

Where's the Cheque? Governance, Ownership, and Dividend Policies of Electric Utilities

By Adam Fremeth and Guy Holburn*

EXECUTIVE SUMMARY

- Municipal electricity distribution companies (LDCs) in Ontario are permitted to earn a regulated financial rate-of-return on shareholder equity, allowing for dividend payments, but regulators have expressed concern that municipal owners of LDCs may extract too high dividends—to fund municipal budgets and social programs—at the expense of re-investment in LDC infrastructure and network reliability.
- The Policy Brief documents and analyzes annual dividend payments by all 71 LDCs in Ontario from 2014 to 2019. Compared to some Canadian privately-owned electric utilities, the average dividend payout ratio of LDCs is marginally lower over the sample period. There is significant variation among LDCs. Some regularly pay out significantly more while others that pay out much less than the average. 31% of LDCs paid no dividends at all or very rarely.
- Statistical analysis suggests that, *all else equal*, LDC dividend payout ratios are higher on average for LDCs with (i) a *lower* share of political directors (councillors and mayors) on the LDC board, (ii), a larger customer base, and (iii) improving system reliability. The negative impact of politically-dominated boards on dividend payments is especially acute for small LDCs and those with a higher achieved financial rate of return. For large LDCs, political director-dominated boards are associated with higher dividend payout ratios, all else equal.
- Transparency in the governance of Ontario LDCs varies significantly across the province. The results of our analyses suggest that this may contribute to agency problems that divert corporate earnings to uses beyond distributing dividends to municipal shareholders. Further can be done by LDCs to disclose and report financial relationships with their shareholders.

INTRODUCTION

Setting the share of corporate earnings to be distributed to shareholders in the form of dividends is a central governance responsibility of a corporation's board of directors. While corporate boards are not obligated to distribute dividends, doing so can send a positive signal to capital markets that the business is financially healthy and remunerative for future investors. Such signals are especially important for firms in

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capital-intensive sectors such as utilities, infrastructure and natural resources, which often require on-going access to capital markets.¹ At the same time, boards must balance the need of the corporation to retain sufficient earnings for re-investment and internal operations, which limits the maximum level of dividends that may prudently be paid out.

We examine how the composition of a corporation's board of directors affects board decisions over the level of dividend payments to shareholders. We focus on government-owned local electric distribution utilities in Ontario, where utility boards consist of a mix of 'political' directors—elected city councillors or mayors—and independent professional directors, all appointed by city councils. Since utility dividend payments directly contribute to municipal budgets, political directors may support higher levels of dividends, which would benefit municipal social budgets. Independent directors, who do not face pressure from citizens, are presumably less likely to pursue political objectives in their dividend decisions. Prior research has found that political directors do indeed prioritize higher dividend payments over re-investment in the business in the hypothetical scenario of an increase in the corporation's net earnings (Fremeth and Holburn, 2018).² The potential for a conflict of interest for political directors has been recognized by the Ontario Energy Board (OEB), the provincial regulator, which in the case of Toronto Hydro required the utility's dividends to be approved by at least a majority of independent directors.³

To test whether political director-dominated boards adopt different dividend policies from independent director-dominated boards, we examine the board composition and annual dividends of all 71 local electric distribution corporations (LDCs) in Ontario from 2014 to 2019. There is significant variation in the representation of city councillors and mayors on LDC boards, with some LDCs that skew heavily towards political directors (e.g. E.L.K. Energy Inc.) and others that skew towards independent directors with no political directors (e.g. Oshawa PUC Networks Inc.). For the typical utility, approximately 27% of directors were city councillors during our sample time period.

INDUSTRY BACKGROUND

In 1999, the government of Ontario implemented wide-ranging restructuring of the provincial electricity sector, which, at that time, consisted of more than 300 municipal local electricity distribution companies (LDCs) and a dominant generation and transmission entity, Ontario Hydro, serving the province (Gregory et al., 2003; Trebilcock and Hrab, 2005). While the government eschewed privatization, it converted LDCs from municipally-run departments into legal for-profit business corporations, wholly owned by municipal governments and regulated by the OEB. This change reduced the discretion that municipal owners had in prescribing LDC operations and altered the benefit of local ownership to one of an investor-owner. The reforms were intended to move the distribution sector towards industry best practices and to encourage efficiency and governance improvements.⁴ Since 1999, there has been considerable consolidation of LDCs through mergers and acquisitions, resulting in 71 LDCs in 2021.⁵

As shareholders, municipal councils are required to appoint boards of directors, who have a legal obligation to adopt private sector standards of corporate governance in overseeing LDC management and performance. Legislation and common law specify that the duties of directors are (i) to act in the interests of the corporation (fiduciary duty), and (ii) to use diligence, skill and prudence in their actions (duty of care). Councils have varied in their selection of LDC directors, with some appointing a majority of independent, professional directors and others appointing a majority of elected municipal councillors. The prevalence of municipal councillors, who often have less business experience than independent directors, on LDC boards

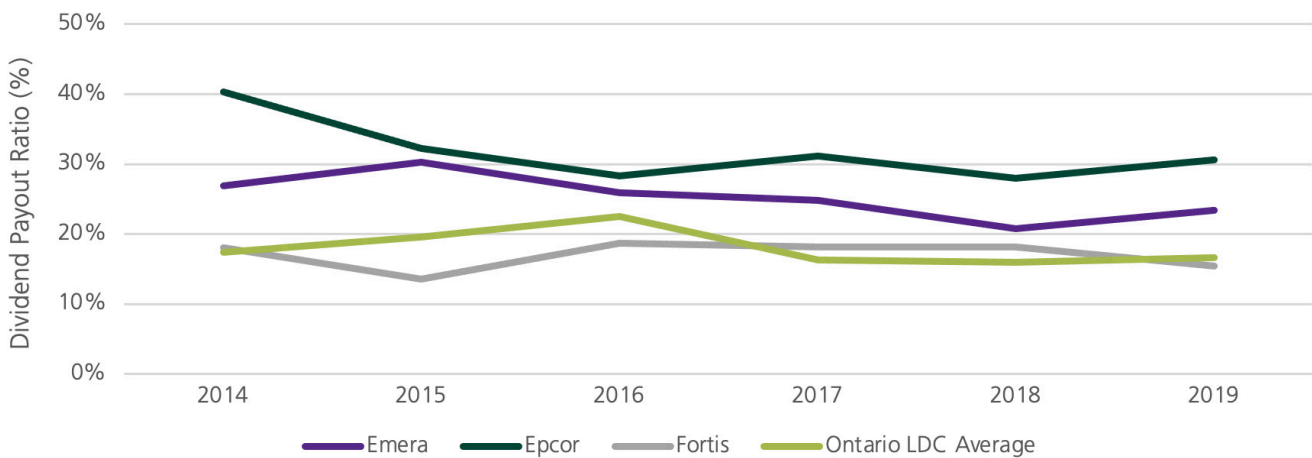
has contributed to increased scrutiny by the OEB of LDC corporate governance practices as well as the impact on strategic issues such as dividend payments, infrastructure investment (Ontario Energy Board, 2006), and LDC consolidation (Ontario Energy Board, 2018; KPMG, 2015; Mowat Centre, 2016).

LDC DIVIDENDS: FACTS AND FIGURES

i. Canadian Utility Benchmarks

As a benchmark, we first examine the dividend policies of several Canadian electric utilities, including private and government-owned corporations. The dividend payout ratio for the three corporations (defined as Dividends / Earnings before Depreciation and Amortization) ranged from 15% to 31% in 2019, with an average of 23% (see Figure 1). This Figure also includes the average payout ratio for all Ontario LDCs (except for Toronto Hydro, which is the largest and most urban LDC, making it less comparable to others in the industry).

Figure 1 | Dividend Payout Ratios for Canadian Utilities⁶



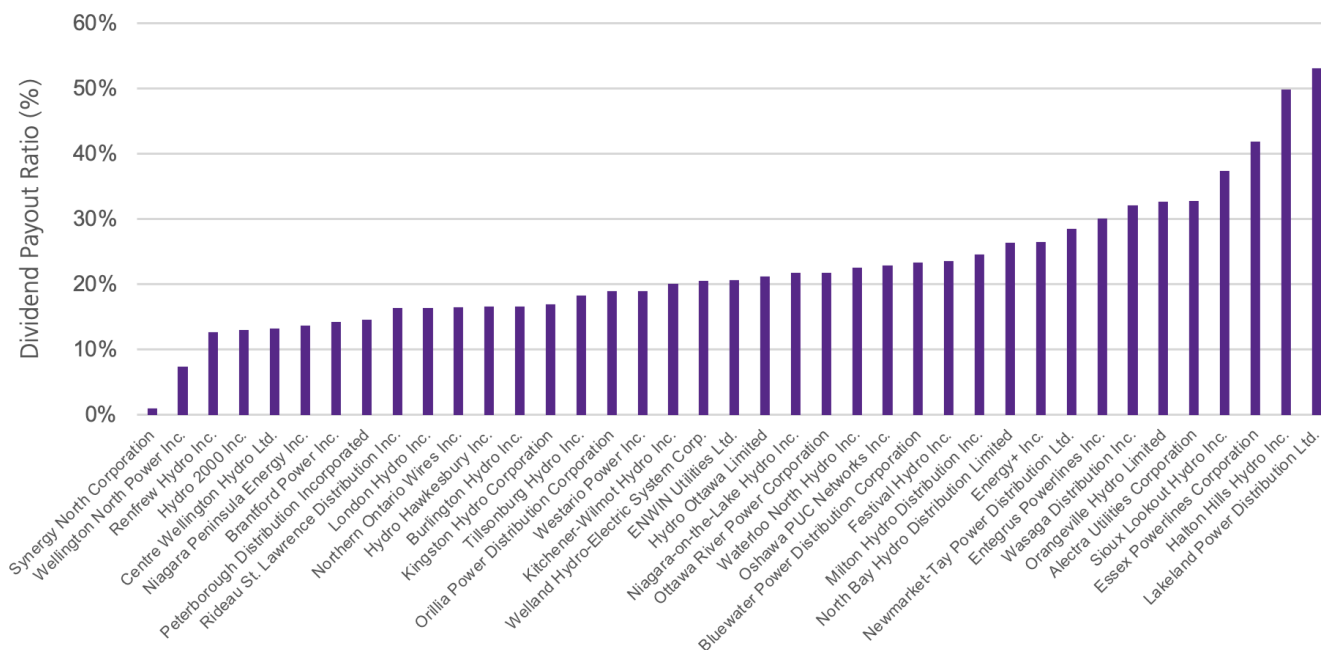
ii. Ontario LDC Dividends

Compared to the dividend payout ratio of the benchmark utilities, Ontario's LDCs distributed on average a smaller fraction of their earnings before depreciation and amortization—18%—between 2014 and 2019.⁷ This percentage has remained relatively stable over the six-year period. However, there is considerable variation among LDCs. At the upper end, Lakeland Power's dividend payout ratio averaged 69% over 2014 to 2019,⁸ while Greater Sudbury Hydro has never paid a dividend to its shareholder.⁹

From 2014 to 2019, LDC dividend payments across the province amounted to \$877 million, with an average (median) annual LDC dividend of \$2.3 million (\$454,000). However, 17% of LDCs did not pay any dividends to their shareholders during the period, and 26% paid a dividend only for three or fewer years.

Figure 2 depicts the dividend payout ratios (Dividends / Earnings before Depreciation and Amortization) for LDCs that paid a dividend in 2019 (thirteen LDCs paid no dividends in that year). The payout ratio ranges widely from 1% to 53%, with a clustering around 25%. In 2019, the average (median) dividend payment among LDCs that paid a dividend was \$3.9 million (\$449,000).

Figure 2 | Dividend Payout Ratios for Ontario LDCs (2019)



WHAT FACTORS INFLUENCE LDC DIVIDENDS?

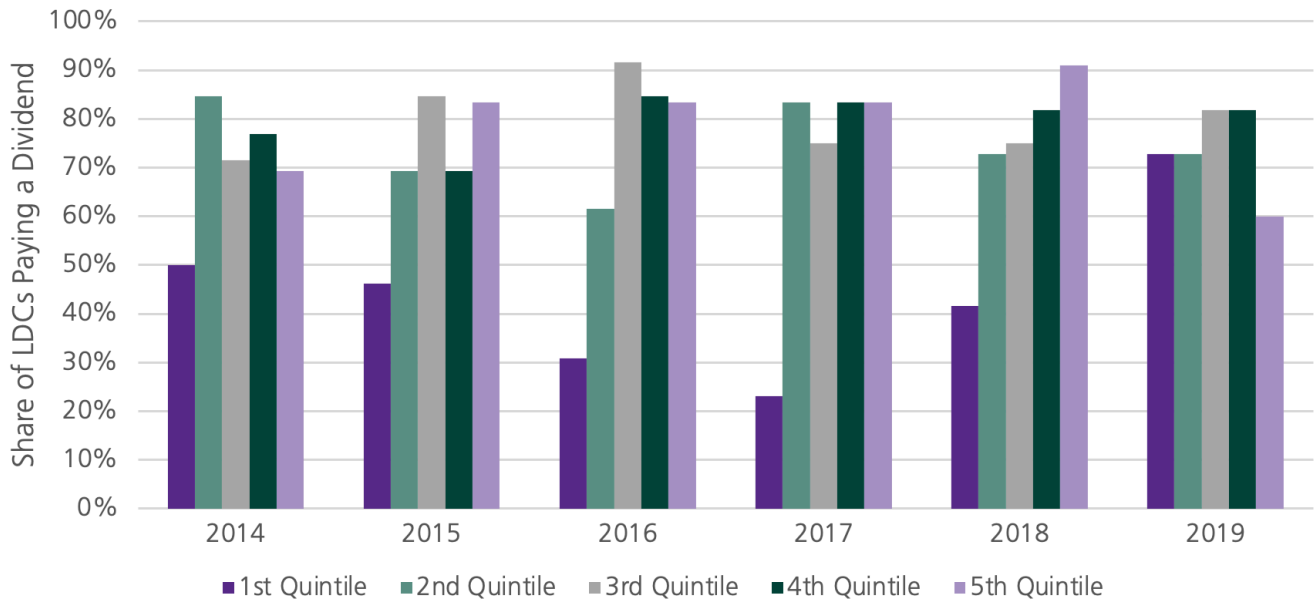
We examine the impact of several factors that might explain why some LDCs pay greater dividends as a share of adjusted earnings: corporate financial performance, network system reliability, board composition, and corporation size.

1. Financial Performance

One potential explanation for the variation in LDC dividends is financial strength: although municipal shareholders sometimes establish a target level of net income to be paid as dividends, boards may be more willing to justify greater payments if the corporation has achieved higher earnings.¹⁰ The OEB sets rates that, in theory, allow LDCs to earn a financial rate of return on shareholder equity (ROE) between 7% and 10%. Actual earned rates of return can differ substantially—which may then impact dividends.

Figure 3 shows for each year 2014 to 2019, the percentage of LDCs in each earned-ROE quintile that paid a dividend. For example, in 2018, 42% of LDCs in the bottom earned-ROE quintile paid a dividend. As expected, for each successive quintile, a greater fraction of LDCs paid a dividend. Among LDCs in the top quintile, more than 90% paid a dividend in 2018. Although not uniformly the case, higher quintiles demonstrate a greater propensity to pay dividends than lower quintiles in most years.

Figure 3 | Share of LDCs Paying a Dividend, Ranked by Financial Performance Quintile

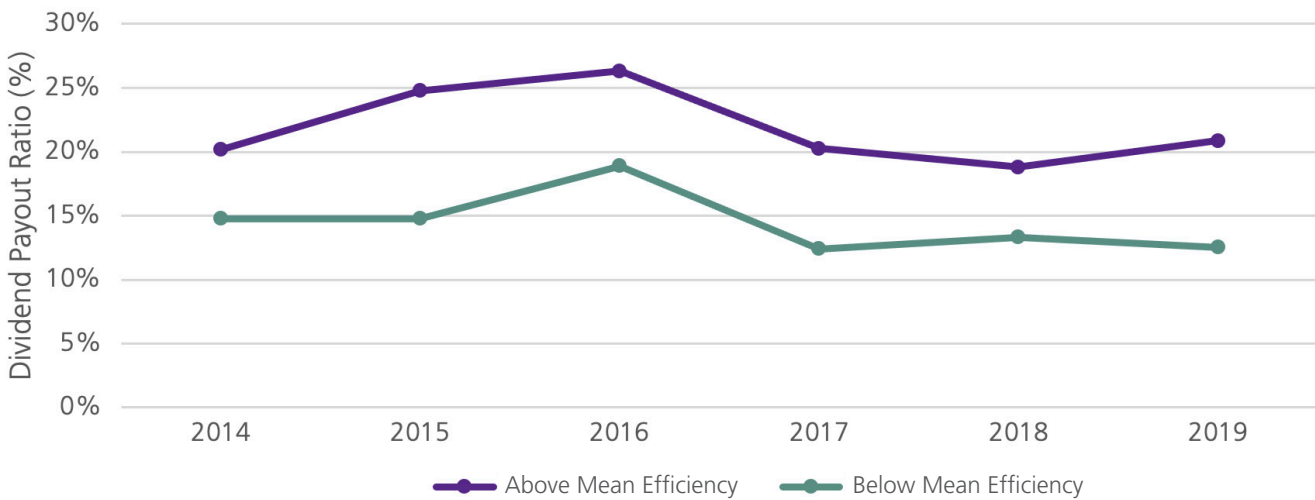


Note: The composition of the quintiles are determined on an annual basis and updated each year.

Figure 4 shows another factor that may contribute to dispersion in dividend policies: the operating efficiency of a utility. More efficient utilities are in a better position to contribute to their shareholder. To examine this possibility, we consider the relationship between the dividend payout and the Operating, Maintenance, and Administrative (OM&A) expenses per customer.

Figure 4 demonstrates a clear distinction in the payout ratios for LDC’s above the median in OM&A from those below, where the more efficient LDCs contribute significantly more of their cash flow in the form of dividends to the shareholder than the less efficient LDCs.

Figure 4 | Dividend Payout (EBDA) by Operating Efficiency



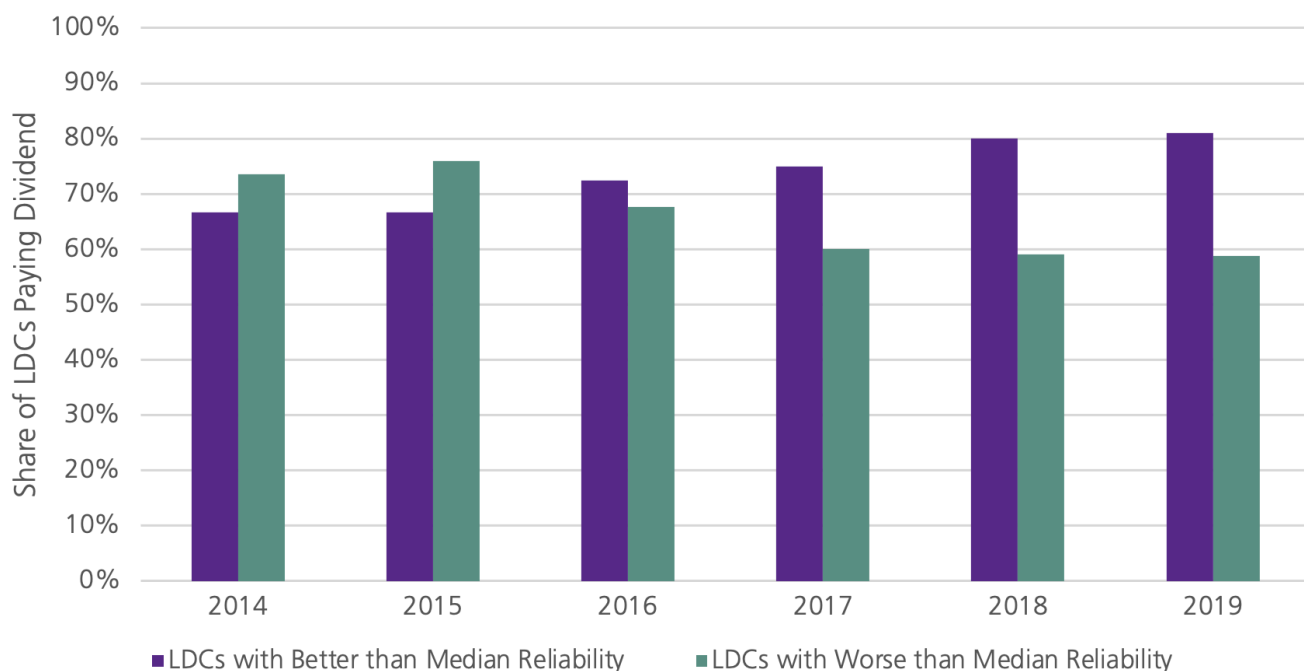
Note: The composition of the quintiles is determined on an annual basis and updated each year.

2. System Reliability

Maintaining network system reliability is a core priority for electricity distribution companies and for industry regulators who monitor reliability statistics. Reliability is driven in part by the age and condition of infrastructure assets, and by the LDC's maintenance, repair and replacement policies, as well as the nature of geographic territory served (e.g. susceptibility to extreme weather events). A systematic, planned capital expenditure programme is a pre-requisite for maintaining or improving system reliability, and preventing frequent or lengthy power outages. As such, LDCs that experience deteriorating system performance may strategically increase their capital expenditure budgets, which could dampen the willingness of boards to distribute net income to shareholders in the form of dividends.

Figure 5 examines the relationship between LDC dividend payments and system reliability as measured by the percentage annual change in the three-year moving average of the System Average Interruption Duration Index (SAIDI), a commonly used indicator. The figure shows, for each year 2014 to 2019, the share of LDCs with above median reliability that paid a dividend and the share of LDCs with below median reliability that paid a dividend. For four of the six years, LDCs with better system reliability were more likely to pay a dividend than those with poorer reliability. The difference is especially marked and statistically different for the three years 2017 to 2019. This pattern is consistent with LDCs prioritizing re-investment in the business over dividends when experiencing distribution network performance shortfalls.

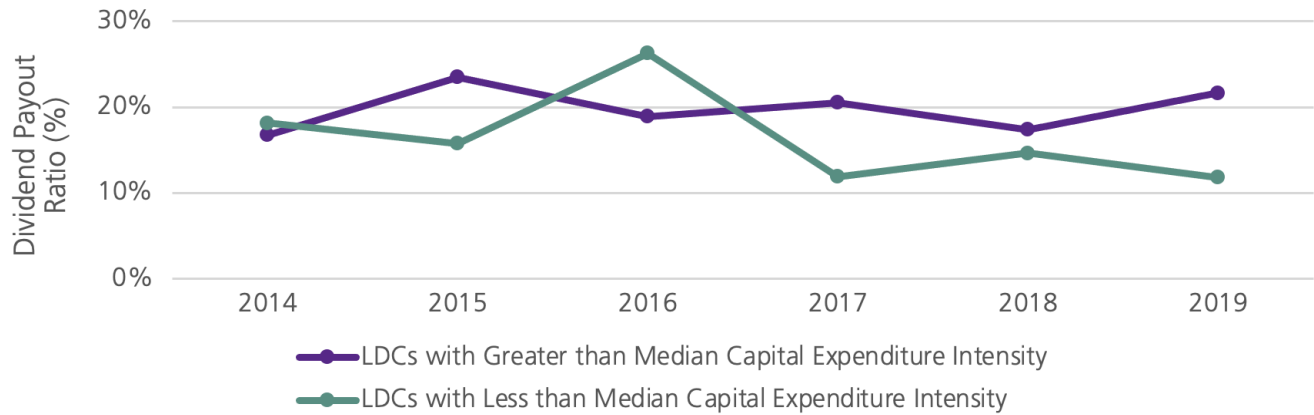
Figure 5 | Share of LDCs Paying Dividends, Ranked by System Reliability



Note: The composition of which LDCs are above/below the median is determined on an annual basis and updated each year.

Relatedly, Figure 6 shows how dividend payout ratios differ for LDCs that have high or low capital expenditures (on a per customer basis). The broad pattern from 2014 to 2019 suggests that LDCs with above median capital expenditure intensity paid out greater dividends. One interpretation of this correlation is that utilities that sufficiently invest in their infrastructure are less likely to experience system reliability problems, affording the flexibility to distribute a share of earnings to shareholders.

Figure 6 | LDC Capital Expenditure Intensity and Dividend Payout Ratio



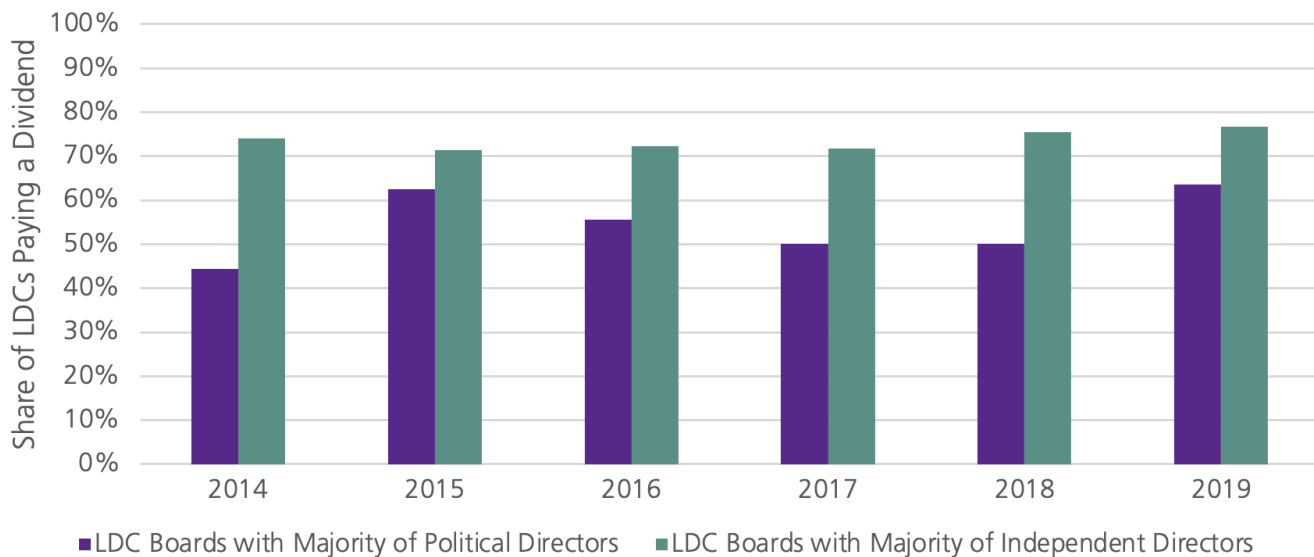
Note: The composition of which LDCs are above/below the median is determined on an annual basis and updated each year.

3. Board Composition: Political and Independent Directors

An LDC board's mix of political and independent directors may shape an LDC's dividend policy. Fremeth and Holburn (2018) find that political directors are more likely to report a preference for higher dividends over greater investment in the LDC if corporate earnings were to increase, which might be consistent with prioritization of political over business objectives. As a result, one might expect that LDC boards with a higher ratio of political directors will distribute higher levels of dividends.

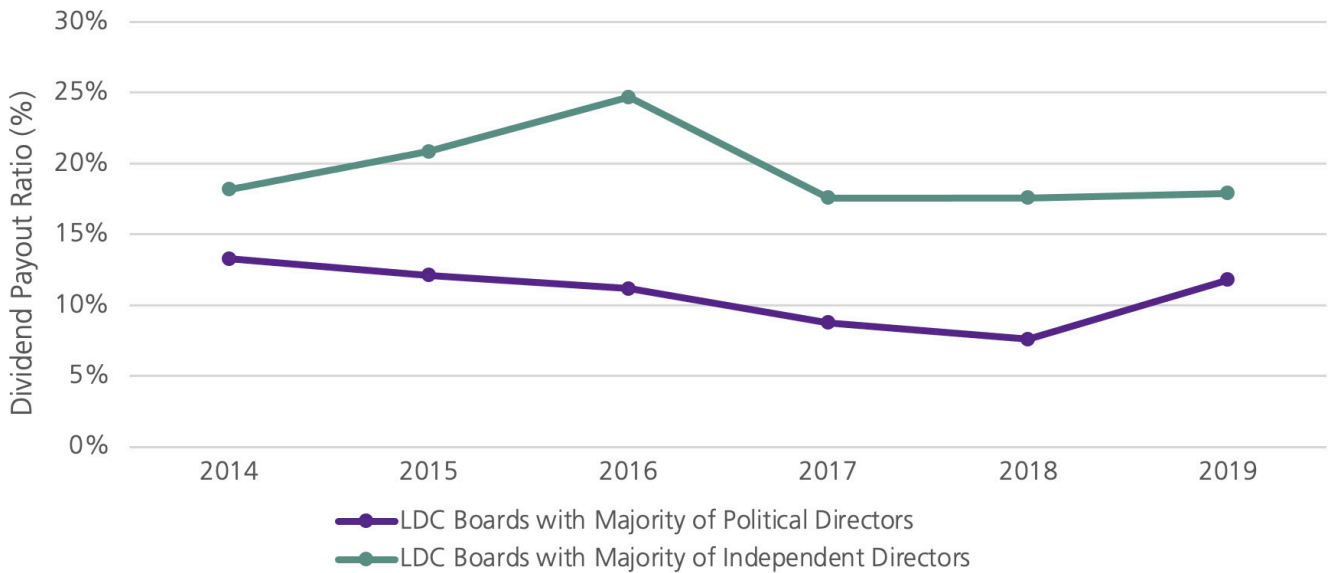
However, Figure 7 demonstrates the reverse correlation: in each year from 2014 to 2019, LDCs with boards dominated by political directors were less likely to pay a dividend than LDCs with boards dominated by independent directors. For example, in 2018, 50% of political-majority LDC boards paid dividends—versus 76% of independent-majority LDC boards. Similarly, the average dividend payout ratio was significantly lower for the former than the latter (Figure 8).

Figure 7 | LDC Board Composition and Dividend Payments



Note: The composition of which LDCs are above/below the majority is determined on an annual basis and updated each year.

Figure 8 | LDC Board Composition and Dividend Payout Ratios

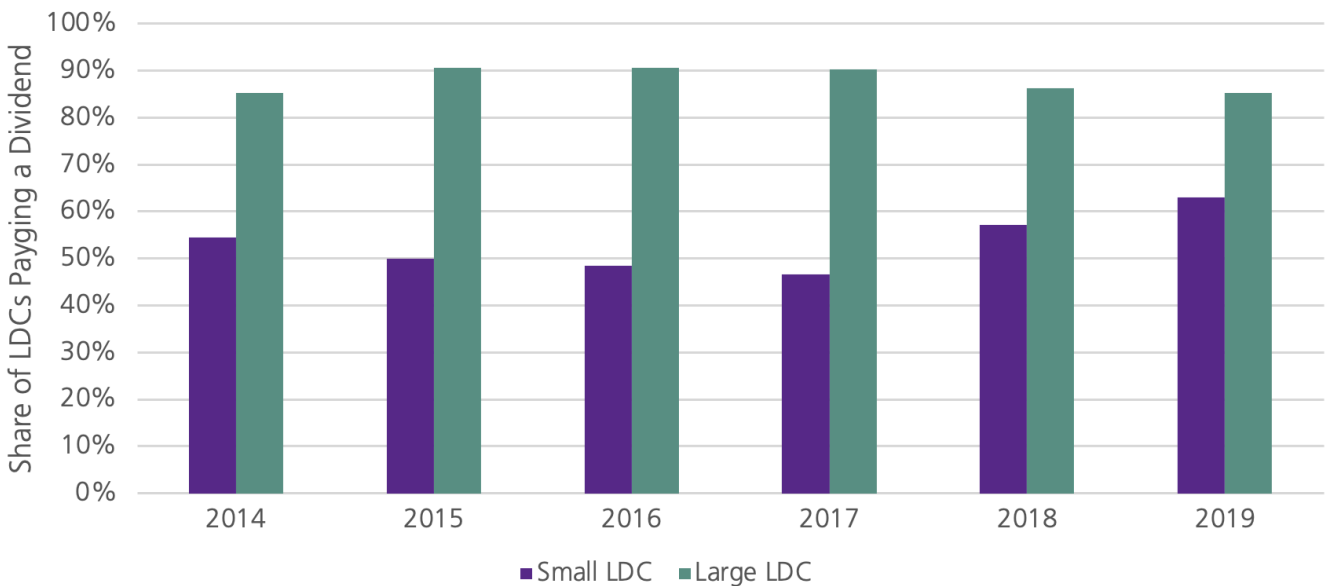


Note: The composition of which LDCs are above/below the majority is determined on an annual basis and updated each year.

4. LDC Size

A further factor that could influence dividend policy is LDC size since there is considerable heterogeneity between large and small LDCs in organizational resources and capacity, corporate governance practices, customer profiles, and in network system demands. Figure 9 examines the propensity for an LDC to pay a dividend based upon the number of customers served: in each year from 2014 to 2019, a smaller fraction of small LDCs (those with fewer than the median number of customers) paid dividends than large LDCs (those with greater than the median number of customers). In 2019, for instance, 62% of small LDCs paid a dividend compared to 85% of large LDCs.

Figure 9 | Share of Small and Large LDCs Paying a Dividend



Note: The composition of which LDCs are above/below the median is determined on an annual basis and updated each year.

STATISTICAL ANALYSIS

The results above are suggestive correlations between LDC characteristics and dividends but they do not control for multiple factors simultaneously. We thus use a multiple regression analysis to statistically identify the effect of the factors above on the dividend payout ratio, while also controlling for several other factors (capital expenditure per customer, OM&A costs per customer, and percentage annual change in number of customers served). Descriptive statistics for the variables included in the statistical analysis are listed in the Appendix.¹¹ The regression analysis yields several core findings that are consistent with the correlations.

First, after controlling for other factors, LDC boards with a greater share of political directors tend to issue lower dividends, on average. Increasing the share of political directors by 20% (which is equivalent to adding an additional politician to the average LDC board) decreases the dividend payout ratio by 16%, all else equal. For the median LDC—which paid a dividend of \$449,000 in 2019—this is equivalent to a \$72,000 dividend reduction.¹² This is consistent with the simple relationship shown above, but counter to our earlier survey evidence of political directors.

Two factors were found to be statistically associated with higher dividend payments: the LDC's size (number of customers) and the change in system performance. Increasing an LDC's size by 100,000 customers is associated with a 10% higher dividend payout ratio, all else equal. And improving an LDC's three-year moving average SAIDI score by 0.445% (which is a one standard deviation improvement in reliability) is associated with a 7% higher dividend payout ratio, all else equal.

Second, the statistical analysis indicated that the impact of political directors varied according to two LDC characteristics, financial performance and size. In the case of financial performance, as the earned ROE increases, LDCs with more politicians on their boards make lower dividend payouts. We present this result in [Figure 10a](#) where the share of political directors on the board is the x-axis and the dividend payout ratio is the y-axis. We graph three lines, one where the LDC's financial performance is at the median level (8.4% earned ROE), one for LDC financial performance that is one standard deviation below the median (3.6%), and one for LDC financial performance that is one standard deviation above the median (13.2%). The slopes of the three lines indicate that the impact of increasing the share of political directors is most pronounced (steeper) for LDCs with stronger financial results. For high ROE LDCs, the dividend payout ratio declines rapidly for boards with more political directors. In other words, financially healthy LDCs payout much higher dividends when there are fewer political directors on the board, all else equal. For low ROE LDCs, however, the decline is much more moderate—almost flat—which may indicate the impact of financial constraints on the capacity to issue dividends, irrespective of board composition.

Figure 10a | Impact of Board Composition on LDC Dividend Payout Ratio, Conditional on Financial Performance

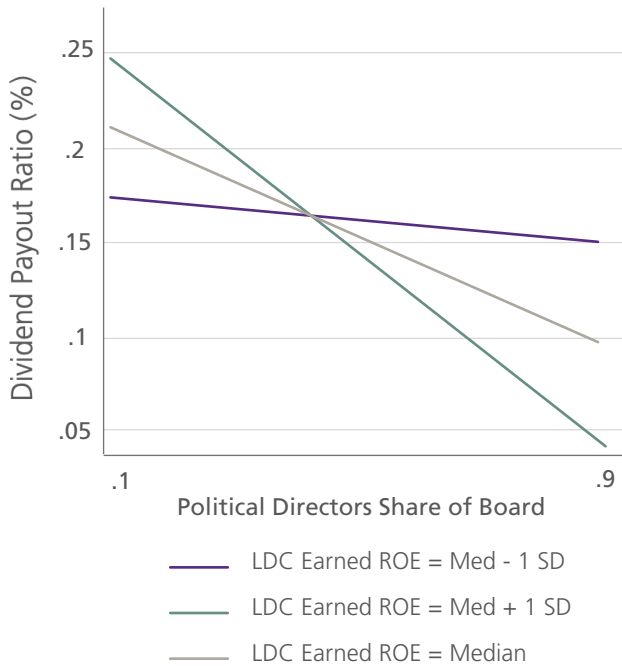


Figure 10b | Impact of Board Composition on LDC Dividend Payout Ratio, Conditional on LDC Size

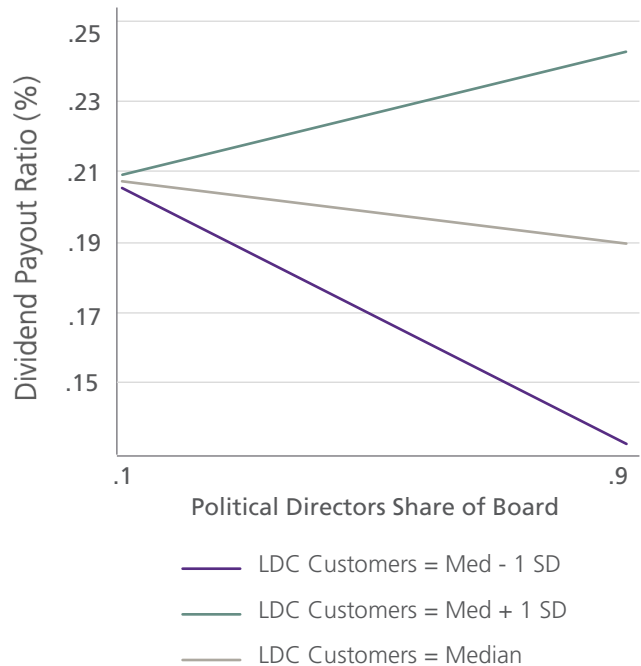


Figure 10b depicts the equivalent relationship between LDC board composition (x-axis) and dividend payout ratio, conditional on LDC size. There are three lines, which depict larger LDCs (320,000 customers), the median-sized LDC (210,000 customers), and smaller LDCs (100,000 customers). For the median LDC, there is a moderate decline in the dividend payout ratio as the share of political directors on the board increases, as shown by the shallow negative slope of the middle line in Figure 10b. However, there is a distinct divergence in the slopes of the lines for small and large LDCs: for small LDCs, the slope is negative but steeper than for the median LDC. That is, the negative impact of political directors on dividends is more pronounced for smaller LDCs. However, this relationship is reversed for larger LDCs: as the representation of political directors on boards for large LDCs increases, dividend payout ratios increase—which is consistent with the traditional concern about the effect of political governance.

DISCUSSION

The results of our statistical analysis provide new insight into the common perception that politically-dominated LDC boards, motivated by social or political objectives, may extract greater dividends from the corporation than more independent boards. Consistent with this thesis, we find a positive association between dividend payments and the share of political directors on utility boards **for larger LDCs**. However, we find the reverse relationship for smaller LDCs: politically-dominated boards of smaller LDCs tend to issue **lower** dividend payments. This presents a puzzle, especially since prior research finds that political directors generally put greater weight on obtaining higher dividends than independent directors. One potential explanation could be that political directors, who often have less business experience than do independent directors, are more likely to agree to management recommendations to retain earnings within the corporation - which gives management the discretion and flexibility to subsequently deploy the funds as they prefer. In this view, politically-dominated boards of smaller LDCs do not act as a strong governance

check and balance on management's control over a corporation's financial strategy, creating the risk of inefficient outcomes. Further research is required to examine this agency-based hypothesis and to identify how corporate earnings are used when they are not distributed as dividends.

The statistical relationship that we uncover between board director independence and LDC dividend payments supports the OEB's recent scrutiny of LDC governance arrangements and its call for LDCs to adopt governance best practices.¹³ Municipal shareholders should pay attention to the recommendations for director independence, board size, and board composition, including the qualifications and experience of directors to support strategic, operational, financial, legal, regulatory, human resources, information technology, customer service and other oversight responsibilities of LDC boards.

From a policy perspective, greater transparency about LDC governance structures and practices would assist regulators and other stakeholders in evaluating their appropriateness, and their relationship, if any, with outcomes that customers value. Basic information about LDC directors, such as names, dates of appointment, independence, committee memberships, and relevant experience, should be publicly disclosed by LDCs—for instance on LDC websites and in annual reports—and formally reported to the OEB. Similarly, LDCs should disclose and report financial relationships with their shareholders, for example annual dividend payments to the municipality or holding company. Such reporting is typical for U.S. municipal electric utilities, which are required to complete comprehensive financial and operating reports that are made public on the regulator's website. Public disclosure of utility governance arrangements and finances may be deemed a best practice, especially in the case of publicly-owned utilities.

APPENDIX

Table 1 | Descriptive Statistics for Variables in Multiple Regression Analysis

Variable	Description	Mean	Standard Deviation
Dividend Payout Ratio	$\frac{\text{Dividends}}{\text{Earnings Before Depreciation and Amortization}}$	0.182	0.2
Political Directors Share of Board	$\frac{\text{Board Members who are Mayors or Councillors}}{\text{Total Members of Board}}$	0.268	0.203
Financial Performance	Return on Equity Achieved	7.964	4.816
Number of Customers	$\frac{\text{Total Customers Served}}{1,000,000}$	0.048	0.107
Change in System Reliability	Percentage annual change in the 3-year moving average in SAIDI	0.011	0.445
Change in Number of Customers	Percentage annual change in Total Customer Served	0.011	0.017
CAPEX per Customer	$\frac{\text{Capital Additions}}{\text{Total Customers Served}} / 1000$	0.219	0.137
OM&A per Customer	$\frac{\text{OM\&A Expenses}}{\text{Total Customers Served}} / 1000$	0.313	0.095

Table 2 | Multiple Regression Analysis of LDC Dividend Payout Ratio

	Model 1	Model 2	Model 3	Model 4	Model 5
Political Directors Share of Board	-0.127** (0.057)	0.063 (0.106)	-0.165** (0.071)	-0.127** (0.057)	0.026 (0.111)
Financial Performance	0.003 (0.002)	0.009* (0.005)	0.003 (0.002)	0.003 (0.002)	0.009* (0.005)
Number of Customers	0.191*** (0.070)	0.168** (0.072)	-0.018 (0.130)	0.190*** (0.070)	-0.05 (0.141)
Change in System Reliability	-0.031* (0.018)	-0.026 (0.0180)	-0.030* (0.018)	-0.023 (0.032)	-0.027 (0.032)
Change in Number of Customers	1.692 (2.038)	1.653 (2.027)	1.628 (2.029)	1.685 (2.046)	1.587 (2.024)
CAPEX per Customer	0.047 (0.092)	0.047 (0.091)	0.051 (0.092)	0.046 (0.092)	0.051 (0.090)
OM&A per Customer	-0.149 (0.156)	-0.159 (0.154)	-0.154 (0.155)	-0.148 (0.156)	-0.163 (0.152)
Political Directors Share of Board * Financial Performance		-0.023* (0.012)			-0.023* (0.013)
Political Directors Share of Board * Total Customers			0.598** (0.294)		0.627** (0.314)
Political Directors Share of Board * Change in System Reliability				-0.033 (0.085)	0.006 (0.089)
Constant	0.190*** (0.069)	0.141* (0.082)	0.199*** (0.068)	0.189*** (0.069)	0.149* (0.081)
Observations	355	355	355	355	355
R-Squared	0.089	0.101	0.093	0.089	0.106

Note: Year fixed effects included in all models. Standard errors clustered by LDC are in parentheses

ENDNOTES

¹ For instance, publicly-traded electric utilities in Canada often maintain dividend yields in excess of 3%. In 2021, Emera had a dividend yield of 4.46%, Fortis 3.49%, and Hydro One 3.33%.

² Fremeth, Adam R. and Guy L.F. Holburn. 2018. Improving Governance and Strategy in Ontario's LDC Sector. Ivey Energy Policy and Management Centre, Ivey Business School. Available at: <https://www.ivey.uwo.ca/media/3780209/january-2018-improving-governance-and-strategy.pdf>.

³ Ontario Energy Board. 2016. Decision with Reasons. In the matter of an application by Toronto Hydro-Electric System Limited. EB-2005-0421.

⁴ Ministry of Energy, Science, and Technology. 1997. Direction for Change: Charting a course for competitive electricity and jobs in Ontario.

⁵ The number of LDCs in the province has reduced over this period due to amalgamations.

⁶ The Ontario LDC Average data includes all LDCs in Ontario except for Hydro One, which underwent a major change in ownership and also engaged in multiple acquisitions during the 2014 to 2019 period.

⁷ Data on LDC dividends were obtained from a variety of sources, including directly from LDCs, municipal records, and regulatory filings with the OEB.

⁸ Grant Thornton. Financial Statements. Lakeland Power Distribution. 2016, 2018, 2019, 2020.

⁹ Keown, Mary Katherine. 2019. Share profits, Greater Sudbury Utilities told. The Sudbury Star (June 19, 2019).

¹⁰ For instance, the City of Ottawa's dividend policy set out an expectation of the greater of 60% of net income or \$20 million to be paid by Hydro Ottawa Holding Inc. See Clark, R., Newman, S. and D'Amico, S. 2020. To Declare or Not to Declare? Should Ontario's Local Electricity Distribution Companies Pay Dividends in the Age of the Pandemic? Available at: <https://www.airdberlis.com/insights/blogs/energyinsider/post/ei-item/to-declare-or-not-to-declare-should-ontario-s-local-electricity-distribution-companies-pay-dividends-in-the-age-of-the-pandemic>.

¹¹ The data set includes annual data from 2014 to 2019 for all LDCs except Toronto Hydro, which is disproportionately larger than other LDCs. We exclude three observations where LDCs were acquired and made a special dividend in their final year of operation. Inclusion of these data points does not alter the main conclusions.

¹² The average LDC dividend payout ratio is 18%, which falls to 15.12% after a 16% reduction.

¹³ Ontario Energy Board. 2018. Report of the OEB: Best Practices regarding governance of OEB Rate-Regulated Utilities. EB-2014-0255.

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