

Government of Newfoundland and Labrador

**Identification of Issues Related to
Potential Merger of
Newfoundland and Labrador Hydro
and Newfoundland Power**

August 18, 2003



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Executive Summary

Deloitte & Touche LLP (“D&T”) has been engaged by the Government of Newfoundland and Labrador (the “Government”) to estimate the cost of acquisition of Newfoundland Power (“NP” or the “Company”), owned by Fortis Inc. (“Fortis”), by Newfoundland and Labrador Hydro (“Hydro”) and to identify and discuss the issues related to a possible merger of NP and Hydro (herein referred to as the “Proposed Transaction”).

Our preliminary review can be summarized as follows:

- The Proposed Transaction would result in a vertically integrated utility in the province with benefits accruing from the resulting economies of scale.
- Our preliminary review indicates a fair market value for common equity of NP within the range of \$310 million to \$380 million (midpoint of \$345 million).
- Estimated annual interest costs of \$24.2 million associated with raising capital for the Proposed Transaction with approximately \$10.7 million in federal tax savings could result in \$13.5 million of incremental annual costs; an additional \$5.7 million in provincial tax savings could potentially lower the annual incremental costs to \$7.8 million. Therefore net annual savings of at least \$7.8 million would be required to offset the estimated incremental annual costs of the Proposed Transaction. The actual incremental costs could exceed the above assumption. As an example, in order to achieve these savings the combined workforce would have to be reduced by about 156 employees. There could be other potential cost savings opportunities.
- The cost to acquire NP could be significantly greater if Fortis does not want to sell NP. The market capitalization of Fortis is over \$1.0 billion and a takeover value of Fortis could exceed \$1.2 billion.
- The Government might wish to consider other alternatives to the Proposed Transaction such as swapping Hydro distribution assets for NP generation and transmission assets, thereby achieving a separation of generation/transmission from distribution.
- Further, there are contractual approaches to sharing services, which could achieve a substantial portion of the economies of scale, without incurring the costs of the Proposed Transaction.

We would be pleased to assist you with any further analyses or discussions of options that you may wish to consider.

1. Description of the Proposed Transaction

- The Government has been considering the possible merger of Newfoundland and Labrador Hydro and Newfoundland Power, by means of an acquisition, into a single corporate entity of the Crown.
- The envisioned transaction would result in a vertically integrated electric utility serving the entire province of Newfoundland and Labrador. The primary supply chain components would consist of generation, transmission and distribution; with wholesale and retail market services being provided to industrial, commercial and residential customers, as appropriate.
- As NP does not serve Labrador, the transaction would be restricted to the Island portion of the province.
- Policy development and oversight would continue to be the responsibility of the Department of Mines and Energy, while the Public Utilities Board (“PUB”) would remain as regulator.

2. Purpose of this Report

This report has been prepared for and is intended solely for use by the Government for the purpose of reviewing the Proposed Transaction at a strategic, or “high” level. This report does not purport to, nor is it intended to, contain all of the information that you may require to complete an evaluation of a potential purchase of NP by Hydro. D&T has not independently verified nor has it made an independent appraisal of the accuracy and completeness of any information contained herein.

Please note that you are requested to refrain from distributing the report, in whole or in part, outside your organization, at any time without the prior written consent of D&T.

The scope of our review was limited to available public information and brief discussions with Government officials.

The value estimates do not constitute an opinion of value.

3. Vertically Integrated Utility

A vertically integrated utility refers to an electrical utility, which owns or controls substantially all of the generation, transmission and local distribution assets required to provide electric power to customers.

Benefits

- Closer coordination of electricity supply and demand throughout the province.
- Better control of the components of the electricity rate and levers thereof.
- Opportunities to pursue economies of scale in all areas of the Island.

Risks

- Potential Government involvement in contentious customer billing issues.
- Additional demands on capital budgets and possible fragmentation of spending leading to smaller amounts of funds being available to potentially higher priority matters.

Implications on Regulation and Oversight

- A vertically integrated utility would be difficult to regulate, especially under Performance Based Regulation (“PBR”).
- The burden of electricity policy oversight would likely become heavier for the Government.
- A new governance framework would need to be negotiated with the Board of Directors.

4. Transaction Considerations

Valuation Issues

- You have asked us to complete a preliminary review of NP and provide an indication of the range of value of the common equity that a transaction might be completed at. Given that NP is owned by Fortis, we have also provided a preliminary indication of the value of the common equity of Fortis.
- It should be clearly understood that we have not been asked to, nor are we, providing our professional opinion as to value. Our scope was limited to a review of certain public information. We have had no discussions with management of NP or Fortis.
- We have been guided by the concept of “fair market value” which is defined as the monetary consideration that, in an open and unrestricted market, a prudent and informed buyer would pay to a prudent and informed seller, each acting at arm’s length with the other and under no compulsion to act.
- Price and fair market value can be different. Fair market value as defined above is a concept of value, which may or may not equal the purchase/sale price in an actual market transaction. Within the marketplace, there may exist “special purchasers” who may be willing to pay higher prices because of reduced or eliminated competition, ensured source of sales, cost savings arising on business combinations following acquisitions or other synergies which could be enjoyed by the purchaser.
- We reviewed valuation metrics implied by selected transactions involving the sale of ‘similar’ businesses and on pricing parameters implied by the market value of shares of selected public companies.
- The primary valuation metric we relied upon was a multiple of enterprise value (“EV”) to capital (“C”) or EV/C (EV – equates to the fair market value of both debt and equity, C – book value of debt and equity).
- We also considered other implied metrics including:
 - Enterprise value per customer;
 - Enterprise value to revenue;
 - Enterprise value to earnings before interest, income taxes, depreciation and amortization (EBITDA);
 - Value of common stock to common stock earnings (P/E);
 - Value of common stock to net book value of common stock.

Target Snapshot

		NP Dec-02	Fortis Q1-03	NP as a % of Fortis
Book value of debt	\$M	362	1,171	31%
Book value of common	\$M	280	592	47%
Book value of capital	\$M	642	1,763	36%
Customers	000s	219	410	53%
Revenue	\$M	370	768	48%
EBITDA	\$M	109	252	43%
Earnings to common	\$M	29	69	42%

- NP is the single largest holding of Fortis.
- NP accounts for about half of Fortis' customers, book value and revenue and about 42% of earnings.
- NP has only regulated operations, the vast majority of which is the transmission and distribution of electric power.
- Fortis has regulated and unregulated businesses involved with electricity generation, transmission, distribution, wholesale and retail, with assets located throughout North America, Central America and the Caribbean.
- It is anticipated that Fortis' other investments will increase in value more quickly (higher growth prospects) than NP, and over time the relative value of NP to Fortis overall will decline.



Comparable Public Company Valuation Metrics

D&T reviewed the merger and acquisition transactions involving Canadian and U.S. electric utility companies for which information was available.

Selected Public Companies – Electric Services

Company	Ticker	Currency	\$ in millions							EV Multiples		
			Enterprise Value (EV)	Net Book Value (NBV)	Tangible Book Value	TTM Sales	TTM EBITDA	Total Assets	EBITDA Margin	Sales	EBITDA	Price/ NBV
Emera Inc	EMA	\$C	4,085.9	1,599.5	1,194.3	1,236.1	439.7	3,907.9	35.6%	3.31x	9.29x	1.43x
Fortis Inc	FTS	\$C	2,230.3	624.4	499.0	807.2	258.3	1,987.0	32.0%	2.76x	8.63x	1.71x
Empire District Electric Company	EDE	\$US	914.8	380.1	329.3	305.9	108.2	970.2	35.4%	2.99x	8.45x	1.43x
IDACORP Inc	IDA	\$US	2,033.5	928.2	843.2	891.0	190.1	3,252.6	21.3%	2.28x	10.70x	1.06x
DQE Inc.	DQE	\$US	2,292.7	695.8	n/a	940.2	265.9	2,811.3	28.3%	2.44x	8.62x	2.22x

Notes:

Source: Bloomberg

n/a = not available.

Enterprise Value = Market Capitalization - Cash & Equivalents + Total Debt + Other LT Liabilities + Preferred Equity.

Market capitalization based on stock price and shares outstanding as at August 12, 2003.

Adjusted average excludes high and low values.

Low	2.28x	8.45x	1.06x
Average	2.76x	9.14x	1.57x
Adjusted Average	2.73x	8.85x	1.52x
Median	2.76x	8.63x	1.43x
High	3.31x	10.70x	2.22x

Business descriptions of the publicly traded companies are as follows:

- 1 Emera Inc is a holding company which operates through three segments: wholly owned Nova Scotia Power Inc (NSPI), a regulated utility that generates, transmits, and distributes electricity in Nova Scotia; Bangor Hydro-Electric Company, also regulated, provides electricity transmission and distribution service to customers in central Maine; and Emera Energy includes the company's activities in the transportation and distribution of natural gas and fuel oil products.
- 2 Fortis Inc. has holdings in six electric distribution companies in Canada, the U.S. and the Caribbean region. During 2002 Fortis restructured its assets in Ontario, separating the generation and distribution businesses under FortisOntario Inc.
- 3 The Empire District Electric Company is an operating public utility engaged in the generation, purchase, transmission, distribution and sale of electricity in parts of Missouri, Kansas, Oklahoma and Arkansas. The company also provides water service to three towns in Missouri and has investments in several non-regulated businesses.
- 4 IDACORP Inc is a holding company whose principal operating subsidiary is Idaho Power Company (IPC). IPC is engaged in the generation, transmission, distribution, sale, and purchase of electric energy.
- 5 DQE Inc is an energy services holding company for Duquesne Light Company that also engages in unregulated energy and related businesses. Duquesne Light Company is engaged in the transmission and distribution of electric energy.

Comparable Public Company Valuation Metrics (continued)

- The selected public companies are generally substantially larger entities than NP, have significant operations outside of Canada, and have both regulated and non-regulated activities. As a result the public companies are not a particularly good fit when compared to NP, with the exception of Fortis, which includes the operations of NP.
- The public trading multiples represent minority interest positions with liquidity, with vastly different geographic areas served and market size, greater growth prospects, and different mix of regulated and non-regulated businesses under different regulatory regimes.
- Fortis exhibited EV to sales multiple of 2.8, EV to EBITDA multiple of 8.6 and a price to net book value multiple (common equity) of 1.7.

Comparable Transactions Valuation Metrics

COMPARABLE TRANSACTIONS	Richmond										St. Catharines	Cornwall	CILCORP	Eastern Utilities Associates	Cornwall Electric	Winnipeg Hydro	Winnipeg Hydro	TransAlta
	Brampton	Hill	Caledon	Port Colborne	Brockville	Lindsay	Mississauga	TransAlta	Cornwall	CILCORP								
Base price	\$000s	260,200	120,000	54,400	15,600	13,800	16,800	20,000	700,000	90,000	68,000	541,000	1,030,000	67,000	259,000	850,000	TransAlta	
Enterprise value	\$000s	260,767	150,000	54,400	n/a	13,800	15,926	470,000	700,000	90,000	68,000	1,401,000	1,030,000	67,000	259,000	850,000	TransAlta	
Announce date		Nov-00	Nov-00	Nov-00	Nov-00	Nov-00	Oct-00	Apr-00	Feb-00	Mar-99	Jul-98	Apr-02	Feb-99	May-02	Feb-02	Jul-01	TransAlta	
Purchaser		Hydro One	Markham / Vaughan	Hydro One	Canadian Niagara Power	Hydro One	Hydro One	Borealis (OMERS)	UtiliCorp	Canadian Niagara Power	Enbridge	Ameren Corp	New England Electric System	Fortis	Manitoba Hydro	AltaLink	TransAlta	
Transaction type		Shares	Shares	Shares	Asset lease	Shares	Shares	Shares	Shares	Asset	Shares	Shares	Shares	Shares	Shares	Assets	Assets	
Date of financial information		30-Apr-00	31-Dec-99	31-Dec-99	n/a	31-Dec-99	31-Dec-99	27-Apr-00	07-Feb-00	31-Dec-96	31-Dec-97	31-Dec-01	31-Dec-98	31-Dec-01	31-Dec-01	31-Dec-01	TransAlta	
Book value of equity	\$000s	200,106	113,098	47,363	n/a	13,191	10,124	180,000	500,000	74,995	39,700	517,077	373,674	44,000			661,400	TransAlta
Book value of debt	\$000s	-	-	-	n/a	-	-	270,000	-	-	-	860,000	400,000	-	-	-	TransAlta	
Total # customers	(#)	80,882	40,000	17,167	9,000	9,582	7,139	n/a	350,000	50,429	24,758	400,000	300,000	22,600	94,000	n/a	TransAlta	
Enterprise value / capital	(multiple)	1.30x	1.33x	1.15x	n/a	1.05x	1.57x	1.04x	1.40x	1.20x	1.71x	1.02x	1.33x	1.52x		1.29x	TransAlta	
Adjusted price / customer	(\$)	3,224	3,750	3,169	1,733	1,440	2,231	n/a	2,000	1,785	2,747	3,503	3,433	2,965	2,755		TransAlta	
TRANSACTION SUMMARY STATISTICS (excluding Cornwall Electric)																		
	Low	High	Average		Adjusted Average													
Enterprise value / capital		1.02x	1.71x	1.30x	1.29x													
Adjusted price / customer		1,440	3,750	2,672	2,686													

Notes

- Information sources: announced prices, share purchase agreements, MEU financial statements, and Ontario Municipal Electric Utility Financial and Statistical Summary 1996.
- Enterprise value is the base price adjusted per the terms of the share purchase agreement for working capital and long-term debt.
- Capital = book value of equity + book value of debt.
- Equity for Caledon adjusted to reflect conversion of long-term debt to equity.
- Multiples for St.Catharines are based on 1999 offer price and 1996 financial information (adjusted assuming equity growth of 2% per annum for 2 years).
- Adjusted average excludes both lowest and highest values.
- TransAlta transaction based on publicly available information: UtiliCorp purchased the distribution and retail operations of TransAlta. It subsequently sold the retail operations to Epcor for \$110 million. Adjusting for this subsequent transaction, the enterprise value / capital multiple for the distribution business would be in the order of 1.20 times.
- CILCORP (holding company) primarily reflects the activities of Central Illinois Light Company, which is involved in the generation, transmission, distribution and sale of electric energy in an area of approximately 3,700 square miles in central and east central Illinois and the purchase, distribution, transportation and sale of natural gas in an area of approximately 4,500 square miles in central and east-central Illinois.
- The Core Electric Business of Eastern Utilities supplies retail electric service in 33 cities and towns in southeastern Massachusetts and Rhode Island.
- Fortis acquired Cornwall Electric from Enbridge in 2002. Cornwall Electric is an Ontario based electric transmission and distribution utility which supplies electricity to approximately 22,600 customers in the city of Cornwall, South Glengarry, South Stormont and the Ontario portion of the Mohawk Territory of Akwesasne.
- In June 2002, Manitoba Hydro purchased the assets of Winnipeg Hydro from the City of Winnipeg.
- In April 2002, AltaLink acquired the Alberta based transmission business from TransAlta.

Comparable Transactions Valuation Metrics (continued)

- Many of the target companies reviewed were different from NP, with vastly different geographic areas served and market size, greater growth prospects and different mix of regulated and non-regulated businesses under different regulatory regimes.
- The Port Colborne (Nov/00), St. Catharines (Mar/99) and Cornwall Electric (May/02) transactions were acquisitions by Fortis with EV/C multiples in the range of 1.2 to 1.5. Port Colborne and St. Catharines are older transactions.
- The majority of the precedent transactions involved target companies with non-regulated operations. Non-regulated operations tend to result in higher prices being paid.
- The precedent transaction involving TransAlta (adjusted to exclude the value of retail operations) was considered more comparable to NP with an EV/C multiple of 1.2.

Conclusions

We have selected a range for each metric from the selected public companies and comparable transactions analyses:

Implied Valuation Metrics	Based on Selected Companies and Transactions		
	Low	High	Based on Fortis
EV/capital	1.0	1.3	1.3
EV/customer	2,000	3,000	5,400
EV/revenue	2.3	2.7	2.9
EV/EBITDA	8.0	9.0	8.8
Value of common/earnings to common	10.0	13.0	14.5
Value of common/NBV	1.1	1.5	1.7

Our review suggests that an investor would likely apply multiples to NP at the lower end of the range based on lower growth prospects and no unregulated activities.



Determining a Range of Value of NP

- Since NP is 100% regulated we relied primarily on the EV/C multiple in estimating the value of NP. Based on our review of NP and the comparable valuation metrics, the appropriate EV/C multiple for NP would be in the order of 1.05 to 1.15.

		Based on Comparable Valuation Metrics		Based on Fortis Metrics
		Low	High	
Appropriate EV/book value multiple		1.05	1.15	-
Capital at book value	\$M	642	642	-
Enterprise value	\$M	674	738	840
<hr/>				
Less book value of debt and preferred shares	\$M	362	362	362
Value of common equity	\$M	312	376	478
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Implied metrics (based on the above valuation)				
EV/customer	\$	3,076	3,369	3,835
EV/revenue		1.8	2.0	2.3
EV/EBITDA		6.2	6.8	7.7
P/E – common equity		10.8	13.0	16.5
Value of common equity/book value		1.1	1.3	1.7

- In our view, the implied multiples appear appropriate for a regulated electric entity with low growth prospects.
- The value 'Based on Fortis Metrics' reflects Fortis' common equity book value multiple of 1.7 applied to NP. We have provided this information as Fortis may take the position that NP's value should be based on Fortis' metrics.
- We have not had access to any non-public information or discussions with management of NP or Fortis. If we had access, our conclusions could be significantly different.
- The above indicates a range of value for common equity of \$310 million to \$380 million or a midpoint of \$345 million.

Financial Position of Combined Entity

- We understand that if NP were acquired, it would be merged with Hydro.

\$M	Hydro	NP
Assets		
Capital, net	\$1,905	\$568
Current	140	50
Other	274	87
	<u>2,319</u>	<u>705</u>
Liabilities		
Long-term debt	(1,355)	(332)
Current	(326)	(83)
Other	(44)	-
	<u>(1,725)</u>	<u>(415)</u>
Shareholder's equity	<u>\$594</u>	<u>\$290</u>

Combined Entity Operating Results

- The merged entity would have combined operating results (based on year ended December 31, 2002) as follows:

\$M	Hydro	NP	Combined (1)
Revenue	428	370	587
Purchased power	16	211	16
Operating expenses	199	51	250
Operating income (EBITDA)	213	108	321
Amortization	57	35	92
Interest	98	28	125
Earnings before taxes	58	45	104
Income taxes	-	16	-
Net income	58	29	104

1) We have assumed all of NP's purchased power came from Hydro and have adjusted the combined amounts accordingly.

- Given the Government does not have equity to invest and assuming a purchase price of \$345 million, the Government or the merged entity would need to borrow \$345 million before consideration of transaction costs and incur additional interest costs.
- Assuming the additional debt would be rated A- (currently Government of Newfoundland and Fortis debt in NP are both rated A-) with an annual interest rate of 7%, the additional annual interest costs would be in the order of \$24.2 million.
- NP (Fortis) is paying approximately \$10.7 million of federal income taxes (assuming 65% of fiscal 2002 income taxes were paid to the Federal Government) and approximately \$5.7 million of provincial income taxes.

Required Savings

Additional annual interest costs	\$M	24.2
Federal tax saved	\$M	10.7
Savings required	\$M	13.5
Provincial tax saved*	\$M	5.7
Additional savings required	\$M	7.8
Employee reductions required (\$50,000/employee)		156
Additional savings as a percentage of Hydro's operating expenses	%	3.9

**Assuming provincial tax savings can be achieved resulting in "nil" income taxes payable by the merged entity.*

- The acquisition of the common equity of NP for \$345 million (before transaction costs) will require additional savings of about \$7.8 million (before considerations of transaction costs). The additional savings required could result from additional revenues (from new sources) or cost savings and would represent about 3.1% of the merged entity's combined operating expenses or 3.9% of Hydro's operating expenses.
- \$13.5 million would equate to the savings from reducing the work force by about 270 employees whereas \$7.8 million would require a work force reduction of about 156 employees. Many of the employees are long-term employees and the costs associated with a lay-off of this size would be significant. The workforce reduction is an example of cost savings; there could be other potential areas where savings could be identified.
- The cost to acquire NP could be significantly greater if Fortis does not want to sell NP. Significant costs would be incurred through an expropriation of NP or a hostile takeover of Fortis.
- The market capitalization of Fortis is over \$1.0 billion and a takeover value of Fortis could exceed \$1.2 billion.

5. Issues Arising out of the Proposed Transaction

Transaction Issues

- Negotiating strategies with Fortis in an acquisition scenario – could lead to significant costs, risks and perceptions of overpayment for NP assets.
- Optimizing the potential tax benefits for the province.
- Managing the potential labour savings to achieve the synergies to cover the investment costs and transaction costs.
- Managing potential integration issues such as differences in culture, IT systems, mode of operation and any other intra-organizational matters.
- Financial and operational due diligence of NP could potentially reveal several other issues that would need to be addressed for a successful merger.

Government Policy Issues

- The Government's relationship with corporate investors will be impaired if they are drawn into an expropriation battle or are perceived to have forced out Fortis.
- Does a merger actually improve electric generation, transmission and distribution for customers in the province? (A positive outcome of such a transaction could be potentially lower electricity rates)
- What would be the role of the PUB as regulator in a vertically integrated government owned utility?
- Is the \$345 million investment in the Proposed Transaction the best use of Hydro's capital?
- Could the Government achieve a more favourable result through an alternative arrangement/transaction such as the swapping of assets between Hydro and NP?

6. Benchmarks for Evaluating the Proposed Transaction and the Alternatives

Consumer Priorities

- Lower electricity rates.
- System reliability.
- Sufficient supply.
- Public/employee safety.
- Protection of the environment.
- Limits to privatization.

Government Priorities

- Ease of policy oversight and control.
- Efficacy of industry regulation.
- Efficiency of generation and distribution operations.
- Ability to meet major consumer priorities.
- Preservation/Improvement of employment opportunities.
- Relative cost and ease of transaction.
- Keeping viable shareholder options open.

7. Overview of Alternatives to the Proposed Transaction

HOLD – Maintain Existing Electricity Structure – (Status Quo)

- Operations on the Island and Labrador are kept intact; in this case the opportunity to realize synergies, efficiencies and savings will be through shared services contracts.

JOINT VENTURE – Create an Integrated Joint Venture Utility – (Public Private Partnership or P3 Ownership)

- Operations on the Island are amalgamated under joint ownership; however the differences in policy priorities and savings pursuits could accentuate the inherently divergent culture and make this option difficult to implement successfully.

SELL – Sell Island Hydro Operations to Fortis – (Full Privatization)

- Hydro operations on the Island are sold to Fortis but not the operations in Labrador; however, the major consideration in this case would be the strong public sentiment against privatization except in case of new operations.

SWAP – Trade Generation for Distribution Assets – (Unbundling)

- Hydro buys generation assets from Fortis, and Fortis buys distribution assets from Hydro; this would be a relatively smaller transaction from a financial perspective; this option would result in capitalizing on supply chain specialization and may be the optimal alternative in meeting perceived consumer and government priorities.