TORYS
LLP

Suite 3000
79 Wellington St. W.
Box 270, TD Centre
Toronto, Ontario
M5K 1N2 Canada
Tel 416.865.0040
Fax 416.865.7380

www.torys.com

September 14, 2009

VIA RESS and COURIER

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

Attention: Ms. Kirsten Walli, Board Secretary

Dear Ms. Walli,

**Re: Board Consultation on Cost of Capital (EB-2009-0084)**
**Presentation of Great Lakes Power Transmission LP**

We are counsel to Great Lakes Power Transmission LP ("GLPTLP") in the above-noted matter. Enclosed please find a copy of GLPTLP's presentation for the upcoming stakeholder consultation sessions.

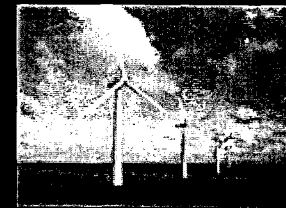
GLPTLP has made this submission using RESS and has sent three hard copies to the Board via courier.

Yours truly,

for S. Britton
Charles Keizer

Tel 416.865.7512
Fax 416.865.7380
ckeizer@torys.com

Power Advisory LLC



# Stakeholder Conference Presentation on the Cost of Capital

Prepared at the Request of :

## Great Lakes Power Transmission LP

September 14, 2009

John Dalton
jdalton@poweradvisoryllc.com
Tel: 978 369-2465

# Overview of Presentation

- ➢ Why important to get ERP Formula right

- ➢ Formula broken demonstrated by
  - ✓ Unrealistic and counter-intuitive values it produces
  - ✓ Increased utility business risk since specified

- ➢ Formula suffers from overly simplistic nature
  - ✓ Fails to consider LCB and utility equities different
    - ▪ Declines in LCBs don't result in declines in utility ROEs

- ➢ NEB suggested that Formula broken

- ➢ Viable alternatives to existing ERP model perform better

# Summary of September 8th Power Advisory Report

- Power Advisory engaged by Great Lakes Power Transmission LP to provide independent assessment of Board's ERP Formula (Formula)

- Report found that Formula broken
  - ✓ While current market conditions exacerbate Formula's shortcomings, it provided inadequate returns for considerable time
  - ✓ Formula's deficiencies will not be remedied when credit markets heal
  - ✓ There are viable alternatives to current ERP Formula that perform better

# Why important to get Formula right

- Fair ROE needed for both public and private investors
  - ✓ Important to compensate existing asset base fairly
  - ✓ Essential for private investors given increased competition for capital
  - ✓ Critical for discretionary investment

- Fair ROE necessary to ensure efficient investment decisions
  - ✓ Particularly allocation of investment between wires, generation and CDM





Power Advisory LLC

# That Formula broken demonstrated by

- The unrealistic ROE values it has produced:
  - ✓ 39 basis point premium relative to long-term debt
    - Inadequate compensation for equity risks
  - ✓ Declined by 56 bp when equities subjected to unprecedented volatility
    - Volatility of utility equities over last 12 months increased at almost twice rate of S&P 500
    - Suggesting utility stocks more, not less risky

**Dow Jones Utility Average vs S&P 500 over the last 12 Months**






Power Advisory LLC

# ERP Formula doesn't recognize that

- Amount of risk faced by regulated utilities increased significantly since Formula first adopted
  - ✓ Increased revenue risk from greater uncertainty regarding future electricity demand
    - From CDM and unprecedented declines of major electricity consuming industries
  - ✓ Magnitude of capital requirements (significant portion of ratebase at risk) and phasing required to get major new transmission facilities in service quickly increase risks

- These increased risks not reflected in ROEs produced by Formula

# The ERP Formula suffers from

- Simplistic nature of Formula in light of amount of investment to which it applies
  - ✓ Assumes changes in utility ROEs explained solely by change in Long Canada Bond rates
  - ✓ Long Canada Bonds distinctly different instrument than equities
    - Utility equities have different and greater risks
  - ✓ Net result Board's Formula missing critical variables that influence required returns for utility equities





Power Advisory LLC

# The ERP Formula produces ROEs that are too low

- Factors that led to declines in Long Canada Bonds (LCBs) do not all result in declines in utility ROEs
  - ✓ Declines in inflation
  - ✓ Declines in inflation risk premiums
  - ✓ Declines in bond interest rate premiums

- LCB yields have declined significantly
  - ✓ Prior to November 2008 LCB yields were below 4% for one month, since then yields have been below 4% every month, but one

- Failure to reflect critical explanatory variables in Formula overstate relationship between LCB rates and utility ROEs

# NEB suggested that ERP Formula broken

- NEB found that world changed, but Formula had not
  - ✓ Significant changes in financial markets and general economic conditions
  - ✓ Increased globalization of financial markets resulting in greater competition for capital

- Formula relied on a single variable: LCB yield
  - ✓ Changes in TQM cost of capital may not be captured in LCB yields
  - ✓ Casting doubt on fundamentals underlying formula

- Alberta and BC evaluating their ERP formulas
  - ✓ Indicating concern with formula's performance

# ERP Formula broken and should be respecified

- Formula should include additional explanatory variables that reflect determinants of required utility ROEs

- Two models performed better than existing ERP model
  1. Corporate BAA bonds used as explanatory variable
  2. Long Government Bonds and Volatility Index

- Both should be relatively easy to implement
  - ✓ No consensus forecast for these variables

- There are viable alternatives to current ERP Formula that perform better





Power Advisory LLC

# In sum, ERP Formula needs to be fixed without delay

- ROEs produced critical to attract capital given increased competition for capital
  - ✓ Essential to fund Ontario's looming capital requirements
    - Both legacy and new build

- There are viable alternatives to current ERP "model" that perform better





Power Advisory LLC