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April 17, 2009

BY EMAIL & BY COURIER

Ms. Kirsten Walli  
Board Secretary  
Ontario Energy Board  
2300 Yonge St, Suite 2701  
Toronto ON M4P 1E4

Dear Ms. Walli:

**Board File No. EB-2009-0084**  
**Consultation on Cost of Capital in Current Economic Conditions**  
**Comments of Energy Probe**

Pursuant to the letter from the Board, dated March 16, 2009, describing the Board's process for determining whether current economic conditions and financial market conditions warrant an adjustment to any of the Cost of Capital parameters, Energy Probe Research Foundation (Energy Probe) is hereby providing three hard copies of its Comments in the EB-2009-0084 consultation for the Board's consideration. An electronic copy of this communication in PDF format is being forwarded to your attention.

Should you have any questions or require additional information, please contact me.

Yours truly,

David S. MacIntosh  
Case Manager

cc. Peter Faye, Counsel to Energy Probe (By email)

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# **Ontario Energy Board**

## **THE COST OF CAPITAL IN CURRENT ECONOMIC AND FINANCIAL MARKET CONDITIONS**

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**COMMENTS OF  
ENERGY PROBE RESEARCH FOUNDATION  
("ENERGY PROBE")**

**April 17, 2009**

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# **THE COST OF CAPITAL IN CURRENT ECONOMIC AND FINANCIAL MARKET CONDITIONS**

**Comments of Energy Probe Research Foundation**

**EB-2009-0084**

## **Background**

By its March 16, 2009 letter to Ontario licensed electricity distributors, and other interested parties, the Ontario Energy Board (“Board”) initiated a consultation process to assist it in determining whether current economic and financial market conditions warrant an adjustment to any of the Cost of Capital values set out in the Board’s letter of February 24, 2009 to Ontario licensed electricity distributors and intervenors in 2009 Cost of Service applications.

The stated intent of the consultation is to consider whether the deterioration in the economic and financial markets during 2008 and 2009 warrant the Board exercising its discretion to adjust any or all of the values produced by the application of its established formulaic methodology. The Board’s established formulaic methodology itself is not at issue.

Input was sought from interested stakeholders to help the Board determine if, when and how to make any appropriate adjustments to any of the values for the 2009 rate year, which may impact the rates for the 23 distributors that had their rates rebased this year. To that end, comments were requested from stakeholders to assist the Board to answer five specific questions.

Energy Probe was assisted in preparing its submissions by attending an interactive presentation by Dr. Lawrence Booth on April 8, 2009, on current economic and financial market conditions, to a number of intervenors in this consultation, and by subsequently reading the evidence he presented before the Alberta Utilities Commission in March of this year. Energy Probe was further assisted by the early circulation of draft submission points by Mr. Peter Thompson, counsel for the Canadian Manufacturers and Exporters.

## **Responses to the Board's Issues**

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?**

The current economic and financial conditions which affect the variables used by the Board's Cost of Capital methodology stem from the 2007 Spring and Summer slowdown in the United States housing market, and the July and August 2008 slowdown in Canada. The slowdown was no doubt cyclical in nature, after a long period of economic buoyancy, but deteriorated into recession, caused by extreme panic in the Fall of 2008 as it became apparent that the United States government's gradual loosening of the credit requirements for individual home purchases, beginning, it can be argued, with the Carter administration in the late 1970's and exasperated by implicit permission for the financial markets to trade in mortgage backed securities under the Clinton administration, came home to roost.

On September 7, 2008, the United States Federal Housing Finance Agency (FHFA) announced that the Federal National Mortgage Association ( known as "Fannie Mae") and the Federal Home Loan Mortgage Corporation (known as "Freddie Mac") were being placed into conservatorship of the FHFA. Between the two of them, they owned or had guaranteed about half of the U.S.'s \$12 trillion mortgage market. Both entities are United States' government sponsored enterprises. Fannie

**Mae's purpose is to purchase and securitize mortgages in order to ensure that funds are consistently available to the institutions that lend money to home buyers.**

**(The Washington Post, September 7, 2008)**

**The result has been a tightening in bond markets, a credit crunch, caused by lack of liquidity as financial institutions became reluctant to lend. At the same time, there has been excessive liquidity in the equity market as stockholders tried to divest holdings.**

**Currently, financial institutions seek security. Although the United States deficit has ballooned, foreign investors, particularly China, have increased their holdings of federal debt and abandoned corporate bonds and equities.**

**(The New York Times, March 9, 2009)**

**The results for the variables used by the Board's Cost of Capital methodology: forecasted yields for the Long Term Government of Canada bonds have been reduced. Borrowing costs are up but not unreasonable.**

- 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?**

**It is the submission of Energy Probe that in the current economic and financial conditions the values produced by the Board's Cost of Capital methodology and the relationships between them are reasonable.**

**Energy Probe is an intervenor in many cost of service rebasing applications by electric distribution utilities in Ontario for 2009 rates rebasing applications. There has not been any indication that these utilities are experiencing difficulty in raising capital at reasonable rates. Further, there has not been evidence that has come to the attention of Energy Probe which indicates that current economic and financial conditions are causing severe earnings distress among those utilities.**

**As an Ontario response to the current economic turmoil, the government provides access to capital for municipally held electricity distributors through Infrastructure Ontario with low cost serial loans.**

**Lending rates through Infrastructure Ontario as of today, April 17, 2009, include 30 year serial loans at a lending rate of 5.71%. The relationship between the long term lending rate of 5.71% and the Board's currently allowed return on equity of 8.01% appears to Energy Probe to be more than reasonable.**

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

**Not applicable.**

**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?**

**It is the recommendation of Energy Probe that no adjustments should be made the Cost of Capital parameter values to compensate or correct for the current economic and financial conditions. The Board's Cost of Capital methodology in itself provides confidence for financial markets in periods of economic stress because it is not arbitrary, nor subject to adjustments out of phase. Financial markets are impressed by stability within the regulatory regime.**

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

**No. During consultations leading to the Board's Cost of Capital methodology, the timing of the variable used by the Board's methodology was subject to debate and determination. Use of the latest, most current available information for input to determine the test year values is prudent.**

- 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?**

**Not applicable.**

**Energy Probe Research Foundation appreciates the opportunity to comment on these most important issues.**

**Respectfully submitted at Toronto, Ontario this 17<sup>th</sup> day of April, 2009.**

**Energy Probe Research Foundation**