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## **Hydro Revenue Review Staff Report to Council**

Report Number: 2021-96

Department(s): Financial Services

Author(s): Mike Mayes, Director, Financial Services/Treasurer

Meeting Date: December 6, 2021

### **Recommendations**

1. That the report entitled Hydro Revenue Review dated December 6, 2021 be received; and,
2. That investment income received from Newmarket-Tay Power Distribution Lt. be transferred from the tax-supported operating budget to the Asset Replacement Fund effective January 1, 2022; and,
3. That the tax-supported contributions to the Asset Replacement Fund be reduced by the budgeted amount as an asset; and,
4. That the Town of Newmarket demand payment of its \$22 million promissory note with Newmarket-Tay Hydro Inc.; and,
5. That the Treasurer be authorized and directed to do all things necessary to give effect to these recommendations.

### **Executive Summary**

In consideration of the economic environment and the Town's Fiscal Strategy, refinements are being proposed to the application of the income derived from the investment in Newmarket-Tay Power Distribution Ltd. (NT Power).

### **Purpose**

This report is seeking Council approval for the proposed changes.

## Background

### Annual Hydro Revenues are \$2.9 million

NT Power currently provides the following revenues to the Town's tax-supported operating budget every year:

Dividend	\$ 1,336,000	Interim revenue review
Interest on promissory note	\$ 1,205,600	
	<b>\$ 2,541,600</b>	
Rent	\$ 335,965	Market rate, future property review
<b>Total</b>	<b>\$ 2,877,565</b>	

The rent for 590 Steven Court is reviewed on a regular basis to ensure that it is being charged at a market rate. As this income is not directly related to our investment, it is excluded from this review.

### The Fiscal Strategy recommended allocating the dividend to reserve funds

Recommendation 60 from the Fiscal Strategy is:

*Over the next five years, the Hydro dividend should be transitioned to a contribution split 75:25 between the tax-supported Asset Replacement Fund and the new Contingency Reserve.*

Although this original recommendation did not contemplate an offset in the tax-supported base budget, the report includes the offset as a transitional step subject to further analysis.

Funding for the Contingency Reserve and additional funding for the Asset Replacement Funds will both be considered as part of the Reserves and Reserve Funds review.

### Dividend payments have been stable since 2012

The dividend payments represent a distribution of approximately 50% of annual net income. However, there is no policy in place to guarantee payments. For instance, there was almost no dividend paid in 2020 because of the impact of COVID on cash flow, but things improved.

Dividends for 2008-2011 were slightly higher, averaging \$1.5 million. Prior to that, for 2002 to 2007, they averaged \$2 million.

NT Power is currently having its dividend policy reviewed by KPMG. The results of this review are not known yet.

## **The promissory note pays maximum interest**

NT Power's predecessor issued a \$22 million promissory note to the Town of Newmarket on October 1, 2001. This was done as part of the incorporation of the Town's interest in the utility, to balance debt and equity. Assets were transferred but no cash changed hands.

The note pays interest at the maximum rate permitted by the Ontario Energy Board (OEB), which is currently 5.48% per year. The original interest rate was 7.25%. Interest is adjusted when a rate filing is made with the OEB – the next filing could be in 2028.

Any changes to the terms of the note - maturity and repayment terms - require 13 months' notice. This requirement can be waived by the two parties.

## **Opportunity for NT Power**

With interest rates at historical lows, NT Power could save by refinancing the promissory note debt at a lower rate. Potentially, this could result in a higher dividend payment in the short term, or in the longer term if it is reinvested for capital or expansion.

## **Discussion**

Re-thinking our Hydro revenues has resulted in the following 4-step plan:

1. Change how the Town accounts for the Hydro income
2. Demand payment on the \$22 million promissory note
3. Put the \$22 million into the Asset Replacement Fund
4. Invest with One Investment

### **1. Change how the Town accounts for the Hydro income**

The Hydro investment income (dividends and promissory note interest) currently in the tax-supported operating budget for \$2.5 million, should be reallocated to go directly to the Asset Replacement Funds (ARF).

To ensure there is no budget impact, the tax-supported ARF contributions (currently \$5.5 million in the draft 2022 budget) would be reduced by \$2.5 million.

To ensure that there is no impact on building ARF balances. The income would be directly transferred to the reserve fund. This would include any fluctuations whether negative or positive. A long-term reserve fund, such as the ARF, is more appropriate for funding sources that may have annual fluctuations but balance out over time.

This change can be made effective with the 2022 budget and fiscal year.

This step can and should be taken even if we do not go forward with the other 3 steps.

## **2. Demand payment on the \$22 million promissory note**

It is probable that when NT Power files for its electricity rates with the OEB, possibly in 2028, that it will again need to lower the interest charges on the promissory note. Therefore the Town will eventually need to replace a high return investment.

One option would be to phase in this change, but there is another option.

With interest rates at historic lows, NT Power would like to refinance its debt, and expects to be able to do so for a lower cost. For this reason it would be willing to waive the 13-month notice period.

This option is viable when coordinated with the next two steps.

While this is being undertaken, the Town should seek clarity on the dividend policy considerations and seek to reduce the risk to its future income stream.

## **3. Put the \$22 million into the Asset Replacement Fund**

Upon receipt, the \$22 million would be deposited in the reserve fund bank account and attributed to the Asset Replacement Funds.

The revenue stream, which is offsetting the decrease in ARF contributions, needs to be maintained. As such, the funds should be treated as an “endowment” and have the principal protected. This could entail enacting a by-law to restrict use of these funds.

It should be noted that this transformation will improve the Town’s comparative reserve metrics.

## **4. Invest with One Investment**

In the financial world, it is a known fact that equity investments will outperform inflation and the money market in the long run. However, municipalities are limited to two avenues for access to equity investing.

The first option is the prudent investor standard. This requires a level of commitment that the Town is not ready for yet.

The second option is One Investment (previously known as the One Fund). It is a non-profit origination created by LAS (Local Authority Services) and MFOA (Municipal Finance Officers’ Association) to provide municipalities with a sound investment option.

Council has previously given the Treasurer authority to use this investment vehicle.

The optimal fund would be the ONE Canadian Equity Portfolio which is managed by Guardian Capital LP. This was designed for investment horizons of five years or more; such as would be required for long-term infrastructure funding, and capital asset maintenance and remediation (aka; Asset Management)

The five-year returns are performing better than the Toronto Stock Exchange composite and exceed our implied benchmark – the prescribed OEB rate.

	ONE Canadian Equity Portfolio	TSX Composite	Prescribed OEB rate
October 2021 annualized	10.45%	n/a	5.48%
2020	9.00%	8.26%	5.48%
2019	7.50%	6.28%	5.48%

## Conclusion

With Council permission, staff will make the changes in the 2022 budget (Step 1), and will initiate the processes to move forward with the remaining 3 steps.

## Business Plan and Strategic Plan Linkages

Under the Strategic Pillar of Long-term Financial Sustainability, this assists in the priority to: *Utilize both internal and external resources to complete an assessment of the Town's overall financial health to support effective and efficient long-term planning.*

It also addresses the Fiscal Strategy recommendation to redirect the use of the Hydro dividend.

## Consultation

There has been consultation with senior management of Newmarket-Tay Power Distribution Ltd., and the Senior Leadership Team (SLT).

There have been discussions with Legal Services about implementation of the recommendations.

## Human Resource Considerations

Not applicable to this report.

## Budget Impact

Although budgets are being shifted, no short-term impact is expected. Increased investment returns, if realized, will provide additional funding for future capital budgets.

## **Attachments**

None

## **Approval**

Mike Mayes, CPA, CGA, DPA  
Director, Financial Services/Treasurer

Esther Armchuk, LL.B  
Commissioner, Corporate Services

## **Contact**

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