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VIA FAX

Ms. Kirsten Walli
Board Secretary
Ontario Energy Board
P.O. Box 2319
27th Floor, 2300 Yonge Street
Toronto ON M4P 1E4

Ms. Walli:

Re: PWU Comments on the Cost of Capital Review – Issues List (EB-2009-0084)

The Power Workers' Union ("PWU") represents a large portion of the employees working in Ontario's electricity industry. Attached please find a list of PWU employers.

The PWU is committed to participating in regulatory consultations and proceedings to contribute to the development of regulatory direction and policy that ensures ongoing service reliability, quality and safety. To this end, attached please find the PWU's comments on the Cost of Capital Review – Issues List (EB-2009-0084).

We hope you will find the PWU's comments useful.

Yours very truly,
PALIARE ROLAND ROSENBERG ROTHSTEIN LLP

Richard P. Stephenson

RPS:jr

encl.
cc: John Sprackett
Judy Kwik

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List of PWU Employers

AMEC Nuclear Safety Solutions
Atomic Energy of Canada Limited (Chalk River Laboratories)
BPC District Energy Investments Limited Partnership
Brant County Power Incorporated
Brighton Beach Power Limited
Brookfield Power – Lake Superior Power
Brookfield Power – Mississagi Power Trust
Bruce Power Inc.
Capital Power Corporation Calstock Power Plant
Capital Power Corporation Kapuskasing Power Plant
Capital Power Corporation Nipigon Power Plant
Capital Power Corporation Tunis Power Plant
Coor Nuclear Services
Corporation of the City of Dryden – Dryden Municipal Telephone
Corporation of the County of Brant, The
Coulter Water Meter Service Inc.
CRU Solutions Inc.
Ecaliber (Canada)
Electrical Safety Authority
Erie Thames Services and Powerlines
ES Fox
Great Lakes Power Limited
Grimsby Power Incorporated
Halton Hills Hydro Inc.
Hydro One Inc.
Independent Electricity System Operator
Inergi LP
Innisfil Hydro Distribution Systems Limited
Kenora Hydro Electric Corporation Ltd.
Kincardine Cable TV Ltd.
Kinectrics Inc.
Kitchener-Wilmot Hydro Inc.
London Hydro Corporation
Middlesex Power Distribution Corporation
Milton Hydro Distribution Inc.
New Horizon System Solutions
Newmarket Hydro Ltd.
Norfolk Power Distribution Inc.
Nuclear Waste Management Organization
Ontario Power Generation Inc.
Orangeville Hydro Limited
Portlands Energy Centre
PowerStream
PUC Services
Sioux Lookout Hydro Inc.
Sodexho Canada Ltd.
TransAlta Energy Corporation - O.H.S.C. Ottawa
Vertex Customer Management (Canada) Limited
Whitby Hydro Energy Services Corporation

Consultation on Cost of Capital – Issues List

EB-2009-0084

Comments of the Power Workers' Union

1. BACKGROUND

On June 18, 2009, the Ontario Energy Board (the "OEB" or "Board") issued a letter stating it was proceeding with a review of its policy regarding the cost of capital, and that it anticipated that any changes to the policy made as a result of this review will apply to the setting of rates for the 2010 rate year. The Board further stated that it would prepare an issues list that would form the basis of its review, and that the issues list would take into account the stakeholder comments received in response to the Board's March 16, 2009 letter and other information that the Board considered relevant.

On July 30, 2009 the Board issued a letter to which the issues list was attached. The Board expressed its view that the Fair Return Standard ("FRS") constitutes the over-arching principle for setting the cost of capital. The Board noted the following articulation of FRS by the National Energy Board ("NEB") in its RH-2-2004 decision as consistent with previous OEB determinations:

> **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 Board also concluded that the Equity Risk Premium ("ERP") approach remains the most appropriate formula-based approach for determining the fair rate of return on common equity ("ROE") in the current circumstances. The Board adopted a two phase process to calculate the ROE: an initial ROE setup that establishes a just and reasonable ROE based on the ERP, and an ongoing adjustment mechanism that automatically adjusts the initial ROE to account for changes in long-term Canada Bond yield expectations.

The Board identified three areas where further information was 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 PWU appreciates the opportunity to comment on the issues list. The PWU's comments below are limited to issues that are of concern to the PWU.

2. PWU COMMENTS

2. *Is the current deemed capital structure appropriate? If not, what alternative(s) might the Board consider?*

   The PWU reiterates its position previously forwarded in submissions to the Board that the Board should allow a higher deemed equity component for smaller distributors who may be challenged in raising capital. This challenge becomes even greater in the context of fulfilling new capital-intensive requirements, including additional cost responsibilities for connecting generation and smart grid investments.

In prescribing a uniform deemed capital structure, the Board stated that differences would present a barrier to consolidation, that one quarter of smaller distributors carried more than 50% debt, and that ratepayers of smaller distributors should not pay higher rates to support a higher equity component.[1]

The PWU submits there is little evidence to support these concerns at this time. There has been only limited consolidation in the sector since the Board prescribed a uniform capital structure, and in those cases where cost savings were quantified, they outweighed the impact of differing capital structures. The actual debt load of smaller distributors should not be seen as indicative of actual debt capacity, when most of this debt is still held by shareholders. Finally, a comparison of distribution rates charged by smaller distributors under different capital structures would reveal that ratepayers were not generally disadvantaged relative to the customers of larger distributors.

The PWU submits that it is entirely appropriate for the Board to reconsider this question in this consultation, since both the capital structure and ROE have a direct impact on the overall rate of return and thus on achieving the FRS.

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

Yes, the analysis in the Concentric Report provides a reasonable foundation for satisfying the comparable investment standard. The analysis identifies similarities and differences between Ontario and US utilities, concluding that the difference in the allowed returns is not fully explained by factors other than the formula-based ROE methodology. Several studies have concluded that the basic sources of risk (regulatory, business and financial) are comparable; thus any related differences are not sufficient to explain the

[1] Ontario Energy Board, Report of the Board on Cost of Capital and 2nd Generation Incentive Regulation for Ontario's Electricity Distributors, December 20, 2006

disparity in allowed ROE between US and Canadian utilities. Consequently, the formula-based approach should be subject to scrutiny. While the report cited in the above question considers natural gas utilities, Concentric made similar conclusions with respect to electric utilities,[2] as did a study commissioned by the Canadian Gas Association.[3] The determination of a "fair" return is not just a Canadian market issue; it is a North American, even a global issue. The PWU considers similarities in terms of risks, regulatory institutions and sources of capital to be more relevant than nationality. Thus, the pool of comparators should include both US and Canadian utilities.

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?*

   Yes, given that the ROE's of the Canadian utilities are, and have been established by a similar mechanism to that currently used by the Board; the PWU believes that there will be a circularity issue with the Board's use of the Canadian utilities as a comparator group. Accordingly the use of Canadian utilities only as a comparator group would not be appropriate, and US utilities should also be included. While recent decisions of the NEB and the Alberta Energy and Utilities Board departed from a formula-based approach which failed to produce a rate of return commensurate with the risks faced by utilities, these instances have been isolated and thus do not provide sufficient mitigation to the issue of circularity.

7. *Should the ERP approach be reset given that when the formula was first established the reference bond rate was 8.75%?*

   Yes. The PWU submits that a new reference rate is appropriate given the fundamental changes in the economic environment since the rate was

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[2] Concentric Energy Advisors, A Comparative Analysis of Return on Equity for Electric Utilities, June 2008 (filed into evidence in proceeding EB-2009-0084) by Hydro One Networks Inc. and the Coalition of Large Distributors

[3] National Economic Research Associates Inc., Allowed Return on Equity in Canada and the United States: An Economic, Financial and Institutional Analysis, February 2008

established, and the need to consider comparable utilities' rates of return. Furthermore, a minimum spread to the long-term debt rate should be specified, since the existing ROE formula fails to consider the actual cost of debt financing in any way, and ROE must consider an appropriate premium to long-term debt rates.

The current situation should not be addressed simply by arbitrarily adjusting the elasticity factor (the coefficient that approximates the relationship between the cost of equity and interest rates) downward from the current 0.75 to e.g. 0.50, as that would penalize investors in a time when interest rates are expected to rise and in fact have no where to go but up. Such an adjustment can be considered once the reference rate is reset, so that impacts of any future volatility in the financial market and economic turmoil are mitigated to an appropriate extent.

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?*

   Yes, for the same reasons provided by the PWU in response to question 7, the ERP approach should be reset on a regular basis. Further, the PWU notes that a reset of the formula is appropriate at this time.

9. *How might the Board address the potential issues arising from the application of the current methodology as a single, point-in-time calculation?*

   In addressing potential issues arising from the application of the current methodology as a single, point-in-time calculation, the Board should strive first and foremost to arrive at and adopt a methodology which remains valid under varying economic circumstances and credit conditions. Such a methodology must yield appropriate results under a number of historical and/or potential scenarios. Given the opportunity to establish such a methodology, there should be little risk that the Board would need to use its discretion to adjust the results at a future point, since any such adjustment would signal the methodology was not sufficiently robust to yield appropriate results under changing circumstances.

10. *How should the Board establish the initial ROE for the purposes of resetting the methodology?*

As the PWU indicates in response to question 7, in establishing the initial ROE for the purposes of resetting the methodology, the Board should consider comparable utilities' rates of return and a minimum spread to long-term debt rates, as well as resetting the reference rate. The PWU notes that the only variable in the current formula is the Long Canada Bond Yield; thus the current ROE formula cannot in its present form account for changes in risk premiums between government and corporate borrowings.

11. *Is the government (of Canada) bond yield the appropriate base upon which to begin the return on equity calculation?*

Assuming there is a periodic reset of the appropriate initial ROE, then the Long Canada Bond, being a risk free investment, is an appropriate basis for deriving the ROE provided. However, the PWU submits that the methodology should also consider the factors identified by the PWU in its response to question 10.

12. *What is the relationship between corporate bond yields and the corporate cost of equity? Is this relationship sustainable?*

There are differing views as to the precise nature of the relationship between the corporate bond yields and the corporate cost of equity, and under which conditions the relationship is maintained. However, it is well understood that for a given enterprise, or enterprises with a similar risk profile, the cost of equity should reflect an appropriate premium to the bond yield. The PWU submits that a formulaic approach could serve to derive the cost of equity based on corporate bond yields. Alternatively, if the existing ERP approach is maintained, a minimum spread to corporate bond yields could be prescribed to adjust the formula's result automatically when required.

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

In the PWU's view the current approach used by the Board to calculate the ERP can be maintained, provided it includes a periodic reset of reference rates and uses some mechanism to consider the actual ROE of comparable utilities and the spread to long-term corporate bond yields. If these factors are neglected in deriving the ERP, the current approach would not be consistent with achieving the FRS.

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)?*

The mechanisms identified by the PWU in response to question 15 should be considered as required tests to ensure the FRS is met, to the extent they are not incorporated directly into the ERP approach adopted by the Board.

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?*

An effective methodology would indeed produce an appropriate reflection of market conditions. Historical market data can provide points in time reflecting varying degrees of economic growth or stability, differences in government bond rates, inflation levels and corporate credit conditions. Testing the results of the methodology using such historical data, against the rates of return achieved by comparable utilities at the time or the then effective spread between equity returns and long-term corporate bond yields, would provide useful evidence as to whether varying market conditions have an appropriate impact on the variables.

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?*

Yes, the PWU believes the Board should consider monitoring indicators on an ongoing basis to test the reasonableness of the results of its cost of capital. As demonstrated by recent experience, it is possible that unforeseen circumstances may not be appropriately captured in any given formulaic approach. It would be more appropriate for the Board to have the information to identify such a condition before any anomalous results are determined, rather than waiting for an annual result which the Board then believes should be re-examined after the fact.

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?*

The yield spread between long-term government bonds and long-term corporate bonds is a measure that could provide an indication of whether financial market conditions are or are not "normal" – indeed it was the sharp increase in this spread which produced the unusual results for the 2009 cost of capital, as well as the higher spread between short-term and long-term borrowing rates. The Market Volatility Index (ticker symbol VIX on the Chicago Board Options Exchange) could also be used as a measure of market volatility, as it measures the implied volatility of S&P 500 index options. An increase in the value of the VIX may indicate potential flight of capital to less risky government bonds, thereby signalling an increase in the yields on corporate bonds and equity, making it more difficult for utilities to attract capital for investment projects.

All of which is respectfully submitted.

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