Yukon Development Corporation Dividend Policy

Discussion Paper

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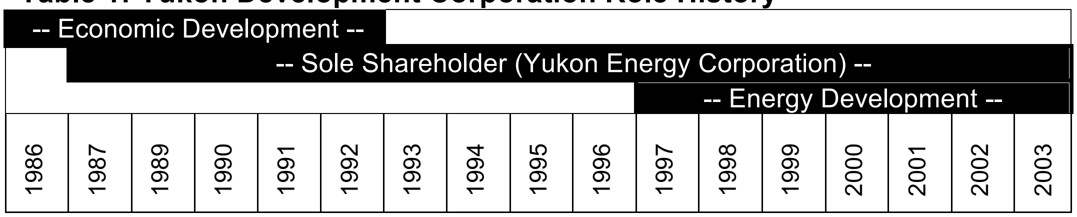
1.0 Preface

In general, a dividend policy which accurately reflects a corporation's aspirations and operating environment is integral to its short and long-term financial health. That said, despite being tasked with three distinct roles over its relatively short corporate history (Table 1), the Yukon Development Corporation (YDC) has yet to develop a comprehensive dividend policy.

Table 1: Yukon Development Corporation Role History



Some aspects of a YDC dividend policy can be found in YDC's history of *ad hoc* dividend payments for direct investments and rate relief made pursuant to Orders-in-Council issued by the Government of Yukon. Other aspects of a YDC dividend policy can be found in the *Yukon Energy Corporation Financial Policies* (1992) which specify a 60/40 debt equity capital structure for the Yukon Energy Corporation (YEC) and the payment of "paper dividends" to YDC. A dividend policy which addresses the relationship between YDC and the Energy Solutions Centre has yet to be articulated in any form. Thus, while YDC has "paid" and "received" dividends payments over the span of its corporate history, dividend transactions have not been carried out under the terms of an explicit and comprehensive dividend policy.

At the same time as YDC's mandate and role has continued to evolve, several factors are bringing, or are anticipated to bring, pressure to bear on YDC's current financial situation. Those factors include:

- possible request(s) by YDC's owner for payment of cash dividends
- diversion of YDC net income to the Rate Stabilization Fund
- a need to build up internal financial capacity to fund the planning and development of infrastructure over the long-term leading to Yukon energy self-sufficiency
- Government of Yukon's limited fiscal capacity to assist with the capital funding of major energy infrastructure projects
- continuing opportunities to partner with the Government of Canada for the provision made-in-Yukon energy cost-saving solutions

The Board of Directors of Yukon Development Corporation acknowledged the growing financial pressures faced by the corporation in May 2003 with passage of an interim Investment and Dividend Policy resolution (YDC 2003-08). The resolution was passed upon review of a Dividend and Investment Policy background paper presented at that time. The same resolution directed that additional work on a Yukon Development Corporation Dividend Policy be undertaken.

The purpose of this paper is to identify considerations for the drafting of a comprehensive YDC dividend policy which considers the dividend relationship between YDC and the Government of Yukon as well as the dividend relationships between YDC and its two subsidiary corporations, YEC and ESC.

2.0 Background

2.1 Corporate Structure, Mandate and Key Business Lines

Structure

The Yukon Development Corporation was created in 1986 by the *Yukon Development Corporation Act.* It is both a business corporation and a Crown corporation. As a business corporation, YDC enjoys all of the powers available to it under the provisions of the Yukon's *Business Corporations Act*. The dual corporate structure enables YDC to operate as both a self-financing holding company and as an agent of the Government of Yukon which can pursue public policy objectives as directed by its owner.

The Yukon Development Corporation wholly-owns two subsidiary corporations: Yukon Energy Corporation and the Energy Solutions Centre Inc. Established in 1987, the Yukon Energy Corporation (YEC) is an electrical utility regulated by the Yukon Utilities Board and the *Public Utilities Act;* YEC is the primary producer and transmitter of electrical energy in the territory. The Energy Solutions Centre was established in 2000 as a joint venture with Natural Resources Canada and is incorporated under the *Business Corporations Act.* The Centre promotes energy efficiency and the adaptation of renewable energy technologies through the delivery of federal and territorial energy programs and the provision of technical services.

While operating in its capacity as a self-financing holding company, YDC may make use of its financial powers which allow it to invest, borrow and make loans. Through use of its financial powers and structure, YDC can provide its subsidiary corporations with financial stability (e.g., long term re-investment of dividends paid by subsidiaries), financial flexibility (e.g., short-term loans) and the backstopping of financial risk.

Mandate

The Corporation is governed by a Board of Directors appointed by the Government of Yukon. The corporation has a legislative mandate to participate with the private sector in the economic development of the Yukon. In particular, section 5 of the *Act* states:

> *5 The objects for which the corporation is established are to participate with the private sector in the economic development of the Yukon and, in particular,*
> *(a) to develop and promote the development of Yukon resources on an economic and efficient basis;*
> *(b) to promote employment and business opportunities for Yukon residents;*

> *(c) to assure a continuing and adequate supply of energy in the Yukon in a manner consistent with sustainable development; and*
> *(d) to carry out development policy directives issued to it by the Commissioner in Executive Council.*[1]

So that it can fulfill its mandate, the *Yukon Development Corporation Act* also grants the corporation the following powers:

> *7(1) For the purposes of attaining its objects as set out in section 4, the corporation has the following powers*
> *(a) to develop and promote the development of energy systems and the generation, production, transmission and distribution of energy in all its forms;*
> *(b) to exercise all of the powers of a corporation under the* Business Corporations Act.[2]

A 1993 Order-in-Council restricted the corporation's mandate to energy-related activities designed to promote the economic development of the Yukon. At the same time as the corporation received its narrower energy-only mandate, it was also presented with a slightly broader mandate within the energy envelope:

> *1. Yukon Development Corporation shall, in undertaking new initiatives, restrict itself to energy related activities designed to promote the economic development of the Yukon, and in particular designed to:*
> *(a) assure a continuing and adequate supply of energy in the Yukon in a manner consistent with sustainable development;*
> *(b) alleviate the effects of any energy shortage that may occur in the Yukon; and*
> *(c) promote the establishment, development and operation within the Yukon of industries or undertakings that are, by their nature, energy-dependent through the provision of cost effective energy or energy-related infrastructure.*[3]

The Government of Yukon's 1998/99 Budget also provided statutory direction with regard to the mandate of the Yukon Development Corporation via a $16 million capital contribution:[4]

- Rate Stabilization Fund ($10 million);
- Green Power ($3 million);
- Energy Conservation and Efficiency ($1 million); and
- Applied Research and Development ($2 million).

[1] *Yukon Development Corporation Act,* (R.S.Y 2002, c. 29).
[2] Ibid.
[3] *O.I.C. 1993/107 Yukon Development Corporation Act (Policy Directive No. 1).*
[4] *Third Appropriation Act, 1998-99,* (S.Y. 1998, c. 27).

Key Business Lines

As outlined in the Yukon Development Corporation 2002 to 2006 Corporate Plan, the corporation's four key business lines are:[5]

1. corporate leadership — This includes board governance and corporate management responsibilities, along with First Nations relations, community and environmental initiatives associated with the business environment, accountability and future opportunities for the corporation.
2. energy sector development — This includes infrastructure planning and development (primarily electricity and related aspects), rural electrification, research and development, renewable resource assessment, and small-scale renewable power installations.
3. energy market transformation — This includes demand side cost-saving and conservation programs, services and measures for residential, commercial, general service and government sectors relating to rate stabilization, energy efficiency, renewable energy technologies, and community energy management.
4. asset management, investment and business development — This includes shareholder oversight and support for Yukon Energy and Energy Solutions Centre Inc.

2.2 Dividends Defined

Before continuing further, it would perhaps be useful to confirm what the term dividend means. A dividend is "an amount distributed out of a company's profits to its shareholders in proportion to the number of shares they hold."[6] In a private sector context, dividends are typically paid in the form of cash dividends or stock dividends.

In the realm of the public sector, within which the Yukon Development Corporation operates, dividends can be paid in cash or 'in-kind'. Note that share dividends are not paid since government-owned corporations tend to be wholly owned by government and because they do not trade in capital markets; the issuance of additional shares would confer no benefit to the owner.

The rationale for issuing dividends, equally valid in both the private and public sector contexts, can be summed up as follows:

> *Dividend payments reflect the division of earnings between payments to stockholders and reinvestment in the firm. Establishing a dividend policy requires a compromise between the stockholder's desire to receive some of the earnings through cash dividends and the corporation's desire to reinvest earnings to finance the future growth of the company.*[7]

Dividend-issuing corporations often fit the profile of enterprises which have grown to an optimal size and feature a high degree of earnings stability. Since capital gains-producing growth is less likely with such mature corporations,

[5] Reproduced from the *Yukon Development Corporation Corporate Plan - 2002 to 2006,* page 8.
[6] *Canadian Securities Course,* The Canadian Securities Institute, 1995, p. 458.
[7] *Finance and Accounting for Non-Financial Managers (3rd edition),* William G. Droms,1990, page 217.

shareholders are rewarded instead with dividend payments. Thus, a corporation's location on its "growth curve" is an important factor in allocating earnings between cash payments in the current period and capital gains in a future period.

Note that a corporation's growth curve location may shift between growth and maturity in response to changing corporate priorities. For example, a corporation may return to the high-growth portion of its growth curve after reaching maturity at an earlier point in time as a result of the implementation of a capital improvement program designed to increase market share.

2.3 Potential to Generate Dividends

A fundamental precondition to the payment of dividends by any corporation is that the corporation have income. Having income, in turn, requires that the corporation have the ability to generate revenue. Further, revenue in a given time period must exceed expenses in the same period for net income to be greater that zero. Positive net income (and the potential for payment of a dividend) thus requires some amount of wealth creation. Indeed, a dividend is the embodiment of the corporation's owners share of the wealth created during the time period in question (less their share the amount held as retained earnings of the corporation).

As a result, the potential for YDC and its subsidiary corporations to pay a dividend up to their respective owners hinges on the ability of each corporation to generate net income derived from wealth creating activities. Since wealth creation requires the sale of goods, services or financial instruments, the potential for each corporation to make dividend payments is directly related to the nature of their respective businesses.

A joint venture between two governments, the Energy Solutions Centre has limited capacity to generate dividend-enabling net income. While some amount of net income is derived from the sale of technical services/expertise and from loan/lease/fee for service arrangements with businesses and other government agencies, ESC is primarily, at the present time, a program delivery agency. While still early in its corporate growth stage, ESC has a strong need to retain earnings to finance internal growth. As a result, ESC has not yet issued a dividend to YDC.

The Yukon Energy Corporation, as the primary producer and transmitter of electrical energy in the territory, generates significant own-source revenues from the sale of electricity. As a result, out of the three corporations, YEC has the greatest potential to generate dividends. The Yukon Energy Corporation's potential to generate dividends is limited by the rate of return set by the Yukon Utilities Board (YUB). The rate of return set by the YUB must, by regulation, allow YEC to recover only a fair return (i.e., a normal commercial return) on it's equity *less 0.5%*.[8] At the same time, however, it should be noted that YUB rate regulation also ensures that YEC has an opportunity to earn sufficient positive

[8] With reference to Government of Yukon O.I.C. 1995/090 (*Public Utilities Act).*

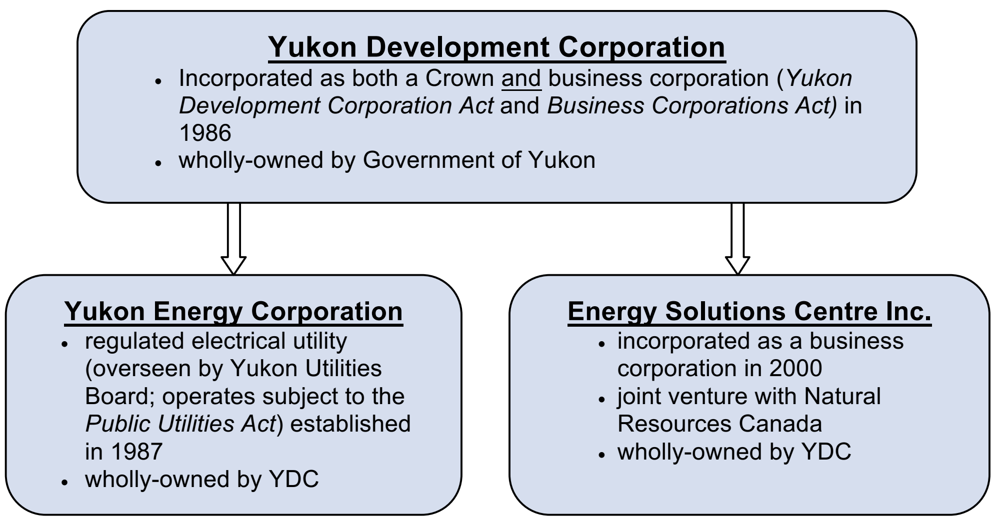
net income so that its electricity supply operations are sustainable in the long run.

It is also important to note that dividend transactions between parent and subsidiary corporations typically include an implicit assumption that the parent corporation will always act in the best interests of the subsidiary corporation. This means that if after having paid up dividends to the parent corporation in one or more years, should the subsidiary corporation shift back into a growth phase, the parent corporation stands ready to equity finance that growth.

The Yukon Development Corporation has limited capacity to generate dividend-enabling net income. While its potential to generate dividends is greater than that of the Energy Solutions Centre, YDC is not in the business of selling goods and services; YDC's revenues are derived primarily from its long term investments, such as dividends and interest from loans to subsidiaries as well as business development/joint venture opportunities. As a result, YDC's net earnings can be significantly impacted by YEC's and ESC's ability to issue dividends and service debt.

The corporate structure of the Yukon Development Corporation and subsidiaries is presented in Diagram 1.

Diagram 1: Corporate Structure - YDC and Subsidiaries



3.0 Framework for Analysis

The development of an optimal dividend policy for YDC requires the discussion and identification of the position of the Board of Directors and the owner on two key issues: 1) potential net income uses by YDC, YEC and ESC and 2) legislative control of YDC. Both issues are discussed in this section of the paper.

3.1 YDC, YEC and ESC Net Income Uses

YDC Net Income Uses

Research undertaken in the course of preparing this paper suggests three possible uses for YDC net income in a given year. One of the uses identified remains a theoretical possibility; the other two have are part of current YDC operating practice.

First, cash dividends could simply be paid, as they become available, into the Government of Yukon's consolidated revenue fund and spent according to general budgetary demands. The Yukon Development Corporation has not, to date, made a direct dividend payment to the Government of Yukon. Such an action is, however, contemplated in the *Yukon Development Corporation Act* in section 15 which states:

> *The Commissioner in Executive Council may make regulations requiring and providing for the transfer of all or part of the net revenue of the corporation in any fiscal year, or in any part thereof, from the Yukon Development Corporation Fund to the general account of the Yukon Consolidated Revenue Fund.*[9]

Note that because YDC is a business corporation, YDC directors are bound by subsection 124(1) of the *Business Corporations Act* which requires the directors to comply with all provisions of the *Act.* In consequence, section 44 of the *Business Corporations Act* restricts YDC directors from approving the issuance of dividend payments unless certain conditions are met:

> *44. A corporation shall not declare or pay a dividend if there are reasonable grounds for believing that*
> *(a) the corporation is, or would after the payment be, unable to pay its liabilities as they become due, or*
> *(b) the realizable value of the corporation's assets would thereby be less than the aggregate of its liabilities and stated capital of all classes.*[10]

Thus, section 44 provides that a corporation may only declare a dividend after satisfying a two-part insolvency test.

Second, as a public corporation YDC could invest its net income in the pursuit of energy supply-side public policy objectives as directed by the Government of Yukon. Net income could be invested in the current period or set aside as retained earnings for spending in a future period on initiatives including capital infrastructure development initiatives and renewable energy development.[11]

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[9] *Yukon Development Corporation Act,* R.S.Y. 2002, c. 236.
[10] *Business Corporations Act* (R.S.Y 2002, c. 20), section 44.
[11] The corporation's statutory objects and powers (as outlined in the *Yukon Development Corporation Act* and presented in subsection 2.1 of this paper) describe the public policy framework within which YDC must operate. A more user-friendly representation of the current span of supply-side public policy objectives as laid out by the Government of Yukon for

With regard to capital infrastructure investments, whether it would generally be more cost-efficient for YDC to finance energy infrastructure with equity (retained earnings) or with debt (by borrowing) is outside the scope of this analysis. This is especially true given YDC's income-tax exempt status and interest rates at 40-year lows.[12] Note that under provisions of a federal Order-in-Council made in 1991 pursuant to the *Yukon Act,* YDC may borrow up to $85 million.[13]

Table 1: *De Facto* Dividends Paid by YDC Pursuant to Orders-in-Council and Owner-Directed Investment Instructions - 1989 to 2002

Year	Use	Total ($000s)	Type[(1)]	Direction via OIC[(2)]
1989	Power rate relief program	1,342	RR	✓
1989	Investment in Yukon Pacific Forest Products Ltd.	2,439	DI	
1990	Power rate relief program	166	RR	✓
1990	Investment in Yukon Pacific Forest Products Ltd.	2,944	DI	
1992	Power rate relief program	305	RR	✓
1992	Investment in Old Yukon College	5,806	DI	
1993	Power rate relief program	3	RR	✓
1993	Deferred fuel price adjustment	681	RR	✓
1993	Investment in Taga-Ku Development Corporation	2,336	DI	
1994	Power rate relief program	2,710	RR	✓
1994	Project cost transfer to Yukon government	60	OTH	✓
1995	Power rate relief program	3,113	RR	✓
1996	Power rate relief program	1,774	RR	✓
1997	Restricted water usage of Aishihik Lake	4,329	OTH	✓
1997	Energy Conservation Fund	500	OTH	✓
1997	Power rate relief program	1,510	RR	✓
1998	Power rate relief program	402	RR	✓
2002	Rate Stabilization Fund	7,800	RR	✓
2002	Propane franchise regulatory process	700 (e)[(3)]	OTH	✓
	Total	**38,920**		

		Share (%)
Subtotal of expenditures on rate relief (RR)	19,806	51
Subtotal of expenditures on directed investments	13,525	35
Subtotal of other expenditures (OTH)	5,589	14
		100

Source: Adapted from table prepared by the Yukon Development Corporation.
Notes: [(1)] RR = rate relief; DI = directed investment; OTH = other. [(2)] OIC = Government of Yukon Order-in-Council. [(3)] e = estimated

achievement by YDC are contained in YDC's 2002 to 2006 Corporate Plan and its 2003 Operational Plan.

[12] The determination of an optimal capital structure for YDC will be a complex endeavor as it needs to balance the interests of the owner, lenders, ratepayers and the regulator with reference to constantly changing market conditions.

[13] Subsection 21.(1) of the *Yukon Act* provides the Government of Yukon with the authority to borrow money for territorial, municipal or local purposes. While borrowing may only be undertaken with the prior approval of federal government, the Government of Yukon is in effect "pre-approved" to borrow up $115 million through a federal Order in Council. Issued in 1991, O.I.C *P.C. 1991-261*, increased the Government of Yukon's borrowing authority from $23.0 million to $115.0 million "of which sum the outstanding balance of monies borrowed for the benefit of the Yukon Development Corporation may not exceed $85.0 million."

Third, YDC could also invest its net income in the pursuit of demand-side public policy objectives as directed by the Government of Yukon. As with the supply-side use of YDC net income, investments could be made in the current period or the net income could be retained for investing in a future period. Demand-side net income uses encompassed by YDC's statutory objects include energy efficiency and renewable energy initiatives as well as the provision of technical services.

None of the three potential net income uses are mutually exclusive; a combination of all three is possible. Choices among the three uses must, however, recognize that the size of the net income pie is limited. Increasing the weight assigned to one particular use necessarily requires a reduction in the weight assigned to at least one of the two other uses. A listing of *de facto* dividends paid by YDC pursuant to Government of Yukon Orders-in-Council and owner-directed investment instructions over the period 1989 to 2002 is presented in Table 1.

YEC Net Income Uses

The research undertaken also suggests two possible uses for YEC net income.

The first use is the annual payment by YEC to YDC of an amount calculated according to the requirements of the "Capital Structure Policy" outlined in the *Yukon Energy Corporation Financial Policies*[14] adopted by the YEC Board of Directors in December 1992.[15] The policy requires that YEC "shall maintain a capital structure resulting in a debt/equity ratio….of 60/40 at the end of each fiscal year". Thus, YEC's capital structure is derived from an accounting truism; the 60/40 debt/equity ratio is a "proxy" for a market-based capital structure. Table 2 on the following page presents the debt/equity calculation for the four most recent years for which financial statements are publicly available.

Table 2: Yukon Energy Corporation Debt/Equity Ratio Calculations ($000's)

	1998	1999	2000	2001
Debt				
Current portion of long-term debt	585	631	687	723
Long-term debt	73,199	74,784	74,937	76,477
	73,784	75,415	75,624	77,200
Equity				
Contributed capital	39,000	39,000	39,000	39,000
Retained earnings, end of year	10,191	11,274	11,416	12,467
	49,191	50,274	50,416	51,467
Debt/Equity Ratio	1.50	1.50	1.50	1.50

Source: *Yukon Energy Corporation Annual Report* (various years)

[14] The *YEC Financial Policies* document may be found in Appendix 1.
[15] Note that under provision of the Yukon Development Corporation Act Regulations (1993/108) YEC may not pay dividends without the approval of YDC Board of Directors.

Note that while the 60/40 debt/equity ratio is apparently accepted as a reasonable compromise by YEC's owner (YDC), lenders and regulators (Yukon Utilities Board), it not based on measures of current local (or national) economic conditions or local economic development objectives. Whether the 60/40 debt/equity ratio results in an optimal (i.e., cost-efficient) capital structure in light of the corporation's current and forecast operating environment is also a question outside the scope of this paper.

The YEC 60/40 debt/equity ratio policy states that entire amount of a dividend issued to YDC by YEC shall be immediately loaned back to YEC in the form of long-term debt.[16] As a result of the 60/40 policy, dividends paid by YEC to YDC since 1992 were not cash dividends; the payment of dividend triggered a simultaneous reinvestment in YEC by YDC in an amount matching the dividend. In summary, dividends issued by YEC have been 'paper transactions' undertaken to fulfill the requirements of the 60/40 debt/equity policy.[17] In consequence, dividend payments issued by YEC to YDC are not accessible by YDC for the financing of YDC operations and activities.

Table 3 presents the times series of non-cash dividends paid by YEC to YDC since the adoption of the 60/40 debt/equity policy in 1992.

Table 3: Non-cash Dividends Paid by YEC to YDC - 1992 to 2001 ($000's)

1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
17,158	1,654	1,627	1,696	3,285	1,110	4,216	3,406	796	2,196
Source: Yukon Energy Corporation *Audited Financial Statements* (for the year ended December 31, 2001), Note 10 (Long-Term Debt).									

Second, in addition to the payment to YDC of a non-cash dividend, YEC could also pay a cash dividend to YDC over and above the 60/40 non-cash dividend amount, financial circumstances permitting. With its rate of return regulated by the Yukon Utilities Board, for YEC to hold cash in an amount beyond that required for short-term operations is not prudent since "surplus cash" held within YEC will dilute its overall financial rate of return. As a result, the payment of a secondary (cash) dividend to YDC could serve to assist YEC with its cash management operations.

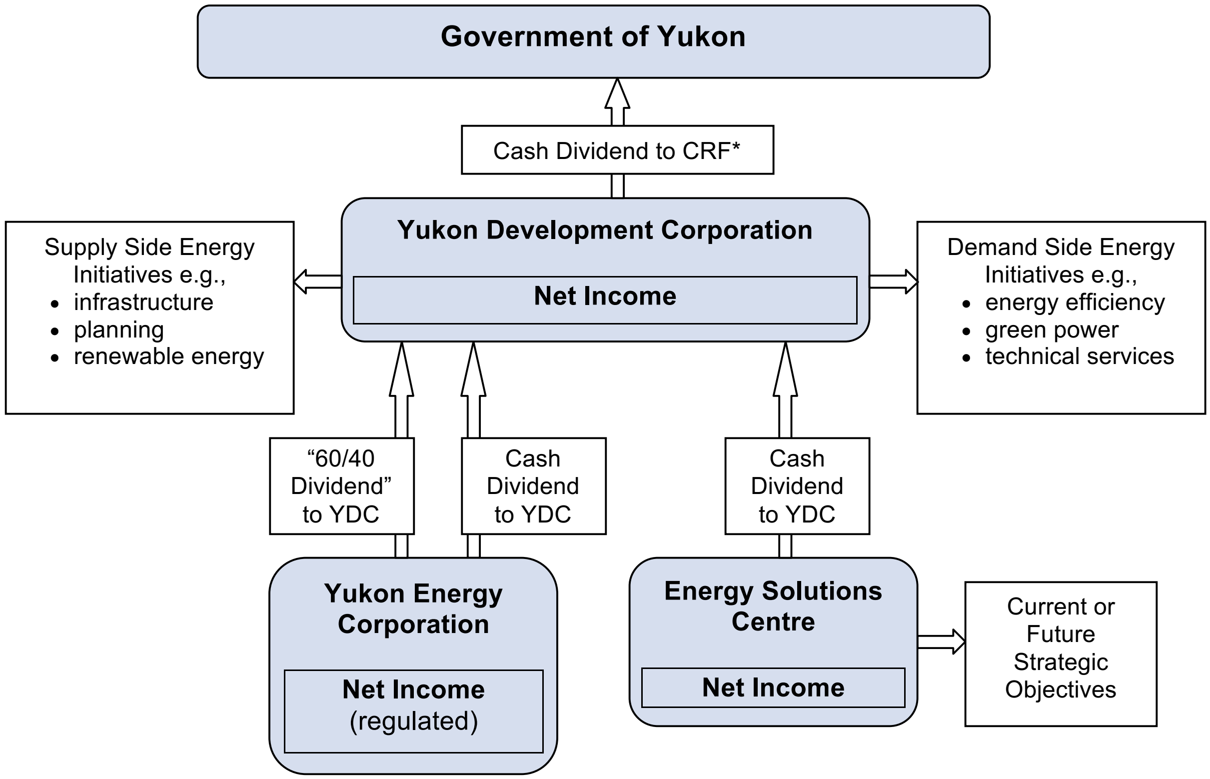
With regard to the first and second YEC net income uses, it is worth noting that YEC is also incorporated under the Yukon *Business Corporations Act.* Similar to the situation faced by the YDC Board, the YEC Board of Directors are bound by subsection 124(1) of the *Business Corporations Act* to comply with all provisions of the *Act.* As a result, the YEC Board may only issue a dividend upon turn satisfying the requirements of the same two-part section 44 insolvency test described earlier in this paper.

[16] Under the Long Term-Loan Policy, also outlined in the 1992 *YEC Financial Policies* document, the interest rate for long-term loans "shall be set as 120 basis points [1.20%] above the average of long-term Government of Canada Bonds as specified by the Canadian Bond Rating Service as at the previous September prior to the issue of the loan."

[17] In practice, YDC receives from YEC a redeemable promissory note in the amount of the "dividend".

As was the case for YDC, neither of YEC's two potential net income uses are mutually exclusive; a combination of the two is possible. The same caveat

Diagram 2: Net Income Allocation Options - YDC, YEC and ESC



*CRF = consolidated revenue fund
Source: Adapted from *Crown Investments Corporation 1997 Annual Report,* page 35.

regarding limits on dividing the dividend pie also applies in the YEC context. The allocation between possible uses is limited by the size of the net income pie in a given year.

ESC Net Income Uses

Two possible uses for ESC net income were identified in the course of research for this paper.

The first is the payment of a cash dividend by ESC its owner, YDC. As the Energy Solutions Centre is incorporated under the Yukon *Business Corporations Act*, any such dividend payments would subject to the two-part section 44 insolvency provisions.

The second possible use identified is the spending of ESC net income in pursuit of current or future strategic objectives as directed by its Board of Directors. The current Board-approved strategic objectives are outlined in the Energy Solutions Centre's 2003-2007 Strategic Plan and 2003 Business Plan.

As noted earlier, the Energy Solutions Centre is an early stage of its corporate growth cycle. This circumstance, together with ESC's limited capacity to generate dividend-eligible net income means that the likelihood of ESC being in a financial position which would permit a dividend payment in the near-term is low. The range of possible net income allocation options choices for YDC, YEC and ESC are presented in Diagram 2.

3.2 Legislative Control of YDC

The Yukon Development Corporation was created with public funds and has received *ad hoc* cash infusions for specific purposes from its owner, the Government of Yukon. At the same time as YDC has operated as an agent of the Government of Yukon, it has also worked to fulfill its role, as allowed by its dual Crown/business corporation structure, of a self-financing holding company. So that it can function as both an agent of the Government of Yukon and a business corporation, YDC operations are carried out at arms-length from the Government of Yukon.

In terms of the system of legislative appropriation, operation of YDC at arms-length requires that the spending authority for funds not explicitly earmarked for certain purposes by the Government of Yukon be delegated to the YDC Board of Directors. While YDC's financial operations are subject to no less (and in some cases more) public scrutiny than Government of Yukon departments and other agencies, the delegation of spending authority to the Board increases the distance between the legislative appropriation process and the day-to-day operations of the corporation.

One advantage of such an arrangement is the high degree of operational flexibility it affords. For example, the corporation may spend in direct response to changing market conditions without having to wait for a legislative opening in which to argue its case alongside an array of government agencies. Similarly, YDC may hold funds over from year to year in the form of retained earnings in preparation for major capital and other corporate initiatives without fear of being "docked" in a future budget cycle for having lapsed funds in a previous period.

A second advantage specific to the Yukon context relates to the Canada-Yukon Formula Financing Agreement. The unconditional grant paid under provisions of the Agreement is the Government of Yukon's main revenue source. Indeed, in the 2003/04 fiscal year, the grant is expected to equal $360 million, fully two thirds of total Government of Yukon revenues for the year.

Formula financing is a 'closed loop' system. This means that if the Yukon's own-source revenues increase, then the amount of the formula grant decreases. The loop is delineated by the Yukon's system of legislative appropriation. Because YDC is not an appropriation agency of the Government of Yukon, it is considered to be 'outside the loop' for purposes of formula financing. Any revenues generated by YDC or its subsidiaries currently have no impact on the formula financing transfer. Thus, any alterations to existing YDC dividend policy which might place YDC 'within the loop' for purposes of formula financing will need to be carefully considered.

A consequence of the distance between the legislative appropriation process and day-to-day operations of the corporation is some inevitable degree of discomfort on the part of the owner.[18] In the Yukon context, the apparent discomfort is compounded by the absence of a mechanism which would, either directly or indirectly, establish a link between the distribution of the net income of YDC (and its subsidiaries) and the consolidated revenue fund. Such mechanisms appear to be common in other jurisdictions. For example, the dividend policies of BC Hydro, EPCOR and Hydro Quebec all require the direct payment of an annual dividend of a fixed amount into the accounts of their respective owners (annual financial results permitting).[19]

Similarly, the Saskatchewan Crown Investments Corporation's current capital allocation policy requires, financial circumstances permitting, that dividends be paid by SaskPower, SaskTel, SaskEnergy and Saskatchewan Government Insurance (SGI). The Crown Investments Corporation is in turn required to pay a cash dividend into the Government of Saskatchewan's General Revenue Fund subject to achieving a stated debt reduction target for the year.[20]

3.3 A Note on Yukon First Nation Final Agreements

Nine of fourteen Yukon First Nation have now completed the land claims negotiation process. Each of the eight First Nation Final Agreements so far in force contain a "Public Corporations" clause, which sketches out the terms for First Nation participation in future Yukon Energy Corporation activities:

> ***22.6.4*** *Yukon First Nation corporations may participate with the Yukon Development Corporation in economic opportunities, and such participation may include, but is not limited to, joint ventures, partnerships and equity participation in subsidiary corporations.*[21]

In addition to the Public Corporations clause, each of the eight Final Agreements contain a "specific measure" for "Strategic Investments". The specific measure provides for equity participation by the First Nation of at least 25 percent in new non-renewable resource or hydro-electric projects located in the Traditional Territories of the eight First Nations.

Note that the intent of clause 22.6.4 and the strategic investments measure are reflected in the *Mayo-Dawson City Transmission System Project and Benefits Agreement* in force between YEC, the Tr'ondëk Hwëch'in and the First Nation of Nacho Nyak Dun. The Agreement provides for the payment of a return on

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[18] In the realm of economics, the potential implications of a disconnect between the objectives the owners (i.e., shareholders) and the objectives of corporate management is well documented in the literature. Known as the "principal-agent problem", the theory seeks to devise solutions which result in enhanced corporate performance monitoring without direct financial control.
[19] *Financial Information Act Return* (for year ended March 31, 2002), BC Hydro, May 2002; *EPCOR Annual Report,* Edmonton Power Corporation, various years; *Hydro-Quebec Annual Report 2002,* Hydro-Quebec, March 2003).
[20] An excerpt from the Crown Investment Corporation's *1997 Annual Report* which more fully describes its current (as of August 2003) dividend policy may be found in Appendix 2.
[21] *Ta'an Kwäch'än Council Final Agreement*, page 285.

investment calculated according to a formula which mirrors the same 60/40 debt/equity calculation found the 1992 YEC *Financial Policies.* While neither First Nation has as of yet executed their option to make an investment in the Mayo-Dawson City Transmission System Project, the groundwork for such a transaction is in place.

4.0 Summary of Issues for Consideration

The formulation of a YDC dividend policy will require the discussion and assessment of a variety of issues. The key issues are summarized below:

Investment intentions - an understanding of YEC's and ESC's location on their respective growth curves is essential to YDC's potential perspectives on a comprehensive dividend policy. Determining the growth curve location will in turn require a thorough assessment of YEC's capital replacement and future infrastructure needs.

Mix of uses for YDC, YEC and ESC net incomes - allocations among the possible uses of for YDC net income which balances the interests of the owner, lenders and regulators needs to be determined. Table 4 summarizes the possible uses for the three corporations.

Table 4: Net Income Allocation Options - YDC, YEC and ESC

YDC	YEC	ESC
• cash dividend to Government of Yukon • supply side energy initiatives including infrastructure development • demand side energy initiatives	• "60/40 dividend" to YDC • cash dividend to YDC	• cash dividend to YDC • current or future strategic initiatives

Optimal capital structure - interrelated with the determination of the appropriate mix of uses of YDC, YEC and ESC net incomes is the calculation of a capital structure which considers YDC's current role and mandate as well as current financial factors and pressures.

Section 44 two-part test - YDC directors are bound under subsection 124(1) of the *Business Corporations Act* to comply with the two-part solvency rule found in section 44 of the *Business Corporations Act*. As a result, any payment of cash dividends by YDC must meet the requirements of the section 44 two-part test.

Formula financing implications - should a mix of YDC net income use which includes a direct cash dividend payment into the Government of Yukon's consolidated revenue fund be selected for consideration, an assessment of the formula financing impacts of such dividend payments will need to be undertaken.[22]

Yukon First Nation Final Agreements - with the inclusion of equity participation provisions in the Yukon First Nation Final Agreements completed to date, a formal YDC dividend policy will need to anticipate potential equity (and dividend) relationships with Yukon First Nation partners. This possibility is highlighted by the inclusion of a strategic investments clause (though as yet not exercised) in the *Mayo-Dawson City Transmission System Project and Benefits Agreement*.

5.0 Options and Recommendation

The foregoing analysis suggests a variety of options are available to the directors of the Yukon Development Corporation in the formulation of a comprehensive dividend policy. Three options are discussed below. The paper concludes with a management recommendation to the YDC Board.

Option 1: continued *ad hoc* YDC dividend arrangements

Pros
- requires least amount of effort/resources to implement
- issuance of dividends via *ad hoc* Orders-in-Council provides some measure of transparency and reduces director liability

Cons
- does not address the possibility of YDC's owners requesting a cash dividend payment
- contributes to financial uncertainty for YDC since timing of dividend requests by owner are unpredictable and focused to short-term considerations
- limits YDC ability to build up internal financial capacity to fund long-term development of energy infrastructure leading to energy self-sufficiency
- does not clarify the determination of net income allocation for YDC and subsidiary corporations

Option 2: fixed annual cash dividend to owner

Pros
- simple approach used in other jurisdictions
- improved transparency of legislative control
- complementary to existing 60/40 debt/equity policy of the Yukon Energy Corporation
- provides Government of Yukon with an additional and stable revenue source

[22] Note that an indirect cash dividend, effected by OIC, or a transaction (within the mandate of YDC) between YDC and another corporation owned by the Government of Yukon, may have different formula financing implications than a direct cash dividend paid into the consolidated revenue fund.

Cons
- if dividend payment is included in formula financing calculations may result in no net financial benefit to Government of Yukon
- should YEC re-enter a high-growth phase and require cash from YDC to finance that growth YDC may be compelled to borrow to pay the fixed dividend
- reduction in ability and flexibility of YDC and subsidiaries to deliver on achievement of supply-side and demand-side public policy objectives as currently outlined in *Yukon Development Corporation Act* and Board-approved corporate planning documents
- limits ability of YDC and subsidiaries to participate in joint opportunities with other agencies including the Government of Canada

Option 3: no cash dividend to owner but net income allocations made in strict accordance with comprehensive dividend policy

Pros
- retains flexibility which will allow YDC and subsidiaries to respond to changing markets conditions and opportunities
- allows YDC to fund energy infrastructure in post-Northern Canada Power Commission (NCPC) environment and outside the limited fiscal capacity of the Government of Yukon
- allows YDC to pursue its statutory objectives and Board-approved long-term priorities
- reaffirms ability of YDC and subsidiaries to participate in joint opportunities with other agencies including the Government of Canada

Cons
- if dividend direction no longer given via Order-in-Council may increase directors' liability
- may not provide the Government of Yukon with an additional and stable revenue source

Recommendation

With reference to YDC Resolution 2003-08 made May 1, 2003 (partial excerpt):

> *1. No additional dividends be approved by Yukon Development Corporation for the direct or indirect benefit of the owner in 2003;*
> *2. Any government request and/or Order-in-Council directive for the provision of a cash dividend be respectfully declined unless the Board is satisfied that it is not contrary to the Business Corporations Act due diligence, current and future requirements based on the Corporate Plan and the Yukon Development Corporation Act;*

YDC management recommends, while recognizing that the formulation of a comprehensive dividend policy will require discussion and decisions regarding issues summarized in section 4 of this paper, that:

1. work continue on the formulation of a written and comprehensive dividend policy;
2. the dividend policy be made available in the public domain upon completion;
3. the dividend policy address the allocation of net income between the Yukon Development Corporation and the Government of Yukon as well as the payment of dividends to the Yukon Development Corporation by the Yukon Energy Corporation and the Energy Solutions Centre;
4. the issuance of non-cash dividends by the Yukon Development Corporation continue to be made only by Government of Yukon Order-In-Council; and
5. future YDC dividend payments (and net income allocations) only be made after due consideration of:
   - paragraph 44 (a) *Business Corporations Act* solvency rule
   - paragraph 44 (b) *Business Corporations Act* solvency rule
   - *Canada-Yukon Formula Financing Agreement* implications

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YUKON ENERGY CORPORATION

FINANCIAL POLICIES

General

The general intention of the Corporation's financial policies are to:

a) maintain a capital structure that results in a debt/ equity ratio of approximately 60/ 40; and

b) to set terms and conditions on long-term loans from Yukon Development Corporation at a level which reflects current market conditions for companies of similar size and business risk to the Corporation.

The policies are intended to be flexible to allow the Corporation to quickly respond to changes in circumstances and market conditions in a cost-effective manner.

Policies

1. Capital Structure

(i) The Corporation shall maintain a capital structure resulting in a debt/ equity ratio, as this term is defined for the purposes of rate applications to the Yukon Utilities Board by the Corporation, of 60/ 40 at the end of each fiscal year.

(ii) In any year when the debt/ equity ratio, as defined in (i) above, is expected to fall below 60/ 40 by December 31, the Corporation shall declare a dividend on or before December 31 of that year in an amount that would result in the Corporation's debt/ equity ratio approximating 60/ 40 at the end of that year after taking into consideration the impact of any new long-term debt provided for in (iii) below.

(iii) In any year when the Corporation declares a dividend pursuant to this policy, the Corporation shall arrange with its shareholder (Yukon Development Corporation) to issue, on the same date, new long-term debt to the Corporation in an amount equal to the dividend and on terms and conditions then applicable to long-term debt issued to the Corporation by Yukon Development Corporation.

... /2

2. Terms and Conditions on Long-Term Loans Issued to the Corporation from Yukon Development Corporation

   Long-term loans issued to the Corporation from Yukon Development Corporation shall provide for the following terms and conditions:

   (i) interest is payable on a monthly basis;

   (ii) interest rate shall be set as 120 basis points above the average of long-term Government of Canada Bonds as specified by the Canadian Bond Rating Service as at the last previous September 30 prior to issue of the loan; and

   (iii) in any year when the Corporation submits a general rate application to the Yukon Utilities Board, the interest rate on each long-term loan issued to the Corporation by Yukon Development Corporation shall be adjusted, effective from January 1 of the first year of such rate application, to equal an interest rate set in the same manner as (ii) above.

   The Corporation will need to make arrangements with YDC to carry out the above.

Application

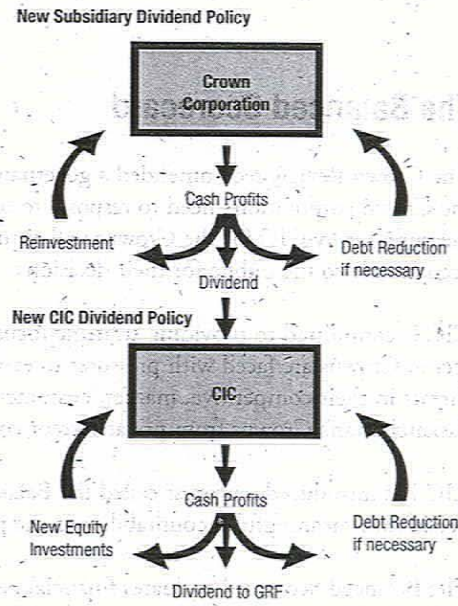
Management is expected to follow the above mentioned policies on an annual basis. If management believes circumstances warrant deviation from the general policies stated above, approval of the Corporation's Board of Directors is required prior to deviating from those policies.

For purposes of determining the debt/ equity ratio, long-term debt shall include the current and long-term portion of long-term debt as disclosed in the Corporation's annual financial statements. Equity shall include contributed capital and retained earnings as disclosed on the Corporation's annual financial statements.

"APPROVED BY YEC'S BOARD OF DIRECTORS ON DECEMBER 18, 1992".

FIN-PLCY.SUB/92/12/16

Capital Allocation in the Crown Sector



In 1997, the CIC Board approved and implemented a new policy to determine dividends to CIC from its four commercial subsidiary Crowns (SaskPower, SaskTel, SaskEnergy and SGI). It allocates cash profits from the commercial Crown business operations among three potential uses. The three uses are reinvestment, debt reduction and dividend payments.

The CIC Board also approved a policy to determine CIC's dividends to the GRF that is based on the same principles. Together, the two dividend policies form an integrated framework (see diagram) for capital allocation in the Crown sector.

Commercial Crown Dividends to CIC

Each commercial Crown's ability to pay dividends is determined after the CIC Board allocates a portion of cash profits to reinvestment to sustain operations, to grow and to diversify. If necessary, the CIC Board also approves an allocation of cash profits to achieve the commercial Crown's approved target capital structure. In general, if a commercial Crown has not achieved its approved target capital structure (with the exception of SGI, the ratio of debt to total assets), it needs to reduce debt[1]. Thus the amount of dividends depends upon how much is first allocated to these other uses of cash profits.

Through this allocative process, the revised dividend policy moves a commercial Crown closer to its approved target capital structure. Once achieved, the revised policy maintains the Crown at or near that target. CIC expects that all commercial Crowns will achieve targets consistent with industry standards by 2002.

CIC's Dividends to the GRF

In a similar way, cash surplus to CIC's requirements can be paid to the GRF after the CIC Board approves amounts for reinvestment and, if required, debt reduction to achieve CIC's target self-supporting debt level ($220 million at December 31, 1997). As CIC reduces its debt toward its target self-supporting level, it can pay sustainably higher dividends to the GRF. As a consequence of its improved financial position, CIC expects to double its regular dividend to the GRF from $50 million in 1997 to $100 million in 1998.

In summary, the revised dividend policy is an integrated framework for allocating capital in the Crown sector. It determines dividends on the public's investment in a way that allows CIC and its commercial Crown subsidiaries to achieve their target capital structures, and provides for reinvestment to sustain operations, to grow and to diversify.

[1] SGI has no debt. The comparable measure of capital structure in the insurance industry is the net risk ratio, the ratio of premiums written (as a proxy for liabilities) to shareholder's equity. It is used in the property and casualty insurance industry to measure claims-paying ability.