

# EX15.7 - CONFIDENTIAL ATTACHMENT #1

made public on June 28, 2024

## CONFIDENTIAL INSTRUCTIONS TO STAFF

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The City Manager and Chief Financial Officer and Treasurer recommend that:

1. City Council authorize the City Manager to execute an amendment to the Toronto Hydro Amended and Restated Shareholder Direction in the form of the attached Schedule 1, which includes targeted fixed dividends for the years 2025-2034, including both partial and suspended dividend amounts to be retained by Toronto Hydro in order to be reinvested.
2. City Council authorize the transfer of up to \$50 million to Toronto Hydro on or before January 2, 2025, as a special equity subscription, to be withdrawn from the Capital Financing Reserve, for the purposes of supporting Toronto Hydro's prudent regulated capital expenditure programs over time as set out in their annual business plans delivered to the City.
3. City Council authorize the allocation of future dividend payments from Toronto Hydro to the Capital Financing Reserve fund, as required.
4. City Council authorize an annual contribution of up to \$25 million to Toronto Hydro from 2025-2034 inclusive as a special equity subscription, with funds to be provided by an offsetting reduction in annual Capital from Current (CFC) funding for a total of \$250 million, for the purposes of supporting Toronto Hydro's prudent regulated capital expenditure programs over time as set out in their annual business plans delivered to the City.
5. City Council authorize the Chief Financial Officer and Treasurer to negotiate and settle the definitive and final terms of the Term Sheet attached as Appendix A and the terms and conditions of a subscription agreement for common shares of Toronto Hydro in consideration for the special equity contributions authorized by recommendations 2 and 4 above, to be completed on the first business day of each year during the period between January 1, 2025 and December 31, 2034 for a total aggregate amount of \$300 million, together with such other definitive agreements and documents (collectively, the Definitive Agreements) as the Chief Financial Officer determines to be necessary or advisable in connection with the special equity subscriptions authorized by recommendations 2 and 4 and in a form authorized by the City Solicitor; and to execute and deliver the Definitive Agreements on behalf of and in the name of the City.

## CONFIDENTIAL INFORMATION OR ADVICE

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## **SUMMARY**

In order to keep pace with the growing city, and to equip the electricity distribution grid with sufficient capacity and capabilities to support implementation of TransformTO, the City's net-zero strategy, Toronto Hydro has identified the need for unprecedented infrastructure investments.

Following the completion of technical work to develop the Ontario Energy Board rate case justifying investments for the period of 2025-2029, discussions started in Fall 2023 between Toronto Hydro and City staff on an approach to ensure Toronto Hydro can make required investments in their infrastructure. These discussions were premised on enabling the system capacity needed for growth demands and to support the City's 2040 climate goals, while adhering to a required 60% debt to capitalization ratio as established by the Ontario Energy Board (OEB).

This report describes the City of Toronto's growing demand for electricity to support growth and climate action and the need to invest in infrastructure to meet that demand. The regulatory and capital market context must be considered to fund the infrastructure and given the required 60% debt to capitalization ratio established by the OEB, the City of Toronto, as the sole shareholder, has a role in responding to Toronto Hydro's need for equity.

The City of Toronto and Toronto Hydro formed a Steering Committee led by the City Manager and the Toronto Hydro President & CEO to oversee a joint City-Hydro Working Group that gathered and reviewed information, performed analysis, assessed options, and prepared a recommendation.

Toronto Hydro and City staff will continue to engage on a longer-term review of the Dividend Policy with a focus to the challenges the current policy creates when attempting to address infrastructure requirements within a 60% debt to capitalization ratio environment.

## **FINANCIAL IMPACT**

In order to keep pace with the growing city, and to equip the electricity grid with sufficient capacity and capabilities to enable a net zero future in Toronto, Toronto Hydro must make unprecedented infrastructure investments. Discussions started in Fall 2023 between Toronto Hydro and City staff on an approach to ensure Toronto Hydro can make required investments in their infrastructure required to enable the system capacity needed to support the City's 2040 climate goals, while adhering to a required 60% debt to capitalization ratio as established by the Ontario Energy Board (OEB).

An increase in the amount of debt (without an increase in equity) would put pressure on the company's financial performance, pushing Toronto Hydro's financial metrics significantly above the OEB approved 60:40 debt-to-equity ratio. This would put Toronto Hydro at financial risk and delay its ability to pursue its operating targets. As such, there is a need for an increase in the amount of equity to offset an increase in the amount of debt.

City and Toronto Hydro staff have developed a phased approach to support Hydro investment requirements over the next 20 years that both limits exposure to the City's budget and satisfies Hydro's investment requirements with a focus on impacts to their current and projected debt to capitalization ratio. This is supported by the targeted fixed dividend payment schedule outlined in Schedule 1, which will enable Toronto Hydro to retain earnings to be reinvested in infrastructure needs. Schedule 1 includes partial dividend payments planned for 2025-2027, 2029 and 2033-2034. For years 2028, 2030-2032, staff have recommended full dividend suspension in order to support critical investments. Overall, a phased approach will reduce the annual year-over-year impact on the City's operating budget. This will be supplemented by a special one-time equity injection of \$50 million by 2025, and annual investments of \$25 million in order to meet Toronto Hydro's needs while limiting the annual impact on the City's financial sustainability. While existing capital from current (CFC) funding will be leveraged to support annual requirements, there will be no impact to existing City projects. Projects will be able to be maintained through the added utilization of all available capital funding, such as increased debt capacity following underspending from prior year actuals, maximized use of all growth-related funding such as development charges, and leveraging any available City Building Fund contributions towards eligible projects.

Additional commentary and financial analysis is outlined in Confidential Appendix B.

## **COMMENT AND ANALYSIS**

### **The Context for Electricity Growth**

The demand for electricity is growing. This is being driven by many factors including housing intensification, associated infrastructure such as transit expansion, economic development, and government policies (municipal, provincial and federal). In particular, TransformTO, the City's strategy to achieve net-zero by 2040, has a primary focus on the energy transition away from carbon-based energy sources towards electrification. Toronto's plans for reaching net zero emissions focus on the electrification of the building and transportation sectors through the adoption of low-carbon technologies (i.e., heat pumps in buildings and electric vehicles).

The demand for electricity is forecasted to double over the coming decades as Toronto grows and customers reduce their reliance on fossil fuels<sup>1</sup>. On a provincial scale, the Province of Ontario's Electrification and Energy Transition Panel states that, "the energy transition will be a cross-cutting, multi-decade endeavor involving all of government, business and society, including Indigenous communities and all customer groups. This transformation will impact all economic sectors and, in Ontario alone, the investment of hundreds of billions of dollars<sup>2</sup>."

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<sup>1</sup> Toronto Hydro. Executive Summary and Investment Plan Overview. 2025-2029 Custom Rate Application. (2023). Available at: <https://www.torontohydro.com/documents/d/guest/2025-2029-investment-plan-executive-summary>

<sup>2</sup> Ontario's Clean Energy Opportunity - Report of the EETP

Significant housing growth is planned for Toronto in major areas of development including Downsview, the Golden Mile, East Harbour and the Port Lands. This is in addition to overall residential and commercial growth across the City. Major transit and economic developments are also planned and underway and will be powered by Toronto Hydro's grid.

City staff are also working to implement the Council approved Existing Buildings and EV Strategies, which will target the transition of over 476,000 buildings in the City and 1 million vehicles to low/zero greenhouse gas emissions, with electricity being the primary source of energy for this transition. These buildings and EVs will largely draw power from the Toronto Hydro grid, and in some cases will serve as "distributed energy resources" or DERs, sending electricity back into the Toronto Hydro grid for use by others (i.e., two-way power flows).

### **To meet this growing demand for and local production of electricity, there has to be investment in capital infrastructure**

A successful climate mitigation strategy relies on electricity distribution companies investing proactively in the grid to be ready to meet growing customer demand in the future, as well as to be able to connect local sources of renewable generation.

In summer 2022, Toronto Hydro, with City staff support, brought forward a Climate Action Plan that identified the most significant opportunity to enhance their contributions to climate action is by substantially expanding its existing, regulated, electricity distribution business to build a grid that is capable of supporting the realization of TransformTO. Extrapolating City modelling for a net zero future, Toronto Hydro calculated potential direct investments of up to \$10 billion in incremental distribution system infrastructure from 2025 through to the City's net zero target year (originally 2050, revised to 2040). Approximately 75% of the emission reductions envisioned in the City's Net Zero Strategy depends on these investments by Toronto Hydro<sup>3</sup>.

In its 2025-29 rate application<sup>4</sup>, Toronto Hydro modelled the grid impacts of a range of possible future peak demand scenarios based on the interaction between different policy, technology and consumer behaviour assumptions. Toronto Hydro system planners and experts identified and applied the least regrets investment principle: the minimum investments and operational requirements that can be made during the 2025-2029 period with a high degree of confidence that such investments will provide value to ratepayers irrespective of what the future holds.

In addition, the plan was informed by the necessary investments to address a significant backlog of deteriorated and obsolete assets at risk of failure, and to adapt the distribution grid to the evolving challenges of serving and operating within a dense, mature and growing major city. As a result, even under the "least regrets" approach,

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3 Toronto Hydro. Climate Action Plan. (2021). Available at: <https://www.toronto.ca/legdocs/mmis/2021/ex/bgrd/backgroundfile-173881.pdf>

4 Toronto Hydro. Executive Summary and Investment Plan Overview. 2025-2029 Custom Rate Application. (2023). Available at: <https://www.TorontoHydro.com/documents/d/quest/2025-2029-investment-plan-executive-summary>

Toronto Hydro is anticipating a significant increase in its capital investments and operating expenditures to address urgent and necessary work in order to provide a safe and reliable service to Torontonians and to meet the demands of a dynamic environment driven by evolving customer preferences and increases in future customer demand due to energy transition and decarbonization goals. Toronto Hydro has proposed funding mechanisms to the OEB that would allow it to keep pace with these customer needs if they are greater than the "least regrets" baseline.

In keeping with the comments above with respect to Toronto Hydro's 2025-2029 rate application, the Toronto Regional Plan for electricity supply is considering both "poles & wires" as well as non-traditional innovative opportunities to add capacity and capabilities necessary to deliver non-emitting electricity from supply sources within Toronto (e.g., distributed energy resource) as well as outside Toronto (e.g., wind turbines, new/expanded nuclear). While many of the required investments that will be addressed in the Toronto Regional Plan will drive procurements by the Independent Electricity System Operator ("IESO") and transmission scale investments by Hydro One, it takes further investments by Toronto Hydro to cover "the last kilometer" (often several kilometers through our dense, complex neighbourhoods). Without these Toronto Hydro investments, the provincial investments would stop short of benefiting Toronto homes and businesses.

## **The Regulatory and Capital Market context for local distribution companies**

The need to invest in infrastructure to meet current and future demand in electricity is described in the previous section. This section provides an understanding of the regulatory and capital market contexts that must be considered, including the Ontario Energy Board (OEB), and the Ontario Securities Commission (OSC), and the credit rating agencies, including their impact on the cost of debt.

### **The Ontario Energy Board (OEB)**

Toronto Hydro falls under the regulatory oversight of the Ontario Energy Board (OEB). This has several important implications.

First, Toronto Hydro's funding is dependent on electricity distribution rates approved by the OEB. These rates are based on the capital expenditures and operating costs required to serve its customers, a fair return on equity to the shareholder and the capital structure established by the OEB based on the assumption of 60% debt and 40% of equity. Extensive OEB oversight is done through a rate-setting process that goes before a quasi-judicial tribunal involving regulatory codes, policies and guidelines, filing requirements, compliance monitoring and audit and review by experts, OEB staff and other stakeholders. The full scale OEB rate review happens every 5 years, with narrower annual rate reviews in between.

Another implication is that under the OEB framework, capital infrastructure costs are paid for by Toronto Hydro as they are incurred, but only gradually included in electricity rates over the lives of the assets. The recovery of these costs includes both

depreciation of those assets and a return to the shareholder based on a rate prescribed by the OEB. Due to the delay in the recovery of capital costs, utilities need to rely on third-party financing to bridge the funding requirement to support the capital investments.

During the energy transition, there will be a longer delay between costs incurred and costs recovered, resulting in a greater need for financing through equity and debt. This is because the infrastructure must be expanded so that households, businesses, and car buyers have the confidence that there is enough grid capacity for them to electrify building appliances and vehicles. There will be unavoidable delays between the grid expansion, customer electrification, and Toronto Hydro rates-funded revenues fully recovering the cost of the expansion.

### **The Ontario Securities Commission (OSC) and the rating agencies**

Toronto Hydro is financed by a combination of long- and short-term debt. As an issuer of debt to the public (investors), it is a reporting issuer with a public debt program of approximately \$3 billion and is subject to the regulatory jurisdiction of the Ontario Securities Commission (OSC), an independent Crown corporation responsible for administering and enforcing compliance with securities legislation in Ontario.

Investors rely on the independent ratings of two agencies DBRS and S&P to assess the credit risk of Toronto Hydro and assign an issuer rating to the corporation. The Shareholder Direction provides that Toronto Hydro Corporation will obtain and maintain a rating of A minus or higher (or its equivalent rating, depending on the credit rating agency) on its senior debt securities. As of December 31, 2023, Toronto Hydro's credit ratings were "A" by both agencies. These ratings have a direct impact on the cost of debt funding in the capital market. Any downward revision in the credit rating, which can be caused, among other factors, by an insufficient level of equity to support debt capital investment in line with the regulatory structure for regulated electrical utilities in Ontario, would increase the cost of debt of any future issuances.

An increase in the amount of debt (without an increase in equity) would put pressure on the company's financial performance, pushing Toronto Hydro's financial metrics significantly above the OEB approved 60:40 debt-to-equity ratio. This would put Toronto Hydro at financial risk and delay its ability to pursue its operating targets. As such, there is a need for an increase in the amount of equity to offset an increase in the amount of debt.

### **Need for equity from the City of Toronto**

In order to keep pace with the growing city, and to equip the electricity grid with sufficient capacity and capabilities to enable a net zero future in Toronto, Toronto Hydro must make unprecedented infrastructure investments at an unprecedented pace. These investments need to stay ahead of customer demand, which means additional capital financing is required. There are regulatory and capital market limits to the amount of debt Toronto Hydro can use for financing. Accordingly, additional capital infrastructure

investments must be supported by incremental equity investments by the City of Toronto as the sole shareholder of Toronto Hydro, which will also create new capacity for Toronto Hydro to obtain incremental debt financing.

The City of Toronto is the sole shareholder and is responsible for working with Toronto Hydro to develop an approach to meeting the equity requirements of Toronto Hydro's corporate structure. The terms and details of the approach, including alternative options that were considered as part of the working group, are discussed in detail in Appendix A and B.

### **Benefits of City of Toronto's equity investment**

Investing in the electricity grid to meet current and future demand will support the City of Toronto's housing, transit and economic development priorities.

As Toronto Hydro increases its capital investment, the overall value of the utility's assets, referred to as "rate base", increases resulting in potential for higher returns to the shareholder under the regulatory model. This model provides a reliable, relatively low-risk, long-term return to the shareholder on the capital investments. Additional analysis and commentary are provided in Appendix B.

### **Additional Comments**

Toronto Hydro and City staff will continue to engage on a longer-term review of the Dividend Policy with a focus to the challenges the current policy creates when attempting to address infrastructure requirements within a 60% debt to capitalization ratio environment.

# SCHEDULE 1

## AMENDMENT TO THE AMENDED AND RESTATED SHAREHOLDER DIRECTION RELATING TO TORONTO HYDRO CORPORATION

WHEREAS the City of Toronto has issued an Amended and Restated Shareholder Direction Relating to Toronto Hydro Corporation dated July 1, 1999 as amended and restated as of October 3, 2002; as further amended as of October 1, 2004; as further amended and restated as of June 27, 2006; as further amended and restated as of October 23, 2007; as further amended and restated as of May 7, 8,9 and 10, 2013; and as amended by an amendment dated June 28, 2017;

AND WHEREAS pursuant to section 11.1 thereof the Shareholder Direction may be amended solely at the discretion of the Shareholder;

AND WHEREAS at its meeting of June 26, 27 and 28 City of Toronto Council authorized the within amendment to the dividend policy contained in the Shareholder Direction;

NOW THEREFORE THE SHAREHOLDER DIRECTION IS HEREBY AMENDED AND WITNESSES AS FOLLOWS:

Section 10.4 is amended by:

- i. adding the words "duties and obligations" immediately after the word "restrictions"
- ii. replacing the period at the end of paragraph b) with the symbol and word “; and”;  
and
- iii. adding the following c) after paragraph b):

c) Notwithstanding paragraph b), targeted fixed dividends in the following amounts for each of the following fiscal years:

- (a) 2025 - \$60M
- (b) 2026 - \$40M
- (c) 2027 - \$20M
- (d) 2028 - \$0
- (e) 2029 - \$75M
- (f) 2030 - \$0
- (g) 2031 - \$0
- (h) 2032 - \$0
- (i) 2033 - \$75M
- (j) 2034 - \$75M

in four (4) equal installments on the last business day of each fiscal quarter of the Corporation.

DATED at Toronto as of \_\_\_\_\_ day of \_\_\_\_\_, 2024.

City of Toronto