ISC: Unrestricted

MEMO

2020, June 26

To: Mayor Nenshi and Members of Council

CC: Administrative Leadership Team

From: Carla Male (CFO, City of Calgary) and Helen Wesley (CFO, ENMAX)

Re: Administrative Inquiry – Contrast between ENMAX and EPCOR

Purpose

The memorandum relates to agenda item 15.2 from the 2020 February 03 Combined Meeting of Council. The specific text of the Administrative Inquiry is reproduced below for your convenience:

15.2 Administrative Inquiry – Councillor Farkas – Review of ENMAX and EPCOR Dividend
"In light of a recent opinion piece published in the Calgary Herald referring to the EPCOR and ENMAX dividends, I request a briefing for Council on this subject, specifically covering the context between the two organizations and their practices.

Such briefing should include a comparison of historical payment performance, operating models, asset base, earnings achieved through regulated and unregulated businesses, regional concentration or diversification, acquisition strategies, history of asset transfers to/from respective municipalities, dividend policy, and board appointment/governance practices."

City Administration worked with and relied upon the vast industry expertise available at ENMAX to develop the memorandum to address the inquiry. The results of the ENMAX analysis is available below. ENMAX was diligent, despite the challenges posed in a COVID-19 environment and others, in providing the analysis to City Administration in 2020 March.

Background

EPCOR and ENMAX were both incorporated in the late 1990s and both have a sole Shareholder in their respective municipality. Each company owns the electric utility within their respective city; EPCOR also owns the water utility for Edmonton

These two municipally owned utilities are very different. However, they both play important roles in their respective City's operations. The following background will serve to explain the key differences in the companies as those differences relate to their dividend paying patterns.

In summary, how do the two compares compare to one another?

As noted, these two municipally owned utilities are very different from one another. However, they both play important roles in their respective City's operations. Key differences can be summarized in the following table:

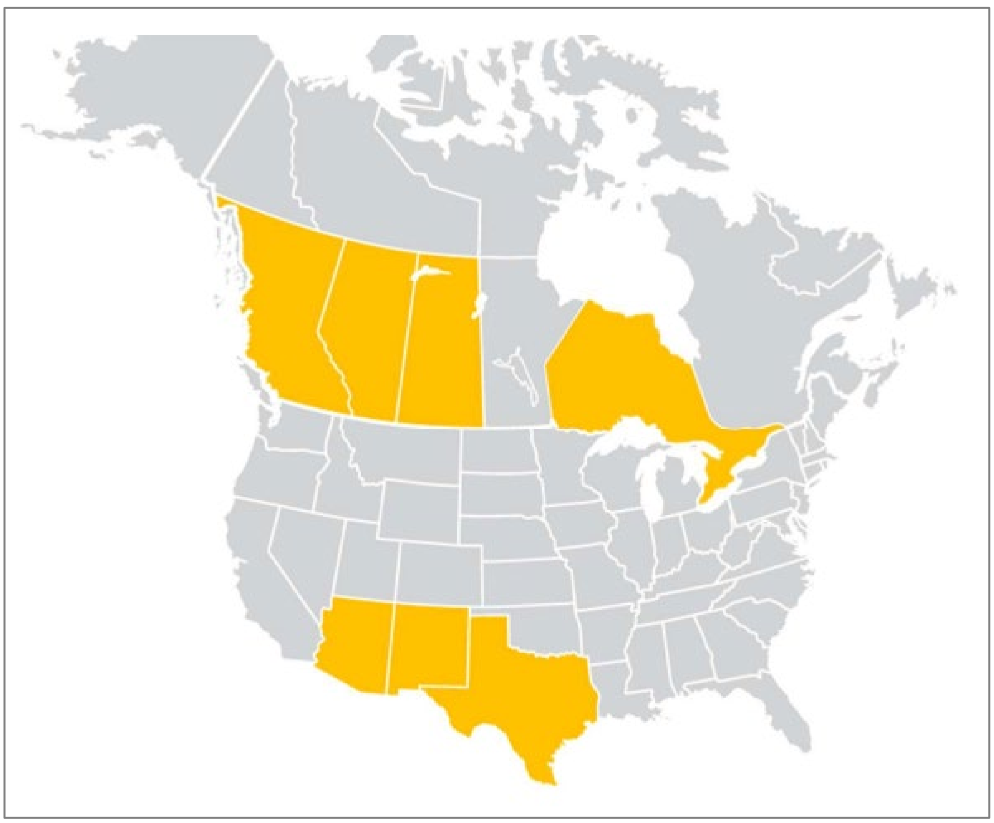
	ENMAX	**EPCOR**
Business lines	Distribution and Transmission of Electricity Competitive Power Supply Competitive Retail and Energy Services	Water Services Distribution & Transmission of Electricity Energy Services U.S. Operations
Regional diversification	Canada: Alberta United States: Maine (upon approval)	Canada: Alberta, Saskatchewan, Ontario United States: Arizona, New Mexico, Texas
Percentage of operating earnings derived from regulated business lines	~55% ~70% (upon Maine approval)	~90%
Net earnings (2018)	$149 million *(comparable)*	$295 million *(reported)*
Dividend policy	Minimum of 30% of comparable net earnings or $30 million	60% of net earnings *(not an official policy)*
Average dividend payout ratio (last 5 years)	34% of total comparable earnings *(approximates 95% of regulated earnings)*	58% of net earnings
Equity contributed by the respective City Shareholder (inception and subsequent asset transfers)	$280 million *(at inception only)*	Over $1.5 B *($800M at inception + subsequent water asset transfer)*

How and where has each company grown?

<u>EPCOR</u>:

EPCOR was formed as a result of a merger of three companies: Edmonton Power, Aqualta (water supplier) and Eltec (electrical service). While EPCOR grew its existing business lines organically, they also understood the value of geographic diversification. They started expanding their geographic footprint outside of Alberta in the early 2000s with retail services acquisitions in Ontario. They also grew their power generation business by acquiring facilities in Alberta, B.C. and the United States. EPCOR has continued to grow its rate regulated investments, predominantly their water business with investments in Alberta, Saskatchewan and the Southwestern United States. Presently, EPCOR is focused on rate regulated investments and developing new hubs in Ontario and Texas (Figure 1). EPCOR's operations are primarily regulated, with over 90% of net assets derived from rate regulated business lines. The company has a geographic footprint that allows for earnings diversity, as earnings are not tied to a single region or regulatory construct.

EPCOR's growth over time has been funded by company restructuring (the spin-out of generation assets into a new publicly-traded entity, Capital Power and subsequent divestment of shares in that company, asset transfers from its shareholder, cash flows and public debt.



EPCOR began operations in Alberta, but quickly established geographic diversification almost 20 years ago, with moves to Ontario and the United States.

Figure 1 – EPCOR Regional Diversification (Source: EPCOR Debt Investor Presentation – February 2020)

ENMAX:

ENMAX Corporation began operations on January 1, 1998 and entered the deregulated electricity marketplace upon market inception in 2001. Through its subsidiaries, ENMAX Power (transmission and distribution utility) and ENMAX Energy (power generation, regulated rate provider for Calgarians and competitive electricity and natural gas retailer across Alberta) the company is focused on serving energy needs of Calgarians and other Albertans. Within the deregulated marketplace, ENMAX operates a billing and customer care division which continues to be the customer care arm of its retail (EasyMax electricity and natural gas) and rate regulated electricity customer base, all within Alberta. ENMAX has also invested heavily in competitive electricity markets, through ownership of natural-gas and wind generation assets, and Power Purchase Arrangements. Most recently, in executing its strategy of building its regulated businesses and diversifying away from the Alberta economy and regulatory environment, ENMAX entered into a definitive agreement with Emera Inc. to purchase Emera Maine, a regulated electric transmission and distribution company in the state of Maine with headquarters in Bangor. ENMAX anticipates that this transaction will close in the first half of 2020.

ENMAX's growth since inception has been self-funded through debt issuances and cash flows. Since spinning out of the City, ENMAX has not received any additional investment from the City and, unlike EPCOR, has also not received additional assets or business lines from the City.

Did either company ever sell any material assets? Why?

EPCOR:

In 2009, EPCOR exited the power generation business after assessing capital required for growth and the risk appetite of their Shareholder. Capital Power was formed to gain access to equity markets in order to finance acquisitions and new generation construction. EPCOR's proceeds from the Capital Power spin-off and subsequent share sale (approximately $1.8 billion) were used to grow its regulated business lines without any additional growth-specific debt, and to fund the City of Edmonton's dividend requirements in times when cash flows were lower (Figure 2). EPCOR sold their interest in Capital Power shares over time, fully divesting of the investment by 2017. They have subsequently replaced the lost operating income from the Capital Power spin-off by growing other business lines (Figure 3).

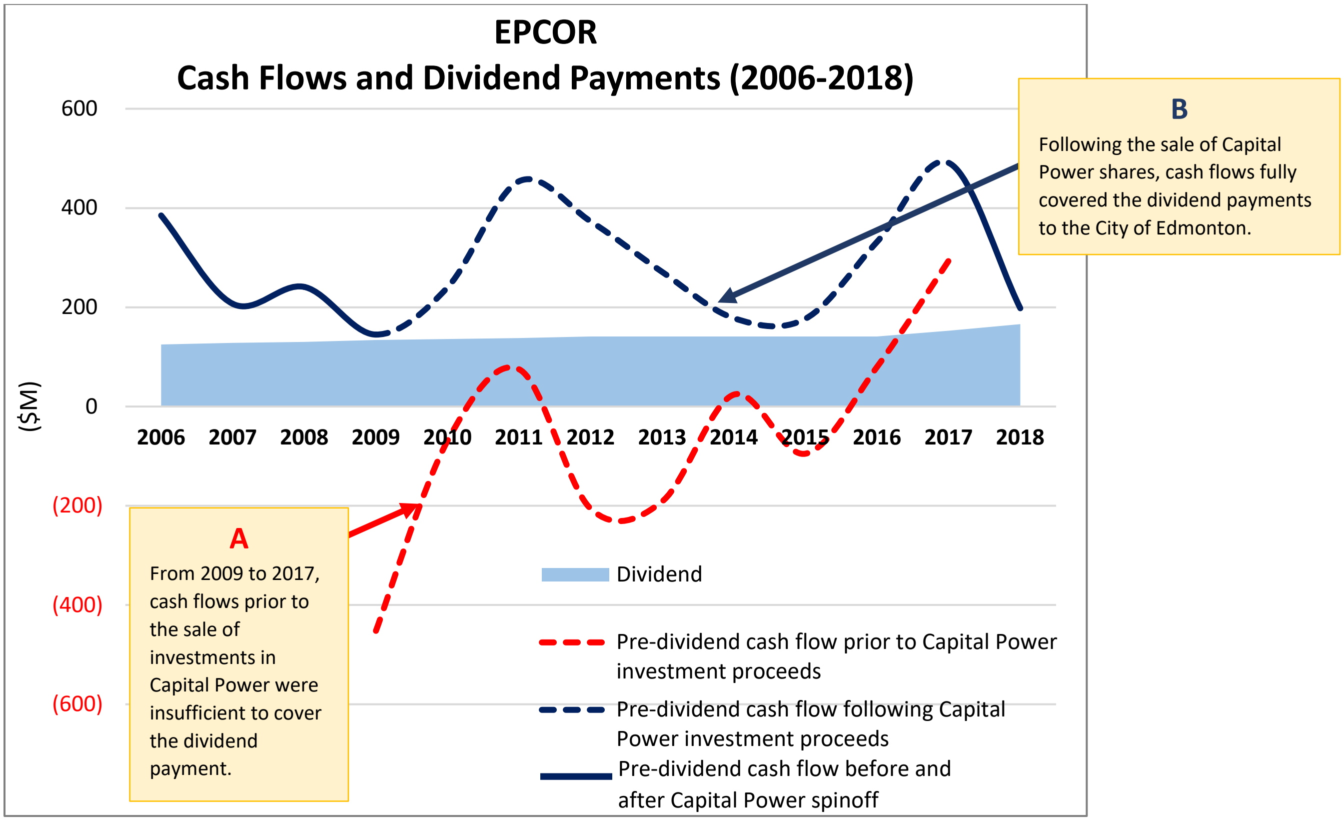
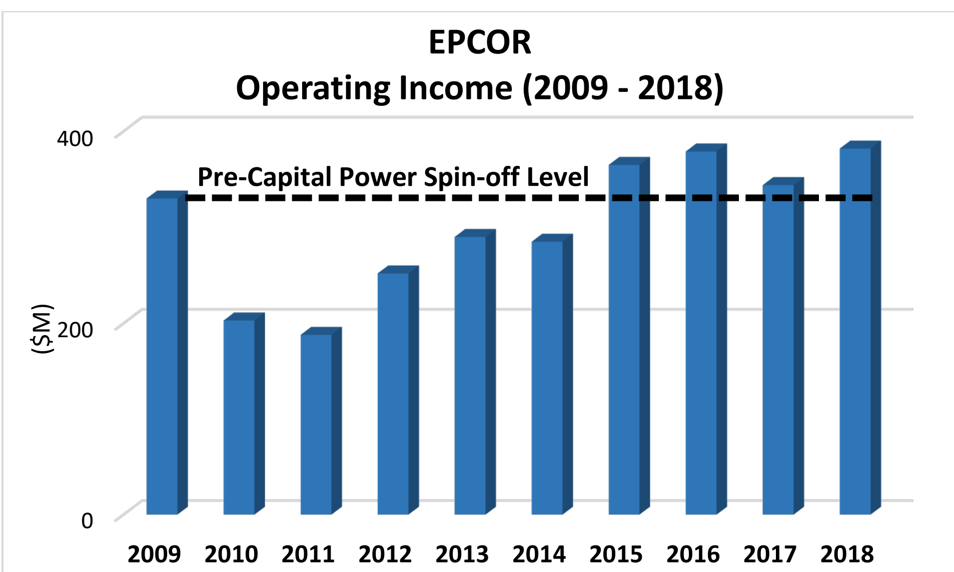


Figure 2 – EPCOR Cash Flow/Dividend (2009 – 2017) (Source: EPCOR Financials/Corporate Responsibility Reports)



Operating income lost from the sale of generation assets has been replaced, and now exceeds levels prior to the spin-out.

Figure 3 – EPCOR Operating Income (Source: EPCOR Financials)

ENMAX:

In 2013, ENMAX sold the Envision business, a fiber-optic company providing high speed internet and data to commercial customers in Calgary, to Shaw Communications for $225M. Proceeds from this sale were used to pay down the debt that had been undertaken to build the Shepard generation facility. Aside from smaller, non-material asset sales, ENMAX has had no other material dispositions in its history, nor has it received funds or asset transfers from its shareholder.

Historically, were there any major asset or equity transfers from their respective Shareholders?

EPCOR:

In 2017, EPCOR approached the City of Edmonton to transfer the City's Drainage Utility's assets and operations. In Q3 2017, the assets were transferred from the City at book value (~$1.1B in net fixed assets, with the assumption of ~$600M in drainage debt), which would bring all the water utility operations under one operator. In exchange for the transfer of assets, EPCOR agree to commit to an additional $20M in annual dividends to the City of Edmonton.

ENMAX:

Aside from the initial transfer of assets to form the company in 1998, ENMAX has not received any assets from the City of Calgary since its inception. Shareholder's equity has grown at a compound annual growth rate of 11% since 1998 without any further equity injections from the City.

What are the comparisons between asset mix/company size?

EPCOR:

EPCOR's total assets in 2019 amounted to over $11 billion. From its early days, one of the company's strategies has been to focus its capital investments in regulated utility infrastructure. EPCOR's asset mix is predominantly rate regulated, and totals almost 90% of net assets (Figure 4). Over 80% of EPCOR's ongoing capital investment is in regulated businesses, with over 95% of operating earnings being derived from rate regulated business lines (Figure 5). Over time, growth has been funded through asset transfers, proceeds from the spin-off of Capital Power, cash flows and debt issuances.

Proceeds from the spin-off of Capital Power, the sale of shares between 2009 and 2917 and distributions from shares owned prior to divestment were material (totaling approximately $1.8 billion) and helped grow the business.

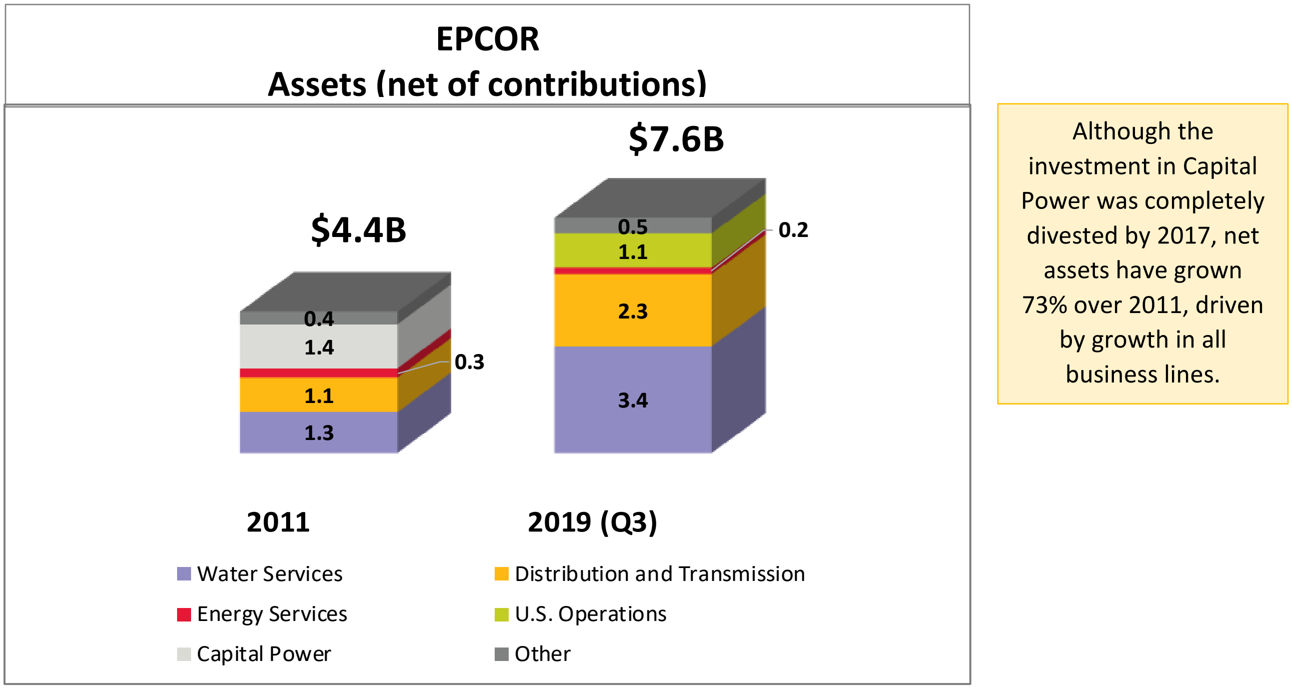
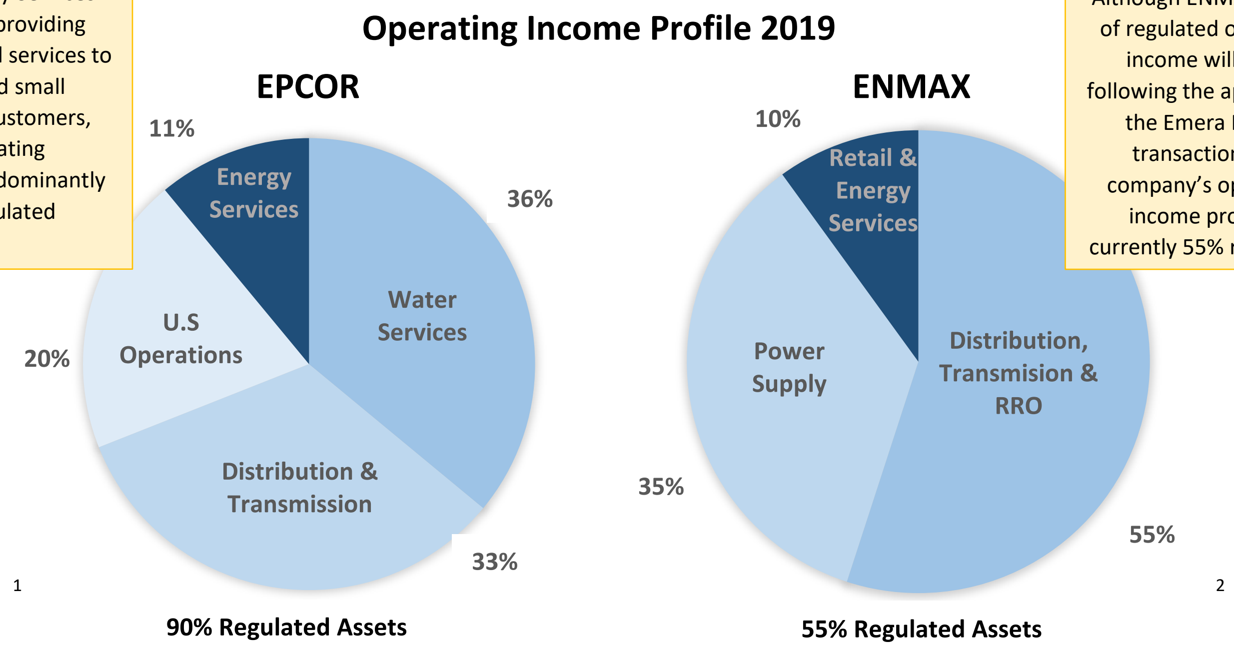


Figure 4 – EPCOR Asset Mix and Growth (Source: EPCOR Debt Investor Presentation – February 2020)

ENMAX:

ENMAX's assets in 2018 totaled approximately $6 billion. Operating earnings are approximately 55% regulated with an asset mix split 60/40 between rate regulated electricity assets and competitive power supply. However, following the acquisition of a rate regulated utility in Maine, operating earnings and assets will both be over 70% rate regulated.

With U.S. Operations being primarily regulated and the Energy Services business line providing rate regulated services to residential and small commercial customers, EPCOR's operating income is predominantly from rate regulated sources.



Although ENMAX's ratio of regulated operating income will grow following the approval of the Emera Maine transaction, the company's operating income profile is currently 55% regulated.

Figure 5 – EPCOR/ENMAX Consolidated Operating Income (Source: EPCOR Debt Investor Presentation – February 2020 & ENMAX Financials)

What are the dividend payments to their respective Shareholders?

EPCOR:

Effective 2019, EPCOR's annual dividend to the City of Edmonton is fixed at $171M per year until further change is recommended by the Board of Directors. The dividend does not fluctuate with earnings, and as a practice, EPCOR has never lowered their dividend. The company employs an informal policy that targets an approximate 60% dividend payout ratio (Figure 6). A highly regulated and geographically diverse business enables a stable dividend, and when cash flows have not been enough to cover the payment in the past (for example, 2009 – 2017), EPCOR used proceeds from their sale of Capital Power to fund the dividend. Now, the dividend has also increased as EPCOR sends an annuity-style repayment for the drainage asset transfer back to the City of Edmonton in the form of a higher dividend.

[1] EPCOR Results 2019 Q3 Last Twelve Months
[2] ENMAX Results 2019

EPCOR Dividend Payout (2008 – 2018)

Year	Dividends ($M)	Net Income ($M)	Payout ratio
2008	130	175	74%
2009	134	125	107%
2010	136	105	130%
2011	138	144	96%
2012	141	19	742%
2013	141	175	81%
2014	141	191	74%
2015	141	260	54%
2016	141	309	46%
2017	153	256	60%
2018	166	295	56%

EPCOR's unusually high payout ratio in 2009, 2010 and 2012 is due to lower earnings, driven from the accounting treatment on the gradual sale of the investment in Capital Power (i.e., loss on sale and accounting impairments)

EPCOR's average payout ratio from 2014 to 2018 is 58%

Figure 6 – EPCOR Historical Dividends, Reported Net Income and Payout Ratio (Source: EPCOR Financials)
NOTE: Payout ratio calculation is current year net income divided by dividend paid

ENMAX:

ENMAX employs a formal dividend policy of 30% of comparable earnings, with a minimum of $30 million paid to the City of Calgary annually. On average, ENMAX's payout ratio has been 34% over the last 5 years, resulting in a total payment well in excess of policy of $15 million.

Regulated businesses, because of their risk/reward ratio and prescribed capital structure, are often viewed as dividend paying companies. Competitive/unregulated businesses, because they typically have a growth mandate and higher earnings variability, often pay no dividend at all. As a result, in looking at ENMAX, it is important to view the dividend ENMAX pays to the City as being proportional to the size of its regulated business. While ENMAX employs a comprehensive hedging strategy that insulates a large portion of their competitive cash flows from considerable market swings, a greater portion of ENMAX's net earnings has historically been from non-regulated and competitive sources. As such, a more appropriate comparison to EPCOR's annual dividend payout ratio and policy should use ENMAX's regulated earnings as opposed to total earnings. When adjusting for this comparison, ENMAX's average payout ratio climbs to 95% over the last 5 years (Figure 7).

ENMAX Dividend Payout (2014 – 2018)

Year	Dividends ($M)	Regulated Earnings ($M)	Payout Ratio
2014	60	53	113%
2015	56	41	137%
2016	47	62	76%
2017	48	62	77%
2018	40	55	73%

The average payout ratio from 2014 to 2018 using regulated earnings is 95%

Figure 7 – ENMAX Historical Dividends, Regulated Earnings and Payout Ratio (Source: ENMAX Financials)
NOTE: Payout ratio calculation is current year regulated earnings divided by dividend paid

What are the differences between each company's governance models?

EPCOR:

EPCOR's sole common Shareholder, the City of Edmonton, appoints their Board of Directors, which is comprised of respected business and community leaders from across Canada and the US. EPCOR's Statement of Corporate Governance Practices notes that a Unanimous Shareholder Agreement ("USA") is in place. Based on EPCOR's corporate governance disclosure, the Board of Directors operates independently of its shareholder, with full authority to make strategic business decisions. No additional shareholder approval is required, outside what is required under corporate law. An independent Chair leads the EPCOR Board and no members of City Council or other elected officials sit on the EPCOR Board of Directors. In addition, unlike Calgary, the City of Edmonton does not intervene in regulatory proceedings. While the first mention of their governance practices was in 2005, EPCOR has had this governance model in place since 1998, with no Shareholder representation on the Board since that time.

ENMAX:

ENMAX's original governance framework was placed into effect over 20 years ago when the company began operations as a private business corporation. Since that time, operations have grown materially across a range of business contexts, including regulated, commercial and competitive electricity markets in Alberta and now into the United States with the proposed Emera Maine acquisition.

ENMAX's governance structure was amended in 2019. While the Shareholder maintains all standard Shareholder duties, an enhanced Shareholder communications schedule was added (the implementation of quarterly briefings with the Mayor and Council), and atypical Shareholder duties were amended (The ENMAX Board is responsible for approving ENMAX's stand-alone budget, business plan and transactions while Council will receive notice of these items). In addition, Council members no longer serve on the ENMAX Board of Directors. This structure is closely aligned to other similar government-owned utilities, such as EPCOR and BC Hydro.