EDA
The Voice Of Ontario's Electricity Distributors

October 30, 2009

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

Via Board's web portal and by courier

Dear Board Secretary:

Re: Board File No. EB-2009-0084, Final Comments on the Review of Cost of Capital

The Electricity Distributors Association (EDA) is the voice of Ontario's local distribution companies (LDCs). The EDA represents the interests of over 80 publicly and privately owned LDCs in Ontario.

Informed by the stakeholder submissions and discussions at the stakeholder conference, the EDA would like to provide the attached submission indicating the final comments and views of electricity distributors with respect to Cost of Capital policy review. The EDA's submission has been prepared in consultation with EDA members and Ms. Kathy McShane of Foster Associates Inc.

Yours truly,

"original signed"

Maurice Tucci
Policy Director, Distribution and Regulation

Attached: EDA submission

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EDA's Final Comments with respect to

Ontario Energy Board's Consultation on Cost of Capital policy review

As articulated by the Chair of the Ontario Energy Board (OEB), the OEB had three purposes in this consultation:

1. to address the potential need to adjust the established cost of capital methodology based on the equity risk premium approach, to ensure that it is adaptable to changes in financial market and economic conditions;
2. to determine the reasonableness of the results based on a formulaic approach for setting the cost of capital; and,
3. to guide the Board's discretion to adjust those results, if appropriate

As the Chair suggested, it is essential that the Board's cost of capital policy determines the opportunity cost of capital for monies invested in utility works as accurately as possible, with the ultimate objective being facilitating efficient investment in the sector. The consultation, as the Chair stated, is about whether the return on equity resulting from the application of the Board's cost of capital policy meets the fair return standard.

In regard to the last point, it bears reiterating what the fair return standard requires.
A fair or reasonable return on capital should:

- be comparable to the return available from the application of the 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)

Based on the evidence placed before the Board in this consultation, the EDA concludes that the automatic adjustment formula as currently constructed does not produce returns that meet the fair return standard.

During this consultation, the Board had the opportunity to hear from a broad spectrum of stakeholders.

From the capital markets panel, there were the following messages:

1. the level of returns allowed Canadian utilities makes it difficult to attract international capital to the traded companies' stocks;
2. it is becoming an increasing challenge to get Canadian investors interested in Canadian utilities;
3. Investors are not interested in Canadian utilities reinvesting their earnings;
4. From the bond investors' perspective, there is concern over the impact on credit quality of the low levels of ROEs, particularly given the utility sector's capital spending requirements as well as increasing operating complexities, both of which translate into higher risk;
5. The credit rating agencies have been cautioning that credit metrics are weak for the existing utility credit ratings and they have only so much tolerance for such weakness. In the absence of some relief on the cost of capital, there is a real risk of utility downgrades; and
6. The NEB's TQM decision was based on significant evidence that the real-world cost of equity capital did not agree with the automatic adjustment formula. The capital markets expectation is that there will be some improvement in allowed ROE and/or capital structure adopted by other regulators.

From Mr. Carmichael, Dr. Vander Weide, Concentric Energy Advisors, and Ms. McShane, key messages were:

1. The current automatic adjustment formula is based on a relationship between utility ROEs and the long-term Canada bond yield which overstates the sensitivity of the former to the latter. Dr. Vander Weide, Concentric and Ms. McShane all presented evidence in support of that conclusion;
2. There is a large and persistent gap between allowed ROEs in Canada and the U.S. which cannot be explained by differentials in risk between the utility sectors in the two countries or by differences in the cost of capital environment in the two

countries but, instead, appears to be largely explained by the premise of the automatic adjustment formula that the cost of equity closely tracks the yield on the long-term Canada;

3. Basing the ROE solely on the changes in the long-term Canada bond yield fails to capture changes in the cost of equity that are independent of changes in the risk-free rate. The NEB's TQM decision (which was for 2007 and 2008 tolls, based on evidence predating the financial crisis) also concluded that changes that could potentially affect TQM's cost of capital may not be captured by changes in the long Canada bond yield and hence may not be accounted for by the results of the formula;
4. The financial crisis highlighted the potential for the existing formula to produce an ROE that was totally at odds with the trend in the cost of equity, as happened in 2009;
5. Ms. McShane's analysis established that the trends in corporate bond yields provide better insight into trends in the cost of utility equity than trends in long-term government bond yields;
6. A recalibration of the fair ROE performed by Concentric Energy Advisors, based on cost of equity tests applied to a sample of proxy companies of reasonably comparable risk to Ontario's electricity distributors, produces an estimated fair return on equity that is considerably in excess of the formula results.
7. A battery of tests of the validity of the formula undertaken by Dr. Vander Weide demonstrates that the formula is broken, that is, it produces an equity risk premium that is neither consistent with investor equity return requirements nor with the market's assessment of the relative risk of utilities.

Standing virtually alone in support of the current formula was Dr. Booth. Dr. Booth concluded that the automatic adjustment formula continued to produce returns that were fair, based on his application of the Capital Asset Pricing Model. In the EDA's view, reliance solely on the Capital Asset Pricing Model is problematic for determining a fair return on equity. The weaknesses of the model were summarized by Ms. McShane in the

EDA's responses to the Board's questions (Question 10) submitted September 8, 2009. Two weaknesses stand out:

1. The model is highly theoretical—it measures the return equity investors **should** require in the context of adding equity shares to a diversified portfolio, rather than the return investors do require. The model does not consider the returns actually available for investments of comparable risk. As Mr. Dafoe of ScotiaCapital indicated during the oral portion of the consultation, "I don't know of any investors that use simple formulas like CAPM in making individual investment decisions when it comes time for a new issue of a bond or even equities for that matter. Very often these formulaic models, which are sort of a theoretical distillation of what happens in the real world, as Matthew [Akman of Macquarie Equities Research] said, don't always agree with the real world."

2. The application of the model effectively assumes that the utility cost of equity closely tracks long-term Canada bond yields (as does the automatic adjustment formula); it does not independently test or verify the relationship between the two. As indicated above, several of the presentations to the Board demonstrated that the utility cost of equity and long-term Government bond yields do not track to the extent implied either by the typical application of the CAPM or the automatic adjustment formula.

In sum, the oral portion of the consultation lead the EDA to conclude that the views set out in its September 8, 2009 Responses to OEB Questions, prepared on its behalf by Ms. McShane, remain valid. Those views and recommendations are summarized for convenience below.

- Ensuring that the fair return standard is met requires that the relationship between capital structure and return on equity is explicitly recognized.
- 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.

- An equity ratio of 40% is not unreasonable for a benchmark, or average business risk, Ontario electricity distributor, provided that, when combined with the ROE, it meets the comparable investment requirement of the fair return standard.
- The determination of the appropriate capital structure and ROE should not be dependent on the source of the utility's debt financing. The stand-alone principle for purposes of setting both should be respected.
- Ensuring adherence to all three requirements of the fair return standard requires reliance on multiple cost of equity tests applied to comparable risk companies, as well as benchmarking the test results against other relevant indicators of a fair return.
- Expressing the ROE in terms of a premium above either long-term Canada bond yields or corporate bond yields does not mean that the initial ROE need be estimated solely using a test or tests that might be defined as equity risk premium tests.
- Sole reliance on Canadian utilities is not a sufficient basis for ensuring that the comparable investment standard is met. U.S. utilities provide a reasonable alternative for the selection of comparable utilities, given the integration of the capital markets, the similarity of the operating environments and the similarity of the regulatory models.
- Objective criteria should be relied upon to select comparable risk companies.
- Each of the various types of tests (Capital Asset Pricing Model, other forms of Equity Risk Premium tests, Discounted Cash Flow, Comparable Earnings) brings a different perspective to the estimation of a fair return. No single test is, by itself, sufficient to ensure that all three requirements of the fair return standard are met.

- The Capital Asset Pricing Model has significant drawbacks, particularly in the context of setting of the fair return, that are sufficient to conclude that it should not be the only cost of equity test relied upon to ensure that the fair return standard is met.
- Empirical analysis indicates that the ROE has changed by approximately 50% of the change in long-term Canada bond yields. Further, the analysis demonstrates that there is a positive relationship between the ROE and spreads between A rated utility and long-term Government of Canada bond yields. To recognize the positive relationship between yield spreads and the ROE, a separate term should be incorporated into the automatic adjustment formula which changes the risk premium by 50% of the year-over-year change in long-term A rated corporate bond yield spreads.
- Establishing a process for review of the ROE and formula every five years would balance the objective of achieving regulatory efficiency with the Board's obligation to establish a fair return.
- If the ROE calculated by reference to the proposed amended formula were to be more than 200 basis points above or below the recalibrated ROE, there should be a process for determining whether there should be a formal review of both the starting ROE and formula.
- The Board should consider adjustments to the ROEs embedded in distributor rates, subject to a dead band, to ensure that groups of distributors are not advantaged or disadvantaged by the timing of their rate rebasing and to ensure that the fair return standard is met throughout the term of the Incentive Rate Mechanism.
- A reset of the initial ROE, the adoption of the proposed formula and trigger mechanism, and the ability to seek review within a specific time frame should mitigate concerns that the ROE will fail to meet the fair return standard.

On October 8, 2009, the National Energy Board issued a letter decision in which it rescinded its automatic adjustment formula, and expressed the views that:

1. since 1994, there have significant changes in financial and economic circumstances; and
2. there is a doubt as to the ongoing correctness of the RH-2-94 Decision

This Board's automatic adjustment formula, while introduced somewhat later than the NEB's, is virtually identical in both construction and results. In the EDA's submission, similar to the finding of the NEB, there is significant doubt as to the correctness of the results of the automatic adjustment formula in Ontario.

The EDA recognizes that the circumstances facing the OEB are different than those facing the NEB. The utilities which are regulated by the OEB do not have the same history of negotiated settlements that has characterized NEB pipeline regulation. Consequently, the retention of a formula approach to ROE for electricity distributors in Ontario may be more compelling as a means to maintain regulatory efficiency and fairness to all stakeholders. Nevertheless, it is time to recognize that the existing automatic formula has veered off-course, to recalibrate the initial ROE and to replace the existing automatic adjustment formula.

The EDA acknowledges that the capital markets value stability in the regulatory environment as well as stability (or at least predictability) of returns. Stability or predictability of returns, however, is not a substitute for fairness of returns. The EDA is of the view that the Board can achieve the objectives of predictability and fairness of returns and, at the same time, maintain a stable regulatory environment, by resetting the "benchmark" ROE and adopting the automatic adjustment formula proposed by Ms. McShane in the EDA's September 8, 2009 Responses to OEB Questions. That formula incorporates both the empirically demonstrated lower sensitivity (than the existing formula) of utility cost of equity to long-term Canada bond yields and the positive relationship between the utility cost of equity and corporate bond yields. By including

the latter component, the proposed formula captures changes in the cost of capital to corporations that the government bond yield does not.

The resulting formula is transparent, objective, simple to apply and more accurately measures the utility cost of equity than the existing formula. As demonstrated in the EDA's September 8, 2009 Responses to OEB Questions, it captures both cyclical and secular trends in the cost of equity, and, simultaneously, would result in more stable allowed ROEs than the existing formula.

The EDA recognizes the importance of the cost of capital, particularly at a time when the electricity distributors are facing significant capital investment, warrants ensuring that the fair return standard is met. The EDA believes the Board has the discretion as a result of this consultation to alter the benchmark ROE and automatic adjustment formula now. Thus the EDA requests the Board determine the bench mark ROE and automatic adjustment formula based on the information gathered in this consultation without further ado, as was done by the Board in the 2006 consultation on Cost of Capital (EB-2006-0088).

Should the Board determine that there is insufficient time to recalibrate the ROE prior to May 2010 when new rates come into effect, then the EDA recommends to the Board that it adopt the interim solution set forth in the EDA's April 2009 submission and reiterated in its September 8, 2009 Responses to OEB Questions. That solution entails maintaining the 75% sensitivity factor between interest rates and the ROE that underpins the existing automatic adjustment formula, but replacing long-term Government of Canada bond yields with corporate bond yields.