IN THE MATTER OF a Review of the Ontario Energy Board's Cost of Capital Policy

COMMENTS OF ONTARIO POWER GENERATION INC.

Introduction

On June 18, 2009 the Ontario Energy Board (the "Board") issued a letter announcing a review of its cost of capital policy "to ensure that, on a going-forward basis, changing economic and financial conditions are accommodated if required".

As part of this review the Board held public consultation sessions with stakeholders on September 21, 22 and October 6, 2009. The Board indicated that the consultation is about whether the return on equity meets the Fair Return Standard and whether the current methodology is "robust enough to guide the Board's discretion at any point in time dealing, obviously, with the various applications."[1]

On October 5, 2009 the Board issued a letter informing participants that it anticipated any changes to its policy made as a result of this review will apply to the setting of rates for the 2010 rate year. Participants were asked to submit final written comments by October 26, 2009.

Recommendation

In OPG's view the material presented in the review overwhelmingly supports the conclusion that the ROEs resulting from the Board's formula no longer meet the Fair Return Standard.

To ensure consistency with the Fair Return Standard and to derive a robust methodology that addresses the Board's objective to ensure that changing economic and financial conditions are accommodated as required, the OEB should:

Reset the Current ROE: The OEB should use multiple tests/methods to reset the ROE as no one test produces sufficiently robust results over time. This position is supported by Concentric Energy, Foster Associates, DAC and other cost of capital experts. To ensure the resulting ROE is consistent with the comparable investment standard, the reset ROE should be considered in the context of the comparable earnings test and the After Tax Weighted Average Cost of Capital ("ATWACC") test. OPG submits that the evidence provided by Concentric meets the above criteria. The information is sufficiently comprehensive and transparent, and stakeholders have had the opportunity to review and challenge these results in this consultation process, that the OEB can use it as the basis of its decision in December, 2009.

[1] Transcript, September 21, page 6.

Apply a Market Adjustment until the ROE is reset: To ensure 2010 rates reflect an ROE consistent with the Fair Return Standard the OEB should apply a market adjustment to increase the ROE. OPG proposed a market adjustment in its previous submissions, and a market adjustment was also proposed by Foster Associates[2] during the consultation process. In OPG's view, the OEB has the discretion to adopt a market adjustment in its December, 2009 decision. This is only required in the event the OEB does not reset the ROE as recommended above.

Once the ROE has been reset, review the annual adjustment formula: The material in this consultation overwhelmingly supports the conclusion that the annual adjustment formula has a number of shortcomings. OPG recommends that the OEB not amend the annual adjustment formula until it has reset the ROE. Based on the evidence that an equity risk premium over long-term corporate bond yields results in a relationship that: is more intuitively justified; is more predictive of common equity costs than the long-term Canada bond yields; is more reflective of economic and capital market conditions; and addresses the perverse ROE results from the application of the current formula over the last 18 months, the annual adjustment formula should be based on the relationship between return on equity and long-term corporate bond yields as advocated by Concentric, Foster Associates and other experts.

OPG expects that a focused written consultation process would provide sufficient information to enable the OEB to establish a new adjustment mechanism prior to setting rates for 2010.

Amend the short-term debt benchmark for 2010: The CLD's materials on this issue make it clear that the OEB's current formula is unrepresentative of utility borrowing costs. While the CLD did not put forward a specific proposal during the consultation, it appears that the use of representative spread information could form the base of a potential solution. OPG expects that the focused written consultation process recommended for establishing the annual adjustment formula would provide the opportunity to develop a better approach to establishing short-term debt costs to be reflected in rates effective 2010. Further, as the OEB's current approach for establishing carrying charges for deferral and variance account balances uses the same formula, revisions made to the approach for establishing the short-term debt cost should be applied to the carrying charges for deferral and variance accounts.

The Board also stated that it wanted to obtain further information in three key areas:

- to determine the reasonableness of the results based on a formulaic approach for setting the cost of capital
- to assess the potential need to adjust the established cost of capital methodology, based on the ERP approach, to adapt to changes in the financial market and economic conditions; and
- to guide the Board's discretion to adjust those results, if appropriate.

[2] Transcript September 22, page 158/159.

OPG's comments on the three key areas for which the Board sought further information follow.

1) **Are the ROEs resulting from the application of the current formula reasonable?**

No. OPG submits the ROEs resulting from the application of the current formula no longer meet the Fair Return Standard; therefore they are not reasonable.

OPG submits that the material in the consultation overwhelmingly supports the conclusion that the annual adjustment formula has a number of shortcomings. These shortcomings have resulted in a steady divergence between comparable Canadian and U.S. utilities that were at, or near, parity prior to the inception of the formula. OPG submits that the Concentric analysis and the conclusions drawn by the cost of capital experts that practice in both Canada and the United States all support the conclusion that there are no fundamental differences that would invalidate a direct comparison between Canadian and U.S utility allowed ROEs. The divergence in approved ROE between these comparable investments has grown consistently since the inception of the formula to the point where the returns no longer meet the Fair Return Standard.

Concentric summarized three of the problems with the formula: "First, when the formula came into effect, utility capital costs and government bond yields were perceived to move together, but, in recent years government bond yields have virtually "derailed" from utility bond yields. Second, the 0.75 coefficient in the current formula is overly sensitive to changes in interest rates, as confirmed by U.S. data showing that the relationship between bond yields and allowed returns justifies a coefficient no greater than 0.50. Third, the absence of any means of corroborating the results of the current formula has allowed those results to steadily diverge from U.S. returns.[3]

Another problematic assumption is that the risk free rate used to establish the initial formula was not risk free.   OPG agrees with Don Carmichael's conclusion that the implication is that the equity risk premium, and therefore future ROEs which apply the initial equity risk premium, were understated.[4]"

OPG finds the NEB's recent decision rescinding its ROE formula particularly informative. The NEB uses a formula that is in all material respects the same as the formula used by the OEB.   On October 8, 2009 the NEB issued its Reasons for Decision which stated that "it is clear that the Board expected the RH-2-94 Decision to remain in place for at least some time. However, in the Board's view, 15 years is a significant passage of time in the context of financial regulation. The Board notes that since 1994, there have been considerable changes in financial and economic

[3] Concentric Report, pages 5-6.
[4] Transcripts, September 21, page 128

circumstances. Based on these considerations, the Board is of the view that there is a doubt as to the ongoing correctness of the RH-2-94 Decision".

The views of capital market participants as to the adequacy of current results is also instructive. Matthew Ackman stated that it is getting harder to attract capital[5] and in fact increasing dividends[6] remove investment cash from Canadian utilities which are channelled by investors to more rewarding activities[7]. Stephen Dafoe commented that the decline in credit quality is real[8]and that maintaining the status quo would be viewed adversely by the bond market[9] which he expects has significant potential to result in material cost impacts to ratepayers[10] in terms of increased borrowing costs. Harold Holloway explained that Canadian investment opportunities are not being undertaken as they are not attracting investment capital[11] and that some bond offerings that did not proceed in the first quarter of 2009 based on no interest and/or pricing.[12]

Investors appear to be avoiding Canadian investment opportunities and effectively harvesting prior investments in utility assets through increased dividend pay-outs at the same time the Ontario government is actively supporting increased infrastructure investments. In OPG's submission, it is in the public interest for the OEB to increase ROEs to ensure that rates effective in 2010 will have a return on equity that meets the Fair Return Standard.

2) **Should the Board adjust the established cost of capital methodology, based on the ERP approach, to adapt to changes in financial market and economic conditions?**

Yes. Once the Board has reset the ROE to ensure that it is consistent with the Fair Return Standard; the OEB should determine the most appropriate formula to annually adjust the ROE.

Capital market participants and cost of capital experts agreed that utility specific capital costs, both debt and equity, were increasing over the last 18 months, while the ROEs resulting from the application of the current formula were falling in conjunction with the long-term Canada bond yield. There was also no disagreement that the formula result was not consistent with current capital market conditions.

Ratepayer advocates tried to portray the situation as temporary and irrelevant since the ROEs resulting from the formula would be both higher and lower than the cost of

[5] Transcript, September 21, page 19
[6] Transcript, September 21, page 19
[7] Transcript, September 21, page 20
[8] Transcript, September 21, page 30
[9] Transcript, September 21, page 68
[10] Transcript, September 21, page 30
[11] Transcript, September 21, page 74
[12] Transcript September 21, page 77

equity over a full business cycle. Ratepayer groups argue that, over a business cycle, total returns resulting from a formula are consistent with the Fair Return Standard, and therefore the OEB should favour stability and not overreact to temporary changes in economic and capital market conditions.

OPG submits these arguments are incorrect and/or miss the point. The situation is not temporary. Capital market participants were consistent in the view that there has been fundamental change in the capital markets that will, at a minimum, impact the next business cycle. The assumption of continued stability ignores the facts as summarized by capital market participants.

Stephen Dafoe commented that: "the utility industry is becoming more complex. Things like consumer consciousness, demanding energy conservation, rising requirements to connect green generation, the rising cost of electricity that's far from over, volatile natural gas costs, technology changes, such as the introduction of smart meters, the current severe demand recession that's going to reduce consumption in revenue but won't obviate the capital spending requirements to connect new loads. The list goes on and on. For the bond investor, all this means increased complexity, which means increased uncertainty over what the future might bring, which equals increased risk".[13]

Harold Holloway asked "Is this a new regime? Have the markets turned into something different? And the one thing I think most people have come to the conclusion is credit isn't going to be as easy, it isn't going to be as cheap, and that has a whole lot of factors for that statement, one being banks at the very heart of it have to keep higher various ratios. So they have a lot more, quote, dead capital, in my opinion. Secondly, you know, all of the various governments and their bodies looking at changing rules and regulations on what banks can do and how they can do it and other non-financial institutions. So there's a pretty big change going on[14]"

Matthew Akman commented that "we have to acknowledge that in capital markets, the economy globally has changed quite a lot in the last several years, through globalization. There's a lot of global -- I think probably disconnects between historical data between what we're seeing going forward and what we are seeing, and that can't be ignored is all I'm saying and I think it has to be a serious consideration in how we're setting returns going forward…..But obviously now in retrospect we realize that things were changing very fast and maybe we're into a new, as Harold suggested, reality for maybe a multiple year period that is much more challenging with the focus much more on risk than we had during that period. But I think that the changing times have been occurring for probably, you know, more than a decade.[15]

Don Carmichael commented that "with various tax changes that have taken place

[13] Transcript, September 21, page 30
[14] Transcript, September 21, page 73/74:
[15] Transcript, September 21, page 83/84:

and the growth of the infrastructure industry in Canada, utilities are facing a reasonable amount of competition for funds from well-rated utility-like operations that are not necessarily regulated, or regulated with a very light hand."[16] He also noted that recent market circumstances have resulted in the repricing of risk, explaining that "the risk could have remained the same except the price to carry those risks was higher. So instead of accepting a 100 basis point corporate credit spread, it all of a sudden became 150". [17]

Similar views expressed in the NEB's review process were accepted by the NEB and was the prime reason the NEB abandoned the application of the formula.

Dr. Booth's main criticism of the use of corporate bonds is that ROEs will be more volatile and the total returns over an entire business cycle should be about the same. Dr. Booth supports the continuation of the current formula, arguing that it produces reasonable, stable results provided that the Canadian Government pursues a target rate of inflation of 2% and manages monetary policy to keep inflation within the 1 to 3 percent range.

OPG submits the OEB should use a robust formula that will be an effective estimate of ROE regardless of the Government's monetary policy of the day. OPG also notes that Dr. Booth's assertion that the current formula based on Canada long-term bond yields promotes stability is not consistent with the information provided during the consultation. The evidence suggests that, with the exception of the exceptional circumstance that occurred during over the last 18 months, other measures are not only more intuitively based and more predictive of actual equity costs than long-bonds, but the resulting ROEs are less volatile. Concentric Energy, stated that it analyzed the ROEs resulting from different adjustment formula since the inception of the formula and concluded that, the OEB's current formula based on the long-term Canada bond yield results in greater volatility in ROE than that resulting from a formula that incorporates a risk premium over corporate bond yields.

OPG also agrees with the summary comment of James Vander Weide that "it seems to me the issue at hand is how can we determine whether we're providing a fair return, not how can we determine whether we can provide a stable or a constant return.[18]" In his view, the appropriate consideration for regulators is the rate impact, and the regulator has other tools at its disposal to address this issue.

The forecast cost of capital for the utility should reflect the best estimate of the cost of capital for the test period, not a normalized investment cycle proxy. It follows that the OEB should apply a formula that most closely reflects capital market conditions for the test period relevant to the utility for which rates are being established.

[16] Transcripts, September 21, page 108
[17] Transcript, September 21, page 142
[18] Transcript, September 21, page 174

3) How should the OEB apply its discretion to adjust the result of its current cost of capital methodology, if appropriate?

It is in the public interest for the OEB to act expeditiously to increase ROEs to ensure rates effective in 2010 will have a return on equity that meets the Fair Return Standard. The Board has the discretion to proceed expeditiously.

In its recommendations highlighted above, OPG has outlined a proposed approach for the OEB to proceed. OPG recommends that the OEB:

i) ***Reset the Current ROE:*** OPG submits that the evidence provided by Concentric is sufficiently comprehensive, transparent, and stakeholders have had the opportunity to review and challenge these results in this consultation process, to enable the OEB to rely upon it.

ii) ***Apply a Market Adjustment until the ROE is reset:*** This is only required in the event the OEB does not reset the ROE in its decision to be issued December, 2009.

iii) ***Once the ROE has been reset, review the annual adjustment formula:*** If the ROE is reset by the OEB in its December decision, OPG expects that a focused written consultation process would enable the OEB to establish a mechanism prior to setting rates for 2010.

iv) ***Amend the short-term debt benchmark for 2010:*** OPG expects that the focused written consultation process recommended for establishing the annual adjustment formula would provide the opportunity to determine a better approach to establishing short-term debt costs to be reflected in rates effective 2010. Further, as the OEB's current approved approach for establishing carrying charges for deferral and variance account balances uses the same formula, revisions made to the approach for establishing the short-term debt cost should be applied to the carrying charge policy for deferral and variance accounts.