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Ontario Energy Board | Commission de l'Énergie de l'Ontario

Ontario

RP-2002-0158

IN THE MATTER OF APPLICATIONS BY

UNION GAS LIMITED

AND

ENBRIDGE GAS DISTRIBUTION INC.

FOR

A REVIEW OF THE BOARD'S GUIDELINES FOR ESTABLISHING THEIR RESPECTIVE RETURN ON EQUITY

DECISION AND ORDER

2004 January 16

Ontario Energy Board

Commission de l'Énergie de l'Ontario

Ontario

RP-2002-0158 1

EB-2002-0484

IN THE MATTER OF the *Ontario Energy Board Act*, 1998, S.O.1998, c.15, Schedule B; 2

AND IN THE MATTER OF an Application by Union Gas Limited for an Order or Orders approving or fixing just and reasonable rates and other charges for the sale, transmission, distribution, and storage of gas; 3

AND IN THE MATTER OF an Application by Enbridge Gas Distribution Inc. for an Order or Orders approving or fixing just and reasonable rates and other charges for the sale, transmission, distribution, and storage of gas; 4

AND IN THE MATTER OF an Application by Enbridge Gas Distribution Inc. and Union Gas Limited for a review of the Board's Guidelines for establishing their respective return on equity. 5

BEFORE: 6

Paul Vlahos 7
Presiding Member

Bob Betts 8
Member

Paul Sommerville 9
Member

DECISION AND ORDER 10

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The Applications 15

Union Gas Limited ("Union") filed an application for rates dated May 27, 2002 with the Ontario 16
Energy Board, under section 36 of the *Ontario Energy Board Act, 1998 S.O. 1998*, c.15, Schedule B (the "Act"). Union filed evidence in support of its application on June 25, 2002. The Board assigned file number RP-2002-0130 to Union's application. By letter dated August 1, 2002, Union added to its application a request for changes to the Board's formula used to establish Union's return on common equity ("ROE").

Enbridge Gas Distribution Inc. ("Enbridge" or "EGDI ") filed an application for rates dated 17
September 2, 2002, with the Board, under section 36 of the Act. Included in its application was a request for a change to the Board's formula used to determine EGDI's ROE. The Board assigned file number RP-2002-0133 to the EGDI application.

The Proceeding 18

The evidence in relation to the ROE issue relied upon by Union and EGDI in their applications is 19
essentially the same, and both Applicants rely upon the same consultant, Ms.K. McShane. With the consent of the Applicants, the Board decided to hear the ROE issue raised in the two applications in a separate stand-alone proceeding. The Board assigned file number RP-2002-0158 (EB-2002-0484) to this separate ROE proceeding.

On December 16, 2002, the Board issued Procedural Order No. 1 setting out the schedule for the 20
proceeding. In accordance with that order, Union filed on February 7, 2003 updated evidence prepared by Ms. McShane.

Procedural Order No. 2 issued on March 3, 2003 amended the dates for the proceeding as follows: 21
interrogatories on the Applicants' evidence were due on April 11, 2003; interrogatory responses were due on April 29, 2003; supplementary interrogatories on the Applicants' evidence was due on May 8, 2003 and responses to supplementary interrogatories, were due May 15, 2003; an Issues/ Technical Conference was to be held on May 21, 2003; an Issues Day proceeding was to be held on May 23, 2003; intervenor evidence was to be filed by June 27, 2003; interrogatories on intervenor evidence were due by July 11, 2003; interrogatory responses were due by July 25, 2003.

Procedural Order No. 3 issued on April 30, 2003 cancelled the Issues/Technical Conference and the 22
Issues Day and specified that a Stakeholders Conference take place on May 23, 2003. Procedural Order No. 4 issued on July 3, 2003 set the commencement of the hearing as September 18, 2003. On August 12, 2003 the Board issued Procedural Order No. 5 which revised the hearing date to September 22, 2003.

The Hearing 23

The oral proceeding commenced on September 22, 2003, and concluded on September 26, 2003 24
after 5 hearing days.

The Applicants filed their written argument-in-chief after the close of business October 20, 2003, 25
rather than October 17, 2003 as originally scheduled. Consequently, some intervenors requested a corresponding extension to file their reply argument, which the Board granted. Six intervenors filed their arguments by November 5, 2003. The Board also extended the date on which the Applicants' reply argument was due from November 7, 2003 to November 12, 2003. At the request of the Applicants, the Board further extended the filing date from November 12 to November 21, 2003.

Parties and their Representatives 26

Below is a list of parties and their representatives who participated actively by leading evidence or 27
cross-examining witnesses in the oral hearing, or by filing argument.

28

Union Gas Limited	Michael Penny Marcel Reghelini
Enbridge Gas Distribution Inc.	Helen Newland Marika Hare
Board Counsel	Patrick Moran
Consumers Association of Canada ("CAC")	Robert Warren
London Property Management Association ("LPMA")	Randy Aiken
Industrial Gas Users Association ("IGUA")	Peter Thompson
Vulnerable Energy Consumers Coalition ("VECC")	Michael Janigan
Energy Probe	Brian Dingwall
Pollution Probe	Murray Klippenstein
Ontario Public School Boards' Association ("OPSBA")	Jay Shepherd
Canadian Gas Association ("CGA")	Laurie Smith

Witnesses 29

The Applicants called the following witness: 30

Kathleen McShane	Senior Vice President, Foster and Associates

IGUA/VECC/CAC called the following witness: 31

Lawrence Booth	Professor of Finance, Rotman School of Management, University of Toronto

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CGA called the following witnesses:

Peter Case	Peter Case Consulting
Michael Cleland	President and Chief Executive Officer, Canadian Gas Association

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The Board called the following witness:

William Cannon	Associate Professor of Finance, School of Business, Queen's University

Submissions and Exhibits 35

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Copies of the evidence, exhibits, arguments, and a transcript of the proceeding are available for review at the Board's offices.

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The Board has considered the evidence, submissions and arguments in the proceeding, but has summarized the evidence and the positions of the parties only to the extent necessary to provide context for its findings.

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The Board, with industry participation, has developed standards and processes for the electronic regulatory filing ("ERF") of evidence, submissions of parties, Board orders and decisions. This Decision and Order will be available in ERF form shortly after initial copies are issued in hard copy. The ERF version will have the same text and numbered headings as the initial hard copy, but may be formatted differently.

2 SUMMARY OF CURRENT GUIDELINES 39

The Ontario Energy Board currently uses a formula based approach to set the return on common 40
equity ("ROE") for most gas utilities under its jurisdiction. The Board's approach is set out in its *Draft Guidelines on a Formula-Based Return on Common Equity* ("ROE Guidelines"). The ROE Guidelines were first applied in the EBRO 495 proceeding which set fiscal 1998 rates for The Consumers' Gas Company Ltd. (now EGDI).

The ROE Guidelines start with the establishment of a benchmark ROE to provide, as it was described 41
in the EBRO 495 decision, "a just and reasonable return on equity" for each gas distribution company. This benchmark ROE is then adjusted for each subsequent fiscal year in accordance with an adjustment mechanism.

The benchmark ROE for a utility is set by taking the forecast yield for long-term Government of 42
Canada bonds and adding an appropriate risk premium to account for the utility's risk relative to the long-term Government of Canada bonds. The equity risk premium test is used to determine the appropriate risk premium.

The Compendium to the ROE Guidelines, at p.5, described this method as follows: 43

> The equity risk premium test is also designed to measure the cost of equity capital 44
> from the capital attraction perspective. It relies on the assumption that common equity is riskier than debt and that investors will demand a higher return on shares, relative to the return required on bonds, to compensate for that risk. The premium required by an investor to assume the additional risk associated with an equity investment is taken to be the difference between the relevant debt rate, usually the yield on long-term government bonds, and some estimate of the stock's cost of equity. The recommended cost of equity value under the equity risk premium approach is therefore usually computed as the sum of the test-period forecast for the government yield and the utility-specific risk premium the analyst has estimated based on historical equity risk premium evidence and forward-looking considerations.

The benchmark ROE becomes the allowed ROE for the first year. EGDI's benchmark ROE was set 45
at 10.65% in the EBRO 495 proceeding, based on a risk premium of 340 basis points. Union's benchmark ROE was set at 11.00 % in the EBRO 493-04/494-06 proceeding, based on a risk premium of 355 basis points. The 15 basis points difference reflects the relative risk of the two utilities. The difference of the returns over 15 basis points is accounted for by the difference in the timing of setting the rate or return for the two utilities.

Once the benchmark ROE has been established, the allowed ROE is automatically adjusted annually, 46
using a formula. The change in the forecast yield for long-term Government of Canada bonds is multiplied by a factor of 0.75 to determine the adjustment to the allowed ROE. This adjustment

factor is then added to the utility's previous test year ROE and the sum is rounded to two decimal points to produce the new ROE.

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<u>Example:</u>

Allowed ROE for test year 1		10.00%
Test year 2 long-term Government of Canada bond yield forecast	5.00%	
Test year 1 long-term Government of Canada bond yield forecast	<u>5.25%</u>	
change in interest rates	-0.25%	
adjustment factor of 0.75 applied		<u>0.1875%</u>
ROE for test year 2		9.8125%
Approved ROE for test year 2 (rounded to 2 decimal places)		9.81%

Regarding the need for review in the future, the ROE Guidelines, in the Compendium at p. 28, state: 48

> The Board believes that the rate of return formula should be reviewed as conditions arise that may call into question its validity (e.g., a change in the relative taxation of the income from debt and equity investments, or a fundamental change in business or financial market conditions). To set a particular time period may be artificial and necessitate an unnecessary review or stifle a review at another time when an adjustment would be appropriate. Parties to a proceeding may ask the Board to review the formula when they feel it is appropriate or the Board may do so on its own initiative. In either case it will be the Board's decision as to the time for a review. 49
>
> From time to time the Board may request the presentation of other tests or require some weighting for other tests in the formula should the Board want to assure itself that the equity risk premium formula approach does not lead to perverse results and is directionally in line with other market indicators.

3 EVIDENCE AND POSITIONS OF THE PARTIES 50

The Applicants 51

The Applicants relied on Ms. McShane's evidence, in support of their request for a new benchmark ROE and a change to the annual adjustment formula. 52

Ms. McShane concluded that the ROE Guidelines produce an ROE for EGDI and Union that is unreasonably low. This conclusion was based upon her proposed methodology, her analysis of changes in the Canadian bond market since March 1997, and her consideration of the allowed returns for U.S. gas and electric utilities. 53

To formulate her recommendation for a new benchmark ROE in the range of 11.5 - 11.75%, based on a forecast 6.0% yield for long-term Government of Canada bonds, Ms. McShane applied three equity return tests; the Equity Risk Premium (ERP) test, the Discounted Cash Flow (DCF) test and the Comparable Earnings (CE) test. 54

Ms. McShane used three versions of the ERP test which produced an ROE range of 10.5% to 11.25%. 55

Ms. McShane's DCF test, which she applied exclusively to a sample of U.S. utilities, produced an ROE of 11.5%. 56

Ms. McShane applied her CE test to both Canadian and U.S. industrial returns covering the 1992-2001 period, and giving primary weight to the Canadian evidence, this produced an ROE range of 12.75 - 13.25%. 57

Ms McShane then combined these results, weighting the ERP and DCF test results 37.5% each, and the CE test results 25%, to produce her recommendation that an appropriate benchmark ROE would be in the range of 11.5 - 11.75% for an average risk utility. She recommended the mid-point of 11.625% as an appropriate benchmark ROE for Union, as an average risk utility, and 11.5% for EGDI, as a slightly lower risk utility. 58

Ms. McShane noted that the regulated ROE for U.S. gas and electric utilities were typically higher than for utilities in Canada. She was of the view that this divergence could disadvantage Canadian utilities and their shareholders within the context of an increasingly integrated North American capital market environment. 59

Ms. McShane also pointed to a number of changes that had occurred in the bond and equity markets after the ROE Guidelines were established, which she relied on to support her contention that the risk premiums used to set the original benchmark ROE for the Applicants are too low in today's context. 60

CGA 61

The CGA sponsored the evidence of Mr. Cleland and Mr. Case. Mr. Cleland was presented as a policy spokesperson for the CGA and his evidence was limited to confirming that the CGA supported a higher ROE for Canadian utilities, including the Applicants. 62

Although Mr. Case did not propose any changes to the current ROE formula or the annual adjustment mechanism, his view was that an ROE in the range of 10.5 - 11.0% would be viewed by equity markets as a fair return, based on his telephone discussions with various equity market participants and analysts. 63

His recommendation was based on the following five factors. 64

First, Mr. Case claimed that the formula no longer compensates investors appropriately for an increase in the perceived riskiness of utilities since 1997. 65

Second, according to Mr. Case, recent market conditions limit the usefulness of the Capital Asset Pricing Model (CAPM) because market conditions have artificially depressed utility stock betas. 66

Third, he suggested that the continuing globalization of capital markets since the Board issued its 1997 ROE Guidelines has made a comparison to higher US utility returns more relevant. The lower returns of Canadian utilities put them at a competitive disadvantage in attracting capital. Mr. Case pointed to the recent sale by Aquila Inc. of its Canadian utility as an example of an investor not willing to invest in a utility in British Columbia or Alberta because the ROE was too low. He also pointed to some examples of Canadian utility holding companies that experienced difficulty in raising common equity as a further demonstration that the current level of ROE for Canadian utilities was a problem. 67

Fourth, with the significant decline in bond yields since 1997, the formula has resulted in a decline in equity returns that is faster than the decline in the utilities' embedded cost of debt. As a result, there has been downward pressure on utility interest coverage ratios, which in turn puts pressure on utility debt ratings. 68

Finally, Mr. Case believed that the majority of institutional equity investors view the returns currently generated by the formula based approach used by the Board and other Canadian regulators as inadequate. 69

CAC, IGUA and VECC 70

CAC, IGUA and VECC sponsored the prefiled report prepared by Drs. Booth and Berkowitz. The authors concluded that a fair ROE for the Applicants is in the range of 8.5%, which includes a 50 71 basis point "cushion" above their estimates of the cost of attracting capital for these utilities. Only Dr. Booth testified in the hearing but he adopted the joint prefiled evidence.

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In their report, Drs. Booth and Berkowitz came to their ROE recommendation by applying two versions of the ERP test and giving equal weight to the results. Their first ERP test was the single-factor Capital Asset Pricing Model (CAPM), while their second ERP test relied on a two-factor model which differentiated between the systematic risk due to changes in the equity market and changes in security returns due to fluctuations in interest rates.

73

Their application of the CAPM model yielded an ROE in the range of 8.02% to 8.47%. This was based on their assessment that (1) the market risk premium is now 4.5% and (2) a reasonable range for the beta risk of an average-risk regulated Canadian utility is 0.45 to 0.55.

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Applying their two-factor model, which incorporates a term premium estimate of 1.00%, produced an ROE in the range of 7.66% to 7.74%.

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In further support of their proposed benchmark ROE of 8.5%, Drs. Booth and Berkowitz produced DCF test results, based on a sample of U.S. utilities, that pointed to an ROE in the range of 7.89 to 8.57%.

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In testimony, Dr. Booth indicated that he did not see a need to move away from the Board's ROE Guidelines, even though their analysis suggested that the ROE Guidelines produced an ROE that was more generous than it needed to be. In their report, Drs. Booth and Berkowitz stated their belief that the 75% adjustment factor was a reasonable compromise between (a) assuming that the overall required return on the stock market is independent of long-term Government of Canada bond yields implied by a 50% adjustment coefficient, and (b) assuming that the riskiness of the long-term Government of Canada bond relative to the equity market is constant, as implied by a 100% adjustment factor.

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Finally, Drs. Booth and Berkowitz pointed out that the market-to-book-value ratios of all Canadian utilities, save one, were well in excess of 1.0. They stated that this was a clear indication that utilities have not suffered a loss of financing flexibility since Canadian regulators moved to automatic ROE adjustment mechanisms based on long-term Government of Canada bond yields, beginning in 1994.

Dr. Cannon 78

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Dr. Cannon was retained by the Board to provide additional evidence on the ROE issues. He prepared a report that was provided to all parties and he answered interrogatories on his evidence. He also appeared as a witness and was cross-examined by the parties. His expert opinion, as with the other expert witnesses, was provided to the Board entirely on the public record.

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In his evidence Dr. Cannon concluded that there had been a substantial decline in the equity capital costs for the average-risk Canadian gas utility and for Ontario's major gas distributors since 1996.

According to Dr. Cannon, there is no evidence to suggest that the application of the Board's ROE formula methodology had resulted in allowed returns which had violated either the fair return or financial integrity standards of regulatory rate setting. 81

He also submitted that the decrease in ROE under the ROE Guidelines had been less than it would have been, applying the capital attraction standard of regulatory rate setting instead. 82

It was Dr. Cannon's view that an appropriate benchmark ROE for the average-risk Canadian energy utility now lies in the range of 7.5% to 7.9%, lower than the ROE that would currently be produced under the ROE Guidelines. Dr. Cannon's benchmark ROE recommendation is based primarily on results from using the three equity return tests that Ms. McShane used. In using those tests, he applied different judgment and reached different conclusions than Ms. McShane did. 83

Using his ERP test, Dr. Cannon concluded that an appropriate ROE would be in the range of 6.35-6.55% for the average-risk Canadian energy utility, based on a mid-June estimate of 4.00% for the yield on a truly riskless long-term Canadian asset and a corresponding "all-in ERP" in the 2.35-2.55% range. His utility ERP test findings reflected the substantial decline in the prospective market risk premium in recent years as well as the continuing low relative investment riskiness of the typical energy utility. 84

Applying the DCF test to a sample of Canadian energy utilities produced a benchmark ROE in the range of 7.9% to 8.5%. 85

The CE test, using data for Canadian industrials over the 1991-2002 period produced an ROE of 10.2% for Dr. Cannon. 86

To arrive at his final recommendation for a benchmark ROE, Dr. Cannon applied different weights to his three test results than Ms. McShane. Dr. Cannon weighted his results from the three tests as follows: ERP - 60%, DCF - 15%, and CE - 25%. 87

Dr. Cannon's ROE recommendation reflected an "all-in benchmark ERP" of 2.93% above the long-term Government of Canada bond yields prevailing in mid-June. 88

With respect to the adjustment formula, Dr. Cannon proposed that the adjustment factor applied to changes in the forecast long-term Government of Canada bond yields be reduced to 70%, from the current 75% value. He based this on his view of the sensitivity of his equity return tests to changes in the long-term Government of Canada bond yields and his weighting of the three tests. 89

Dr. Cannon concluded that, all other things being equal, the ROE numbers produced by the ROE Guidelines in recent years are likely too high. 90

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LPMA

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LPMA did not rely on the evidence of any particular expert as, in its opinion, the analysis of any one expert did not produce a definitive estimate of a fair return. Instead, LPMA gave equal weight to the results of the work done by Ms. McShane, Dr. Cannon and Drs. Booth and Berkowitz, with one exception. LPMA argued that zero weight should be given to Ms. McShane's CE test because, in the view of LPMA, the market risk premium was overstated.

93
LPMA's final recommendation for a new benchmark ROE was 8.96% based on giving equal weight to the three expert's evidence, removing the CE test, applying a market risk premium of 325 basis points, and averaging the three ERP estimates produced by Ms. McShane, Dr. Cannon and Drs. Booth and Berkowitz.

94
LPMA submitted that the CE test should not be relied on because of the difficulty in assembling an acceptable sample of comparable companies against which to assess the regulated utility. First, LPMA noted that both Dr. Cannon and Ms. McShane selected comparable industrials yet the results were 300 basis points apart. Second, there had been debate regarding the appropriate earnings to use and widespread concern regarding corporate reporting which placed the accuracy of the information in doubt. Third, the American returns were not suitable comparators as the American economy was generally more competitive resulting in higher risks and consequently higher returns. Fourth, LPMA noted that Canadian regulators often gave little or no weight to the CE test.

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School Boards

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School Boards also did not call any evidence. School Boards recommended that the Board approve an ROE of 9.0% for EGDI, assuming a risk-free rate of 5.4%.

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With respect to Union Gas, School Boards believed that there was no evidence to suggest that Union Gas was any riskier that EGDI. The premium paid by Duke when it acquired Union suggested that Union was not as risky as Ms. McShane or Dr. Cannon believed. Further, the fact that the two utilities are at the same deemed equity ratio implied that they could be considered to be at the same risk level. Therefore, School Boards submitted that the Board should approve an ROE of 9.0% for Union Gas as well.

98
School Boards noted that the debate of the experts demonstrated that the same underpinning numbers could produce different results. Therefore the expert evidence was suspect, as all of the experts chose and manipulated data in ways that limited the objectivity of their conclusions. The School Boards argued that, given this uncertainty among experts regarding the appropriate ROE tests, greater weight should be placed on evidence other than that of the experts.

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School Boards' position was therefore not tied to that of the experts. Instead it proposed a different approach. School Boards proposed five tests to arrive at its 9.0% ROE recommendation.

The first test, named the "mind experiment", consisted of arriving at a number representing the intersection of the experts' broadest ranges of ROE. 100

The second test, using the Seigel Tables, implied a long term market return for utilities of 7.56% to 7.74% if compound returns were used. If arithmetic mean returns were used, then the resulting ROE would be in the range of 8.46% to 8.72%. 101

The third test, based on expectations of pension funds, suggested that utility ROE should be no more than 8.5%. 102

The fourth test, the premium paid by Duke, Union's parent company, demonstrated that the current ROE resulting from the formula was somewhat high. According to School Boards, assuming that the current ROE was too high by 50 basis points, the resulting ROE would be 8.76 for EGD and 8.91% for Union Gas. 103

The fifth test, a simple average of the experts' recommendations, resulted in an ROE of 9.05%. 104

Combining these five approaches led School Boards to recommend a new benchmark ROE of 9.0% for both Applicants. 105

With respect to the adjustment mechanism, the School Boards supported the proposal of the Applicants to adjust the ROE annually by 50% of the change in the forecast long-term Government of Canada bond yields. 106

Energy Probe 107

Energy Probe also did not rely on the evidence of any particular expert. It submitted that there was no need to make any changes to the ROE Guidelines and that the ROE Guidelines should be re-affirmed to signal stability and predictability in Ontario's natural gas environment. 108

Energy Probe submitted that there was no evidence that the Applicants had suffered any capital shortage under the current ROE Guidelines. In fact, the formula seemed to provide adequate consideration of costs related to maintaining access to capital markets. Furthermore, it was not necessary to make changes to the ROE formula to address changes to business and financial risk because other mechanisms, such as deferral accounts, were available to the Board for this purpose. 109

Energy Probe suggested that the actual financial performance of utilities demonstrated that they were low risk enterprises and that the argument for any alteration to the ROE formula was weak. Energy Probe noted that over the last decade, both utilities had consistently outperformed the Board allowed ROE. 110

Pollution Probe 111

Pollution Probe did not address the issue of the appropriate ROE formula. Rather it requested that the Board permit the Applicants to earn an additional ROE, over and above what the ROE Guidelines would produce, as an incentive to aggressively promote cost effective energy conservation and efficiency. 112

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4 BOARD FINDINGS

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The Board's ROE Guidelines suggest that there are two reasons which would justify a review of the formula. The first justification would be significant changes in market conditions. The second justification would be significant changes in the utility risk. The Applicants have based their request for a review on their assertion that there have been significant changes in the capital markets. There is no claim that the utility risk per se has increased. The Board recognizes that the ROE Guidelines are not binding and that it is always open to a party to propose a new approach. The Applicants have made such a proposal and the Board has considered on its merits.

115
The first issue for the Board is whether the adjustment mechanism contained in the current ROE Guidelines produces a prospective return on common equity that continues to be appropriate. The formula in the current guidelines produces an ROE of 9.71% for Enbridge and 9.86% for Union at a long-term Government of Canada bond yield of 6.00%. This reflects a risk premium of 371 basis points for Enbridge and 386 basis points for Union. At a long-term Government of Canada bond yield of 6.00%, the Applicants are asking the Board to set a new benchmark ROE of 11.50% for Enbridge and 11.65% for Union. This proposal reflects an increase in the risk premium to 550 basis points for Enbridge and 565 basis points for Union. They are asking the Board to move from sole reliance on the equity risk premium (ERP) test, as set out in the ROE Guidelines, to weighted reliance on three tests described in Ms. McShane's evidence: the ERP test (37.5%), the discounted cash flow (DCF) test (37.5%) and the comparable earnings (CE) test (25%).

116
The second issue for the Board is the Applicants request, based on Ms. McShane's evidence, for a change to the annual adjustment formula, so that in each succeeding year, the ROE is adjusted by 50% of the change in the forecast yield for long-term Government of Canada bonds, rather than the 75% required by the ROE Guidelines. However, this request was contingent upon the outcome of the first issue.

117
The third issue for the Board is the request by the Applicants, based on Ms. McShane's evidence, that the factor representing the yield spread between the 10 and 30 year Government of Canada bonds be fixed, rather than being calculated annually. Dr. Cannon makes the same suggestion, although he recommends a lower spread than Ms. McShane.

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First, we will deal with the primary issue of whether a new benchmark ROE should be established for EGDI and Union.

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In approving or fixing rates, the Board derives its jurisdiction from section 36 of the Act. Pursuant to that section, the Applicants can only charge rates for the distribution of gas with the approval of the Board. The burden of proof to demonstrate that the rates applied for are just and reasonable lies with the Applicants. The setting of just and reasonable rates involves the balancing of the interests of the Applicants, on the one hand, and the ratepayers, on the other hand. Rates will be just and reasonable when the ratepayers are paying a fair price for the distribution services that they receive and the Applicants have an opportunity to earn a fair return on their invested capital. Allowance for

a prospective fair return on common equity is therefore a component of establishing just and reasonable rates.

Section 36 (3) of the Act provides that the Board can adopt any method or technique for the setting of rates that it deems appropriate. The method to be adopted is at the Board's discretion, which the Applicants, the expert witnesses and other parties acknowledge. Currently, for the purpose of establishing the ROE for a utility, the Board uses a formula based approach, as set out in the ROE Guidelines, based on the ERP test. The institution of this formula and its application dates back to 1997. None of the parties have proposed that the Board should move away from a formula based approach. We are of the view that it is appropriate to continue with a formula based approach because it provides a significant degree of predictability and is compatible with both cost of service and performance-based regulation. 120

A great deal was made in the hearing by Ms. McShane and the Applicants about comparisons with American utilities and returns awarded by other Canadian jurisdictions. The Applicants argue that the returns of American utilities are higher and that this supports the need for higher returns for the Applicants. They also cite decisions by certain Canadian regulators in support of higher returns. Yet, they also argue that the Board should not be influenced by the unfavourable decisions for recalibrating the existing formula by certain other Canadian regulators, on the basis that this Board should lead rather than follow. Also, they state that the Board must consider the applications on their own merits. 121

Discussions of ROE decisions from other jurisdictions invariably come into the evidence and arguments of parties. We continue to view such evidence as informative. However, we do not believe that decisions in other jurisdictions are determinative of what ought to be a prospective fair ROE for Ontario utilities. There are many reasons why ROE may differ from one jurisdiction to another in North America. These may include differences in legislation, timing, tax laws, accounting practices, risk considerations arising from different capital structures and from regulatory practices which may or may not shield the utility from business or weather risks, and other regulatory considerations unique to each jurisdiction, including varying reliance on the common tests for determining a fair ROE. There was no evidence that would allow the Board to make a meaningful comparison of these factors, including the relative riskiness of Canadian and American utilities, in order to understand the difference in ROE between American and Canadian utilities. The bare fact that American utilities might earn a higher ROE than Canadian utilities, as suggested by Ms. McShane and argued by the Applicants, is an inadequate basis upon which to determine whether the ROE for the Applicants should be increased to a level similar to the ROE for American utilities. Similarly, the fact that some Canadian regulators may have awarded higher or lower returns than the Ontario Energy Board, while informative, is not determinative for largely the same reasons. 122

Ms. McShane suggested that the difference in ROE between American and Canadian utilities was a factor that could create a disadvantage for Canadian utilities and their shareholders. However, we find no evidence to suggest that such a disadvantage currently exists or is likely. Mr. Case suggests that Union, for example, must now compete for equity capital with the other global subsidiaries of Duke Energy, Union's parent; if Union cannot offer a competitive return with the other units, capital might be more difficult to obtain from the parent company. There was no evidence before the Board to suggest that the Applicants are experiencing any difficulty in raising equity capital from or through their respective parents. 123

A long standing regulatory principle espoused by the Ontario Energy Board, and by other regulators in North America, is the stand-alone principle. Applying this principle, the issue is what ought to be a prospective fair return on investment for a utility on a stand-alone basis, and not how a prospective return may compare or compete with other business units of the parent company. Should it be the case that the Ontario gas utilities are unable to attract equity capital by virtue of competition at the parent company level, whether the parent company is foreign or domestic, this would be of great concern to the Board. 124

There was no evidence before the Board to suggest that Canadian utilities in general were experiencing difficulty in raising capital, or doing so at unreasonable terms. Mr. Case mentioned that BC Gas had difficulty raising equity; the equity issue "sat on the shelf" until the dealers were willing to discount it. Dr. Booth countered this point by explaining that the reason that the equity issue sat on the shelf was due to the fact that there was a bidding war amongst investment dealers due to a shortage of such deals at that time. The winning dealer paid a premium for the equity issue in order to secure the underwriting fees. Dr. Booth suggested that this example was in fact a demonstration of how easily a utility could raise capital. 125

Mr. Case pointed to the recent sale of a Canadian pipeline utility by Aquila Inc. as an example of an investor unwilling to invest in Canada. However, the evidence revealed that Aquila was able to sell its pipeline utility to Fortis Inc. at a considerable premium, which would suggest that there are investors willing to invest in Canadian utilities. There was no evidence that Aquila Inc. sold its utility because of concern of the ROE earned by that utility. In fact, the evidence reveals that utility ownership transfers in recent history have taken place at above book value. While there may be many reasons that a company may be willing to pay more than book value for utility assets, there was no evidence to suggest that investors are deterred from investing in Canadian utilities because of inadequate prospective returns. 126

We found no evidence of the Applicants being in financial hardship as a result of the authorized ROE. The Applicants confirmed that they continue to be responsible for raising their own debt capital. There was no evidence, for example, that the allowed ROE has resulted in inadequate financial ratios to preclude raising debt capital on reasonable terms. Similarly, there was no evidence before the Board to suggest that credit ratings of the Applicants were deteriorating. The evidence is that the Applicants enjoy favourable credit ratings. In fact, Union's credit rating is more favourable than its parent company. 127

Mr. Case made references to changes in the business risk faced by the Applicants, but that issue was not before the Board. The Applicants made their request for a change in ROE based on the capital markets and not on any financial or business risk that they were facing. Ms. McShane confirmed in responding to questions that business and other risks covered by the equity component of capital structure were not matters at issue in this hearing. The Applicants did not dispute this testimony. 128

Having found no evidence of returns being inadequate so as to jeopardize the financial and operational aspects of Enbridge and Union, the issue then is whether the rate of return resulting from the equity risk premium test under the current ROE Guidelines is appropriate. 129

Three tests, and their variants, were employed or critiqued by the experts. All three witnesses had varying views with respect to the appropriateness of relying on the ERP test, the DCF test and the CE test. This was a large contributor to the differences between their recommendations. The other large contributor to the difference was the results arrived at by employing the same tests. The evidence of Ms. McShane, Dr. Booth and Dr. Cannon makes it clear that a great deal of judgment is involved in determining what is an appropriate ROE for a utility. Those three witnesses, along with Mr. Case, were looking at the same capital markets but came up with significantly different recommendations to the Board. However, Dr. Booth and Dr. Cannon also conceded that the current ROE Guidelines were still generally appropriate, despite their recommendations for a lower benchmark ROE. Ms. McShane was more categorical in her view that the ROE Guidelines were no longer producing a fair ROE and that a new benchmark ROE and adjustment formula were needed. 130

On the basis of the evidence adduced in this proceeding, we find that the reservations the Board expressed in the compendium to the current ROE Guidelines about the CE and DCF approaches and the Board's decision not to employ these tests remain valid. With respect to the CE test, we continue to be concerned with the problems associated with the assembling of an acceptable list of comparable companies against which to assess the regulated utility, as well as the selection of a suitable time period from which to draw historical evidence. We note that the subjectivity involved in the selection of an appropriate sample of comparators and the selection of the time period were the primary factors in arriving at an ROE difference of 300 basis points between Ms. McShane and Dr. Cannon. We also reiterate our concern with this test's heavy reliance on past performance as an indicator of future performance. 131

With respect to the DCF test, we note the sensitivity of the results to assumptions, including growth estimates. We note that as a result of different assumptions, Ms. McShane's ROE result from the DCF test is over 200 basis points higher than the results obtained by Dr. Booth and Dr. Cannon. Further, in the context of the specific applications before us, we remain uncomfortable with the results of the DCF test given that the shares of the Applicants are no longer traded on the open market. 132

As a result of the above, we reiterate the Board's conclusions reached when it developed the existing ROE Guidelines that the results from the CE and DCF tests should be given little or no weight for purposes of these applications. 133

We do not accept the suggestions by certain parties to use the approach of averaging the recommendations or to embark on tests that do not have theoretical foundation. Therefore for the purposes of this proceeding we will rely primarily on the results of the ERP test. Other than Mr. Case, all expert witnesses used this test. 134

There are four basic components to this test: a determination of the risk-free rate; a determination of the equity risk premium for the market as a whole; an adjustment (beta) to reflect the lower risk of utilities; and an allowance for financial flexibility or "cushion". Supplemental analysis to the basic ERP test was performed by Ms. McShane and Drs. Booth and Berkowitz. 135

No party has disputed the use of the long-term Government of Canada bond yield as the basis of the risk free rate, or the basis for its forecast as contained in the current ROE guidelines other than the 136 suggestion to fix the spread between the 10 and 30 year bond yields. Also, there was no dispute about the 50 basis points cushion. The disputes are around the determination of the market risk premium and the risk adjustment to reflect the lower risk for utilities.

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Ms. McShane calculates a market risk premium of between 600 and 650 basis points. Dr. Booth calculates the premium at about 450 basis points and Dr. Cannon at about 350 basis points. The recommendations of a benchmark return under the basic ERP test of about 400 basis points for Ms. McShane, about 200 basis points for Dr. Booth, and about 160 basis points for Dr. Cannon reflect their choice of a relative risk adjustment of 0.60-0.65, 0.45-0.55, and 0.45, respectively. Adding the 50 basis points of cushion, the recommended benchmark equity risk premium under the basic test for Ms. McShane is 450 basis points, for Dr. Booth 250 basis, and for Dr. Cannon 210 basis points.

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On the basis of the record adduced in this proceeding, we are of the view that Dr. Cannon's result is too low and Ms. McShane's too high. We find that the record reasonably supports a risk premium for the market as a whole between 500 and 550 basis points. We note from the evidence that the Alberta Energy and Utilities Board which recently reviewed similar data concluded that the market premium is 525 basis points. This is the mid-point of our 500 to 550 range. Using this mid-point figure, and without any modifications to Ms. McShane's recommended risk adjustment, one would obtain an overall equity risk premium of about 375 basis points, inclusive of the 50 basis points cushion. These equity risk premiums compare with 371 basis points for Enbridge and 386 basis points for Union under the current ROE Guidelines. Ms. McShane's recommended risk adjustment is higher than the other experts. A lower risk adjustment than that recommended by Ms. McShane would result in the equity risk premium under the current formula being favourable to the Applicants.

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Ms. McShane used two other tests under the risk premium method, both utilizing utility data only. The first was the DCF based equity risk premium test, which produced an equity risk premium of 460 to 470 basis points. For the reasons outlined in the discussion of the DCF approach above, and our observation that the results indicate a much higher equity risk premium than the basic test produces, we place little or no weight on these results.

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The second is a historic test, using data from both Canadian and American utilities. This test produced an equity risk premium of 475 to 500 basis points. We similarly place little or no weight on these results. We are not comfortable with the circularity that is inherent using regulated utility data, and the inclusion of American utilities which may bias the results without a thorough understanding of the justification for the higher returns of these utilities.

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We conclude that not only does the equity risk premium formula approach not lead to perverse results, but that the results it currently provides continue to represent fair and reasonable returns. If we had to set a new benchmark rate of return based on the ERP evidence in this proceeding, this rate would not be materially different from that produced by applying the current formula.

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Therefore, with respect to the first and primary issue of whether a new benchmark ROE should be established for EGDI and Union, we find that the current ROE Guidelines methodology continues to produce appropriate prospective results. We have not found any demonstrated need to set a new benchmark ROE.

Given this finding, the second issue, the Applicants' request for the annual ROE adjustment to be decreased to 0.50 from 0.75 of the change in the forecast yield for long-term Government of Canada bonds, is moot. 143

As for the third issue, the suggestion that the factor representing the yield spread between the 10 and 30 Government of Canada bonds be fixed rather than being calculated annually, the Board does not consider this to be of sufficient consequence, by itself, to justify a change to the existing guidelines. 144

Accordingly, based on the foregoing findings, the Board orders that the applications are dismissed. 145

In making this determination, the Board also considered the proposal put forward by Pollution Probe to increase ROE as an incentive to promote cost effective energy conservation and efficiency. The Board notes that the Applicants currently have demand side management programs in place that have already been ruled upon. This proceeding is focussed on whether conditions in the capital markets warrant a change to the Board's formula based approach to setting the ROE for the Applicants. The Board also notes that Pollution Probe and the Applicants are participating in a broad Board initiative that is examining energy conservation and efficiency. 146

The Board will issue a separate decision on cost awards. 147

DATED at Toronto January 16, 2004 148

On behalf of the Hearing Panel

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Paul Vlahos
Presiding Member