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File 17885

October 30, 2009

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

Ms. Walli:

Re: PWU Final Comments on the Cost of Capital Review (EB-2009-0084)

The Power Workers' Union ("PWU") represents a large portion of the employees working in Ontario's electricity industry. Attached please find a list of PWU employers.

The PWU is committed to participating in regulatory consultations and proceedings to contribute to the development of regulatory direction and policy that ensures on going service reliability, quality and safety. To this end, attached please find the PWU's final comments on the Cost of Capital Review (EB-2009-0084).

We hope you will find the PWU's comments useful.

Yours very truly,
PALIARE ROLAND ROSENBERG ROTHSTEIN LLP

Richard P. Stephenson

RPS:jr

encl.

cc: Judy Kwik

John Sprackett

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List of PWU Employers

AMEC Nuclear Safety Solutions
Atomic Energy of Canada Limited (Chalk River Laboratories)
BPC District Energy Investments Limited Partnership
Brant County Power Incorporated
Brighton Beach Power Limited
Brookfield Power – Lake Superior Power
Brookfield Power – Mississagi Power Trust
Bruce Power Inc.
Capital Power Corporation Calstock Power Plant
Capital Power Corporation Kapuskasing Power Plant
Capital Power Corporation Nipigon Power Plant
Capital Power Corporation Tunis Power Plant
Coor Nuclear Services
Corporation of the City of Dryden – Dryden Municipal Telephone
Corporation of the County of Brant, The
Coulter Water Meter Service Inc.
CRU Solutions Inc.
Ecaliber (Canada)
Electrical Safety Authority
Erie Thames Services and Powerlines
ES Fox
Great Lakes Power Limited
Grimsby Power Incorporated
Halton Hills Hydro Inc.
Hydro One Inc.
Independent Electricity System Operator
Inergi LP
Innisfil Hydro Distribution Systems Limited
Kenora Hydro Electric Corporation Ltd.
Kincardine Cable TV Ltd.
Kinectrics Inc.
Kitchener-Wilmot Hydro Inc.
London Hydro Corporation
Middlesex Power Distribution Corporation
Milton Hydro Distribution Inc.
New Horizon System Solutions
Newmarket Hydro Ltd.
Norfolk Power Distribution Inc.
Nuclear Waste Management Organization
Ontario Power Generation Inc.
Orangeville Hydro Limited
Portlands Energy Centre
PowerStream
PUC Services
Sioux Lookout Hydro Inc.
Sodexho Canada Ltd.
TransAlta Energy Corporation - O.H.S.C. Ottawa
Vertex Customer Management (Canada) Limited
Whitby Hydro Energy Services Corporation

Consultation on Cost of Capital

EB-2009-0084

Final Submission of the Power Workers' Union

1. BACKGROUND

On June 18, 2009, the Ontario Energy Board ("OEB" or the "Board") issued a letter stating it was proceeding with a review of its policy regarding the cost of capital, and that it anticipated that any changes to the policy made as a result of this review will apply to the setting of rates for the 2010 rate year. The Board further stated that it would prepare an issues list that would form the basis of its review, and that the issues list would take into account the stakeholder comments received in response to the Board's March 16, 2009 letter and other information that the Board considered relevant.

On July 30, 2009 the Board issued a letter to which the Issues List was attached. The Board expressed its view that the Fair Return Standard ("FRS") constitutes the over-arching principle for setting the cost of capital. The Board noted the following articulation of FRS by the National Energy Board ("NEB") in its RH-2-2004 decision as consistent with previous OEB determinations:

> **The Board [NEB] is of the view that the fair return standard can be articulated by having reference to three particular requirements. Specifically, a fair or reasonable return on capital should:**
>
> - **Be comparable to the return available from the application of invested capital to other enterprises of like risk (the comparable investment standard);**
> - **Enable the financial integrity of the regulated enterprise to be maintained (the financial integrity standard): and**
> - **Permit incremental capital to be attracted to the enterprise on reasonable terms and conditions (the capital attraction standard).**

The Board also concluded that the Equity Risk Premium ("ERP") approach remains the most appropriate formula-based approach for determining the fair rate of return on common equity ("ROE") in the current circumstances. The Board adopted a two phase process to calculate the ROE: an initial ROE setup that establishes a just and reasonable ROE based on the ERP, and an ongoing adjustment mechanism that automatically adjusts the initial ROE to account for changes in long-term Canada yield expectations.

The Board identified three areas where further information was needed:

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

A stakeholder conference on the above issues took place over three days, ending on October 6, 2009.

The PWU appreciates the opportunity to make a final submission in this matter.

2. THE THRESHOLD ISSUE

The PWU submits that the key task for the Board is ensure that the mechanism selected by it achieves all of the elements of the Fair Return Standard, including the Comparable Investment Standard, as expressed by the NEB in its articulation of the FRS: *a fair or reasonable return on capital should be comparable to the return available from the application of invested capital to other enterprises of like risk.*

The Comparable Investment Standard is an essential element in meeting the other requirements of the FRS for Ontario utilities. If investors were able to achieve superior returns by investing capital in enterprises of like risk, the ability

of Ontario utilities to attract capital on reasonable terms and conditions (the "Capital Attraction Standard") would be severely impaired. Over the long term, in a context where utility investment requirements are expected to increase to meet a number of provincial policy objectives, particularly those mandated under *The Green Energy and Green Economy Act*, an impairment to a utility's ability to attract capital would ultimately compromise its ability to maintain the financial integrity of the regulated enterprise, contrary to the "Financial Integrity Standard".

During the course of the proceeding, it became evident that Dr. Laurence Booth, speaking at the request of ratepayer groups, was the sole presenter to assert unequivocally that a properly selected sample of distribution utilities in the United States would not represent an appropriate comparator group for Ontario utilities in applying the Comparable Investment Standard. There was little dispute that, in general, US utilities tend to have a higher allowed ROE than similar Canadian firms. Thus if US utilities are considered to be enterprises of like risk to Ontario utilities, it follows that the current methodology used by the OEB does not produce a ROE which meets the Comparable Investment Standard.

As a result, the PWU believes the Board should closely examine the evidence on this issue as presented during the stakeholder conference and previously in the parties' submissions on the Issues List.

3. COMPARABILITY OF US UTILITY RETURNS

The PWU submits that the position taken by Dr. Booth on this question is not based on an appropriate empirical foundation. In his pre-conference submission, Dr. Booth makes a number of assertions which do not constitute an adequate basis for concluding that US utilities face higher risks, and therefore do not meet the Comparable Investment Standard.

In his introduction to address this issue, Dr. Booth references a quote from the Canadian Prime Minister in describing what he calls 'light-handed' regulation in the US banking sector compared to the application of regulation in Canada.[1] Even if one were to accept the premise on this basis, the application of regulation in the banking sector does not lead to the conclusion that regulation of US electric distribution utilities is more 'light-handed' than in Canada.

Dr. Booth devotes substantial attention to the question of overall market risk in Canada relative to the United States. He concludes that the overall Market Risk Premium in Canada is lower than in the US, based primarily on the responses of Finance professors to a survey. With respect, a poll of reputed experts does not constitute an appropriate basis for determining a Market Risk Premium. Rather, the strength of the underlying basis of their views must be considered. If the word of reputed experts was a sufficient basis for making such an important determination, it could be argued that the global economic crisis which began in 2008 would have been foreseen and likely averted. Surely that experience has informed us that the opinion, even the consensus opinion of 'experts' is far from infallible.

More importantly, even if one accepts that overall market risk is higher in the US, that conclusion does not necessarily extend to a particular market sector. National market risk is very dependent on the risk levels of enterprises that make up each country's principal equity index. In Canada, the TSX is dominated by relatively large, risk-averse chartered banks, energy companies and commodities. In the US, the S&P 500 features a greater preponderance of technology firms, investment banking, insurance and other service industries. On that basis alone, it is not reasonable to conclude that market risk within the utility sector specifically is very different between the two countries.

[1] Booth submission, September 2009, page 23

Turning to evidence relating more specifically to the utility sector, Dr. Booth presented a chart which purported to show the deterioration in the credit ratings in the US Power and Utility Industry in 2008 vs. 1998.[2] However, when questioned by Mr. Cass, the representative for Enbridge Gas Distribution (EGDI), as to the nature of the companies which made up the sample upon which the chart was derived, Dr. Booth could not provide any information indicating these companies were in fact primarily regulated distribution utilities.[3] The source presentation for this chart was produced for the benefit of stakeholders at the conference, but again it did not provide specific information on the companies included in the sample.[4]

On the other hand, in its submission on behalf of EGDI, Concentric Energy Advisors ("Concentric") produced a chart which showed the credit ratings of a number of specific Ontario and US electricity distributors, virtually all in the "A" range.[5] Dr. Booth questioned whether the sample used by Concentric was representative of the entire population of electricity distributors,[6] but no evidence was introduced to suggest Concentric's sample was in any way biased towards lower-risk US utilities. In fact, Mr. Coyne of Concentric pointed out that his sample did not include municipal and government-owned utilities in the US which typically have superior credit ratings than investor-owned utilities,[7] suggesting that any bias in the sample would be towards US utilities with relatively higher credit risk.

In looking at specific factors which drive risk levels in regulated utilities, Dr. Booth presented a chart which made several assertions to claim that US utilities face higher risks.[8] The PWU submits that little if any specific information was

[2] Booth Presentation, October 6, 2009, page 22 (titled "US vs Canada")
[3] Conference Transcript, Day 3, October 6, 2009, page 37
[4] Bank of America / Merrill Lynch, *Outlook for 2009 and Implications for Regulators*, February 17, 2009, page 14
[5] EGDI Submission, September 9, 2009, page D-5
[6] Conference Transcript, Day 3, October 6, 2009, pages 59-60
[7] Conference Transcript, Day 3, October 6, 2009, page 61
[8] Booth Presentation, page 23 (titled "US utilities are higher risk: 1")

produced to substantiate these assertions, and Dr. Booth himself conceded he was not an expert in the regulation of US utilities.[9] His reliance on the expertise of his colleague, Dr. Safire, was of limited usefulness as Dr. Safire did not appear before the conference to defend his positions to stakeholders in this proceeding.

To note one example of a specific point on his chart, Dr. Booth claimed that US utilities were less likely to achieve their allowed ROE, whereas he also stated that he has produced data showing that the actual returns earned by Canadian utilities consistently exceed the allowed rates of return.[10] This data was not produced for the conference. However, it is known that in 2008, when the allowed ROE for Ontario electricity distributors was either 8.57% (for those who rebased in 2008) or 9.00% (based on 2006 cost of service decisions), 51 out of 64 Ontario distributors reporting, or 80%, had earned ROEs of less than 8.5%.[11]

On the other hand, it is the view of the PWU that the analysis produced by Concentric, as summarized in one of their charts presented at the conference,[12] represents a far more comprehensive analysis of the key characteristics of distribution utilities in Ontario vs. a North American proxy group. Differences and similarities were thoroughly considered before arriving at the conclusion that based on a careful selection of like companies, a proxy group which includes US distribution utilities adheres to the Comparable Investment Standard. Moreover, Concentric was better suited to complete such as an analysis, having recognized expertise in the risks faced by both Ontario and US electricity distributors.

Dr. Booth also claimed that US utilities have greater holding company risk.[13] He states that Enron raided its pipeline subsidiaries for cash with no action from the regulator. However, there is reason to believe that, under the OEB's current regulatory jurisdiction, the prospect of similar risk exists in Ontario. In an appeal

[9] Conference Transcript, Day 3, October 6, 2009, page 29
[10] Conference Transcript, Day 3, October 6, 2009, page 19
[11] Ontario Energy Board, *2008 Yearbook of Electricity Distributors*, pages 41-54
[12] Concentric presentation, September 21, 2009, page 11
[13] Booth presentation, page 24 (titled "US utilities have more 'event' Risk")

by Toronto Hydro Electric System Ltd., the Court ruled that the OEB had exceeded its jurisdiction in imposing conditions on the utility's declaration of dividends.[14] Dr. Booth also provides several examples of credit downgrades following takeovers in the telecom industry during the "internet bubble". There is no evidence to suggest that electric utilities have anywhere near the risk level experienced by telecom companies during that period.

Dr. Booth correctly suggests that the absence of 'ring fencing' would tend to lower the credit ratings of US utilities. Indeed, in responding to a question from Mr. Shepherd representing the Schools Energy Coalition, Dr. James Vander Weide, expert consultant for Union Gas, indicated that since Canadian utility bonds tend to have more covenants than US utility bonds, they would receive a slightly higher credit rating.[15] That conclusion would be consistent with the credit ratings data from Concentric's sample previously mentioned, accounting for the average "straight A" rating for Canadian utilities compared to the "A-minus" rating common for US utilities. It is noteworthy that the slight variance in ratings can be attributed to specific features of debt instruments, rather than fundamental differences in the underlying business or regulatory risks faced by the utilities.

4. THE EQUITY CAPITAL MARKET FOR ONTARIO LDCs

The potential sources of equity capital were not discussed at the conference. Virtually all the evidence on actual equity returns achieved by regulated utilities was based on the stock price performance and dividend yields of publicly traded utilities. Of course, market data of this nature is objective and easily obtained, so it is naturally the best source of empirical data on equity returns. However, the application of this data in determining a fair and reasonable return ignores an important particular characteristic of the capital market for Ontario electric utilities.

[14] Kiteley J. (for the majority), Ontario Supreme Court of Justice, *Toronto Hydro-Electric System Ltd. v. Ontario Energy Board*, September 9, 2008.
[15] Conference Transcript, Day 1, September 21, 2009, page 165

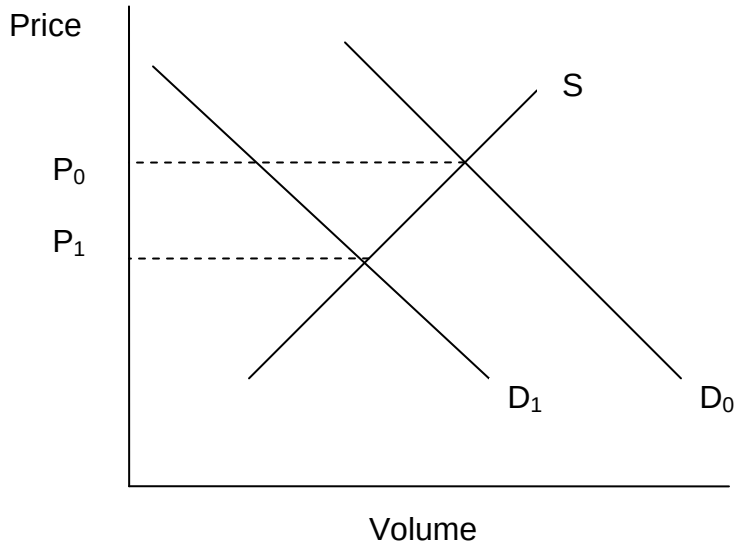
In Ontario, the overwhelming majority of ownership interests in electricity distribution and transmission assets rests within the public sector i.e. municipalities and the provincial government. Equity interests in electricity utilities are not publicly traded. This feature of the capital market for utilities is highly significant. It is generally well recognized that the stock price of publicly traded shares incorporates a "liquidity premium". In other words, investors are willing to pay a higher price for an investment of comparable risk, in exchange for the ability to dispose of the investment at a future date with relative ease in a liquid market. Ultimately, the liquidity premium reflects a reduction in the investor's assumption of risk, since the investor can lock in gains or limit losses through straightforward, timely sales at the prevailing market price of the shares. Absent a liquid market for the shares, the investor's level of risk is higher and thus commands a higher ROE.

This characteristic of the capital market for Ontario electric utilities is unlikely to change in the near future. A transfer tax of 33% applies to most acquisitions of ownership interests in electric utility assets, based on their market value. Ontario's Finance Minister recently announced a permanent exemption from the tax on transfers of utility assets within the public sector.[16] However, the transfer of ownership interests to private sector investors generally remains subject to the transfer tax.

The transfer tax effectively acts like a 'poison pill', limiting private sector demand for equity investments in Ontario electricity distributors. For the most part, equity investment is limited to the public sector, which constitutes only a small fraction of the potential pool of equity capital. It is a basic economic truism that when demand is constrained, price will be lower, as illustrated by the classic demand

[16] Ontario Ministry of Finance, Information Bulletin: Electricity Act, 1998: Permanent Transfer Tax Exemption, October 16, 2009

and supply graph, where S represents the supply curve, D_0 represents the unconstrained demand curve and D_1 represents the constrained demand curve:



The market price resulting from a constrained demand (P_1) is lower than the market price where demand is not constrained (P_0). Applying this principle to the equity capital market, the price an investor is willing to pay for an equity investment in a utility is lower when the demand for such investments is lower, leading to a higher return on investment. As the transfer tax in Ontario limits demand for equity investment in electricity distribution assets by individual and institutional investors, the resulting ROE in a market environment would be higher than it would otherwise be, all other things being equal.

The PWU submits that the Board should consider this special characteristic of the Ontario capital market for electricity distribution utilities, in arriving at an approach for setting an allowed ROE that meets the FRS. In particular, a true application of the Comparable Investment Standard would include some upward adjustment to the allowed ROE, to account for the illiquidity of equity investments and the constrained demand for equity investment in electric utilities which are particular to the situation in Ontario.

5. PROPOSED METHODOLOGY FOR SETTING THE ROE

In general, the PWU supports the proposal advanced by Concentric, whereby the initial ROE would be established with reference to the equity returns of a North American proxy group based on a combination of the Discounted Cash Flow ("DCF") and Capital Asset Pricing Model ("CAPM") methods.[17] The variety of expert opinions on the most appropriate methodology in setting an initial ROE should lead the Board to avoid relying exclusively on any single method. While Dr. Booth presented evidence suggesting the CAPM was the most common method always (or almost always) used by Chief Financial Officers,[18] that conclusion does not indicate that CAPM was the sole method used in any given instance by respondents to that survey. Rather, it does suggest that it is reasonable to include the CAPM as one of the methods to be considered in setting the initial ROE.

It is also reasonable, as Concentric suggested, for the allowed ROE to vary based on the approved equity ratio. A higher equity ratio should lead to a lower reasonable ROE, all other things being equal. This proposal is significant should the Board approve differing levels of deemed equity for utilities according to their size, which is addressed in the following section of this submission.

The PWU also supports the update mechanism proposed by Concentric, where the annual ROE adjustment would be determined by 50% of the change in a 30-year Canadian utility A-rated bond index, plus 50% of the change in a weighted average index of North American rate case decisions.[19] This approach would capture both risk factors that are specific to Canadian utilities, and the allowed returns of US and Canadian utilities in an appropriate proxy group, that should be considered under the Comparable Investment Standard.

[17] EGDI submission, Appendix F
[18] Booth presentation, page 8 (titled "Graham and Harvey survey of CFOs (JFE 2001)")
[19] Concentric presentation, page 15

The implicit assumption in this position is that the existing ROE formula is not adequate. Almost all parties at the conference were aligned with the position of the PWU in its submission on the Issues List, that a formula whose sole variable is the Long Canada Bond Yield cannot produce an appropriate estimate of corporate returns for any sector, including regulated utilities, under a wide range of economic conditions. If the Comparable Investment Standard requires the Board to consider the ROEs of like enterprises across North America, and not just within Canada, then clearly a formula which is entirely dependent on a Canadian government bond yield cannot be consistent with that standard.

Finally, the PWU supports the inclusion of an additional adjustment to the ROE to account for the unique constraints in the equity capital market for Ontario utilities, as described in the previous section of this submission.

6. OTHER ISSUES

Deemed equity ratios

The PWU reiterates the position stated in its submission on the Issues List,[20] that the Board should allow a higher deemed equity component for smaller distributors who may be challenged in raising capital. That submission addressed the concerns raised by the Board in its previous determination on the Cost of Capital,[21] with respect to introducing a barrier to consolidation, the apparent ample debt capacity of smaller distributors and rate discrimination to the detriment of customers of smaller utilities.

As previously stated in this submission, the PWU concurs with Concentric that the allowed ROE should be adjusted based on the deemed equity ratio, with a higher equity ratio leading to a lower allowed ROE.

[20] PWU Submission, September 8, 2009, pages 2-3
[21] Ontario Energy Board, *Report of the Board on Cost of Capital and 2nd Generation Incentive Regulation for Ontario's Electricity Distributors*, December 20, 2006

Deemed debt rate

There was little if any discussion at the conference to address the Board's existing methodology in calculating the deemed debt rate. It is important to note that the formulaic rate applies only in limited circumstances, as the Board has recently ruled it should not apply in all cases to unissued debt[22] or to callable affiliate debt.[23]

In the absence of any evidence indicating a deficiency in the existing formula, the PWU submits the formula should be maintained to determine the deemed rate in those cases where it is applicable. It is important to note that the deemed debt rate formula incorporates both the Long Canada Bond Yield and the spread of corporate bond yields. Unlike the existing ROE formula, it does not depend solely on a single variable, and appropriately reflects credit conditions which impact the cost of corporate borrowing.

Short-term debt rate

The PWU supports the position advocated by Mr. Sardana of Toronto Hydro, to establish a survey of major Canadian banks' short-term lending rates to corporations with short-term ratings of 'R1 (low)',[24] so that the deemed short-term debt rate would more closely reflect utilities' actual cost of short-term borrowing.

All of which is respectfully submitted.

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[22] Ontario Energy Board, *Motion Hearing Transcript*, EB-2008-0130, pages 74-75
[23] Ontario Energy Board, *Decision*, EB-2008-0222/EB-2008-0223, July 15, 2009
[24] Conference Transcript, Day 3, October 6, 2009, pages 149-150