incorporated into the valuation through the Terminal Value.

Many factors can affect the decision of an owner to retain or sell an income-producing asset, but assuming that the amount of cash flows is at least as important to the owner as timing (i.e. there is no urgent need for the proceeds of sale); the decision can be made on the basis of the relative net present value of these two options.

In deciding whether or not to approve the Transaction, consideration needs to be given both to the potential value to the Shareholder if the investment in Mergeco is retained in the very long term, and to the proceeds if it is sold. If MEC wishes to keep sale open as a potential future strategy for its electricity sector investments, the effect of the Transaction on that choice needs to be well understood.

All of the valuations and analysis discussed in Section 2.6 assume that all of the Mergeco Shareholders who are municipalities choose to hold the investment in perpetuity. The effects of a choice to sell all or part of the equity interest by one or all shareholders is discussed in this section.

2.4.2.2 What is Liquidity?

One of the factors in the desirability of an investment is its liquidity, i.e. the ability of the investor to realize the value of the investment through sale. Any factor that stands in the way of being able to sell at the time desired by the seller, or to obtain the full value, reduces the liquidity of the investment. Factors in the liquidity equation are:

- Availability of potential buyers;
- Contractual obligations enabling or limiting ability to sell; and

- Effect of tax provisions on the value of proceeds of sale, in comparison to the value of the "hold" option.

It has been suggested that MEC's investment in Mergeco will be more liquid than its present investment in PowerStream. If true this is a significant strength of the Transaction.

BDR believes that potential buyers exist for MEC's interest in PowerStream or in Mergeco at a favourable multiple, and therefore this factor is equal in terms of liquidity.

If the Transaction takes place, certain limitations on sale will be in place in the medium term, but thereafter any shareholder will be free to sell its interest without requiring consent of the others. This is an improvement in liquidity over the present arrangement, where consent is required if any Shareholder wants to sell.

With regard to tax consequences, the tax provisions are a disincentive to sale at any time and under any conditions, but worse if done outside the current tax "holiday" (See Section 2.4.2.3). As well, the proportion of the company being sold is an important factor, because once 10% is owned by non-tax exempt owners, the Company will exit the PILs regime, triggering one-time Departure Tax in addition to the Transfer Tax that will apply to every sale. Thus, timing is an important factor as to how much tax will apply to reduce the proceeds of a particular sale.

2.4.2.3 Tax Regime

Applicable taxes on disposal by a municipality of their interest in the LDC can include two elements: Transfer Tax, and Departure Tax.

(a) Transfer Tax is applicable on the pre-tax sale price of the interest being transferred, regardless of the cost base, and generally applies at the rate of 33%. Transfer Tax is applicable at the time of the sale regardless of whether the LDC remains in the PILs regime, exits the PILs regime as a result of this sale, or has already exited the PILs regime. The seller can claim as a credit against Transfer Tax a share of PILs already paid. This includes both the PILs paid annually based on income, and Departure Tax if triggered by the sale. If an LDC had two municipal shareholders and one sold in 2020 and one in 2022, the first seller would pay Transfer Tax on the proceeds of its sale in 2020, and the other shareholder would pay Transfer tax in 2022 on the proceeds of its own sale. In each case, the tax would be determined on the basis of the price that the selling shareholder was receiving, and could therefore be different for each of the two shareholders.

(b) Departure Tax is triggered one time only, at the time of the first sale that puts the LDC over the 10% limit for non-tax exempt (i.e. non-municipal) ownership. It is computed following the computation model that the Income Tax Act provides for sale of assets that have been depreciated for tax purposes over time. If the sale price is higher than the Adjusted Cost Base (usually the original cost of the assets), the amount of tax depreciation ("CCA") already claimed must be considered income and is taxed at the regular rate for income taxes. The difference between the sale price and the Adjusted Cost Base is considered a capital gain, and attracts tax at the capital gains rate, which is less than the rate for regular income taxes.

The Ontario provincial Budget, issued in the spring, 2015, provided a temporary "tax holiday" to encourage consolidation in the sector. For the years 2016 to 2018, the Transfer Tax rate has been reduced from 33% to 22%, and the rate for the capital gains portion of Departure tax is reduced to zero.

2.4.2.4 Effects of Tax on Proceeds of Sale

Navigant modeled the effects of tax upon the proceeds of sale of Mergeco or PowerStream (status quo), assuming various points in time for the sale. In all cases, the assumption was that all municipal shareholders divest their full interest at that same time.

BDR reviewed documents explaining the application and computation of the taxes and the confirmed that the computations made by Navigant were consistent with BDR's understanding of the way that the taxes would apply.

The computations show that if the municipal shareholders intend to sell their interest in the near term (3-5 years):

- ***They will incur a significant loss of value as compared with the hold option;***
- ***If a sale is intended, it should be done within the tax holiday timeframe (i.e. by the end of 2018); and***
- ***In this situation, there does not appear to be any gain in after tax value resulting from the Transaction.***

2.4.2.5 Whether to Sell if Others are Not Selling

Since the proposed shareholders agreement ("USA") would permit on the Shareholder, with two-thirds consent, to sell its interest, BDR has also considered the effect on value and cash flows if MEC were to sell its interest, triggering Departure Tax, with all other Shareholders retaining their interest at that time. Also important to consider is the effect if another shareholder triggered the Departure Tax, before such time as MEC wished to sell.

Such scenarios are much more complex to develop, because as well as the tax provisions themselves, the effect would be determined by any agreement of the shareholders as to how tax responsibility would be shared.

Two alternative points of view can be taken on the issue:

- one is that it is "fair" for the non-sellers to be protected from tax impacts triggered by the seller;
- the other is that since the sale transaction creates value for the non-sellers (the Departure Tax, being paid at the time, does not have to be paid by the non-sellers later, and the resulting re-valuation of the assets creates a future tax deduction available to the non-sellers), the benefits and costs should be shared by all.

In the Mergeco negotiations, this latter point of view has been taken, and consideration has been given to alternative mechanisms to share the impact when it occurs, and to alternative structures intended to help in addressing tax effects.

Following preliminary analysis and discussion with Navigant, BDR has concluded that:

- ***If there is no final arrangement under which the non-selling shareholders assist in mitigating the tax effects on the seller, being the first to sell out of either PowerStream (Status Quo) or Mergeco will very significantly reduce the after-tax proceeds of sale to MEC;***
- ***Since the ownership proportion of MEC is higher in PowerStream Status Quo than it will be in Mergeco, the effect is worse in Mergeco;***
- ***A mitigation approach in which MEC, as the first seller, was compensated by others for the present value of future tax deductions, would be sufficient to eliminate most of the "penalty" of being the first seller; and***
- ***MEC should be aware that if it is not the first seller, under a mitigation arrangement as a non-seller, MEC could be faced with a requirement, directly or indirectly, to contribute to funding tax payments at a time when MEC itself will not be receiving any sale proceeds.***

2.4.2.6 Findings and Conclusions Related to Tax Provisions

BDR concludes that tax liability is a very significant factor, reducing the desirability of selling to realize value, even with expectation of high premiums. The highest value is obtained, whether from the existing investment or from Mergeco, by continuing to hold and receive annual cash flows over the long term.

A priority for MEC if the Transaction is approved, is to gain understanding of the effects of tax responsibility sharing provisions as they are drafted, from the standpoint both of

being the triggering seller, and of not selling when the Departure Tax is triggered. This will inform MEC's strategic decisions with regard to its investment in the next several years.

Time is an important factor in this decision since lower Transfer Tax rates apply in the years 2016-2018.

2.5 *PowerStream Solar*

2.5.1 Separation of Solar from the Mergeco Analysis

PowerStream's solar portfolio is owned and operated by PowerStream, and allocated a share of PowerStream's cost to provide financing and operating resources to the business. The three PowerStream Shareholders own the business through a separate class of shares.

Unlike the LDC business, in which capital must continually be reinvested, the solar portfolio consists of a series of projects, each of which has a relatively finite asset life and expectation of revenue stream. The cash flows from the solar shares were therefore structured from the outset, by negotiation between the Shareholders and PowerStream, so that as well as the net operating proceeds, the Shareholders would gradually receive, over the lifetimes of these projects, their invested capital repaid in full. This dividend structure has a high value for the PowerStream Shareholders, because they have a defined mechanism to extract their capital investment for either re-investment or use in municipal projects, without a sale transaction to incur costs and potentially attract taxes.

In the initial negotiations for the merger, it was planned that the PowerStream solar portfolio would be included in the overall Mergeco business, in which each shareholder would receive common shares. After careful consideration and a review by Navigant of the value implied in the proposed treatment, the agreements were re-negotiated, so that the PowerStream Shareholder would own all of a separate class of Solar shares (the "Class S shares"), in exchange for a slightly reduced proportion of the common shares. It was intended that the unique value of the existing solar shares of PowerStream would be duplicated through the Class S shares.

Under the current PowerStream structure, therefore, Shareholders receive two streams of dividends: one from the common shares, and one from the solar shares. Since the solar business and other businesses (mainly the LDC, but also PESI) share certain services and resources, the allocation of costs for these services and resources affects whether a dollar of net cash flows is attributed to the solar shares or to the common shares. However, as long as ownership of each type of shares is in the same proportion among shareholders, decisions as to the appropriate allocation of costs do not have the potential to benefit one shareholder at the expense of another.

On the formation of Mergeco, however, the situation will be otherwise. Enersource and Horizon will own relatively more of the common shares as a result of the separation of the solar business and Class S shares, but will own no Class S shares. The allocation of costs to the solar business therefore has an differential effect on the value of the investment to each shareholder.

2.6 *Findings as to the Mergeco Business Case*

2.6.1 Selection of a Basis for Evaluation

It has been previously discussed in this report, that DCF is the approach being used to value Mergeco, and thus to determine whether the Transaction and the required investment of new capital into Mergeco will produce "value". If the present value of all the cash flows, taking into account the new capital injection, is higher than the present value of cash flows in Status Quo (no Transaction) then it can be concluded that the Transaction creates value.

The question would then be, is the value created sufficient to warrant the additional risks that MEC will assume as an investor in Mergeco. While the information in support of this decision comes from analysis, what is "sufficient" in the face of risk and uncertainty is more than a matter of simple numbers. It must take into account the ability of the investor to tolerate the risks, the availability of alternative investments, the time frame in which investment decisions are made, and the compatibility of this particular investment with the investor's non-financial objectives.

In evaluating an investment, the investor has a choice of treating the benefit as received when it is received by the company, or of considering the benefit only when it is received by the shareholder as a dividend. The former method is more appropriate when the investor is more concerned about total value than about timing, and is relatively content for incomes to be held by the company as retained earnings and re-invested in operations to create future value. The latter method is more appropriate when the investor depends on the paid-out dividends from the investment; in this case, the earnings of the investment are "cash" only when they are paid directly to the investor.

In view of the dependence of MEC and the City on the ability to receive income from their investments, whether as dividends or as interest, this discussion focuses on the approach where value is compared by discounting the flow of dividends on the common shares and the solar shares, and the interest on the shareholder loan, in order to compare value.

2.6.2 Comparison of Overall Cash Flows

Navigant prepared a summary which computes cash flows under several scenarios, including assumptions about the level of synergies that will be achieved, and the manner in which MEC chooses to fund the investment. This discussion focuses on a simple comparison of two cases, one in which Mergeco is formed and achieves the synergies as forecast, and one in which the Transaction is rejected, and PowerStream continues in business as today.

The results of this comparison are affected by the assumption of the amount that MEC will actually need to invest, and to the method by which Terminal Value is computed.

Assuming that the investment to be made by MEC at the time of closing is the currently estimated amount of $43 million, and that in the absence of the Transaction, there would have been an investment of $5 million, so that the net additional amount is $38 million, Mergeco results in an increase in value (over and above the investment), of about $6 million. It is possible that when recalculated at the time of closing, the actual investment will be different, either higher or lower. Any additional investment will reduce value, while a reduction in the required investment will increase net value correspondingly.

On the basis of these figures, it is reasonable to say that there is positive value to the transaction, but that the amount is not “compelling”. If the amount of required investment were to increase by, for example, $3 million, an amount that is within a reasonable range of possibility, the value increase would be reduced to $3 million. Furthermore, risks such as the ability to realize synergies affect the results. An improvement in the realization of operating synergies of 25% above forecast could add about $6 million to the net value of Mergeco; but if synergies are 25% below forecast, the value would be reduced.

2.6.3 Comparison of Net or “Incremental” Cash Flows

Navigant included in its report an analysis that uses annual cash flow figures, combined with a terminal value methodology, to look at the value of the Transaction in a different way.

In this approach, the computation is of the internal rate of return that is considered to be generated if the new capital is considered the investment, and the change in annual cash flows is assumed to be the return from that investment. In this case, the results are sensitive to the Terminal Value approach.

On this basis, Navigant shows that, assuming the investment is never sold and continues to generate income at the forecast levels, MEC would earn a return ranging between 6% and 9%. This rate of return is higher than a long term low risk interest-bearing investment (3-4%), but of course, carries a variety of business risks that are common to the electricity sector, as well as risks from the transaction in Mergeco.

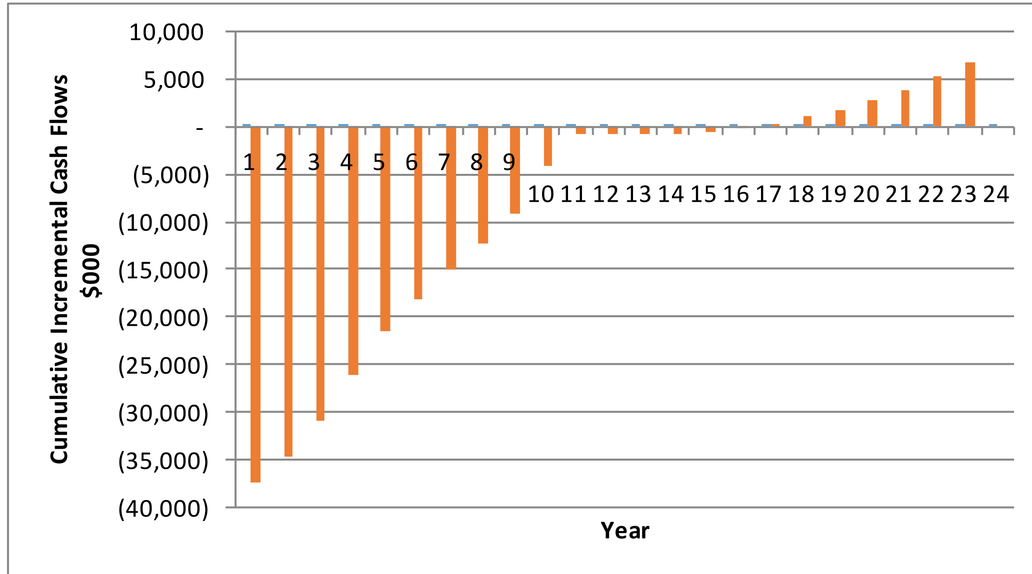
The question then becomes, is this range of rates acceptable, given the risks. It is lower than the OEB-allowed return on equity for electricity LDCs, which is currently 9.3%. However, the willingness of investors to purchase Ontario LDCs at premium prices, and the fact that other utility stocks in the market trade a premiums to book value, indicate that the market considers rates of return somewhat below 9.3% (perhaps in the 6% to 8% range) as commensurate with the risk. And, as any given new acquisition taken as an alternative to the Transaction would likely take place at a premium, the ability of MEC to make an investment at the same risk, with a better return, is expected to be limited.

2.6.4 Immediate Cash Flows

Given the uncertainties of the future, and the fact that after 10 years the value-creating power of synergies will be redirected to customers, an alternative approach is to look only at cash flows to 2026.

The following graph shows the gradual recovery of a $38 million net investment (the difference between $43 million expected to be required on closing by Mergeco and a $5 million that will otherwise be made in PowerStream), over 10 years through increased net cash flows from dividends and interest. Once rebasing has taken place, the incremental cash flows to the Shareholders is reduced. Additional value after that point is forecast to occur, but slowly.

Again, from this standpoint, the Transaction is neither strongly positive, nor strongly negative. The investment is forecast to be recovered in 10 years, but additional value is realized only in the very long term. If the investment on closing is higher a net of $38 million, the payback period would be significantly longer.



3 Decision Factor #2 -- Mergeco as a Platform for Future Business Growth

All of the comparative valuations and financial modeling carried out and described in Section 2 is based on the existing scope of business of the component Companies, i.e.:

- That the service territory of Mergeco will be the combined existing service territories of PowerStream, Enersource, Horizon and HOBNI, including any customer growth in those territories, but not assuming the addition of service territory through merger and/or acquisition; and
- Only solar installations contemplated today will be part of PowerStream Solar (i.e. the Class S shares); and
- That the other affiliate businesses included in the Transaction will not experience any significant change in nature, scope or volume of business.

However, PowerStream has become the company it is today through growth—i.e. through mergers and acquisitions in the regulated business, and through development of unregulated business opportunities that are within the acceptable risk profile of the Shareholders. Today, PowerStream continues to have an approved mission for continued growth, which is stated as:

"to build on our core electricity distribution to become Ontario's premier integrated energy services provider".

The underlying assumption is that growth through carefully selected strategic investments in the regulated and unregulated energy sector will improve profitability and continue to build shareholder value over time. In the case of the City of Markham as a shareholder, the ability of the investments to generate a growing stream of dependable cash flows is part of the decision equation. BDR, in preparing this report, has therefore assumed that an effective platform for the right growth strategies is desirable from the standpoint of the City. PowerStream management and its advisors and Navigant have taken the view that Mergeco will provide a better platform for future growth than the existing PowerStream, particularly because of its larger scale.

In this portion of the analysis, BDR addresses, on a high level and conceptual basis, some of the factors affecting whether Mergeco may or may not be a better platform for growth. The Table below indicates the pro's and con's of the Mergeco vision compared to a more status quo vision of PowerStream, with specific reference to the ability to grow (i.e. to enter into further mergers and acquisitions in the regulated business, and/or to expand unregulated opportunities). Note that developments in the industry may increase or limit profitable opportunities for growth in the sector that apply equally to PowerStream status quo, and to Mergeco. No analysis of any specific business opportunity or portfolio of opportunities has been considered in this review. The comparison reflects BDR's decades of experience the sector, and with mergers and acquisitions generally, and the knowledge that BDR has acquired as to the strong competitive position that PowerStream currently occupies in the Ontario LDC sector.

Ways that the Transaction Will, or May, Enhance Growth Opportunity	Ways that the Transaction May Create Barriers to Growth Opportunity
1. This transformational transaction will result in a very significantly larger customer base, revenue base and service territory. 2. The service territory will include some of the most desirable areas of the Province: urban, relatively affluent, growing. 3. Prevents the merger participants and HOBNI from being acquired by a business interest adverse to PowerStream. 4. *May* show Mergeco in the marketplace as a successful merger partner and acquirer. 5. *May* improve business case of future mergers and acquisitions – other adjacent territories, with potentially more financial synergies. 6. *May* improve ability to market unregulated services within service territory and beyond.	1. Transaction *may* decrease desirability as a partner to other LDCs who may prefer to merge or sell only a partial interest (i.e. may prefer a merger partner similar in size). 2. Internal issues of successfully integrating four companies *may* result in a loss of focus on future growth, and/ or ability to manage future growth. 3. Required commitment of new investment for the Transaction *may* reduce willingness or ability of existing shareholder to fund new opportunities, for an extended period. 4. Concentrates investment in regulated (LDC) sector, limiting diversification at least in the short run. 5. *May* reduce the potential flow of synergy savings to shareholders from future

Ways that the Transaction Will, or May, Enhance Growth Opportunity	Ways that the Transaction May Create Barriers to Growth Opportunity
7. *May* increase the base of shareholders who *may* be able to fund further growth initiatives. 8. *May* improve ability to attract private sources of capital. 9. *May* increase desirability of the company as partner in new initiatives within and beyond Ontario. 10. *May* receive (have) endorsement of Provincial Government in support of various initiatives (including possible reform of the tax regime).	transactions, thus reducing their value. 6. Wider base of ownership *may* create difficulties in maintaining consensus on vision and strategy 7. *May* change the criteria for desirable growth opportunities in unforeseen ways 8. *May r*educe willingness of existing shareholders to welcome new capital investors because of the resulting dilution of interest, or of tax concerns 9. PowerStream may already be a highly desirable partner for new initiatives, at least equal to Mergeco. 10. *May* change the perception of the company with stakeholders (customers, OEB, employees or communities) in unforeseen ways

In summary, a larger entity has a number of scale and other competitive advantages for growth, but also potentially sacrifices the benefits of focus, unity, and existing position of trust and leadership with stakeholders. In a large measure, the outcome will depend on the ability of decision-makers in the new organization to build on strengths in a timely manner.

4 Decision Factor #3 -- Benefits to Customers

4.1 *How and When Customer Benefits are Created by the Transaction*

Over the years, the Ontario Government has supported a policy of voluntary consolidation among LDCs, in the belief that the formation of larger operating units will reduce duplication and therefore the overall costs of providing service. It makes sense generally that the sharing of resources would reduce the average costs per customer served. While formal mergers and acquisitions are only one of several possible approaches to creating efficiencies of scope and scale[4], the merger and acquisition approach has, since 1998, reduced the number of LDCs in Ontario from more than 300 to about 70 today. PowerStream itself was formed by a series of mergers and acquisitions,

[4] Other possibilities include sharing of facilities and services with other LDCs without formal merger; sharing with other municipal services such as the water utility; and contracting out.

and its management can point to both cost efficiencies and uninterrupted quality service to customers.

BDR has been advised that the managements of the Companies have worked together over many months to identify specific synergy opportunities in all aspects of their operations, and to develop plans for implementation, supported by estimates of both the resulting savings and the investment required. It was not within BDR's scope of work to review these plans and estimates, but Navigant has done so, and has concluded that the forecast is reasonable.

The OEB sets rates for LDCs to recover the costs incurred and the approved rate of return (net income for the shareholders). Under routine circumstances, an LDC's cost structure is reviewed by the OEB at five-year intervals, and if cost increases are supported as necessary by the LDC, the OEB approves them for recovery through rates from customers. If cost reductions can be achieved, rates can be reduced, or at least, the upward pressure on rates can be mitigated.

It is the OEB's policy that LDCs that merge or acquire can defer rebasing for up to 10 years. This postpones the time when rates have to be adjusted to pass operating cost savings through to customers, and provides an opportunity for shareholders to recover the amounts they have invested in the transaction (i.e. any premium paid for an acquired LDC as well as the costs of carrying out the transaction and integrating the operations of the new merged company).

It is planned that Mergeco will defer its rate rebasing until 2026, during which time synergy savings from operations will raise shareholder dividends and contribute to recovery of the new investment in Mergeco.

During this time, Navigant believes, and BDR concurs, that customers will in fact receive some benefits. This is because LDCs have the opportunity, between rebasings, to apply to recover the costs of growing levels of capital expenditures. If synergies reduce the need for capital expenditures in Mergeco, this creates a benefit for customers right away. As well, assuming that PowerStream would, without the merger, apply for a rate increase after only five years, customers would receive the benefit of that increase having been deferred.

Once Mergeco rebases its rates, all of the benefits achieved through the consolidation of the four LDCs will be shared among the customers of the LDCs. The shareholders will continue to earn the OEB-allowed rate of return on their investment.

The result is that some level of savings is expected to flow to customers in the years 2016 through 2025. However most of the benefits will be realized by customers in the years after 2026.

4.2 *Magnitude of Benefits*

PowerStream management has estimated that on average over 25 years, synergy savings produced by the Transaction will total over $1 billion, averaging between $40 and $50 per customer per year. Navigant concurs with this estimate, but has conservatively adopted the lower figure of $40 in its report and models. On this basis, over 25 years, PowerStream management and Navigant believe that customers in the City of Markham will save a total of $130M as a result of the transaction. These savings are being forecast to average approximately $3.3M per year in the first 10 years, and $7M per year thereafter.

BDR anticipates that the value of any synergy savings would be shared by customers in proportion to the distribution component of their electricity bills, so that a residential customer would have a smaller absolute saving than a large business, but a similar amount of savings on a percentage basis.

Using 2014 statistics for PowerStream, BDR developed the following table of average bill sizes and savings, based on the estimated average saving of $40 per year. It is important in considering the computations, that $40 is an average over time. The amounts in early years will be somewhat lower, and the amounts in later years, somewhat higher. As well, over time changes can occur in the electricity rates that affect the way the savings are shared within the service territory of Mergeco ("harmonization"), and among the different classes of customers. PowerStream management in its report did not commit to any strategy on rates at the end of 10 years, so no assumptions can reasonably be made at this time about those issues.

2014 Statistics	Customers	Revenue	Class % of Distribution Revenue	Allocation of Savings by Distribution Revenue	Average Annual Distribution Bill/ Customer	Annual Savings per Customer	Annual Bill (Assumes Distribution is 20%)	Savings as % of Distribution Bill	Savings as % of Total Bill
Residential	316,765	86,155,968	54.6%	7,779,059	$ 271.99	$ 24.56	$ 1,359.94	9.0%	1.8%
General Service < 50 kW	31,865	24,609,120	15.6%	2,221,968	$ 772.29	$ 69.73	$ 3,861.47	9.0%	1.8%
General Service > 50kW to 4999 kW	4,789	46,332,480	29.4%	4,183,379	$ 9,674.77	$ 873.54	$ 48,373.86	9.0%	1.8%
Large User	2	304,608	0.2%	27,503	$152,304.00	$ 13,751.59	$761,520.00	9.0%	1.8%
Unmetered Scattered Load	2,890	448,896	0.3%	40,531	$ 155.33	$ 14.02	$ 776.64	9.0%	1.8%
Total Customers	356,311	157,851,072	100.00%	14,252,440					
Total Savings Avg $40/cust	14,252,440	-							

On this basis, a typical residential customer of PowerStream with a monthly electricity bill of about $113 would benefit from synergy savings by, on average, about two dollars per month.

4.3 *Timing and Amount of Total Benefits*

Navigant reviewed the forecast synergies and believed on the basis of their team's experience in the sector that the estimates are reasonable and in some areas conservative. Markham decision-makers can, in BDR's opinion, give credibility to this independent review, and to the fact that PowerStream management has a successful record of managing the integration of LDC operations before. In the period following the formation of PowerStream, it faced the task of bringing together the merger participants Markham Hydro and Hydro Vaughan, along with Richmond Hill Hydro, which Markham and Vaughan had acquired jointly.

Nonetheless, the implementation of the synergies represents probably the most significant risk faced in the transaction, and discussed further in Section 2. Customers will receive no benefits unless savings are realized. However, customers are less "at risk" than the shareholders in the sense that there is no time limit to customers in participating in synergy benefits. Customers will benefit from synergies even if the time needed to implement them is longer than forecast.

4.4 *Findings as to Customer Benefits*

BDR has no significant issue with the analysis of the quantum and timing of customer benefits as documented by PowerStream and by Navigant.

BDR notes that Navigant, in presenting its conclusions on this issue, combines customer savings with shareholder cash flows as a cost/benefit analysis of the Transaction. In BDR's experience, municipal councils give consideration to community benefits of various kinds in weighing the future of their electricity sector investments.

Markham decision-makers will need to explicitly consider the degree to which they want to take customer benefits into account in deciding whether to approve the Transaction.