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April 17, 2009

Ms. Kirsten Walli
Board Secretary
Ontario Energy Board
2300 Yonge Street
Suite 2700
Toronto, Ontario, M4P 1E4

Dear Ms. Walli:

Re: EB-2009-0084 – Written Comments of the London Property Management Association on the Cost of Capital in Current Economic and Financial Market Conditions

This letter is in response to the Board's March 16, 2009 letter related to the Cost of Capital in Current Economic and Financial Market Conditions (EB-2009-0084). Three paper copies have been provided to the Board and an electronic version has been file through the Board's web portal at www.errr.oeb.gov.on.ca.

These are the written comments of the London Property Management Association (LPMA) dealing with the specific questions posed by the Board in its March 16, 2009 letter to interested stakeholders.

General Comments

In the Board letter to all licensed electricity distributors and all registered intervenors in 2009 cost of service applications dated February 24, 2009, the Board determined the values for the Return on Equity ("ROE") and the deemed long-term and short-term debt rates for use in the 2009 rate year cost of service applications.

The Board applied the methodologies as documented in the *Report of the Board on Cost of Capital and 2nd Generation Incentive Regulation for Ontario's Electricity Distributors* ("Board Report") dated December 20, 2006.

The Board determined that the ROE for the 2009 cost of service applications was 8.01%, with the deemed term-debt rate of 7.62% and the deemed short-term debt rate of 1.33%.

Compared to the parameter values set for 2008 using the same methodology, the ROE reflected a reduction of 0.56% from 8.57% to 8.01%. This reduction was driven by a decrease in the forecasted yield on long-term Government of Canada bonds from 4.456% used for the 2008 calculation to 3.714% used for the 2009 calculation. A closer analysis shows that the reduction of 0.742% in the long-term Government of Canada bond yield is comprised of two distinct changes that went in different directions. First, the *Consensus Forecasts* average of the three and twelve month forecasts for 10 year Government of Canada bond yields **decreased** from 4.2% in 2008 to 2.9% in 2009, a reduction of 1.3%. Second, the spread between 30 year and 10 year Government of Canada bond yields increased from 0.256% in 2008 to 0.814% in 2009, an **increase** of 0.558%.

This illustrates that medium term bond yields (10 year) dropped by a significantly larger margin (130 basis points) as compared to the longer term bond yields (74 basis points for 30 year government bonds). The 3-month bankers' acceptance rate has fallen even faster, declining by more than 300 basis points.

However, despite the decrease in short term rates (3-month bankers' acceptance), medium term bond yields (10 year Government of Canada) and long term bond yields (30 year Government of Canada), the deemed long-term debt rate has posted a substantial increase in 2009 as compared to the level in 2008.

Based on the methodology described below the deemed long-term debt rate has risen from 6.10% in 2008 to 7.62% in 2009, an increase of 152 basis points. This increase is the net result of a decrease in the 30 year Government of Canada bond yield of 74 basis points and an increase in the spread between this long-term Government of Canada bond yields and corporate bond yields of approximately 230 basis points (see below).

The deemed long-term debt rate is calculated by adding the 30 year Government of Canada bond yield used in the calculation of the ROE to an average spread for "A/BBB" rate corporate bond yields. In the original Board Report, this corporate bond yield information was available from the Bank of Canada. However, this information is no longer available from the Bank of Canada. The Board now uses 'Long-term Bond Yields – All Corporates' from TSX Inc. The subscription precludes the Board from publishing the data. This methodology and source of information used for the 2009 calculations is unchanged from that used in the 2008 calculation.

Under normal circumstances, when interest rates and bond yields decline, there would be an increase in the spread between the ROE and the deemed long-term interest rate, assuming the spread between long-term Government of Canada yields and corporate bonds remained the same or approximately the same. This is because the ROE declines by only 75% of the reduction in the long Canada bond yield. As noted above, the yield on long Canada bonds has declined by 74 basis points in 2009 from that in 2008. This would result in a reduction in the spread between the ROE and the deemed long-term debt rate of about 18 basis points, all else being equal.

Based on the deemed long-term debt rate and the long–term Government of Canada bond yields, the average spread between long term Government of Canada bond yields and Long-term Bond Yields – All Corporates has increased from approximately 160 basis points in 2008 to approximately 390 basis points in 2009. This is an increase in the spread of about 230 basis points.

The Board's March 16, 2009 letter notes that the spread between the ROE and the deemed long-term debt rate has declined from a spread of 247 basis points (8.57% - 6.10%) to a spread of 39 basis points in 2009 (8.01% - 7.62%). This decrease in the spread is 208 basis points. This reflects the increase in the spread related to the corporate bonds noted above of 230 basis points, partially offset by the 18 basis point reduction due to the ROE formula, also noted above.

Calculation of Long Term Debt Rate

It is not clear of the comparability between the average spread for A/BBB rate corporate bond yields that was previously available from the Bank of Canada to the long-term bond yields – all corporates that is now obtained from TSX Inc.

LPMA notes that a review of the information available from TSX Inc. indicates that long term corporate bond indexes are available for BBB, A and AA rated corporates. Further, long term corporate bond indexes are also available for a number of industries, including energy and infrastructure. The Board may want to investigate whether any of these other indexes is more appropriate to use than the all corporates index.

Response to Questions Posed by the Board

1. How do the current economic and financial conditions affect the variables (i.e., Government of Canada and Corporate bond yields, bankers' acceptance rate, etc) used by the Board's Cost of Capital methodology.

In all respects except one, the current economic and financial conditions have affected the variables used by the Board's Cost of Capital Methodology as expected. In a recession, Government of Canada bond yields can be expected to decline as these bonds are a safe haven for investors. Money is moved from equity markets and corporate bonds to government bonds. This drives up the price of Government of Canada bonds, reducing the yield.

Corporate bond yields usually rise during a recession as they become relatively riskier investments. This is because corporate profits tend to fall during a recession. In particular, BBB rate corporate bond yields almost always rise significantly during a recession. Corporate bonds with an A rating also experience rising yields during a recession, but usually to a much lesser degree than BBB bonds. In this recession however, the A rated bonds have also experienced a significant increase in yield. As noted above in the General Comments section, this has resulted in a significant spread between Corporate bond yields and Government of Canada bond yields.

The decline in the yields for Government of Canada bonds and in the bankers acceptance rate are not unusual in the current circumstances. A low rate of inflation has allowed these yields to fall. The only unusual event is the increase in the spread between long Canadas and A rated corporates.

In other words, the return on equity, which is based on the Government of Canada long bond yield is not out of the ordinary. Neither is the short term interest rate. What is unusual is the relative high level of the corporate bond yield that has resulted in an increase in the deemed long term debt rate based on the Board methodology when other bond yields and interest rates are declining.

2. In the context of the current economic and financial conditions, are the values produced by the Board's Cost of Capital methodology and the relationships between them reasonable? Why, or why not?

As noted above, the relationship between the return on equity and the yield on long term Government of Canada bond yields remains reasonable.

In EB-2007-0905 Ontario Power Generation filed evidence by Kathleen McShane of Foster Associates. In that evidence (Exhibit C2, Tab 1, Schedule 1, page 110) Ms. McShane stated that:

"I recommend that the formula should be reviewed if forecast long Canada bond yields fall below 3.0% or exceed 8.05%. Long Canada yields outside of the range of 3.0% - 8.0% may indicate a materially altered relationship between long Canada bond yields and the utility cost of equity. The specification of 3.0% as the bottom end of the range recognizes there has been no experience with long-term Canada yields near this level since the early 1050s. With respect to the upper end of the range, if long Canada bond yields were to reach 8.0%, the real cost of capital or inflation would be materially higher than that which is currently anticipated. Both circumstances would warrant a review of the validity of the formula."

As shown in the Board's February 24, 2009 Cost of Capital Parameter Updates for 2009 Cost of Service Applications, the forecast for long Canada yields was 3.714%, significantly above Ms. McShane's bottom of the range. It is submitted that there is no adjustment to the ROE formula or the rate determined by that formula required.

The corporate bond yields have risen significantly, reflecting the impact on corporate earnings for all companies, including those with A rated bonds, of the recession. This increase may be saying as much about the lack of confidence in the bond ratings as in the companies themselves, if not more. Bond rating agencies have come under increased scrutiny as the result of ratings given to the various structured financial products that have recently imploded. This has cast aspersions on the credit agencies ratings for corporations.

The spread between the return on equity and the deemed long term debt rate has fallen significantly, but much of this decline is normal during a recession. In addition, it appears that the spread between A rate corporate bonds and long Canada bonds has peaked and is beginning to decline.

2.1 If the values are not reasonable, what are the implications, if any, to a distributor?

LPMA believes the values are reasonable. LPMA also notes that the Board has only asked for implications, if any, to a distributor. There are also implications to ratepayers. The Board should not forget this.

The return on equity generated by the ROE formula is reasonable in the current economic and financial circumstances, although it may be at the higher end of the reasonable range. Very few other industries have any chance of earning a return of equity of 8%. Most would be happy in the current circumstances of having a return greater than 0%.

The short term debt rate is also reasonable given the low level of interest rates. This is reflected by the low rates distributors are now paying on customer deposits.

Of the three capital parameters, only the long-term debt rate may be considered to be unreasonable. It may be unreasonable given that distributors have access to capital at rates significantly lower than 7.62%, as determined by the Board's methodology. In the recently completed EB-2008-0272 case for Hydro One Transmission, it was indicated that Hydro One had issued a significant debt issue in late February of this year at a rate of 6.035 percent (Tr. Vol. 5, page 32). This is significantly lower than the deemed rate of 7.62%.

In addition, distributors have access to capital through Infrastructure Ontario. Rates over the last several months have ranged from around 3.2% for a 5 year serial loan to approximately 5.9% for a 40 year serial loan. A 30 year serial loan has generally ranged from 5.6% to 5.8% over the last several months. Current rates from Infrastructure Ontario are available on their website at www.infrastructureontario.ca/en/loan/rates/sectors/local_distribution_rates.asp

Based on a 30 year rate of 5.8%, the spread between long term debt available to distributors and the return on equity of 8.01% is 221 basis points. This is consistent with the spread of 247 basis points in 2008 between the return on equity and the deemed long term debt rate.

The deemed long term debt rate is only supposed to be applicable to new affiliated debt, variable-rate debt and all affiliate debt that is callable on demand (Report of the Board on Cost of Capital and 2nd Generation Incentive Regulation for Ontario's Electricity Distributors dated December 20, 2006, pages 13 to 15). This debt generally reflects a relatively small portion of the overall debt of the distributors that have filed cost of service applications in 2009. As a result, it may not have a significant impact on the overall cost of capital and on the revenue requirement for these distributors.

However, as shown in the EB-2008-0233 Decision and Order dated April 6, 2009 for Innisfil Hydro Distribution Systems Limited, the Board appears to have expanded the use of the deemed long term debt rate to other debt. In that Decision it is stated that

"The Board finds that Innisfil should use the Board's current deemed long term debt rate of 7.62% as the imputed rate on its new bank loan in determining its cost of debt for regulatory purposes rather than its proposed rate of 5.08%, since as of the completion of the record for this proceeding, Innisfil has not issued its new bank loan and as such, the rate on this instrument is unknown."

It should be noted that the 5.08% proposed by Innisfil was an Infrastructure Ontario rate.

If the Board intends to extend the application of the deemed long term debt rate to debt beyond that specified in the Report of the Board then LPMA believes that the deemed long term debt rate should be reduced to reflect that debt is available to distributors at rates significantly lower than 7.62%.

3. What adjustments, if any, should be made to the Cost of Capital parameter values to compensate or correct for the current economic and financial conditions?

As noted above, there is no rationale for any adjustments to either the return on equity or the short term debt rate. If the Board intends to expand the usage of the long term debt rate, then this rate should be reduced to reflect rates available to the distributors as noted above.

4. Going forward, should the Board change the timing of its Cost of Capital determination, for instance, by advancing that determination to November?

No. The rationale for using the January Consensus and Bank of Canada data is that this is the latest information that is available to be used by the Board in setting the cost of capital parameters that can be implemented in May 1 rates. Using older more out of date information makes no sense. Distributors are expected to use the latest information available in a cost of service filing for OM&A costs, capital expenditure plans, revenue forecasts, and income and capital taxes. It would not be reasonable to use cost of capital parameter information that is not the most recent available for the determination of May 1 rates.

5. Are there other key issues that should be considered if the Board were to adjust any or all of the Cost of Capital parameter values produced by the application of its established formulaic methodology?

If the Board were to consider adjusting any of the cost of capital parameters values, then it should also adjust the deemed capital structure to reflect that very few, if any, distributors have or require a capital structure with only 4% short term debt.

The Board has indicated numerous times that capital borrowings should match the life of the assets for which the capital is required. The Board set the deemed capital structure to include only 4% short term debt. However, a review of a number of 2009 cost of service filings clearly demonstrates that the working cash allowance component of rate base is substantially higher than 4%. Working cash allowance is a short term asset that should be financed by short term debt. The following table shows the working cash allowance as a percentage of the total rate base for 2009 based on 9 of the 2009 cost of service filings.

File Number	Distributor	%
EB-2008-0226	COLLUS	26.6
EB-2008-0233	Innisfil	13.0
EB-2008-0234	Lakeland	19.1
EB-2008-0235	London	19.6
EB-2008-0237	Niagara-on-the-Lake	10.1
EB-2008-0244	PowerStream	14.0
EB-2008-0245	Thunder Bay	17.1
EB-2008-0246	Tillsonburg	30.6
EB-2008-0247	Welland	23.2
	AVERAGE	19.3

LPMA believes that the divergence in the capital structure, where short term assets range from 10% to more than 30% of rate base while short term debt is fixed at only 4% is much more of an issue than the cost of capital parameters related to the return on equity, the short term debt rate and the long term debt rate. These parameters reflect the current economic and financial circumstances. They will change in absolute value and in relative terms to one another throughout the business cycle. However, the 4% of the capital structure related to short term debt is fixed and should be corrected to reflect actual circumstances for distributors. Until the capital structure is corrected to reflect a lower long term debt component of rate base, with an associated increase in the short term debt component, ratepayers will continue to pay based on rates (deemed and actual) for long term debt that is in excess of that needed to finance long term assets. This increases the overall cost of capital to be paid by ratepayers. This is neither just nor reasonable.

As a concrete example of the above impact, LPMA refers the Board to the EB-2008-0233 Decision and Order dated April 6, 2009 for Innisfil Hydro. The result of that Decision allows Innisfil to include in the revenue requirement a weighted average long term debt rate of 7.81% on a deemed long term component of $12,052,484. However, the actual long term debt held by Innisfil, including projected issues in 2009, totals only $9,008,894 (or 39.4% of rate base). In other words, Innisfil includes an interest cost of $237,700 (7.81% of the difference between the deemed long term debt and the actual long term debt), whereas if this unfunded debt was included at the short term debt rate of 1.33%, the interest cost would only be $40,480. In other words, Innisfil is recovering nearly $200,000 in phantom interest costs. These phantom interest costs effectively allow Innisfil to generate a higher return on equity than the Board allowed level. In the specific case of Innisfil, this adds about 2.0% to the return on equity ($200,000 divided by a deemed equity amount of $9.9 million).

LPMA suggests that the Board should keep this in mind as this result is not unique to Innisfil Hydro. If the Board is considering changes the cost of capital parameters (return on equity, short term debt rate, deemed long term debt rate), then by necessity it should also be reviewing the capital structure components of short term debt and long term debt. Only by reviewing the capital structure related to debt in conjunction with any changes in the cost of capital parameters can the Board ensure it is appropriately and effectively addressing concerns of both the distributors and their ratepayers.

Sincerely,
Randy Aiken
Randy Aiken
Aiken & Associates