April 17, 2009

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

Dear Ms. Walli:

RE: **Consultation on the Cost of Capital in Current Economic and Financial Market Conditions**
Board File No.: EB-2009-0084

Please find attached the submission of the Coalition of Large Distributors (CLD), listed below, with respect to the above-captioned proceeding.

Yours truly,

(Original signed on behalf of the CLD by)

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Coalition of Large Distributors
Comments in Response to Ontario Energy Board Request
The Cost of Capital in Current Economic and Financial Market Conditions
EB-2009-0084

April 17, 2009

These are the comments of the Coalition of Large Distributors (the "CLD"), in response to the March 16, 2009 request of the Ontario Energy Board (the "OEB" or the "Board") to interested stakeholders asking for comments on certain identified issues (the "Cost of Capital Questions"). The CLD consists of Enersource Hydro Mississauga Inc., Horizon Utilities Corporation, Hydro Ottawa Limited, PowerStream Inc., Toronto Hydro-Electric System Limited, and Veridian Connections Inc.

The CLD comments are organized in the following manner:

1. Introduction
2. Discussion on Concentric Report
3. Cost of Capital Questions
4. Recommendations and Conclusions
5. Appendix A: CLD Adjusted Formula

1. Introduction

The CLD is pleased to assist the Board in determining whether current economic and financial market conditions warrant an adjustment to any of the Cost of Capital parameter values (i.e., the Return on Equity, Long Term Debt rate, and/or Short Term Debt rate). The CLD appreciates that the OEB is not asking for interested stakeholders to provide another treatise on the theory of the cost of capital. Instead, we are being asked to provide practical experience operating under the OEB's established method, and specifically, to provide opinions on the current parameter values for Return on Equity, Long-Term Debt rate and Short-Term Debt rate.

However, the CLD, along with Hydro One Networks Inc. ("HONI"), believed that the OEB could be better informed in this consultation if provided with some factual information on the current economic and financial market environment in which we operate, as well as a brief historical perspective on the Ontario cost of capital. To that end, the CLD and HONI have retained the research and analysis services of Concentric Energy Advisors ("Concentric") to provide some assistance in this consultation. In the interests of efficiency, the CLD has not attached the work of Concentric here but refers the OEB to the submission of HONI for such material.

2. Concentric Report

In addition to responding to the Board's questions, the Concentric report (or the "Report") provides a discussion on the issue of fairness in the context of a reasonable rate of return, and examines the ability of the current Ontario formula to meet fairness standards. The Report also compares the resulting Ontario ROE against those in other jurisdictions.

The CLD acknowledges that the OEB is not opening up the entire capital structure at this time and that not all of the criticisms of the current formula can be addressed under this current consultation. However, the Report provides useful context and guidance to the OEB in its consideration of changes to the Cost of Capital parameters, even if only on an interim basis. Presumably, this Report will also act as impetus for the Board's consideration of a sustainable solution, which requires a full evaluation of the cost of capital for both current and anticipated market conditions.

3. Cost of Capital Questions

In this section, the CLD augments the Concentric report's responses to the Board's Cost of Capital questions.

The Board seeks comments on the following questions, each of which is followed by a response from the CLD:

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?

   Response:

   Please see Appendix A.

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?

   Response:

   The values produced and the relationships between them are not reasonable under the current economic conditions. As addressed in Appendix A, the current formula for ROE in the Board's Cost of Capital methodology assumes that the spread between government long bonds and corporate bonds remains relatively constant. Since inception of this method, that spread has widened considerably, with government bond rates having declined steadily over the past decade while corporate bond rates have risen sharply in the past year.

Furthermore, the deemed short-term debt rate is set based on a fixed spread of 25 basis points. With a fixed spread, the calculated deemed rate is not responsive to current economic conditions.

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

Response:

The implications are that the Board's formula produces results which do not reflect the economic reality of the distributors. For example, the deemed May 1, 2009 value of 1.33% for the Short-Term Debt rate does not match the much higher rates (in some cases three to four times the rate) actually being incurred by distributors in today's market. As a result, the overall rate of return is somewhat lower than it should be.

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?

Response:

Please see Appendix A for a recommended adjustment to the Board's ROE formula to reflect the changes in the economic and financial conditions from inception until the current state.

As to short-term debt, the CLD has reviewed the actual spreads that are indicative at this time. On that basis, we concur with the recommendation of Concentric that the spread should be 175 basis points for distributors with an A credit rating.

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

Response:

With respect to timing, it is highly unusual to have a different rate year and fiscal year, particularly with respect to cost of service rate applications. This difference exacerbates problems in the timing of determining the factors, i.e., for Cost of Capital. Many distributors may seek to address this issue in future rate applications.

Parameters to be used in the formula may vary widely depending on whether they were in effect just prior to the period for setting rates or at some period prior to that. Further, timing affects the behaviour of distributors with respect to deciding when to apply to the OEB for cost of service rate re-basing. The CLD supports the comments of Concentric that the cost of capital rates should be determined as close to the effective date of rates as possible (three months prior is reasonable). However, given that different distributors may have different effective dates (particularly once distributors seek to align the rate year and fiscal year), the Board may need to set the cost of capital rates more than once per year.

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?

   Response:

   Despite the fact that we are recommending a short term fix we must realize that distributors will be required to make large infrastructure investments in the future and the Board will have to reconsider the proper funding for those, and other long term issues.

4. Recommendations and Conclusions

The CLD reiterates the conclusions reached in the Concentric report, and augmented here, that the values produced from the Board's Cost of Capital formula have not kept pace with the financial markets.

The recommendation of an interim solution includes addressing the change in spreads between government long bonds and corresponding corporate bonds since the inception of the Board's formula. The short term debt rate should also be recalibrated to reflect the significant difference between the actual much higher rates and the deemed rate.

However, the CLD also recommends that the Board consider the fairness of changing the formula for only a sub-set of electricity distributors, and what effect this will have on the remaining distributors with respect to the timing of their rate applications. Adjustments applied to the formula for the benefit of such a sub-set may result in increasing economic disparity among distributors, and negatively affect, for example, their willingness to merge. Also, the CLD is concerned about "cherry-picking" changes to the Board's formula and methods, whereby such changes result in improvements to certain outcomes, but are possibly offset by worsening aspects elsewhere in the utility's portfolio, particularly in a period of incentive rate-making when few financial elements can be addressed.

With all of these considerations and those raised in the Concentric report, the CLD recommends that the Board initiate a proceeding to review cost of capital in the longer-term.

Appendix A

CLD Adjusted Formula

To further assist the Board in its deliberations around an appropriate level of the ROE for LDCs given current financial market conditions, the CLD proposes a generalization for the existing model so that changes in the spread between government long bonds and corresponding corporate bonds can be recognized.

The current model implicitly assumes that the spread between government long bonds and corporate bonds remains relatively constant, and in particular that both rates move in the same direction over any arbitrary time period. Under this assumption, changes in the level of long bond rates can be 'translated' into changes in the level of corporate bond rates.

This assumption of parallelism between government long bonds and corporate bonds represents a special case of a more general model in which changes in the spread between these instruments are recognized in addition to changes in the levels. The CLD submits that the generalized model responds to and better represents the highly unusual economic conditions now prevailing, and specifically the facts that the spread between government long bonds and corporate bonds has widened markedly and that while government long bond rates have dropped dramatically, corporate bond rates have actually increased significantly.

Under the generalized model proposed by the CLD, ROE would be determined by the sum of an initial ROE value (i.e., 9.35%) plus 0.75 of the change in government long bond levels plus the change in the spread between the instruments, with that change determined as the difference between its value at the time of ROE adjustment and its initial (fixed) value.

The corresponding equations are as follows:

Current Formula:
ROE = 9.35% + 0.75 *(3.714% - 5.5%) = 8.01%

CLD Adjusted Formula:
ROE = 9.35% + 0.75 *(3.714% - 5.5%) + (2.85% - (6.90%-5.5%)) = 9.46%

Where:

- 2.85% = bond market's current indicative spread on 30-year government of Canada bonds for utilities rated similarly to CLD utilities; and

- 6.90% = average interest on deemed debt for CLD utilities in 1999/2000.

This alternative uses the "initial" long Canada Bond yield of 5.50% together with the average interest rate on the deemed debt that CLD utilities had at inception (6.90%) to calculate the initial spread. The difference between the initial spread (i.e., 1.40%) and the current spread (i.e., 2.85%) is relatively conservative at 1.45%, and is simply added to the ROE. This result from the generalized model produces a reasonable proxy for the bond market's current indication of the cost of new long-term debt.