Presentation to the Ontario Energy Board Regarding the Cost of Capital EB-2009-0084

By: Donald A. Carmichael

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Who Are The Market Opinion Makers?

- **Lenders**
  - Life Insurance Companies, Money Managers, and Pension Funds
- **Credit Rating Agencies**
  - DBRS, Standard & Poor’s, and Moody’s
- **Equity Investors**
  - Corporate Holding Companies, Pension Funds, Money Managers, Mutual Funds and Retail Investors
- **Equity Analysts**
Market Opinion Makers

- Debt and equity analysts provide favorable or unfavorable opinions to institutional and retail investors
  - Large institutions do their own credit and stock research to form their opinions
  - New issues of securities are built around large lead orders from significant “opinion making” institutions
  - Lead orders influence capital availability and pricing
- Opinion makers will determine which regulatory jurisdiction to invest in based on the “Fairness” of the regulatory regime
What Do Lenders & Investors Look For?

- **Lenders**
  - Financial flexibility – ability to attract debt and equity capital on reasonable terms
  - Reasonable coverage of interest by earnings (at least, 2.5x and cash flow, at least 3x)
  - Maintain financial integrity (maintain or improve upon existing credit ratings)

- **Investors**
  - Appropriate risk/reward relationship
  - Financial flexibility
  - Financial integrity

- Lenders and investors want returns to meet the Fair Return Standard
Fair Return Standard

- **Risk/Return Relationship**
  - Comparable Investment Standard
  - Opportunity to earn the return available from other enterprises of like risk
  - Expected returns usually derived from comparable earnings test, DCF’s and equity risk premium models

- **Financial Integrity**
  - Financial Integrity Standard
  - Maintain credit ratings, provide dividends and support stock market prices

- **Capital Attraction**
  - Capital Attraction Standard
  - Ability to attract incremental capital on reasonable terms and conditions
All 3 standards are important and need to be considered
  • More information leads to better decisions - no single model provides the “ANSWER”
  • Each model has strengths and weaknesses
  • Process requires informed judgment

Market participants focus on the outcome rather than the process used
ERP / Formula – Market Views

Likes

• Timely
• Transparent
• Predictable
• Regulatory efficiency
• Eases expansion of regulated sector
ERP / Formula – Market Views

Concerns

• Is the formula appropriate?
• Formula calibration
• Ability to capture changes in risk/return environment
• Ability to keep equity levels in touch with ROE’s
• Do the results meet the Fair Return Standard and continue to do so over time?
Capital Market Issues

- Formula is “broken”, focus on companies with low exposure to formula - returns are too low and moving in the wrong direction
- Competition for funds: foreign and domestic infrastructure financing – utilities not competitive
- Removal of limits on foreign investment: relevance of U.S. comparators and U.S. rates of return – greater range of options available today
- Unusual market conditions have existed for a period of time – recent market conditions are not the only issue
- GOC yield versus corporate cost of capital - GOC yield declined to 65 year lows while corporate debt & equity costs are increasing