Canadian Government Executive

Rebuilding Sustainable Communities

As Canada looks for ways to recover and rebuild in the wake of the COVID-19 pandemic, infrastructure is often cited as a way to get people back to work and to build the foundation for a broad-based economic recovery. To encourage private investors to help develop and deliver new community infrastructure, this paper proposes a revival of the "limited dividend" company, which the Canada Mortgage and Housing Corporation (CMHC) previously used to expand affordable housing. In a post-pandemic recovery, the limited dividend company may prove to be an effective way to provide essential infrastructure services to households and businesses and accelerate sustainable recovery, especially in hard-hit municipalities and regions across Canada.

The Challenge

Infrastructure investment programs are important contributors to economic and ultimately fiscal recovery.[1] Infrastructure programs can also be designed to help to achieve environmental and social goals. Decisions regarding post-pandemic fiscal-stimulus spending will need to strike an appropriate balance between immediate job creation, economic growth, environmental benefits, resiliency, and affordability. The United Nations' principle of "Build Back Better" was conceived precisely to reflect these considerations.[2] As was the Canadian government's standard that it's not enough for a project to be "shovel-ready"—it needs to be "shovel-worthy" as well.[3]

Historically, federal and provincial governments have seen it as their proper role to build the infrastructure needed to support sustainable communities and improve the quality of life of residents. Public assistance for community infrastructure has typically come upfront, in the form of grants and generous loans to reduce the service provider's obligation to finance and build capital-intensive enabling infrastructure.[4] This arrangement, in turn, allows the service provider to reduce the user fees and achieve a corresponding increase in public usage rates because the project is not burdened by excessive financing and depreciation costs.

Most governments express a desire to see more private-sector investment in public infrastructure to mitigate risk and reduce the financial burden for taxpayers. However, in the post-pandemic environment, many policymakers and political leaders are expressing concerns about fiscal support and stimulus measures being used to fund dividend payments, share buybacks, and executive bonuses.[5]

These are legitimate concerns, but they should not negate the potential benefits of a major role for the private sector in building infrastructure projects as part of the economic recovery.

What Is a Limited Dividend Company?

In the 1960s, CMHC created the limited dividend company program to encourage private investors to develop and operate low- to moderate-rent housing. Rents on these projects were based on the cost-of-service (COS) rate model, which included a rate of return of 5 per cent per year or less.[6] The *Income Tax Act* was amended so that limited dividend owners did not pay tax on income earned by these companies.[7]

The limited dividend owners benefited from direct government loans at interest rates below prevailing conventional lending rates.[8] Projects were governed by an operating agreement between CMHC and the owner; this agreement dictated the renting of units to households below specified income levels and placed restrictions on rent increases. The agreement was in force through the duration of the mortgage (30 to 50 years), but the owner could prepay the mortgage and terminate the operating agreement after an initial period.

By the 1990s, most limited dividend owners had repaid or prepaid the mortgages and the CMHC had moved to other housing initiatives.[9] However, the limited dividend company remains on the books as a tax-exempt entity to improve the quality of life in Canadian communities.[10]

What Is Cost of Service?

The COS model used by a limited dividend company to set the rates it charges consumers is essentially the same as the one used by a broad range of rate-regulated public services in Canada (e.g., energy, broadband, housing).

Under the COS model, the provider recovers the cost of delivering the public or utility service through rates charged to consumers—unlike roads, bridges, or parks, which are paid for by taxpayers. The provider is overseen by an independent board, which approves investments and rates as prudent and ensures that the provider operates in the public interest.

The COS rate-setting process provides price transparency for all stakeholders. The rate charged by a provider to a consumer is the sum of all the costs of delivering the service to that consumer, including a provision for return on invested capital that is deemed by the overseeing board to be fair and reasonable.[11]

The COS model has proven effective in addressing the problem of "privatizing profits and socializing losses," where the profitability of assets may be maximized for the benefit of shareholders while poorly executed or underperforming ventures become the responsibility of taxpayers.[12] In addition, this model responds to a perceived lack of responsiveness in certain utility sectors to the needs and wishes of local consumers.[13]

The COS model is established as a good public policy in areas well beyond affordable housing and utility services. It has been used in Canada and internationally in a range of critical infrastructure, from airports to postal services, and can be applied to community projects such as district energy and renewable power. Three attractive features of the COS model are:

1. **Transparency** in financial operations by demanding that the provider recovers only its direct actual costs including a return on invested capital that is deemed fair by an independent board;
2. **Protection of the public interest** by ensuring that providers do not exploit their market power to set prices above reasonable levels or engage in business practices that are likely to be harmful to consumers; and
3. **Appropriate sharing of risk.** Providers are allowed to exceed their allowable return only if they deliver a project under budget or exceed their financial forecasts. Conversely, providers may not earn their allowable return if they deliver a project that is over budget or they fail to meet their financial forecasts.

Why Revisit the Limited Dividend Company Now?

There is a long waiting list of community infrastructure projects seeking federal and provincial funding, and these projects are at risk due to municipal operating deficits and large decline in GDP resulting from the economic slowdown caused by the COVID-19 pandemic.[14] New private-sector resources could be allocated to help address this funding gap through a modified limited dividend company program that is based on the COS model for community infrastructure investments.

Virtually all regulated municipal utilities that provide water, wastewater, gas and electricity services, and broadband infrastructure services use a COS model and are subject to operating agreements and covenants to protect the public interest. Most of these municipal utilities also lack access to private-capital markets, so their ability to build new facilities and provide new services is constrained.[15] At the same time, Canada has seen an emergence of progressive infrastructure ventures that have access to deep pools of private capital and have employed the limited dividend concept and COS model as part of their goal to maximize social and environmental returns.

Are there examples of this model in practice? Nipigon LNG is an example of an infrastructure services provider fashioned as a limited dividend company and based on environmental, social, and governance (ESG) principles of investing. Nipigon LNG is an affordable-energy provider in Ontario that has adopted the COS model to expand natural gas infrastructure in northern Ontario using LNG. Consumer rates recover only Nipigon LNG’s direct actual costs (without markup) including a return on capital that is aligned with Ontario Energy Board guidelines—even though its rates and pricing are not subject to regulatory approval. Nipigon LNG is a public-private co-investment. The public-sector sponsor is the Government of Ontario and the private-sector sponsor and facility owner is Northeast Midstream LP.[16]

Following the precedents of limited dividend housing companies, municipalities, regional authorities, band councils, and Indigenous organizations could be encouraged to engage with private-sector partners to establish new limited dividend companies for community infrastructure. These limited dividend public-private ventures would use the COS model to channel post-pandemic fiscal-stimulus spending to deliver new infrastructure services to create long-term economic growth, support a low-carbon green economy, and build inclusive communities.

Conclusion

In the post-pandemic environment, the public policy question is not, "Do we invest in infrastructure?" Rather, it is, "How do we invest in infrastructure over the short and medium-term for the greatest impact?" The limited dividend company is a proven investment vehicle to provide essential public services for Canadians and assure that the public interest is served and upheld. It can readily be revived to accelerate sustainable recovery in communities and regions across Canada.

In a limited dividend company for community infrastructure, each party's primary needs are met:

1. Public stakeholders realize significant economic, environmental, and social benefits, with downstream fiscal dividends, by leveraging private-sector co-investment as well as development and operating expertise to deliver projects on time and on budget.
2. Municipalities and First Nations gain better infrastructure services and a boost to the local economy and their quality of life, with the assurance that the public interest will be served and upheld, backed by operating agreements and covenants. This reduces the potential for opposition to the project and completion delays, disappointingly recurrent risks in most infrastructure projects, large and small.
3. Private investors have access to reliable, utility-type returns in a globally volatile investment environment, along with the opportunity to achieve broader environmental and social impacts.

---

[1] Smetanin, P., & Stiff, D. (2016). *Investing in Ontario's Infrastructure: A Prosperity at Risk Perspective, with an analysis of the Greater Toronto and Hamilton Area*. "A $1 billion infrastructure spend generates $1.6 billion in federal tax revenue collected from the province of Ontario… $1 billion public investment by the Ontario government will generate $1.7 billion in provincial tax revenues" (p. 47).

[2] The "Build Back Better" principle was adopted by the UN General Assembly (June 3, 2015), based on the Sendai Framework for Disaster Risk Reduction from the Third UN World Conference on Disaster Risk Reduction, held in Sendai, Japan.

[3] See the address by the Honourable Amarjeet Sohi, then minister of infrastructure and communities, to the Toronto Region Board of Trade on January 21, 2016. On May 21, 2020, Infrastructure and Communities Minister Catherine McKenna announced that the government will allocate $3 billion of existing infrastructure funds towards a new COVID-19 funding stream, stating: "We need to get the most value for our money, which is not just shovel-ready projects, but shovel-worthy projects." See https://www.theglobeandmail.com/politics/article-feds-unveil-new-covid-19-stream-for-provincial-infrastructure-program/.

[4] For example, Metrolinx/GO rail passengers and Toronto Transit Commission riders pay about two-thirds of the operating cost of those services, but they are not burdened with funding capital improvements.

[5] The Government of Canada has been sensitive to potential misuse of public relief funds directed to companies who have been affected by the COVID-19 outbreak. For example, the conditions of the Large Employer Emergency Financing Facility (LEEFF) specifically states that the borrower will be subject to certain operating requirements while the loan is outstanding including: "(i) prohibitions on dividends, capital distributions and share repurchases, and (ii) certain executive compensation restrictions." See https://www.cdev.gc.ca/leeff-factsheet/.

[6] A "Limited-Dividend" company is defined under Section 2 of the federal *National Housing Act*, as "a company incorporated to construct, hold and manage a low-rental housing project, the dividends payable by which are limited by the terms of its charter or instrument of incorporation to five per cent per annum or less."

[7] *Income Tax Act* (R.S.C., 1985, c. 1 (5th Supp.)), Section 149(1)(n). Providing a tax exemption in this way mirrors the tax-free municipal bonds program in the United States, which has for decades underwritten the building of much of the infrastructure for America's cities and towns.

[8] Van Dyk, N. (1995). Financing social housing in Canada. *Housing Policy Debate*, 6(4), 815-848.

[9] Hulchanski, J. D., & Network, F. (2002). *Housing policy for tomorrow's cities*. Ottawa: Canadian Policy Research Networks.

[10] The limited dividend housing company is recognized as an investment vehicle in the current versions of the *Income Tax Act* (Canada) and the *National Housing Act* (R.S.C., 1985, c. N-11). Further study is required to determine to what degree existing legislation would need to be amended and/or enabling regulations would be required to extend the attributes to include infrastructure.

[11] In addition, the board may make some adjustments to account for conservation goals, efficiency programs and low-income assistance.

[12] An often-cited example of privatizing profits and socializing losses was the post-financial-crisis bailout of banks and insurers in the United States under the Troubled Asset Relief Program

(TARP) in 2008. The importance of balancing risks and benefits is well illustrated in the privatization of the 407 highway in Ontario. See Cole, L. (2015). 407 ETR lessons of the past shape its future. *Daily Commercial News*, *88*(6), 1-2.

[13] Public-opinion research suggests that Canadians generally give relatively low trust scores to large private-sector providers of telecommunications services, ranking them in the bottom third of companies, below banks and above social media companies (source: Proof Inc. CanTrust Index 2020, https://www.getproof.com/what-we-do/cantrust/). In the Canadian electricity distribution sector, a majority of consumers (56% in 2016) express satisfaction with their distribution companies in terms of reliability and quality, but 40% or less feel distributors provide value for money, act in the best interest of customers, listen to community concerns and give back to the community (source: Canadian Electricity Association 2016 National Public Attitudes Survey). Less than half of Canadians (42% in 2017) are "very" confident about the safety and quality of the water in their homes. Three in ten (and around four in ten in the Prairies and Quebec) have experienced living in an area under a boil water advisory. Eight in ten (79%) are "very" and "somewhat" concerned about water conditions on First Nations reserves. (Source: RBC Canadian Water Attitudes Study 2017.)

[14] *Navigating the COVID-19 Socio-economic Shock: How infrastructure investments will facilitate future growth in Ontario*. Canadian Centre for Economic Analysis for the Residential and Civil Construction Alliance of Ontario (RCCAO). June 2020.

[15] Municipal corporations, such as local electricity utilities, can provide the municipalities with a reliable and critical source of income. However, if a municipality disposes of more than 10% of a municipal corporation's assets (either through a sale or an equity issue) to a private investor, the corporation loses its tax-exempt status (although some are subject to payments in lieu of taxes) and the municipal owners are subject to a transfer tax on the value of the transaction. These tax rules are significant barriers preventing municipalities from accessing capital markets, realizing new business opportunities or selling their utilities to private interests. See Mowat Centre (2016). *Background Report on the Ontario Energy Sector*.

[16] For more information about Nipigon LNG and Northeast Midstream, see https://northeastmidstream.com/.