

GSU Shareholder Declaration Recommendation

BACKGROUND

This report supplements the report entitled “GSU Shareholder Declaration Recommendation” from the General Manager of Corporate Services presented to Council on June 25th, 2019. When deferring the June 25th report to the September 24th agenda, Council made three requests for information and action:

1. That staff ask for comments from the GSU Board of Directors (“the Board”) on the revised shareholder declaration and dividend policy in the June 25th report.
2. That staff obtain a copy of GSU’s five year capital plan.
3. That a provision be added to the shareholder declaration providing for a review of the declaration every 5 years.

In order to satisfy these information requests and actions City staff met with GSU staff and its Board on two occasions in August and September.

Appendix A contains the comments received from the Board.

Appendix B contains a summary of the capital expenditure plan from GSU’s 2019 Distribution System Plan.

Appendix C contains a revised shareholder declaration which is recommended by staff for Council’s approval. This declaration includes a provision for a review every 5 years.

ANALYSIS

Revised Dividend Policy Adopted by the Board

The two meetings with the Board allowed for further discussion about the interests of both parties. These discussions have produced a revised dividend policy which was adopted by the Board on September 6th, 2019. This revised policy is attached as Appendix D.

Free Cash Flow

The revised policy includes a target dividend set at 25-50% of free cash flow for the year, after net movements in regulatory balance. Free cash flow is the net cash generated by operating and investing activities and calculated by adjusting net income for non-cash items like amortization or accounting for future obligations not actually paid in cash. Movements in regulatory balance refers to the difference between the total cost of power paid by GSU and the fees collected from customers. GSU reports negative (\$1,530,000) one million five hundred thirty thousand dollars and negative (\$631,000) six hundred and sixty thousand dollars on this measure for the past two years (2017 and 2018) respectively. The calculation does not include changes in working capital. This is a non-standard method for calculating free cash flow and results in a very conservative accounting for cash flow at the end of a fiscal period.

The result is that positive free cash flow is highly unlikely and therefore, the dividend formula is highly unlikely to yield an actual dividend.

The revised policy also includes a provision for the Board to declare a special dividend if GSU's consolidated debt to equity ratio falls below 60/40. At the end of 2018, the debt to equity ratio was 67/33.

The revised policy further requires that the calculation and the rationale underpinning any dividend declaration to be presented to the shareholder annually at or before the annual general meeting.

Based on the capital plans outlined in Appendix B (which call for the expenditure of over \$50 million over the next 5 years and the potential to take on new debt of upwards of \$25 million), this ratio is very likely to remain above the 60/40 threshold. Also, with such significant capital plan requirements and the GSUs history of using available cash to finance long term investments in fixed assets like plant and equipment, the corporation is likely to remain cash negative for the foreseeable future.

CGS to have First Right of Refusal on GSU Debt

Discussions with the Board also resulted in a commitment, contained in the recommended shareholder declaration, which provides a "first right of refusal" to CGS on GSU debt. GSU is confident it will be seeking large tranches of external debt in future (up to \$25 million over the next five years). The recommended shareholder declaration contains a provision that would result in GSU obtaining quotations from external lenders and prior to accepting a quotation, the City would have the opportunity to lend funds to the GSU on the same terms and conditions.

The City could use reserves to loan money to the GSU or use its strong AA stable credit rating to borrow money to loan to the GSU. It is possible for the City to borrow for 30 basis points (0.3%) or more less than the rate obtainable by a Municipal corporation like the GSU. If the City financed the full \$25 million GSU anticipates borrowing, a differential of \$75,000 in annual revenue could be realized. This revenue could be used in turn to finance additional City capital projects or be applied against operating requirements and the net tax levy.

Number of Directors

The GSU is seeking to increase the number of Board members from 5 to 7, comprising 4 independent directors and 3 City directors. The Board currently comprises 3 City directors and 2 independent directors.

The GSU relies on, among other documents, the Ontario Securities Commission's National Policy 58-201, which provides guidance on corporate governance practices, including recommending that boards should have a majority of independent directors. The OEB has recently reinforced the requirement for such utility corporations to adopt effective governance mechanism, noting that governance practices will be scrutinized in future rate review applications, though it has as yet refrained from prescribing specific standards. The Board strongly favours an approach that would increase the number of board members and the number of independent board members.

The original GSU Shareholder Declaration Recommendation report presented to City Council on June 25th contained a legal opinion from Aird Berlis LLP which states that while the trend for governance in the Ontario energy sector may be toward greater independence, this is simply a recommendation of OEB, not a requirement. In fact, the OEB has not changed its Affiliate Relationship Code (ARC) which only requires that one third of the board of directors of OEB regulated distributors be independent directors. Consequently, any recommendations for independent directors applies to Greater Sudbury Hydro Inc. (the distribution company), not to GSU which is addressed by the shareholder declaration revisions being contemplated by this report.

The draft shareholder declaration at Appendix C includes the current Board composition at section 4.1.1 and depending on the option Council chooses, staff will prepare a final shareholder declaration for Council to formally accept in the form of a by-law.

Option 1 – The Board continue to be comprised of five individuals which shall include three City directors and two independent directors.

Option 2 – The Board be comprised of seven individuals which shall include three City directors and four independent directors.

REFERENCES

GSU Shareholder Declaration Recommendation Report from June 25th City Council –

<http://agendasonline.greatersudbury.ca/index.cfm?pg=agenda&action=navigator&id=1325&itemid=16938&lang=en>