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Ontario Energy Board
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Re: The Cost of Capital in Current Economic and Financial Market Conditions
Board File No.: EB-2009-0084

To Whom It May Concern,

This comment is in response to a consultative process initiated by the Ontario Energy Board (the "Board" or the "OEB") in a letter dated March 16, 2009. We understand that the objective of the consultation is not a reconsideration of the Board's established methodology for the determination of the Cost of Capital, but rather is an inquiry into whether current economic and financial market conditions warrant an adjustment to any of the Cost of Capital parameter values.

We believe that economic events and developments in Canadian capital markets during the past year have not only further depressed the return on equity of Canadian publicly-owned utilities, but also distorted the values of other components of the Cost of Capital formula used by the OEB. As a bondholder with a significant investment interest in Ontario and other Canadian utilities, Sun Life Financial would like to take this opportunity and offer our views on the latest economic and financial developments, as well as provide comments on several of the Board's questions.

> *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?*

Unprecedented events in the economy and the financial markets over the past year have undoubtedly had an impact on the companies' ability to raise financing and made the financing cost more expensive. On the equity front, declining equity valuations have made equity financing less attractive for most companies. On the debt front, a liquidity squeeze and higher spread levels have made the cost of issuing new debt more expensive, both in the public and bank markets, affecting both the short-term and the long-term cost of debt. Overall, the ability to find affordable capital may cause companies to delay planned capital expenditure projects.

It is also important to note that a period of several years prior to the current financial crisis should also not be considered normal market conditions. Capital was much more available than it normally would be, was available more widely for companies with high leverage, and at much more attractive rates than would be true in a more normal lending environment.

Although higher, the overall cost of debt financing has benefited from the lower Government of Canada bond yields, which have been trending down for a number of reasons (i.e. declining debt to GDP levels, flight to government issued fixed income, fears of quantitative easing, deflation, etc.). Given that capital markets have no expectations for a significant near-term rebound in government bond yields, we believe the OEB's review of the Cost of Capital parameter values is prudent and relevant.

> *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?*

The examination of the various debt and equity cost parameters established by the Board for the 2009 rate year has allowed us to identify two glaring disconnects: a) return on equity ("ROE", 8.01%) that is not much higher compared with the cost of long-term debt (7.62%), for only a 39 bps differential in 2009, down from 247 bps in 2008, and b) the low level of short-term debt cost (1.33%).

On the subject of the ROE, we note that the deemed cost of long-term debt appears reasonable or even slightly at the higher end of the spread range, reflecting the increased spread levels for A/BBB corporate bonds during 2008 and in early 2009. In addition, since the deemed long-term debt rate applies only to some of the Ontario utilities' debt load, it is of somewhat limited importance to the companies' overall cost of debt.

Being only 39 bps higher than the deemed long-term cost of debt, the ROE level is too low and in our opinion, requires adjustment to the upside. We believe that the ROE level does not provide a fair and reasonable return to equity investors on the basis that no reasonable equity investor would invest and hold an equity risk in a company in exchange for receiving such a slim equity premium in comparison to other potential investments. For example, if you look at the ROE for the S&P 500, the annual ROE has ranged from 11% to 19% over the last two decades (as calculated by RBC Capital Markets).

Despite the low ROEs currently being earned by Canadian utilities, we believe that in the shorter-term these assets remain very attractive to their owners for a variety of reasons. Reasons may include: a belief that ROEs will be adjusted over time to become more reflective of fair return; owning regulated assets allows a holding company to underpin its credit rating making it possible to cross-subsidize their unregulated subsidiaries through cheaper overall debt financing; and owning the original regulated assets allows the companies access to growth projects that the companies are largely completing on a contracted or negotiated basis at potentially higher returns.

From the bondholder's perspective, higher ROEs would reduce Canadian utilities' risk levels, strengthen their financial and liquidity profiles, as well as provide fewer incentives for companies to take on greater risk with their non-regulated assets in order to achieve average ROEs required by their shareholders. Overall, however, it appears to us that the root cause for a disconnect between the calculated costs of debt and equity lies in the Cost of Capital formula itself.

On the second point, the deemed short-term debt rate (1.33%, a sum of 3-month bankers' acceptance ("BA") rates plus 25 bps) is low and may not be reflective of the true cost of short-term borrowing. Looking back 12 months to April 2008, we note that 3-month BA rates have ranged between 2% and 3% for a prolonged period of time and have come down only recently. With respect to the fixed 25 bps spread, we note that in the current environment no A/BBB company would be able to obtain short-term debt financing at such a low rate.

> *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?*

One of the most striking aspects of the Cost of Capital is a segregation of the cost of debt and the debt composition itself into a short-term and long-term component. Having two debt components and the need to go through the exercise of determining the value of these parameters annually not only adds to the work load of the Board, but also constrains financial decision-making by the companies under the OEB's jurisdiction. We believe that allowing companies to determine their own-mix of short-term and long-term debt and relaxing the deemed split between the two components of the debt capital structure will not increase the riskiness of Ontario utilities and will not hinder the sector's ability to access debt financing for three reasons: a) market forces and rating agencies would provide sufficient input and incentive to management teams to maintain conservative (i.e. long-term) debt maturity profiles, b) companies will have the ability to better respond to changes in market conditions and to take advantage, in a disciplined manner, of lower-cost opportunities to finance their debt needs, and c) the short-term debt component is small and therefore, not overly material to the companies' creditworthiness.

Basing return on equity off of government bond yields should also be reconsidered. Although theoretically government bond yields are a risk-free rate of return, in practice, as we have seen in this past year, there are many drivers for these yields over the short and mid term, including capital and currency flows, flights to quality or liquidity, short-term inflation expectations, and demographics. For example, if government bond yields are on average earning investors a negative real return during a given period due to flows such as the above, can that truly be considered a "riskless" return? If government bond yields are truly a riskless return, then why is there a credit derivative market that allows you to buy insurance against the potential default of major OECD countries such as the US and UK? Perhaps there should be some parameters, such as minimum and maximum bond yield levels, set to recognize that for periods of 5 to 10 years financial markets may be acting in ways that would be considered outside of reasonable levels by theoretical approaches, and could therefore be driving unreasonable results in a formulaic method.

Finally, we believe that the Board should take into consideration some of the interplay of the various factors involved in the overall cost of capital to an individual company. For example, if a given company is allowed a higher ROE, than perhaps having a lower equity portion in their capital structure is justifiable. The higher ROE itself could reduce the overall company risk with respect to liquidity, impact of credit rating downgrades, and the company's ability to maintain its own capital structure and fund growth or maintenance projects internally, as opposed to having to source additional capital from a parent or the markets. It is neither the ROE nor the percentage of equity that determines the financial stability of the regulated entities, it is the combination of these two factors.

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

Although the Board's process with respect to the timing of determination of the Cost of Capital has been set for a period of time, a change to a January 1 – December 31 rate year, and a related advancing of the Cost of Capital determination to November would align the Board's timelines with those in other jurisdictions and ease comparison of regulatory decisions across jurisdictions.