

IN THE MATTER of the *Ontario Energy Board Act 1998*, S.O. 1998, c.15, Sch. B;

AND IN THE MATTER OF a consultation by the Ontario Energy Board with respect to the cost of capital for electricity distributors.

**SUBMISSIONS
OF THE
SCHOOL ENERGY COALITION**

1. On July 30, 2009 the Board issued a letter (the “Notice”) to stakeholders posing a series of 19 questions relating to the cost of capital for electricity distribution companies, and specifically relating to whether the current methodology for determining cost of capital is sufficiently robust to be reliable in unusual economic circumstances. The Notice invited stakeholders to comment on the questions. In a letter dated August 20, 2009, responding to a query from the Consumers Council of Canada, the Board added further clarifications with respect to this consultation.
2. These are the submissions of the School Energy Coalition. Our submissions follow the questions and the headings set out in the Board’s “Issues for Discussion” document attached to the Notice.
3. We note that, while we are providing our preliminary views on the questions posed by the Board, these comments precede a stakeholder conference starting September 21, 2009, at which a number of parties, and their respective expert advisors, will be providing their views and discussing their differences. We expect that our views will be informed by the discussion at the stakeholder conference, and we would anticipate that after having the benefit of what we learn at the stakeholder conference, we will be in a better position to provide thoughtful input to the Board on many of these issues.
4. We also note that the School Energy Coalition made submissions on April 16, 2009 relating to a previous phase of this consultation. In that phase, the fundamental question was whether the Board should suspend or adjust the application of its cost of capital rules for electricity distributors relative to their 2009 rates, and we approached our comments with that in mind. While some of our comments in those submissions may be relevant to the questions currently posted in the Notice, they were mostly about a more narrow issue.

Fair Return Standard

5. ***Question 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?***
6. The Board currently uses the Equity Risk Premium approach in establishing the comparable investment standard for return on equity. The intention of ERP is to determine from empirical data what the market thinks is the correct equity return for a given risk level. There seems to be a general consensus that, if the correct data is looked at in the correct way, it is possible to discern the view of the market as to the correct equity return for utilities. But the devil is clearly in the details, and the Board has had on a number of occasions battles of the experts, all employing their own approach to ERP to reach wildly different numbers for ROE.
7. The Board is now also using external data to identify the appropriate interest rates for short term and long term debt, again on the assumption that if the data is looked at in the correct manner, an empirically justifiable answer can be determined. This has also been the subject of considerable debate.
8. In our view, the existence of a single formula for each of the components of the cost of capital is an efficient approach to determining the comparable investment standard for the large number of rate regulated entities for which the Board is responsible. Having debates about these issues on a regular basis is not practical, and in our view not necessary.
9. That having been said, when the components of cost of capital are being “rebased” – that is, re-set based on raw data, rather than based on a formula from a previous year – it is appropriate for the Board to consider as many categories of evidence as possible is calibrating the results of the ERP/debt review and ensuring that they fairly reflect the fair return standard.
10. Thus, we would propose that the Board, in reviewing cost of capital, would hear the evidence of the various experts with their different views of the ERP result, for example, but would also look at other ways in which the market directly speaks about returns, e.g.:
 - (a) The expected returns of pension funds, insurance companies, and other holders of large, long-term portfolios, on their various categories of investments. These investors apply a lot of rigour to their assumptions going forward, and have many of the types of investments the Board is considering to be comparable. For example, if a pension fund’s actuarial calculation assumes that investment grade long term debt will yield 5.5%, the Board should be doubtful if some experts are proposing a “market-driven” calculation of 7.2%. Similarly, if low risk equity assumptions by pension plans are 8% going forward, a result from the ERP test done by a utility expert of 11% should give the Board cause to ask lots of questions.

(b) The purchase price premiums paid by acquirers for regulated distribution utilities. If an acquirer, knowing that the ROE is 8.01% for a target company, is willing to pay a substantial premium for its purchase, then either there will be large economies of scale (which so far have not been materializing in the Ontario market) or this is evidence that the regulated returns are generous. The converse may in some circumstances also be true.

(c) Sometimes governments develop financing programs, like Infrastructure Ontario, which are credible evidence of at least the government's view of market returns for particular investments. If the government is lending to electricity distributors at 6%, it is hard to argue that affiliate debt at 7.62% is at market rates.

(d) Often utilities in their rate applications file (or would file, if asked) information on the financing terms offered to them by banks and other commercial lenders. Since lenders in this category are likely to be competitive each with the other, their quotes should be reflective of market debt rates for given terms.

None of the above examples of information sources is, in our view, sufficiently pervasive or sufficiently rigorous to be the primary basis for ROE or debt rates. However, they – and many other examples – are ways in which the market communicates the returns for investments comparable to utility investments. These sources are therefore useful in testing whether the results of various ERP or other market studies of cost of capital are realistic.

11. Once the Board determines a rate or rates that meet the comparable investment standard, we are less clear on what either the financial integrity standard or the capital attraction standard add to the analysis.
12. With respect to the financial integrity standard, it is difficult to imagine a circumstance in which the market allows a cost of capital of X, but that cost of capital is insufficient to maintain the financial integrity of the enterprise. Markets generally seek returns for any given risk that ensure as much as possible the investors will not lose their money. Any situation in which the market established a return, and the investee could not maintain its financial integrity, would seem to us to be highly unusual.
13. We would therefore invite the various experts for the parties to assist us, and the other parties and the Board, to understand the circumstances in which the financial integrity test adds something to the comparable investment test. It is only once that is understood that the role, and therefore structure, of any method for applying this test can be assessed.
14. We have a slightly different problem with the capital attraction standard. Very few Ontario rate-regulated entities actually seek capital in the public markets. For those that do – Enbridge, Union, Fortis, and a few others – there is no evidence of which we are

aware that at current rates any of them have any difficulty in attracting capital. While the situation is complicated by the fact that none of them are purely rate-regulated entities (the more complex parent companies engage the public markets), there is sufficient variety that we would have expected to see someone have some problems getting money if current returns are too low.

15. For most electricity distributors, their biggest problem with attracting capital is that their capital comes from their municipal shareholders, who sometimes are – or perceive themselves to be – capital constrained. That is, any difficulty in attracting funds is not because the rate of return on debt or equity is too low, but rather that the sole source of the money simply doesn't have any. This is a “have your cake and eat it too” problem. Municipalities that own LDCs are entitled to market rates of return, as the fair return standard implies, but for those market returns the shareholder is supposed to provide all needed capital. If the shareholder is not willing to provide the capital at any price, one must question whether they are entitled to market rates of return at all.
16. This is particularly problematic because municipal shareholders often also hold all the debt of the LDC, at returns for that debt that far exceed the municipality's cost of funds. Shareholders that “cannot” provide additional equity because of tight budgets, could in some cases easily solve the problem by replacing the LDC's affiliate debt with lower rate bank debt, and that would free up cash for the shareholder to invest in equity.
17. Given these facts, it appears to us that there is no evidence any Ontario rate-regulated entities are having difficulty attracting capital due to under-market rates of returns.
18. We would be interested in hearing from the various experts on what evidence the Board could use to determine whether utilities are actually having problems attracting capital, and if so the reasons for those problems.
19. ***Question 2: Is the current deemed capital structure appropriate? If not, what alternative(s) might the Board consider?***
20. As the Board has noted in previous proceedings, capital structure and cost of capital are two parts of an integrated whole. If the Board is going to consider changes to any of the components of cost of capital, all should be considered, and that would include capital structure. For the reasons we note below, we do not believe an overall review of the cost of capital is an urgent need, but when the appropriate time comes to consider evidence on this area, all components should be considered.
21. ***Question 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?***

22. In our submission, the management of a competitive business, if acting prudently, would seek the lowest cost capital on reasonable terms. This is the test that should be applied to LDCs. We continue to have difficulty understanding why it would be OK for a utility to borrow from its sole shareholder at 7.5% when its local bank will give it the same money at 6%. The Board's role as regulator of these monopoly franchises is to be a proxy for the competitive markets. In a competitive market, if a company elects to use more expensive capital for no good business reason, that company makes less money. That discipline, which is imposed by the market, is what the Board does as regulator. We believe the Board should expect every rate application to include evidence that management has sought the lowest cost capital available. In this regard, we do not see the service of lending as materially different from the service of renting office space. If it comes from an affiliate, the onus should be on the applicant to demonstrate that they cannot get the same thing cheaper on the open market – whether it is office space or long term debt.
23. For this reason, we do not in general think that how an LDC chooses to finance itself is a key part of the equation. Cost of capital parameters values only really matter when the LDC has chosen not to seek market capital, whether that market capital is from the public markets, a bank, or Infrastructure Ontario. The utility that has arms-length debt is entitled to the presumption, absent compelling evidence to the contrary, that the arms-length debt is at market rates. The Board's deemed rates are not relevant to this situation. It is only when the LDC decides that it will get its money from an affiliate, and not at market rates, that the Board's parameter value matters.
24. We believe that the optimum result is that each utility must demonstrate, if they want to rely on affiliate debt, that they tried to get money cheaper, and were unable to do so. In addition to this, the Board may wish to consider whether affiliate debt rates should be subject to some further limits to incent beneficial behaviour. It is in the interest of the sector for more utilities to get market-based debt, for example from the public markets or banks. If the Board were to impose a "penalty" rate on affiliate debt, that would encourage more LDCs to access market debt. By way of example, the Board could establish a policy that affiliate long term debt is always at the current long Canada rate, unless the individual LDC can establish through bank or other market financing offers that some higher rate is what is actually available to them in the market. An LDC that goes to its bank and gets a term sheet for 6% long term debt should be able to choose to take those identical terms from their shareholder. If they are not willing to at least try to get the best rate possible, then it is not appropriate for the default affiliate debt rate to be overly attractive.

Use of US Comparables

25. *Question 4: Does the analysis in the Concentric Report provide a reasonable foundation for satisfying the comparable investment standard?*

26. We do not believe that the analysis by Concentric Energy Advisors is a useful document, for several reasons, including the following:
- (a) There is ample evidence that the current unusual economic situation has played out very differently in Canada and the United States. This is in part because of endemic government deficits in the US, in part because of tighter bank regulation in Canada, and in part because of our more resource-driven economy. If the Board is considering robustness of its method, that last thing it would want to do right now is use US data, which today reflects much different economic conditions than we have in this country.
 - (b) If cross-border capital attraction is to be considered for ratemaking purposes, then the impact of the changing relationship between the Canadian and the US dollar, and the differing levels of inflation in each country, have to be accounted for. If they are not accounted for because it is assumed that domestic investors on each side of the border invest in their own currency, then the cost of capital in each country is logically only relevant to domestic investments in that country.
 - (c) There is no evidence that Ontario electricity distributors raise money in the US. The cross-border argument only makes sense if the capital pools that companies are calling on ignore the border. There is no evidence that is true with respect to LDCs.
 - (d) If US comparables are regulated entities, the comparison is by necessity not a comparison of market rates, but is rather a comparison of regulatory attitudes. Rates of return for those entities are not set by the markets, but by regulators. To use US data as comparables, the Board would have to be satisfied that US regulators exhibit the same attitude to return, to risk, and all other material aspects of a distributor's business, for the returns they have ordered to be useful. The Board knows well that many US regulators have different views of appropriate returns, in some cases with a very laissez-faire approach, or with multi-year rates, or many other variants.
 - (e) If Canadian returns were so below market as is implied by the Canada/US comparison, the Board should anticipate that US owners of Canadian regulated entities would be divesting themselves of these underperforming assets to new, Canadian owners. To the best of our knowledge, there is no evidence of this in the last ten years.
27. ***Question 5: If not, what might the Board use as a comparator group?***
28. We are interested in looking at the views of the various experts before commenting on this question.
29. ***Question 6: Were the Board to only consider the use of Canadian utilities as a comparator group, is there an issue of circularity, given that the ROEs of these utilities are, and have been, established by a mechanism similar to that currently used by the Board?***

30. As noted above, any time the comparator group is made up of rate-regulated entities, the empirically-based cost of capital methods break down. Those methods rely for their credibility on the theory that investors in the market set the correct rates for various risks, and all the regulator needs to do is tease those market standards out from the raw data. If the comparator group is made up of rate-regulated entities, the market has not spoken, and the results are not empirical at all (except to the extent that they empirically measure the actions of other regulators). In our view, it doesn't matter what mechanism is used. It matters, instead, whether the market or a regulator sets the rates.

ERP Test

31. *Question 7: Should the ERP approach be reset given that when the formula was first established the reference bond rate was 8.75%?*
32. Yes, because the rate was set some years ago, not because the bond rate has changed. See our discussion under questions 8 and 9 below.
33. *Question 8: Should be 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?*
34. Yes. The reason that the approach must be reset is not only that the initial number might be wrong (although that too would be dealt with in any "rebasings" of the rate), but because the adjustment formula is not perfect.
35. It is important to distinguish between the uncertainties surrounding the original setting of the ROE, and those around the new ROE set each year under the formula. In the original setting of the rate, the Board looks at the evidence before it, considers the duelling expert reports, and uses its best judgment to get a fair rate. This is not science, and the Board, despite using its best judgment, can only be confident that it is close to the right number. Further, the Board's initial number assumes both that the current year is a "normal" year in the capital markets (see our later comments on "normal" years), and the historical data set applied to get the rate is perfectly representative of the short term future. Neither of these is likely to be exactly true.
36. Then, once the Board has a starting point that is close to being right, it applies a formula that assumes a robust relationship between ROE and long Canadas. That relationship is also not perfect, so over time the adjustments may or may not produce results that maintain constant reliability.
37. The combination of the starting point being close but not perfect, and the adjustment formula each year being close but not perfect, is that over time the accuracy of the result may be more in doubt. The solution to that is a regular reset, much like the Board does in rebasing rates using cost of service, and then allowing a formula for an interim period until the next rebasing.

38. *Question 9: How might the Board address the potential issues arising from the application of the current methodology as a single, point-in-time calculation?*
39. There are two components to this question.
40. At the methodological level, the question asks whether a calculation done once, in February, can be relied on for an entire year. This is a balancing question. If the Board instead used its current methodology, but monthly for each of twelve months, and then averaged the results to get the number utilities should use for the next twelve months, there would be an element of smoothing of the market's ups and downs, and the Board would avoid the errors that could arise if the one calculation month of the year is particularly unusual. That may be the case, for example, in 2009. On the other hand, if a series of calculations is averaged to obtain smoothing, one result is that some of the base data being used is twelve months older than would be the case with the current approach. Arguably, older data is less relevant to the fair return this year than the most recent data. What the Board must do is balance the need for the most current market information, and the need to avoid anomalous timing, and those two goals are inherently in conflict.
41. At a more conceptual level, this is about whether the current methodology is sometimes just "wrong". This is really an inherent weakness of using formulae to set rates, and is a problem shared with many other aspects of efficient ratemaking.
42. Two examples of formula-based ratemaking are IRM and weather normalization. ROE works in a similar manner to these. That is, the Board establishes a formula that, if you use it year after year, will on average produce robust results. There is no guarantee that, in any given period, the results are correct. What is robust is the pattern of results over a number of time periods.
43. So, when a gas utility forecasts weather, and later normalizes for it, it uses a formula that is based on a historical data series, as if the next year will be the average or trend of the historical data. It never is. No-one expects it to be. What everyone expects is that, over time, the formula will on average track closely to reality. Variances in any given year are irrelevant, since each year is not supposed to be right.
44. Similarly, the IRM formula assumes that a utility will need an additional, say, 1.3% per year added to rates to cover its costs. Most years, this is not correct. Most years, the utility's costs will be less or more than the revenue generated by the formula. Some of that will be because of management controls, and some of that is because of the natural ebb and flow of cost pressures in any business. This year the union contract is up for renewal, so the cost increase is higher. Next year is a very hot summer, so revenues go up faster than costs. The IRM system does not need to be right every year to be effective. It does need to be right on average.
45. In our submission, ROE works much the same way. It is a formula, and you can't ask a market formula to be right all the time. The markets do not move in a formulaic way. (If

they did, we would all be rich.) The markets have unpredictability, perhaps even some randomness, in any given period. What the Board knows, however, is that over time the formula will produce answers that on average are fair.

46. Of course, this implies that the right of a utility to earn a fair return is not absolute in any year, but only over time. If this is a problem for regulated entities, there is only one solution: cost of capital has to be established, on hard evidence, for every utility in every year. That is, if we can't allow the ROE methodology to be wrong in any given period, then we can't have a formulaic approach. This is, of course, impractical, but it is the inevitable result of complaining that the methodology produces the wrong result "this year". We note that, if the right is absolute in a given year, then that means IRM is no longer possible either, since that also relies on averages.
47. We note that this is different from saying that the formula is not robust. Robust does not mean that it is right all the time. Robust means that as market conditions change, the formula continues to be right on average. If that is not the case – if the formula never works when there is an inverted yield curve, for example – then the solution is to find out why the formula doesn't work in those circumstances, and fix the formula. But if the formula produces non-intuitive results in one year, that is not by itself reason to change anything. That is just a normal phenomenon the Board should expect from formula-based rates from time to time.
48. ***Question 10: How should the Board establish the initial ROE for the purposes of resetting the methodology?***
49. In terms of the types of things the Board should look at in "rebasings" ROE, please see our answer to Question 1.
50. However, we also want to add that at a more basic level this is an issue in which it is important for the Board to consider only evidence properly put before it in a SPPA-compliant hearing, with all sides represented and full testing of the evidence.
51. The Board will be aware that we do not always cry out for a formal hearing on issues. There are many situations in which the Board has used policy-based approaches, including consultations, working groups, and the like, to get to good answers that inform the ratemaking process. This is one of the advantages that regulatory tribunals have over courts.
52. Cost of capital is not like that. The fair return standard requires that the Board identify as a matter of fact the comparable returns for a given risk. While the facts are often founded on the opinions of experts in the field, the fundamental nature of the inquiry is fact-finding, and it is one in which there are widely and intensely diverging views on how those facts can be identified and/or calculated. Deciding what things are factually correct is exactly the category of dispute in which filing of rigorous evidence, and testing of that evidence through cross-examination, is most necessary. Add to that the fact that a change

in ROE or deemed debt rate is, in this province, an issue with many hundreds of millions of annual rate dollars riding on it, and it is, in our submission, essential that the Board's decision be the result of a full hearing with tested evidence.

Long Bonds Base

53. *Question 11: Is the government (of Canada) bond yield the appropriate base upon which to begin the return on equity calculation?*
54. It is fundamental to the concept of an equity risk premium calculation that you have as a starting point a risk free rate. We have not seen any alternatives to the long Canada rate as a risk-free starting point that both reflect the basic concept, and are readily available at all times.
55. *Question 12: What is the relationship between corporate bond yields and the corporate cost of equity? Is this relationship sustainable?*
56. We have not seen any evidence, in this proceeding or any other, that there is a long term, robust relationship between corporate bond yields and corporate equity returns.
57. Such a relationship does not seem intuitive to us. Although both will be influenced in much the same way by inflation, and in the long term equity will have higher returns because it is higher risk, the spread between them does not appear to us to be a constant or predictable amount. Bond yields and equity yields often move in opposite directions as investors move between debt and equity markets, and perceptions of future returns, future risks, and future inflation change.
58. That having been said, we believe it would be useful if some of the expert witnesses bring before the Board any authoritative academic research that has been done showing a long term and predictable relationship of this type, to see whether there is something that can give the Board some guidance in this area.

Calculation of ERP

59. *Question 13: Does the current approach used by the Board to calculate the ERP remain appropriate? If not, how should the ERP be calculated?*
60. We have reviewed the six bullets in the preamble to this question, all of which appear to be ways that the utilities believe they can justify higher ROE. All of these adjustment factors and similar ways of bumping up the ROE number suffer from a common problem: the calculation of ERP is a known methodology. You can't just adjust the result to get something more in tune with what you like. If you do, then the methodology is no longer internally consistent or methodologically sound.
61. For example:

(a) An increase to ROE to reflect stock market volatility implies that the historical data on which the original ROE was set did not contain any volatile years. If it didn't, then it is never been right, because any reasonable data series should include both volatile and stable years. If the data series does include both, then the methodology already gives due weight to volatility, and more would be double counting.

(b) Adjusting the ROE for the spread between debt (whether the long-term debt rate, or the market cost of debt) and ROE cuts both ways. You can assume that the debt rate is right, and increase the ROE to maintain the appropriate spread. Or, you can assume that the ROE is right, and decrease the debt rate to maintain that spread. Unless there is compelling evidence that only one of these answers could be right, this "adjustment" is simply not viable.

(c) Including an ROE differential for US – Canada differences is also a non-starter. If the Board uses the correct comparators, the result is correct. If the comparators are wrong (we disagree – see our comments on Question 4 above), the solution is to redo the calculation with the right comparators. An after the fact adjustment is never justified if the underlying methodology is correct, and if the underlying methodology is not correct, the best response is to fix it, not adjust for it.

(d) Changing the formula to use the deemed utility rate instead of the long Canada rate has no empirical foundation whatsoever. The theory underlying the formula is that as the risk-free rate changes, ROE changes in a predictable way over time. There is no evidence that changes in the deemed utility rate – already a problematic number – imply predictable changes in ROE over time.

(e) The long Canada to corporate bond spread changes over time, but we have some difficulty understanding why changes in that spread would influence the ROE. If the correct inference is that changes in long Canada rates imply changes in ROE in a predictable way, that is the formula the Board should use. Corporate bond rates in that situation are irrelevant. As soon as you posit that corporate bond rates are relevant, that can only be true if there is a predictable relationship between corporate bond rates and ROE, in which case long Canada rates would be irrelevant. For the same reasons set forth in (d) above, this cannot be right.

62. In our submission, none of the proposals to tweak the ERP methodology have any merit. They appear to be nothing more than weak rationalizations for higher ROE.

Dead Band/Trigger

63. *Question 14: Should the Board adopt a dead band? If so, what should the range of the dead band be?*
64. The purpose of a dead band is generally to allow relatively non-material variations in a variable without action, rather than go to the time, trouble and expense of adjusting rates

or other amounts to reflect the change. For example, a dead band on earnings sharing is intended to ensure that sharing is not required for the normal minor forecast errors inherent in rate setting on a forward test year basis.

65. In contrast, ROE is a formula, and the math is not really complicated. Since ROE is recalculated only at a time when rates are being changed anyway, there is no additional work to be done, and the calculation is relatively trivial in any case. Thus, we don't see the value of a dead band in this context.
66. ***Question 15: Should the Board adopt trigger mechanism(s)? If so, how often should the Board review the methodology?***
67. We do not believe that a trigger mechanism is required or useful if the Board regularly resets the ERP base number in a formal review. A five to eight year cycle, for example, would not give enough opportunity for the formula to go far offside in relative to the fair return standard, and there is no reason to think that any variance from the "correct" figure would be biased one way or the other. With a regular reset, it would appear to us that the long term ROE for any regulated utility in Ontario would be quite accurate, and there is no need to have a trigger mechanism for shorter term resetting of the rates.
68. We note that the idea of having some form of trigger mechanism to test whether the cost of capital numbers are "still good" is inherently attractive. Not only does it appear to provide a safety net in case things start going horribly awry, but it has as an analogy the "off-ramp" in IRM, which many parties accept and even prefer. It is tempting to say "Why not?", and build in a benchmark or test that flags to the Board that one or more of the cost of capital numbers is wonky.
69. For example, the Board could establish a measure of pension fund equity return assumptions, and test the calculated ROE based on the ERP methodology each year against the pension fund calculations. If the difference is 200 basis points or more, that would then trigger a detailed review of the cost of capital parameter values. This is not an unreasonable approach, particularly if (as the Board does with IRM) the trigger level implies such a large differential that it won't be happening all the time.
70. But there are problems with this.
71. First, it is not clear how you resolve the difference between the basic calculation and the benchmark. Do you re-set the rate using the ERP methodology? If so, it is unlikely to get very close to the benchmark, if there was that much difference, because ERP still uses an historical time series of data. If not that, what other way is there of resolving the difference?
72. Second, ROE discussions are time consuming and, with all the experts, extremely expensive. If the trigger mechanism does kick in, the impact is a very expensive process.

73. Given these problems, it may be better to leave the concept of a “trigger” to the collective judgment of the Board. This year, the cost of capital numbers looked funny. The Board didn’t need a trigger mechanism. It saw a possible problem, and is moving to address it. While the Board may ultimately conclude that no change is required, as we are proposing (because in the long term the methodology is still producing good results on average), no formula was required for the Board to consider the issues. All that was needed was that the Board exercise its existing right to inquire into any aspect of the regulatory process that may not be working the way it should.

Other Tests

74. *Question 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)?*
75. See our previous discussion.
76. *Question 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?*
77. In our view, market conditions are always having an effect on the variables, and that is a normal aspect of applying a formula to produce a predicated result. While it is not possible to say categorically that a specific set of market conditions can never be so anomalous as to warrant intervention, a robust methodology should be relied on year to year as long as in the long term the results are correct.

Additional Indicators

78. *Question 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?*
79. We have seen no evidence that any of the proposed “indicators” are in fact true for distributors in Ontario.
80. We are struck by the fact that these things, if they were happening, are all the kind of risks that private sector companies have to deal with on a routine basis. It is part of being in a competitive financial marketplace. Part of the return that investors get in a competitive market compensates them for the fact that the market for capital is not 100% stable. So, the fact that interest rates might go up or down, or that equity valuations can go up or down, are all perfectly normal events that investors expect and price into returns. By necessary implication, the ERP methodology, which tracks historical data, must be presumed (absent any evidence of data series bias) to include the value of this risk in the historical risk premiums paid to investors.

81. *Question 19: What other key metrics used by financial market participants to determine whether financial markets are not “normal” might the Board consider?*
82. As we have indicated previously, we generally reject the notion that there is such a thing as a normal financial market. Financial markets are never “normal”. There is always a degree of unpredictability, and financial market conditions at any given point in time are not the same as a month previously, a year previously, or a decade previously. The data series will reflect this.
83. By way of example, if the ROE is set in a hearing in 2010 based on the ERP methodology, the historical data set will include both the stock market run up, and bust, around the 1999-2001 period. Those years were certainly not normal to anyone who lived through them, but when the Board resets ROE those highs and lows (in risk perception and spreads) will be included, along with many years that were much more boring.

Conclusion

84. We hope our input has been of assistance to the Board, and we look forward to the stakeholder conference where further discussion should assist all parties in refining and filling out their views on the issues.
85. The School Energy Coalition hereby requests that the Board order payment of our reasonably incurred costs in connection with our participation in this process. It is submitted that the School Energy Coalition has participated responsibly in all aspects of the process, in a manner designed to assist the Board as efficiently as possible.

Respectfully submitted on behalf of the School Energy Coalition this 8th day of September, 2009.

SHIBLEY RIGHTON LLP

Per: _____


Jay Shepherd