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October 29, 2009

VIA RESS and COURIER

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

Attention: Ms. K. Walli, Board Secretary

Dear Ms. Walli:

Re: Consultation on Cost of Capital - Board File No. EB-2009-0084

We are counsel to Great Lakes Power Transmission LP ("GLPT"). In respect of the above-noted matter, attached are the submissions of GLPT.

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

Yours truly,

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IN THE MATTER OF a consultation by the

Ontario Energy Board on the Cost of Capital

for Electricity Distribution Companies

Submissions of Great Lakes Power Transmission LP

These are the submissions of Great Lakes Power Transmission LP ("GLPT") in respect of Ontario Energy Board's "Consultation Process on Cost of Capital Review" (EB-2009-0084).

In its letter dated July 30, 2009, the Board indicated that it would review the application and the derivation of the current ERP formula to determine if it is sufficiently robust to guide the Board's discretion in applying the fair return standard. In doing so, the Board identified three areas where it sought guidance:

- potential adjustment to the established cost of capital methodology (i.e. based on the ERP formula) 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.

In essence the issues above can be summarized as follows:

- Is the current ERP formula broken?
- If so, what new approach should be used in its place?
- Does the Board have the discretion to implement such a change and how does it ensure its functionality over time within the context of that discretion?

Respectful of the Board's desire that stakeholders' submissions should be a summing up and not a recitation of what was discussed, GLPT will address each of these issues in turn.

Is the Current ERP Formula Broken?

After two rounds of written submissions (April 17, 2009 and September 8, 2009) and three days of oral presentations from well respected financial experts, the Board has heard a detailed account of the failings of the current ERP formula and the concerns it presents to Ontario's ratepayers and utilities. The preponderance of evidence submitted indicates that the current ERP formula is broken:

- **Professor Vander Weide** performed six tests of whether the ROE produced by the ERP Formula was fair; all of which indicated that it understated the fair ROE. (Vander Weide Response to Issues List, September 8, 2009, p. 2-3).

- **Professor Vander Weide** concludes that, "contrary to a reasonable expectation, the Board's ROE formula produces a lower ROE estimate at a time when the increased risks of highly uncertain economic and capital market conditions are causing capital costs to increase dramatically." (Appendix A to Responses of James H. Vander Weide, Ph.D., Page 11 of 87.)

- **Kathleen McShane** comments that "Both the initial ROE and the automatic adjustment formula should be reset. Reliance on a formula which has been governed solely by a close tracking of changes in the long-term Canada bond yield has resulted in allowed ROEs that have fallen below levels commensurate with a fair return." (Fosters Associates, Inc., Responses to OEB Questions, p. 1)

- **Concentric Energy Advisors, Inc.** "determined that Ontario's currently allowed ROEs and capital structures do not meet an objective test of the Fair Return Standard. While it may be possible to rebase ROEs using the ERP method, Concentric recommends the utilization of multiple methods to determine ROE, and provides a detailed cost of capital analysis by sector to support this determination. The existing Formula tied to the Canadian Long Bond has not been an effective method for tracking equity costs." (2009 Consultative Process on Cost of Capital Review, September 8, 2009, p. 4)

- **Power Advisory** notes that "The equity risk premium (ERP) formula used by the Ontario Energy Board (OEB or Board) to set the Return on Equity (ROE) allowed for gas and electricity distributors and electricity transmitters under the Board's jurisdiction does not meet the Fair Return Standard (FRS). … the Board cannot assume that the current perverse results produced by the ERP formula will be remedied when the credit markets heal. The deficiencies of the current ERP formula are more systemic." (Evaluation of the Ontario Energy Board's Equity Risk Premium Formula, p.1).

- **Paul Carpenter** found that "the fact that the results of the formula-based methodology are not producing a fair return for 2009 is clearly established by the current relationship between the formula ROE and current bond yields."(Report of Paul R. Carpenter, PhD For Enbridge Gas Distribution, Inc., p. 5 of 28) Dr. Carpenter also found that "there have been significant changes in the level and volatility of energy commodity prices, the health of the industrial sector, energy conservation and environmental policies, and regulation. These changes are not being captured by the current formula-based methodology for determining the allowed return on capital." (Report of Paul R. Carpenter, PhD For Enbridge Gas Distribution, Inc., p. 7 of 28).

These findings were supported by the independent financial and credit market experts that the Board asked to participate in the Stakeholder consultation.

- **Stephen Dafoe** (Director of Corporate Bond Research, Scotia Capital) noted that the ratings agencies have cautioned that "credit ratios are weak for the ratings" (September 21st presentation, p. 11). In his April 17, 2009 filing with the Board he noted that "I think the ROE result of the Board's Cost of Capital methodology is no longer reasonable. While the real-world cost of corporate debt and equity was rising sharply, the allowed ROE was falling." (p. 2). Dafoe also noted that "In the past two years, I've become quite concerned about the effect lower ROEs is having on credit quality." (September 21, 2009 Transcript, p. 30).

- **Mathew Akman** (Equities Analyst, Macquarie Capital Markets) noted that "the current formula return on equity is getting very negative feedback from equity markets today. What the equity markets are saying is that the current formula across Canada that bases allowed ROEs solely on changes in government bond yields is not working." (September 21, 2009 Transcript, p. 12).

With respect to Dr. Booth's position in support of the current ERP formula, GLPT submits that the Board should not take any comfort from Dr. Booth's analysis since he:

- acknowledges that the Formula will only be right on average
- oversimplifies the relationship between Long Canada Bond yields and utility ROEs
- fails to recognize that the industry and the associated risks have changed.

The Formula will only be right on average

Dr. Booth acknowledges: "I have repeatedly said the adjustment mechanisms cannot be completely accurate at every stage in the business cycle." (Dr. Booth Transcript, p.15) Dr. Booth also notes that the LTC bond yield "will deviate temporarily as we go through the business cycle" (Dr. Booth September 8th filing, p. 26). "Temporary" deviations can have serious consequences in the real world of utility operation.

GLPT believes that a formula that results in such deviations does not satisfy the Board's obligation to ensure a fair return. Having an ROE that is appropriate during only some portions of the business cyclical is unacceptable.

GLPT believes that the OEB needs to employ a higher standard when evaluating the fairness of the ERP formula. GLPT's consultant (and other experts in this proceeding), Power Advisory, proposed an alternative formula that would remedy the deficiencies of the current ERP Formula during these different stages of the business cycle. GLPT believes it is critical to employ an approach that yields a fair return under all stages of the business cycle.

Oversimplified the relationship between Long Canada Bond yields and utility ROEs

Dr. Booth fails to acknowledge that the determinants of the required return on equity for utilities are fundamentally different than those for Long Term Canadas (LTCs).

However, the evidence put forward by virtually all other experts supports the contention that the determinants of utility ROEs are considerably different from those for LTCs. (McShane, Carpenter, Concentric, Vander Weide, and Dalton). Contrary to Dr. Booth's suggestion, utility returns on equity depend on several factors (including credit and return risks) in addition to the long-term real interest rate.

The statistical relationship between corporate bond yields and corporate cost of equity is demonstrated by the analyses performed by many of the experts in this case. Corporate equity values are not at all correlated with government bond values,[1] while corporate bonds yields are a more reliable explanatory variable (as judged using objective statistical tests) of utility ROEs than government bond yields. This relationship can be explained by the fact that when credit market conditions cause bond yields to increase (as a result of increasing perceived credit risks and the liquidity issues) the same macroeconomic conditions that are driving these variables are also leading to declines in equity markets which effectively raise the cost of equity.

The industry and the risks have changed

In his oral testimony, Dr. Booth asserts that there have been no increases in utility risks. (Dr. Booth Transcript, p. 8) and asserts that "Black Swans" were not industry occurrences in Canada (Dr. Booth Transcript p.22). Yet Hydro One's experience with its Niagara Reinforcement Project provides concrete evidence regarding the existence of black swans and also the risks posed by new construction. The outcome of the Bruce to Milton line remains to be seen.

In spite of the increase in risk identified by Dafoe[2] and the not previously acknowledged existence of "black swans" in Ontario, Dr. Booth asserted, as he has for the last decade, that it is safe to continue to calculate the enterprise risk premium using a value of Beta of 0.5 (Dr. Booth Transcript p.15). Yet Ms. McShane's written testimony at the BCUC[3] in May 2009 suggests that Beta has varied quite significantly over the past decade, and that according to Bloomberg data the appropriate value for Canadian utilities is now approximately 0.65.

GLPT submits that:

What the evidence in this proceeding clearly establishes to the Board is that the current ERP Formula is based on historical relationships that are no longer valid. The fundamental issue remains that the Board has to set prospective rates for future years that meet the fairness standard using a formula or analysis based on historic data. In employing the current ERP Formula the Board is attempting to carry out its obligation to establish a fair return by relying on a formula derived from data which in part is over 25 years old and does not reflect a meaningful statistical

[1] Power Advisory LLC, Evaluation of the Ontario Energy Board's Equity Risk Premium Formula, September 8, 2009, p. 9.

[2] Mr. Dafoe noted: "As well, 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."

[3] Page 57, Capital Return and Fair Return on Equity, Foster Associates, May 2009 British Columbia Utilities Commission, Terasen – Return on Equity and Capital Structure, Exhibit B-1.

relationship. Based on the forgoing evidence and the underlying analysis, it is unreasonable for one to assume that a fair return could be established using the current ERP Formula.

A New Approach and the Board's Discretion

Experts in this proceeding have offered alternative formulas which will provide better results than the current ERP formula. Both Concentric Energy Advisors and Kathleen McShane suggested two-factor formulas, though their choice of factors differs.[4]

Experts in this proceeding also agreed that the initial ROE for the revised formula should come from a rebasing of the ROE and that the performance of the formula should be monitored annually and formally reviewed at least every 5 years.[5]

The Board's Discretion in Implementing Change

According to the Supreme Court of Canada, the Board has a duty to establish just and reasonable rates:

> "the duty of the Board was to fix fair and reasonable rates; rates which, under the circumstances, would be fair to the consumer on the one hand, and which, on the other hand, would secure to the company a fair return for the capital invested."[6]

The Court has found that the regulator has an "absolute" obligation to set rates which allow for cost recovery and a fair and reasonable return.[7] The Board can not adjust the return on equity to mitigate an impact on rates. The return on equity is set independent of rate impact and is based on factors that have been discussed thoroughly in this proceeding.[8]

It is in this context that the Board must exercise its discretion to establish a fair return for the 2010 rate year. It is submitted that the Board can not properly fulfill its duty based upon the current ERP Formula as the evidence clearly establishes that it fails to reflect a fair return. Commencing in the 2010 rate year, the Board can and should implement the measures above in order to provide the flexibility to establish returns that are fair throughout the business cycle. If necessary, the Board should conduct a periodic review to ensure that the changes implemented continue to produce fair rates.

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[4] Concentric September 22 presentation, slide 15; Transcript September 22, pg. 21, lines 10-18; and October 22 transcript, pg. 157 line 20 - pg. 158 line 3.
[5] September 22 transcript, pg. 4, lines 3-4; Concentric September 22 presentation, slide 10; September 22 transcript, pg. 157, lines 16-18; and EDA September 22 presentation, final slide.
[6] Northwestern Utilities Ltd. v. Edmonton [1929] 2 DCR 4 (S.C.C.)
[7] b.c. Electric Railway v. Public Utilities Commission of British Columbia et al. (1980) 60 D.L.R. (4th) 682
[8] TransCanada PipeLines Ltd. v. National Energy Board, April 5, 2004 (Fed CA); Hemlock Valley Electrical Services Ltd. v. British Columbia et al.; Utilities Commission, [1992] 12 B.C. A.C. 1