Ontario Energy Board Consultation on Cost of Capital A Bond Market Perspective

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EB-2009-0084

September 21, 2009

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Introduction

- Debt financing makes up 60% of an electricity LDC's capitalization (64% for natural gas distributors)
- Bonds give the cheapest cost of financing for those issuers large enough to issue a bond in the public market
- Corporate bond research is read by Institutional Investors (Pension, Insurance, Mutual Fund managers)
- Research offers fact and opinion on company/ industry fundamentals, bond market trends, insight into credit ratings

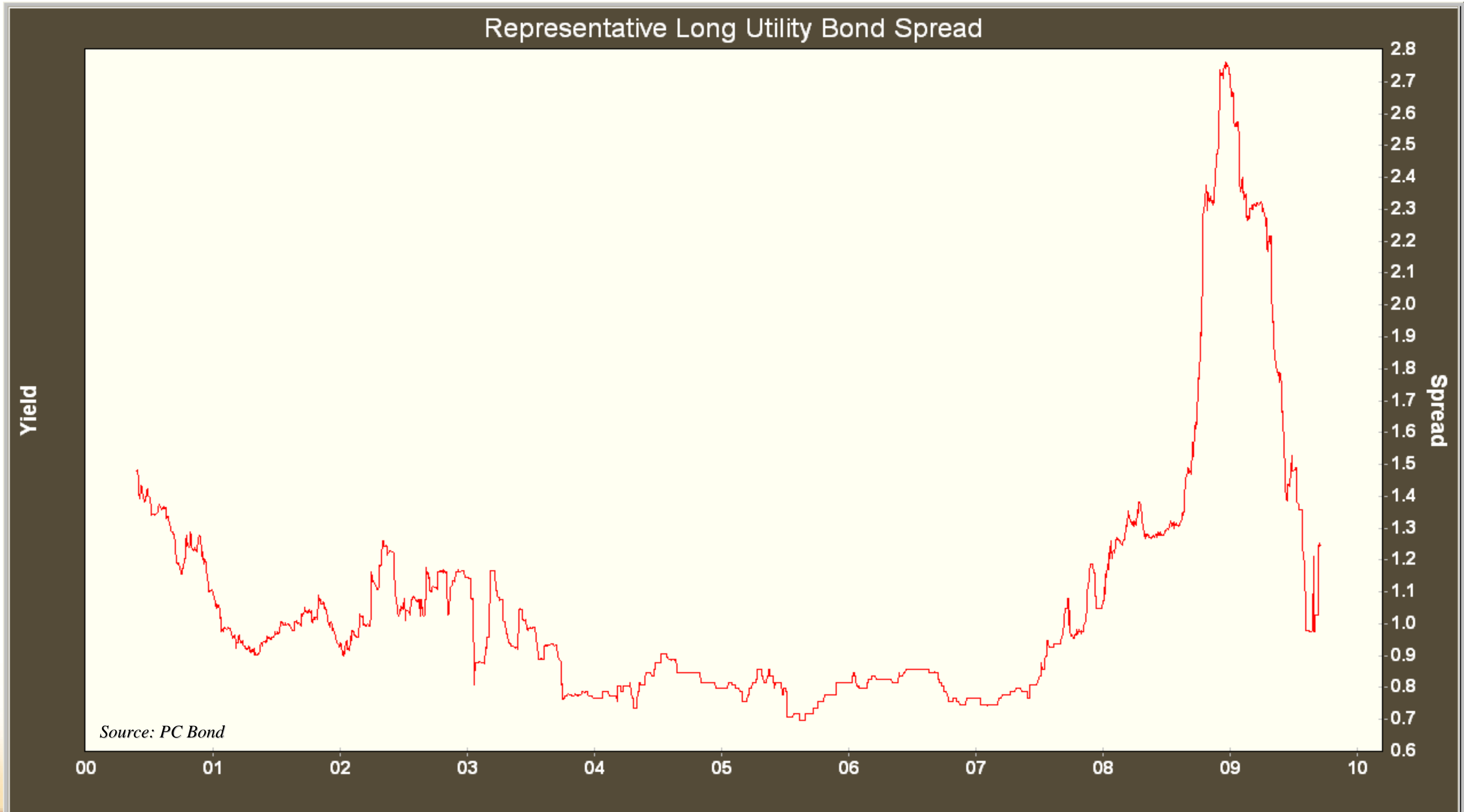
Bond Market Harder to Understand

- Bond market is subtly different from the equity markets
- Each bond issue is unique, not like common equity where each new issuance of equity is the same
- Liquidity is often a selling and pricing consideration
- Not exchange-traded, so secondary market price discovery sometimes volatile for individual bond issues
- New issues can be challenging for small, non-financial issuers to execute

Why the Bond Market cares about ROEs

- Allowed ROEs, together with deemed equity capitalization, dictates utility credit metrics: interest coverage, funds from operations, free cash flow,…
- Credit metrics affect credit ratings, which influences the cost of new utility borrowing, the spreads on outstanding bonds, and the value of bond portfolios
- In a capital spending cycle, utilities need new equity (even if this only means owners forgoing dividends) to maintain the regulatory deemed debt to cap ratio
- Hence, bondholders want a utility's equity investors to be satisfied enough to put in new equity

Evolution of My Views on ROE



Evolution of My Views on ROE

- **Early in the decade, I was generally bullish on values and thought utilities, including the Ontario LDCs, offered attractive risk-reward for bond investors**
- **By mid-decade, many Canadian utility owners felt ROEs / equity capitalization levels were too low**
- **My opinion at that time was ROEs/capitalization were thin, but still sufficient for the bond investor- *provided regulators kept the risk of under-earning very, very low***
- **Evolving "best practices", technological change, good management allowed the sector to consistently meet (and sometimes better) ROE targets**

Evolution of My Views on ROE

- I critiqued the rating agencies for being overly cautious about financial ratios, given industry stability
- Market participants saw utilities as not especially good value, though bond market alternatives were also “priced to perfection”
- In hindsight, corporate bond spreads prevailing in the 2004-2007 period are now viewed by many as too low, and not likely to recur near-term or mid-term
- In the past two years, fundamentals and market conditions have changed dramatically, and so my opinion has changed

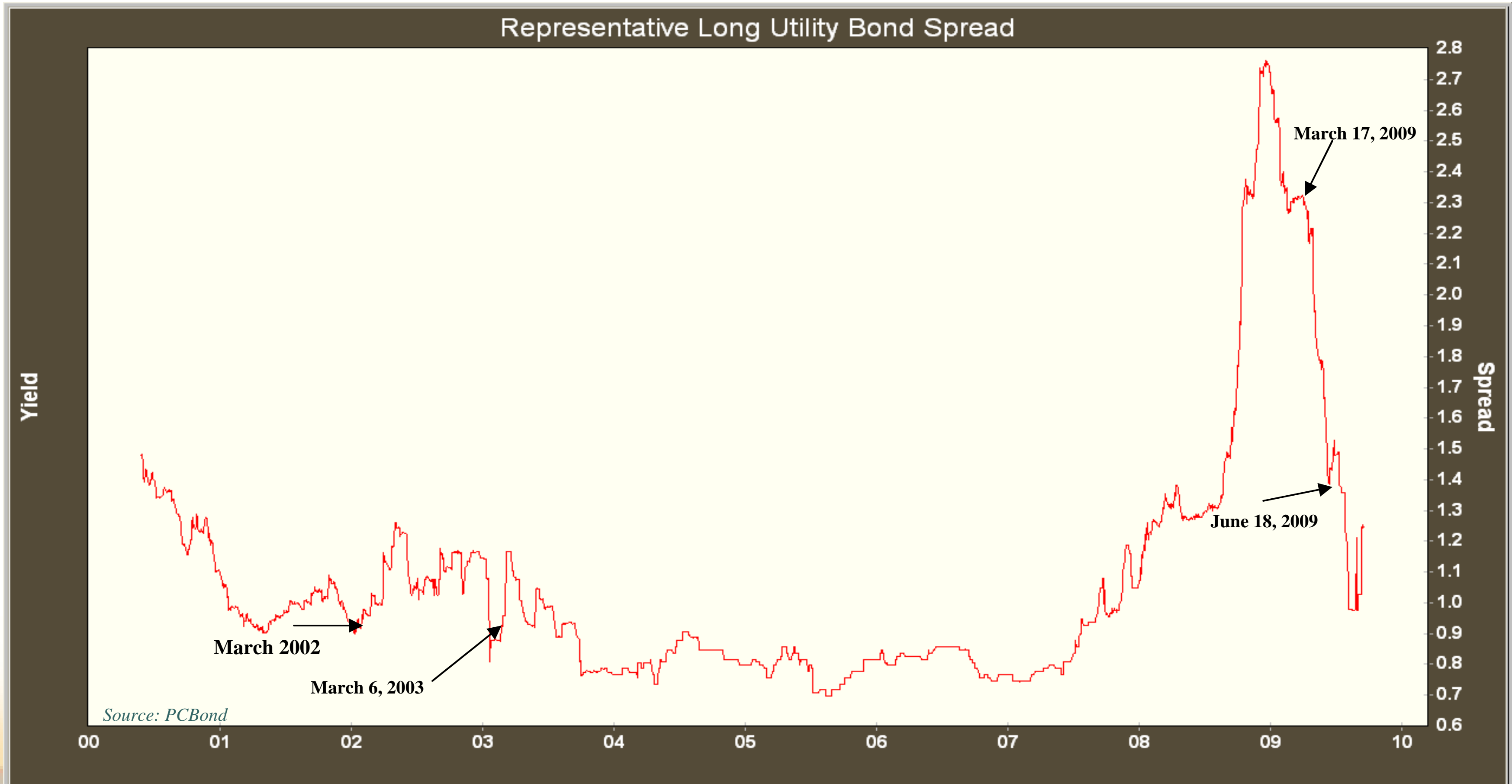
What has changed?

- ROEs continued to fall with long Canada bond yields
- Industry has become more complex: conservation; "green generation"; rising cost of electricity; volatile natural gas costs; technology change; severe demand recession;…
- For the bond investor, complexity = uncertainty = risk
- Many utilities entering a generational cycle of capital spending, on top of demand growth, technical, other changes
- All this brings pressure on credit ratios, particularly interest coverage and free cash flow

Ratings Greatly Influence Bond Values

- **The 2003 Experience- March 6th CreditWatch viewed by many investors as a false alarm**
- **Yet it still affected utility spreads for nearly a year**
- **Rating actions can lag their underlying events**
- **Agencies to date nearly silent on declining ROEs- possibly reluctant to mix in the regulatory process**
- **However, warning has been given: "Credit metrics are weak for the rating" ubiquitous in rating reports**
- **If rating downgrades were made *and investors agreed with the reasoning*- bond spread/valuation impact <u>likely much more material than in 2003</u>**

The Bond Market is Listening



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Conclusions

- While rating agencies have made few explicit references to falling ROEs, their caution- “Credit ratios are weak for the ratings”- has been abundant and frequent. Risk of downgrades is real.
- If agencies and investors agree the sector is riskier, cost of new debt financing could be materially higher
- A higher cost of new financing is borne by ratepayers
- The corollary effects of ROE/capitalization levels on the utility’s cost of debt are material to the companies and ratepayers, and should not be ignored

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