uniongas
A Spectra Energy Company

April 17, 2009

Ms. Kirsten Walli
Board Secretary
Ontario Energy Board
2300 Yonge Street, 26th Floor
Toronto, ON
M4P 1E4

Re: The Cost of Capital in Current Economic and Financial Market Conditions
EB-2009-0084

Dear Ms. Walli:

On March 16, 2009, the Ontario Energy Board (the "Board") initiated a consultative process to help it determine whether current economic and financial market conditions warrant an adjustment to any of the cost of capital parameters.

In its letter initiating the consultative process, the Board refers to its February 24, 2009 letter establishing the return on equity ("ROE") and the deemed long-term and short-term debt costs to be used by electricity distributors in their 2009 cost of service applications.

Although natural gas distributors are not specifically referenced by the Board in its communications to date, it is Union's view that, should the Board find that an adjustment is warranted, the adjustment should also apply to natural gas utilities as those utilities are also affected by the Board's ROE formula. Accordingly, Union is making the following submission in support of an adjustment to its ROE, organized under the following headings:

1. Introduction
2. Current Economic Conditions
3. Concentric Energy Advisors Report ("Concentric") to the Ontario Energy Board
4. Trans Quebec & Maritimes Pipeline Inc. ("TQM") Cost of Capital Decision
5. Conclusion and Recommendation
6. Next Steps

Introduction

As part of this consultation the Board has specifically excluded a review of the current ROE formula. Instead, the Board is considering whether the ROEs produced by that formula are reasonable in light of the current economic and financial market conditions.

It is Union's view that the formula is not producing ROEs that are reasonable or sufficient to attract capital and appropriately compensate investors. An adjustment to approved ROEs in the range of 150 to 250 basis points is warranted. This adjustment is supported by the degree of convergence between ROEs and long-term debt rates as a result of current economic conditions, the Concentric report prepared for the Board on ROE levels for natural gas utilities in Ontario, and the recent findings by the NEB in the TQM cost of capital decision.

Current Economic Conditions

There is no disputing that Canada and Ontario are caught up in the worst global recession since the Depression. Starting in the fourth quarter of 2008 and continuing into 2009, global equity markets have been characterized by significant value declines and increased volatility. At the same time, debt markets have tightened and long-term debt rates have increased.

The volatility in the equity markets has driven investors towards safer investments such as bonds. The increase in the demand for bonds have driven up bond prices and, in turn, driven down bond yields. The expectation is that bond yields will remain low over at least the next 2 years. Given that a key component of the Board-approved ROE formula is long-term bond yields, ROEs for Ontario utilities will remain unusually low for that period. The expectation is that long-term debt rates will also remain high over at least the next two years. The result is that the spread between ROE levels and long-term debt rates has decreased significantly. As the Board noted in its March 16, 2009 letter, the spread between the result of applying the ROE formula and the long-term debt rate applicable to electricity distributors has declined to 39 basis points in 2009 from 248 basis points in 2008.

In a global capital market, where utility ROEs are already considerably lower relative to US jurisdictions, a spread of 39 basis points between the regulated ROE and the long-term debt rate makes attracting investment capital to Ontario utilities even more difficult. For Union Gas, this has manifested itself in a deferral of the next expansion of its Dawn-Trafalgar transmission system despite having adequate market demand for service, as the company's cost of capital is not competitive with other investment alternatives available to its owner. There is no indication that the spread will increase for at least the next two years. Accordingly, the Board should use its discretion to increase allowed ROEs relative to long-term debt rates.

Concentric Energy Advisors Report to the Ontario Energy Board

Initiated in response to suggestions that ROE levels for Ontario natural gas utilities were lower than those of utilities operating in other jurisdictions, the OEB commissioned a report, prepared by Concentric Energy Advisors ("Concentric"), to review the ROE levels of gas utilities in Ontario.

The Concentric report, *"A Comparative Analysis of Return on Equity of Natural Gas Utilities"* (dated June 14, 2007), provided a comparison of awarded ROEs in other jurisdictions to those awarded in Ontario. It also provided an analysis of the rationale behind the differences between those ROEs. The report did not provide a comprehensive examination of the ROE for any specific company, but rather an overall examination of the major factors contributing to differences between ROE awards in Ontario and those in other jurisdictions.

Concentric did not attempt to estimate the "correct" ROE for Ontario gas distributors. It also did not address which ROE calculation methodology (i.e. formula) or rate-setting approach is most appropriate for Ontario. Rather, the report quantifies the differences in existing allowed ROEs between jurisdictions and countries, and discusses the factors that help explain the disparity.

In its findings, Concentric acknowledged a gap between allowed ROEs for Ontario gas distribution companies and similar companies in the U.S. Specifically, at the time the report was completed, Concentric noted the ROE differential between Canada and the U.S. was in the range of 1.5% to 2.0% (i.e. 150 to 200 basis points). Although Concentric stated that specific characteristics of individual gas utilities and their respective regulatory environments can lead to differences in allowed returns, it found no apparent fundamental differences between gas utilities in Ontario and the U.S. that would cause such a gap in ROEs.

Trans Quebec & Maritimes Pipeline Inc. Cost of Capital Decision

On March 20, 2009, the National Energy Board ("NEB") released its RH-1-2008 Decision with Reasons related to the 2007 and 2008 cost of capital application for TQM.

In the decision, the NEB agreed to vary from its previous methodology established in its RH-2-94 decision and set a 6.4 percent total after-tax weighted average cost of capital (ATWACC) on rate base for 2007 and 2008. The NEB further granted TQM an aggregate return on capital, leaving it to TQM to choose its optimal capital structure without the need for specific regulatory approval. RH-2-94 was a multi-pipeline cost of capital proceeding held in the fall of 1994.

As highlighted at section 3.2.2 of the RH-1-2008 decision, changes in business circumstances, financial markets and general economic conditions prompted TQM to request a review of the RH-2-94 decision as it applies to 2007 and 2008. The NEB not only accepted TQM's position but agreed that a move to a market-based ATWACC methodology was an appropriate mechanism to vary TQM's cost of capital.

The RH-1-2008 decision results in an ROE of 9.7 % on equity of 40% or 11.2% on equity of 32%. For 2009, NEB formula, established in 1994, produces an ROE of 8.57% (113 to 263 basis points lower than the ROEs resulting from the RH-1-2008 decision). For Union, with equity of 36%, applying RH-1-2008 decision would yield a ROE of 10.4% relative to Union's Board approved ROE of 8.54%.

Conclusion and Recommendation

Union recommends that the Board implement an adjustment to the approved ROE for all Ontario regulated utilities as soon as possible. The adjustment should be in the range of 150 – 250 bps. Such an adjustment will address the current economic conditions and restore a more traditional relationship between the cost of debt and the cost of equity. For Union, the rate impact of such an adjustment on a typical residential customer would be approximately $1/month. However, the beneficial impact on competitiveness and the increased ability to attract capital for new utility infrastructure investments would far outweigh the customer cost.

Next Steps

Although the Board, as part of this consultation, is not reviewing the current ROE formula or capital structure, Union believes that a review is required and should be initiated by the Board next year. The current ROE formula used in Ontario was derived from the formula first approved by the NEB in 1994. Since 1994, there have been significant changes in financial markets and the economy, not the least of which has been the globalization of financial markets which has increased the competition for capital. Furthermore, there is no other area of utility regulation or operations that has remained unchanged over the past 15 years. It certainly appears that a cost of capital review is overdue.

Union appreciates the Board's willingness to consider using its discretion to adjust utility ROE levels in recognition of the current economic conditions. This approach, however, only addresses the immediate impact of current economic conditions on utility ROEs. It is Union's view that the only way to adequately address longer term issues of low utility ROE relative to other jurisdictions is through a comprehensive review of the method used to determine ROE and capital structure for Ontario's regulated utilities. The need for a comprehensive review is also supported by recent reports from the Canadian Gas Association ("Natural Gas Utility Return Determination in Canada: Time For A New Approach", April 2008) and the American Gas Association ("Regulatory Policy of Return on Equity", December 2008).

Please contact me directly should you have any questions on the foregoing submissions.

Yours truly,

[original signed by]

Mark Kitchen
Director, Regulatory Affairs

cc: M. Penny (Torys)