

Background

Greater Sudbury Utilities Inc. / Services Public du Grand Sudbury Inc. (GSU) was incorporated on October 1st, 2000 and is the parent company for four subsidiary companies: Greater Sudbury Hydro Inc., (GSHI) Agilis Networks, @Home Energy and Convergen. GSHI is one of over 60 Local Distribution Companies (LDCs) in Ontario and each LDC, although regulated by a single body, the Ontario Energy Board (OEB), have engaged in a variety of strategies to suit the needs of communities involved in ownership and operations of the utilities. Many have affiliate or subsidiary companies, many provide returns to their shareholder municipalities and those returns take multiple forms. The City of Greater Sudbury (CGS) is the sole shareholder of GSU.

When GSU was incorporated, the City adopted a shareholder declaration which outlined expectations of the shareholder. The declaration outlined expectations of the shareholder to establish policies in respect of a number of matters, including a dividend policy. The GSU Board adopted a dividend policy on May 27th, 2019 and recommended a set of changes to the shareholder declaration at GSU's Annual General Meeting on June 4th, 2019. These changes were deferred to the City Council meeting of June 25th, 2019 for further consideration consistent with an outstanding City Council motion to make revisions to the shareholder declaration which among other revisions would include the long-outstanding expectation for a dividend policy.

Purpose

This report responds directly to motion CC2018 – 304 (Appendix C) directing that:

1. The Treasurer request from Greater Sudbury Utilities Inc., such documentation as deemed necessary in his sole discretion, including but not limited to unconsolidated financial statements for the Great Sudbury Utilities Inc.'s corporations and subsidiaries as well as any business plans and/or operational reviews related to the past five (5) years; and
2. The General Manager of Corporate Services make such revisions to the Shareholder Declaration as deemed appropriate to the Shareholder in its sole discretion, including but not limited to requiring the Greater Sudbury Utilities Inc. to provide the Shareholder on an annual basis unconsolidated financial statements, business plans, operational reviews, and dividends; and
3. The revised Shareholder Declaration, including a Dividend Policy, be presented to Council no later than June 2019.

Analysis

The Shareholder Declaration with the GSU

What is a Shareholder Declaration?

The purpose of the shareholder declaration is to outline the expectations of the shareholder relating to the principles of governance and other fundamental principles and policies of a corporation. The declaration leaves considerable latitude with the Board of the GSU to manage the business affairs of the Corporation and any of its subsidiaries.

The current shareholder declaration was passed by Council on June 25th, 2008 and took effect on June 1st of that year. It has remained unchanged since that time.

The OEB has provided significant guidance about the governance of OEB rate regulated utilities. The OEB recommends that the quality of governance of an LDC would likely be improved if a majority of directors are independent among other governance recommendations.

The Board is proposing to add two (2) independent directors.

The OEB has, in at least one instance, required that a dividend proposed to be paid out to a shareholder be approved by a majority of a Board's independent directors in addition to being approved by a majority of the entire Board thereby adding an extra level of scrutiny to the amount and timing of any dividend.

In this example, the OEB was concerned because the LDC had historically been paying very large dividends to the shareholder despite the LDC's need for increased capital spending to maintain system reliability. If the LDC continued to pay out such large dividends to its shareholder, the LDC would have had to ignore its aging infrastructure or undertake significant borrowing to address it - the OEB also considered the impact of the continued dividend payment on the LDC's pricing and the adequacy, reliability and quality of service. All of which could adversely impact the LDC's ratepayers.

GSU has never paid a dividend to the City. The OEB's guidance with respect to independent directors is not OEB policy or regulation. In addition to three (3) City Councillors, the GSU Board includes two (2) independent directors selected for their sound judgment, personal integrity, experience and knowledge. In light of the Board's accomplishments to date as set out in its report at its June 4th, 2019 AGM, the Board appears to be performing capably in its current iteration and there is no demonstrable business need to increase the number of directors, independent or otherwise.

What are the proposed changes to the Shareholder Declaration?

The changes to the Shareholder Declaration are minor in nature and reflect CGSs desire for additional financial and strategic planning information from the GSU. Secondly, the Board is requested by the shareholder to adopt the dividend policy contained in Appendix B to the declaration. These changes are reflected in Section 5 in Appendix A.

Dividend Policy

What is a Dividend Policy?

A dividend policy contains the parameters used by a board of directors as the basis for its decisions to declare dividends for payment to investors (or shareholders). The current shareholder declaration with GSU calls for the establishment of "a policy relating to the dividend to be received by the Corporation from the Subsidiaries consistent with a prudent financial and capitalization structure". Council resolution CC 2018-304 calls for a revised shareholder agreement that includes a dividend policy to be presented to the shareholder for approval.

On May 27th, 2019, the GSU board of directors adopted a dividend policy. This policy indicates that the board of directors may approve, on an annual basis, the payment of a dividend to the shareholder on the basis of its normalized comprehensive income (NCI).

Normalized comprehensive income is net income adjusted for the change in value of certain assets, these adjustments result in comprehensive income which is further normalized by adjusting for non-cash items (like depreciation or amortization), permanent cash differences, investing activities and net negative financing activities. It is a proxy to cash generated or used by the business in a given period but does not take into account positive financing activities (like taking out a bank loan or using a line of credit). For 2017 and 2018, NCI was negative (\$1,529,570 and \$631,365 respectively). Given that GSU is entering a period of significant capital investment, some of which may be financed by debt, it very unlikely to be positive in the near term.

The policy also specified that the dividend must be in compliance with the OBCA, the Ontario Energy Board and approved by a majority of independent board members. The provision relating to independence of board members is analyzed above and is unnecessary based on legal opinion received by staff. In fact, the OBCA under which GSU is incorporated, does not address any notion of the affiliation or independence of board members.

Dividend policies generally contain parameters which are used by the board of directors to evaluate a company's financial position and determine if the declaration and payment of a dividend is advisable in the circumstances. Unsurprisingly, boards do not normally declare dividends in situations that would create non-compliance with standards and regulations, would breach contract terms or interfere with other financing arrangements, impair continued reliability, operations or maintenance etc. Further, boards of directors must take into account the organization's ability to pay a dividend in any given period based on having sufficient cash and strong financial indicators.

Subsequent to the direction received in December of 2018, staff have undertaken an analysis of a variety of financial indicators such as income, leverage, free cash flow and liquidity at GSU. These calculations all support strong and improving financial ratios.

Free cash flow and the level of cash and cash equivalents certainly fluctuates and is highly influenced by financing choices to use available cash for purchases of property, plant and equipment. On a consolidated basis, GSU invested \$12,643,752 and \$11,557,261 in cash for purchases in 2018 and 2017 respectively. Analysis of financial indicators is contained in Appendix B.

Interests of the GSU Board

Corporate Services staff have listened to the interests expressed by the GSU Board and senior staff. It is clear that GSU is interested in a policy that:

- Does not place present or future upward pressure on rates
- Considers the potential that despite strong consolidated net income, capital expenditures and the likelihood debt will be required to address capital requirements means that cash will be constrained in the near term
- Is tax effective and considers the relatively high rate of interest on its promissory note with the City.

GSU commissioned BDR North America to perform research into the cash flow, capital structure and dividend policies of Ontario municipally owned electricity distribution companies. The report describes a variety of 2017 data for all of the LDCs in the province reported on the OEB's performance dashboard website. While it is clear in the report that GSU has managed to keep distribution rates low (60th lowest out of 75 LDCs in the study) and they are paying a relatively high rate of interest on shareholder issued debt (third highest total amount of interest and second highest per customer amount of interest in the study), the study also finds that "over the past 10 years, there has been a significant shift to LDCs paying dividends" (40 LDCs in the study paid a dividend in 2017 and only 15 did not). In fact, GSU is the largest LDC in Ontario (in terms of number of customers) that does not pay a dividend. The study also finds that the majority of dividends are in the range of 25% to 60% of net income or between \$20 and \$55 per customer.

When one considers total cash per customer (interest on shareholder issued debt plus dividends) provided to shareholders, it is clear that there are many utilities paying more to their shareholder on a per customer basis than GSU, several of which maintain distribution rates comparable to GSU.

Local Distribution Company	Residential Bill*	Cash/Customer
GSU/GSHI	\$93.63	\$74.47
North Bay Hydro	\$93.71	\$132.17
Oakville Hydro	\$98.86	\$109.52
Festival Hydro	\$96.38	\$106.06
Waterloo North Hydro	\$96.65	\$95.65
Orillia Power Distribution	\$98.19	\$87.32
Halton Hills Hydro	\$97.57	\$83.84
Kitchener Hydro	\$89.24	\$83.26
Niagara on the Lake	\$93.89	\$81.09
Burlington Hydro	\$93.38	\$79.66

* = Includes 750 kwh of consumption, 65% Off-Peak, 17% Mid-Peak and 18% On-Peak using distribution rates from:

https://www.oeb.ca/_html/performance/rates_chart.php

The total cash paid to the shareholder in GSU's case is \$3,795,000. It could be considered to include a deemed portion as a dividend payment if one deducted the prescribed allowed interest rate on shareholder debt by OEB. The difference that could, in theory, be deemed to be a dividend payment is approximately \$1,200,000. When one looks at the dividend per customer ratios among municipalities with 40,000 – 60,000 customers (i.e. similar sized utilities) and controlling for interest rates on shareholder debt paid at the prescribed interest rate, most municipalities our size pay a larger dividend than the “deemed dividend” of \$1,200,000.

Local Distribution Company	Total Customers	Dividend per Customer
GSU/GSHI	47,427	\$0.00
Entegrus	41,142	\$36.46
Bluewater Power Distribution	36,585	\$30.07
Brantford Power	39,622	\$20.19
Milton Hydro	37,896	\$39.58
Newmarket/Tay Hydro	35,712	\$39.20
Niagara Peninsula Hydro	54,919	\$25.49
Oshawa PUC Networks	57,584	\$39.94
Thunder Bay	50,844	\$39.34
Waterloo North Hydro	57,041	\$61.36
Average Dividend Per Customer		\$36.85

At \$36.85, GSU's customer base of 47,427 would, on average, lead to a dividend payment of approximately \$1,750,000, significantly higher than the “deemed dividend” that one could theoretically say is embedded in the current level of interest paid to CGS.

What Dividend Policy Should the GSU Adopt?

The dividend policy adopted by the GSU Board is highly conservative in comparison to virtually all of the policies that formed a part of BDR North America's research and research performed by CGS Finance staff. It is recommended that the dividend policy with GSU should follow the form and content of the vast majority of policies in the municipally owned electrical utility space. These policies have common characteristics:

- They contain a formula for calculation of a dividend based on net income (or some version of consolidated income)
- They are declared and directed by the Board provided a set of negative criteria are avoided
- They are “in favour” of the shareholder: That is, they are worded in such a way that the default is declaration and payment, unless the payment would satisfy one of the negative criteria

The dividend policy adopted by the GSU Board does not contain a formula for calculation, it uses a basis of “normalized comprehensive income”, it indicates that the Board “may” approve a dividend and therefore is not in favour of the shareholder. Further, it contains a provision that only a majority of independent directors approve any dividend. Currently, there are two independent directors, both would have to agree to the declaration and payment of a dividend.

Conclusion of the Analysis section

Most local distribution companies have a dividend policy. Generally, across the Province,

- they pay a percentage amount from 25 – 60%,
- this amount is calculated on net income in line with a set of criteria outlining the circumstances which would give rise to the Board electing not to declare a dividend and,
- are “in favour” of the Shareholder (meaning the policy default is that Board will decide to declare and pay the dividend unless the criteria can be met and reasons for not declaring a dividend are clear to the shareholder).

As above, one of the key interests of the GSU Board is to protect against the potential that the total cash paid to the shareholder impacts distribution rates. The impact of increasing the total amount of cash contributed to the City from GSU in terms of rates is unknown at present. In any event, the distribution rate is a relatively small component of the overall bill paid by consumers, at present, with all of the fixed charges on residential and commercial electrical utility bills, it accounts for less than twenty (20%) of the overall electricity bill. GSU is a corporation under OBCA rules with profitable subsidiaries, it is not a not-for-profit corporation and it has demonstrated financial strength.

GSHI has been able to keep distribution rates low. This is a notable accomplishment and should be credited to them as a sign of efficient operations and a creative mix of energy product offerings that are providing services as well as beneficial rates to their customer base. It is noteworthy however, that several municipalities with similarly low distribution rates are paying dividends and or contributing more total cash to their respective municipal shareholders.

Staff recommend the dividend policy attached to the recommended revised shareholder declaration as Schedule A.

Recommendation

That the General Manager of Corporate Services be directed to present a by-law adopting the revised shareholder declaration in Appendix A.

And that the General Manager of Corporate Services work with the CEO of Greater Sudbury Utilities to establish a schedule for the declaration and payment of a dividend in accordance with Schedule A which results in payments commencing in 2020.

References

Report of the Ontario Energy Board: Best Practices regarding Governance of OEB Rate-Regulated Utilities <https://www.oeb.ca/sites/default/files/report-of-the-board-corporate-governance-20181220.pdf>

https://www.osc.gov.on.ca/documents/en/Securities-Category5/rule_20050617_58-201_corp-gov-guidelines.pdf

https://www.oeb.ca/oeb/Documents/EB-2014-0255/KPMG_Report_Corporate_Governance_20150429.pdf

Current Shareholder Declaration

Dividend Policy Adopted by GSU Board on May 27th, 2019

Shareholder Declaration tabled by GSU Board at June 4th, 2019 GSU Annual General Meeting