Attachment B: Issues for Discussion at Stakeholder Conference

EB-2009-0084

IN THE MATTER OF a consultation by the Ontario Energy Board on the Cost of Capital for Electricity Distribution Companies.

The Board is making provision for further information to be gathered in this process. Below is a list of issues for discussion at the stakeholder conference scheduled for the week of September 21, 2009.

Interested stakeholders are invited to provide the Board with written comment addressing these issues by August 27, 2009.

Historically, the Board has found the Equity Risk Premium ("ERP") approach to be pragmatic and efficient given the Ontario market structure and the number of utilities that the Board regulates. These factors remain unchanged and the Board has concluded that an ERP approach remains the most appropriate in the current circumstances. However, the Board will review the application and the derivation of the current ERP approach to determine if it is sufficiently robust to guide the Board's discretion in applying the FRS.

The application of the FRS will be central to this consultation.

The Board has identified three areas where further information is needed:

- potential adjustment to the established cost of capital methodology (i.e. based on the ERP approach) to adapt to changes in financial market and economic conditions;
- determination of reasonableness of the results based on a formulaic approach for setting the cost of capital; and
- Board discretion to adjust those results, if appropriate.

The Board has identified the following specific issues for stakeholder comment to gather information in these areas. Appended to the issues list are: a summary of stakeholder options in response to the Board's March 16, 2009 letter; and a list of references to documents that are germane to this consultation.

Preamble:

The National Energy Board (NEB) in its RH-2-2004 Phase II Decision stated the following with regard to the application of the Fair Return Standard ("FRS"):

> *"The Board [NEB] is of the view that the fair return standard can be articulated by having reference to three particular requirements. Specifically, a fair or reasonable return on capital should:*
>
> - *Be comparable to the return available from the application of invested capital to other enterprises of like risk (the comparable investment standard);*
> - *Enable the financial integrity of the regulated enterprise to be maintained (the financial integrity standard): and*
> - *Permit incremental capital to be attracted to the enterprise on reasonable terms and conditions (the capital attraction standard)."*

The NEB's articulation of the FRS is consistent with the principled approach described on page 2 of the Board's March 1997 *Compendium to Draft Guidelines on a Formula-Based Return on Common Equity for Regulated Utilities (the "1997 Compendium"). Further, t*he Board also determined in its *Report of the Board on Cost of Capital and 2nd Generation Incentive Regulation for Ontario's Electricity Distributors* dated December 20, 2006 that "the current approach [as set out in the 1997 Compendium] for setting ROE would be maintained."

The NEB reaffirmed this articulation of the FRS in its RH-1-2008 Reasons for Decision. Further, in that same Decision, the NEB also stated: "In the Board's view, the Federal Court of Appeal was clear that the overall return on equity must be determined solely on the basis of a company's cost of equity capital, and that the impact of any resulting toll increase is an irrelevant consideration in that determination".

Questions:

1. What method(s)/test(s) might the Board formally consider to determine whether the return on capital meets: (i) the comparable investment standard; (ii) the financial integrity standard; and (iii) the capital attraction standard?
2. Is the current deemed capital structure appropriate? If not, what alternative(s) might the Board consider?
3. Should the approach to setting cost of capital parameter values differ depending on whether a distributor finances its business through the capital markets or through government lending such as Infrastructure Ontario or through bank lending? If so, what would be the implications, if any, of doing so?

Preamble:

Concentric Energy Advisors in its report entitled “A Comparative Analysis of Return on Equity of Natural Gas Utilities” (dated June 14, 2007) found that “there are no evident fundamental differences in the business and operating risks facing Ontario utilities as compared to those facing U.S. companies or other provinces that would explain the difference in ROEs”.

Questions:

4. Does the analysis in the Concentric Report provide a reasonable foundation for satisfying the comparable investment standard?
5. If not, what might the Board use as a comparator group?
6. Were the Board to only consider the use of Canadian utilities as a comparator group, is there an issue with circularity, given that the ROEs of these utilities are, and have been established by a mechanism similar to that currently used by the Board?

Preamble:

The Board in the 1997 Compendium indicated its intention to move to a formula-based approach using the Equity Risk Premium (“ERP”) method for determining the fair rate of return on common equity (“ROE”) for Ontario natural gas utilities. The Board adopted the same approach in 1999 for electricity distributors. A two phase process was established to calculate the ROE: an initial ROE setup will establish a just and reasonable ROE based on the ERP, and an ongoing adjustment mechanism will automatically adjust the initial ROE to account for changes in long-term Canada yield expectations.

The Board noted the following on the use of an ERP test and on the concept of a formula-based ROE:

- “a disadvantage of using the ERP approach is that…historical-average risk premium calculations are time sensitive and subject to considerable volatility from period to period” (1997 Compendium, page 6); and
- “over time these parameters and adjustment factors will have a cumulative or compounding effect on the results of the formulaic ROE mechanism. The use of an inappropriate initial ROE will either inflate or understate subsequent rate determinations” (1997 Compendium, page 7).

Questions:

7. Should the ERP approach be reset given that when the formula was first established the reference bond rate was 8.75%?
8. Should the ERP approach be reset on a regular basis (e.g., every 4 or 5 years) to mitigate the issues described in the 1997 Compendium?
9. How might the Board address the potential issues arising from the application of the current methodology as a single, point-in-time calculation?
10. How should the Board establish the initial ROE for the purposes of resetting the methodology?

Preamble:

The Board in the 1997 Compendium stated that the equity risk premium methodology "relies on the assumption that common equity is riskier than debt and that investors will demand a higher return on shares, relative to the return required on bonds, to compensate for that risk. The premium required by an investor to assume the additional risk associated with an equity investment is taken to be the difference between the relevant debt rate, usually the yield on long-term government bonds and some estimate of the stocks cost of equity" (1997 Compendium, page 6).

Questions:

11. Is the government (of Canada) bond yield the appropriate base upon which to begin the return on equity calculation?
12. What is the relationship between corporate bond yields and the corporate cost of equity? Is this relationship sustainable?

Preamble:

In the comments submitted in response to the Board's March 16, 2009 letter, many participants suggested interim approaches to adjust the Cost of Capital parameter values. A summary of these submissions is provided as Appendix A. Suggested interim approaches or adjustments included:

- Adjusting the ROE to reflect historical spread between long-term debt rate and ROE (i.e. 250 basis points);
- Adjusting the ROE to include the ROE differential between Canada and the U.S. noted in the Concentric report;
- Including an incremental risk premium factor to reflect the return required to compensate investors for risks posed by increased stock market volatility;
- Including a "market adjustment" factor to directionally maintain the relationship between the cost of debt and the ROE;
- Substituting the deemed utility debt rate for the long-term Government of Canada bond yield in the adjustment formula; and
- Including an adjustment factor to capture the spread between government and corporate bond rates since the inception of the ERP formula.

Questions:

13. Does the current approach used by the Board to calculate the ERP remain appropriate? If not, how should the ERP be calculated?

Preamble:

Some jurisdictions have a "dead band" within which no adjustments are made and/or a trigger mechanism that balances reviewing the methodology for setting the cost of capital too often with not reviewing the mechanism often enough.

Questions:

14. Should the Board adopt a dead band? If so, what should the range of the dead band be?
15. Should the Board adopt trigger mechanism(s). If so, how often should the Board review the methodology?

Preamble:

The Board in the 1997 Compendium (page 32) indicated that “from time to time the Board may request the presentation of other tests or require some weighting for other tests in the formula should the Board want to assure itself that the ERP formula approach does not lead to perverse results and is directionally in line with other market indicators.”

Questions:

16. What is the appropriate test(s) to ensure the FRS is met (e.g. corroborating results for reasonableness relative to other benchmarks or through other methods)?
17. What information might the Board need to definitively determine that market conditions are having an effect on the variables used by the Board’s cost of capital methodology?

Preamble:

As part of the comments in this consultation, some participants cited the following as indicators that conditions in the capital market have changed:

- Declining equity valuations reduced the attractiveness of raising equity capital.
- Liquidity squeeze and higher spreads have increased cost of issuing short-term and long-term debt.
- Capital expenditure projects may be delayed as the ability to find capital on reasonable terms and conditions is reduced.

Questions:

18. Should the Board consider monitoring indicators like these on an on-going basis to test the reasonableness of the results of its cost of capital methodology?
19. What other key metrics used by financial market participants to determine whether financial markets conditions are or are not “normal” might the Board consider?

Appendix A – Summary of Stakeholder Options in Response to the Board's March 16, 2009 Letter

Participant	Key Messages	Recommended Values (if explicit)		
		ROE	S/T Debt	L/T Debt
Canadian Manufacturers & Exporters	• Current values produced by the adjustment mechanism remain appropriate for rates effective May 1, 2009	8.01%	1.33%	7.62%
Chatham-Kent Hydro	• ROE: add 250 bp to L/T Debt rate to derive ROE (7.62% + 2.5%). Historically, spread has averaged 250 bp. • A change to the formula may be necessary if the resulting ROE calculation results in a spread between LT debt and ROE that is unreasonable or does not meet the FRS.	10.12%	2.50%	7.62%
Coalition of Large Distributors	• ROE: adjust ROE with change in spread between government and corporate since inception of method ((9.35* + 0.75*(3.714% - 5.5%) + (2.85 %- (6.90% - 5.5%))). • ST Debt rate: increase spread to 175 bp (1.08% + 175 bp).	9.46%	2.83%	7.62%
Consumers Council of Canada	• The values produced by the Board's cost of capital methodology are reasonable and do not need to be changed. • Any adjustments should be made pursuant to a hearing.	8.01%	1.33%	7.62%
Electricity Distributors Association	• ST Debt rate: increase spread to 175 bp (1.08% + 175 bp). • ROE: Substitute the deemed utility debt rate for the long-term GOC bond yield in the adjustment formula (9.35% + 75% (7.62% – 6.26%)).	10.37%	2.83%	
Enbridge Gas Distribution Inc.	• ROE: Add 200 - 300 bp to ROE as interim measure and then have a comprehensive proceeding. • In addition to the 200 - 300 bp, for a return to meet the FRS requirement, the ROE level would also include compensatory adjustment to reflect difference in equity ratio with US comparisons (50%).	10% to 13%		
Energy Probe Research Foundation	• The values produced by the Board's Cost of Capital Methodology and the relationships between them are reasonable.	8.01%	1.33%	7.62%
Great Lakes Power Transmission LP	• ROE: Apply coefficient of 0.472 instead of 0.75; substitute 30-yr Government bond for 2008; and add an incremental risk premium to reflect the return required to compensate investors for risks posed by increased stock market volatility (9.35%+0.472*(4.3%-5.5%))+((50%)*1.5%).	9.53%		
Hydro One Networks Inc.	• ROE: add no less than 200 bp as interim measure to bridge gap. If formula were to be changed, substitute a corporate utility bond for the Canada long bond; and reduce the 0.75 elasticity factor to 0.50. • S/T Debt rate: raise spread over BA rate to 175 basis points for the most creditworthy utilities, to 250 basis points for utilities below the A-rated level.	10.01%	2.83% to 3.58%	

Participant	Key Messages	Recommended Values (if explicit)		
		ROE	S/T Debt	L/T Debt
Industrial Gas Users Association (IGUA)	• The current economic and financial conditions are clearly atypical, and likely transitory. • Any change in the Board's basic approach to setting cost of capital in response to the current financial markets is unnecessary.	8.01%	1.33%	7.62%
London Property Management Association	• If the Board is considering changes the cost of capital parameters, 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. Deemed S/T debt thickness (4%) is too low.	8.01%		
Ontario Power Generation	• ROE: A "market adjustment" (MA) factor should be added to the current formula pending the outcome of the generic review proceeding. MA would directionally maintain the relationship between the utility cost of L/T debt and the ROE. Proposed MA will decrease with the gradual return to more normal market conditions (9.35% + .75 (3.714% - 5.50%) + 0.75(3.91% - 1.64%)).	9.71% (illustra-tive)		
Power Workers' Union	• Options include: retain last years parameter values; adjust ERP up; adjust spread used to calculate S/T debt rate up. Dx will file comments to help Board to determine most appropriate option. • Consider Dx size and load concentration in forming view about reasonableness of the parameter values in the context of business risks faced by each Dx. Also consider: FRS; increasing need of many Dx for resources as a result of increased work programs; and developments in other Canadian jurisdictions.	Not Explicit		
Scotia Capital - Stephen Dafoe	• ROE: Two suggestions: (1) adopt implied ROE in TQM decision, or (2) add 247 bp to ROE (247 is last years spread). • S/T Debt rate: current cost of short-term debt is something in the range of Canadian BA rate plus 200 bps to 225 bps, for single-"A" category rated utilities. Many Dx may have ratings lower than single-"A", and could face higher short term borrowing costs.	9.8% to 10.1%	3.08% to 3.33%	
Sun Life Financial	• 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 markets may be acting outside of realm of reasonableness. • Perhaps allow companies to determine their own-mix of short-term and long-term debt.	Not Explicit		

Participant	Key Messages	Recommended Values (if explicit)		
		ROE	S/T Debt	L/T Debt
School Energy Coalition	• The Board's options are: apply the current methodology without alteration; use 2008 values; set values on a utility specific basis based on evidence filed in each utility's rate case; or adopt an arbitrary set of values for 2009. Recommend first option. • The ROE net of inflation has changed negligibly over the last year, suggesting that the narrowing of the gap between long term debt and equity rates in the formula is not the result of an ROE problem.	8.01%		
Union Gas	• ROE: Implement an adjustment for all Ontario regulated utilities as soon as possible. The adjustment should be in the range of 150 – 250 bps (ROE differential between Canada and the U.S. noted in Concentric report).	9.51% to 10.51%		
Vulnerable Energy Consumer's Coalition (VECC)	• No adjustments are required to the Board's approach to Cost of Capital at this time. • ROE values and short-term debt values are reasonable.	8.01%	1.33%	7.62%

Appendix B - References

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