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August 4, 2024 **VIA E-MAIL**

Ms. Nancy Marconi
Registrar (registrar@oeb.ca)
Ontario Energy Board
Toronto, ON

Dear Ms. Marconi:

Re: EB-2024-0063 Generic Cost of Capital Proceeding
Interrogatories of the Vulnerable Energy Consumers Coalition (VECC)
to Dr. Sean Cleary -Exhibit M4 – AMPCO/IGUA

Please find attached the revised interrogatories of VECC in the above-noted proceeding. We have also directed a copy of the same to the Applicant.

Yours truly,

Mark Garner
Consultants for VECC/PIAC

Mark C. Garner

Digitally signed by Mark C. Garner
Date: 2024.08.04 09:43:43 -04'00'

Email copy:
Ian Mondrow, Gowling LLP (Counsel for IGUA)
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REQUESTOR NAME	**VECC**
TO:	**EXHIBIT M4: AMPCO/IGUA DR. CLEARY**
DATE:	**August 4, 2024**
CASE NO:	**EB-2024-0063**
APPLICATION NAME	**GENERIC COST OF CAPITAL PROCEEDING**

1.0 Reference: Exhibit M4, page 18

Preamble: The Report states:
"*With respect to 1a), OEB's current practice of using actual debt rates in most cases considers the impacts of different funding sources, as noted by LEI. However, the deemed long-term debt rate (DLTDR) can be used as an estimate or a ceiling (if the actual rate is higher than DLTDR). This approach satisfies the FRS, is intuitive, and is easy to apply, and I agree with LEI that there is no need to make changes to this practice*."

1.1 Based on Dr. Cleary's understanding, for all of the electric and natural gas utilities regulated by the OEB, is the DLTDR used as a ceiling in all instances where the actual rate is higher than the DLTRDR regardless of source of debt (e.g., affiliate vs. non-affiliate) and the nature of the debt (e.g., fixed vs. variable rate)?

1.1.1 If not, in those instances where the DLTDR is not used as a "ceiling", is it Dr. Cleary's recommendation that it should be used as a ceiling?

2.0 Reference: Exhibit M4, page 21

Preamble: The Report states:
"*This conclusion is supported by the ranking of regulatory support provided by S&P as of November 2023 (as included in Figure 47 on page 129 of LEI's evidence), which shows the OEB ranked as one of just jurisdictions (out of 60) that was ranked in the top category of "Most credit supportive (strong)," recognizing that of course other considerations play an important role in such a ranking*."

2.1 Please provide S&P's ranking of Ontario in terms of regulatory support in 2009, when the OEB's decision following its last comprehensive cost of capital review (EB-2009-0084) of Ontario's regulated utilities.

2.2 Please provide S&P's ranking of Ontario in terms of regulatory support in 2016, when the OEB Staff's review of the OEB's cost of capital policy was issued.

3.0 Reference: Exhibit M4, pages 22 and 27

Preamble: The Report states**:**
"*For electricity transmitters and distributors (T&D), the deemed short-term debt rate (DSTDR) is used to set short-term debt rates, while the short-term rates applied for natural gas distributors and OPG are based on these utilities' forecasts of short-term debt rates based on their actual debt portfolio. In addition, for electricity T&D, the DSTDR applies to 4% of their capital structure*." (page 22)
And
"*In addition, as mentioned previously, the OEB uses 4% as a proxy for the short-term debt component for electricity T&D, which it also uses for the unfunded portion of the capital structure for other utilities*." (page 27)

3.1 With respect to the second reference, by other utilities, is Dr. Cleary referring to both OPG and Ontario's natural gas utilities?

3.1.1 If yes, does Dr. Cleary consider the use of the actual short-term rates for the unfunded portion of these utilities deemed debt structure to be appropriate?

3.1.2 If not, to what utilities is Dr. Clear referring and is the use of the actual short-term debt rate in such circumstances appropriate?

4.0 Reference: Exhibit M4, page 22
Exhibit M1 (LEI's Report), pages 76 and 83

Preamble: Exhibit M4 states:
"*LEI further recommends estimating the spread for an R-1 rated borrower to this rate based on a confidential survey of banks, which they recommend should be extended from the current sample of 6 to a larger sample of 6-10 banks. I am fine with this suggestion, assuming that it does not lead to including less reliable estimates (i.e., from the smaller banks) nor adds unnecessary complexity to the survey process*."

Exhibit M1 states:
"*The spread can continue to be determined based on the confidential survey of banks. However, LEI recommends considering a larger sample size (of at least 6-10 banks) for the survey to obtain CORRA-based spreads for R1-low rated entities (similar to OEB-regulated entities*)."
(emphasis added)

4.1 At page 76 the LEI Report (footnote 184) describes three different R-1 ratings. Does Dr. Cleary agree with LEI's recommendation to use the CORRA-based spreads for R1-low rated entities?

5.0 Reference: Exhibit M4, page 28

Preamble: The Report states:
"*I agree with LEI's comments on page 100 of its evidence that support "continuation of the status-quo approach (consider deemed capital structure regardless of the actual capital structure*)"."

5.1 For electricity transmitters and distributors, in those instances where the actual long-term debt is less than the deemed long-term debt portion of the capital structure, what should be the basis for the rate applied to the unfunded portion of the deemed long-term debt?

6.0 Reference: Exhibit M4, page 30

Preamble: The Report states:
"*This time period also includes a period of extremely low interest rates (from 2009 until 2022), which is positive for utility stock returns, since they are generally high dividend-paying stocks. In addition, during the 2001-24 period, there were three periods of extreme market declines and uncertainty, due to the technology crash (2001-02), the financial crisis (2008-09) and COVID (2020), and during such periods utility stocks tend to perform better than the average stock in the market due to their low-risk nature (i.e., there is a flight to safety). As such, I agree with LEI's decision to not consider this Ke estimate (based on ERP analysis) in their final ROE estimate." (added for clarification*)"

6.1 Please confirm (or otherwise explain) that Dr. Cleary's agreement with LEI's decision not to use its ERP results is based on the time-period used by LEI in its analysis and not on issues/concerns regarding the ERP methodology in general.

7.0 Reference: Exhibit M4, page 32

Preamble: The Report states:
"*As a result of the sampling and growth estimation issues identified above, I conclude that LEI's DCF estimates of Ke are upward biased and should not be relied upon, which is in agreement with LEI's decision not to include these estimates in their final Ke estimate*."

7.1 Please confirm (or otherwise explain) that Dr. Cleary's agreement with LEI's decision not to use its DCF results is based on concern regarding the proxy companies and growth estimates used in LEI's DCF analysis and not on issues/concerns regarding the DCF methodology in general.

8.0 Reference: Exhibit M4, page 36

Preamble: The Report states:
"*Similar to my response regarding debt financing transaction costs provided in Section 3.8, I believe the current practice of adding 0.5% to Ke estimates seems reasonable, since it embeds the actual costs of equity financing related to new equity issues into the cost of equity, as they should be. The fact that most companies (utilities and other businesses alike) do not frequently engage in new equity issues does not*

detract from the fact that such issuing costs have a legitimate impact on their actual long-term equity financing costs when they do occur."

8.1 In Dr. Cleary's view is 0.5% a reasonable estimate as to the actual cost of equity financing?

8.2 For those Ontario-regulated utilities that do not issue common equity (e.g., where the equity is held by the municipality), why is appropriate to include in the ROE an allowance designed to compensate the equity holder for the costs associated with the sale of new issues of common equity?

9.0 Reference: Exhibit M4, page 37

Preamble: The Report states:
"*Section 5.1 of my evidence shows that since 2004, both RF and A-rated utility yields have declined markedly, while the allowed ROEs have declined much less so over this period. As a result, the spreads between allowed ROEs and these yields, both of which directly affect the utilities' cost of capital, have increased dramatically though the years. For example, in January 2004, the allowed ROE by the OEB was 9.88%, at a time when 30-year government yields (RF) were 5.3% and A-rated utility yields were 6.1%. So, the spread between the allowed ROE and RF was 4.57%, and between ROE and A yields was 3.78%. However, as of June 5, 2024, the allowed ROE was 0.67% lower than in 2004 at 9.21%, while RF was 2.0% lower at 3.30%, and A yields were 1.42% lower at 4.68%. As a result the ROE-RF spread was 1.34% higher than in 2004 at 5.91% (a 7 29% increase), while the ROE-A yield spread was 0.75% higher at 4.53% (a 20% increase). The average ROE-RF spread during the January 2004-June 2024 period was 6.03%12 and the average ROE-A-yield spread was 4.61%."*

9.1 Please provide a similar analysis comparing December 2009 (when the OEB's decision following its last major cost of capital review was issued) and June 2024.

10.0 Reference Exhibit M4, page 45

Preamble: The Report states:
"*I agree that this variable should continue to be included in the ROE formula; however, I recommend that this spread would be best determined using the actual spread as of September 30th, rather than using an average for the month (or for the previous 12 months). It is always preferable to use the most timely estimate of current capital market conditions as is feasible since this spread, like most capital market factors, can change through time. For example, while the average spread over the 2003-2024 period was 1.40% (as shown in Figure 3 of my evidence), it fluctuated from 0.76% to 3.05% over the period, and sat at 1.38% as of June 5, 2024. In particular, something(s) could have happened during the most recent month (or months) that could either ease (or elevate) bond investors' risk assessments, which would be reflected in lower (or higher) yield spreads, and hence spreads existing before this unexpected event (or events) would not be as representative*

as the prevailing spreads at the end of the month, which reflect the most recent capital market conditions."

10.1 How would Dr. Cleary respond to the concern that reliance on spreads as of a particular date (e.g., September 30) could result in the spread that's used being unduly influenced by a short-term event that will not necessarily influence capital markets over the coming year?

11.0 Reference: Exhibit M4, page 46

Preamble: The Report states:
"The data included in Attachment A was used to produce Table 6 of my evidence, which reports summary statistics for Canadian capital markets over the 1938 to 2023 period. Based on these 85 years of Canadian capital market observations, the correlation coefficient between Canadian stock returns and long Canada bond yields (i.e., RF) was +0.01 – very close to the CAPM predicted correlation of 0. Hence, it seems that any regression designed to predict the exact adjustment factors to be used for LCBF, and for UtilBond Spread, will not provide meaningful results. Therefore, I disagree with LEI's recommended adjustment factors – the existing adjustment factors of 0.5 would be preferable."

11.1 Please explain more fully why "any regression designed to predict the exact adjustment factors to be used for LCBF, and for UtilBond Spread, will not provide meaningful results".

11.2 Given the correlation results cited in the Report, why is it reasonable for the OEB to adopt a formula for annually adjusting the allowed ROE that relies on the LCBF and the UtilBond Spread?

12.0 Reference: Exhibit M4, page 51
Exhibit M1 (LEI Report), page 119

Preamble: Exhibit M4 states:
"*I concur with LEI's position that the OEB's current practice of setting a uniform ROE and adjusting the capital thickness if it determines upon application that there has been a meaningful change in business/financial risks is appropriate, which is consistent with current practice in many other jurisdictions*."

In Exhibit M1 LEI calculates its recommended ROE using the CAPM and a weighted average beta value based on the beta estimates for electricity transmission and distribution; electricity generation and natural gas distribution.

12.1 To the extent the average uniform ROE adopted by the OEB differs from that determined (using the same methodologies and approach) to be applicable to specific segments of Ontario-regulated utilities (e.g., electricity transmission & distribution, electricity generation and nature gas distribution) should the capital structure approved for each segment be adjusted to recognize these differences?

13.0 Reference: Exhibit M4, page 52

Preamble: The Report states:
"*My recommendation, which is consistent with that of LEI, is:*
14) The OEB's current practice of continuous monitoring through the review of quarterly reports adds value and should be retained."

13.1 Has Dr. Cleary reviewed any of the quarterly reports prepared by the OEB?

13.1.1 If yes, are the items being monitored and reported on adequate for purpose of determining the reasonableness of existing cost of capital parameters and, if not, what else should be monitored/reported on?

13.1.2 If not, please provide Dr. Cleary's views as to what specific items/issues such a quarterly report should be monitoring and reporting on.

14.0 Reference: Exhibit M4, page 53
OEB Letter, 2024 Cost of Capital Parameters. October 31, 2023

Preamble: The Report states:
"*My recommendation, which is consistent with that of LEI, is:*
15) - The OEB retain its current annual review practice.
- The current annual review process can be supplemented by adding annual reporting requirements for utilities to provide credit ratings, as well as details regarding new short-term and long-term debt and equity issued/borrowed during the year."

14.1 The OEB's 2024 Cost of Capital Parameters letter states:
"*The OEB considers the cost of capital parameter values shown in the above table, and the relationships between them, to be reasonable and representative of market conditions at this time. For this reason, the OEB concludes that the numerical results from the formulaic methodologies meet the Fair Return Standard.*
The OEB monitors macroeconomic conditions and may issue updated parameters if economic conditions materially change."

In his recommendation, Dr. Cleary identified an additional item to be reported by utilities and to be considered by the OEB it its annual review. Apart from the additional item identified in Dr. Cleary's recommendation, in Dr. Cleary's view, what are the other factors and relationships that the OEB should be considering annually in order to determine if the ROE formula is producing results that are reasonable and representative of market conditions?

15.0 Reference: Exhibit M4, page 55

Preamble: The Report states:
"*In particular, if the Canadian A-rated utility yield spreads exceed 2%, I recommend an immediate and thorough assessment of existing capital market conditions. This could lead to a full regulatory review, depending on the results of this assessment. This is because, a spread greater than*

2% would be indicative of a period of extreme uncertainty in Canadian capital markets. For example, over the January 2003-June 5, 2024 period, the average A-rated yield spread was 1.40%, with a minimum of 0.76% and with a maximum of 3.05% during December 2008, which was at the height of the financial crisis. However, for the most part, these spreads fluctuated but did not approach such high levels again. In fact, the 96th percentile for the spread over this period was 2.00%."

15.1 Would there also be a need for an immediate and thorough assessment of existing capital market conditions if the Canadian A-rated utility yield spreads fell below a certain value (e.g., the 5th percentile for the spread over the cited period)? If not, why not?

16.0 Reference: Exhibit M4, page 57

Preamble: The Report states:
"*Currently, the OEB sets the prescribed interest rate for CWIP equal to the FTSE Canada (formerly DEX) Mid Term Bond Index All Corporate yield, which it applies to all projects under construction, regardless of duration of the construction period. I support continuing this policy, as does LEI*."

16.1 What is Dr. Cleary's rationale for supporting the OEB's current policy for setting the prescribed interest rate for CWIP?

17.0 Reference: Exhibit M4, page 58

Preamble: The Report states:
"*The prescribed interest rate for DVAs should be revised to align with the recommended DSTDR methodology by using CORRA as the base rate instead of the BA Rate, where the base CORRA rate is estimated as the average of 3-month CORRA futures rates over the next 12 months, and the spread added to it is determined by sampling 6-10 banks to determine the appropriate R1-low rated utility spread*."

17.1 What is Dr. Cleary's rationale for supporting the use of a short-term interest rate (i.e., using CORRA as the base rate and adjusting by the R1-low rated utility spread) for purposes of determining the prescribed interest rate for DVAs?

18.0 Reference: Exhibit M4, page 77

Preamble: The Report states:
"*This study provides evidence "demonstrating empirically that allowed returns on equity diverge significantly and systematically from the predictions of accepted asset pricing methodologies in finance." A large part of this can be explained by the fact that allowed ROEs "tend to exhibit considerable stickiness around focal 'odometer' points." Consistent with the evidence for Ontario and Alberta discussed above, the authors note that "awarded ROE spreads over risk free treasuries have progressively widened significantly since 2005, <u>even though systematic risk in the utilities industry has fallen continuously during the same time period</u>*." (emphasis added)

18.1 Does Dr. Cleary agree that "systematic risk in the utilities industry has fallen continuously during the same time period" and, if so, what evidence does Dr. Cleary have that this is the case.

19.0 Reference: Exhibit M4, page 90 and Appendix C, pages 130-135
Exhibit M1 (LEI Report), page 117

Preamble: Exhibit M4 states (page 90):
"*Canadian utility beta estimates have averaged somewhere between 0.20 and 0.40 – with 0.35 representing the best estimate*."

Exhibit M1 states:
"*LEI finds that un-levering the raw betas with the operating leverage of peer companies and re-levering the average un-levered beta with deemed operating leverage allowed by the OEB provides for a prudent estimate of beta*."

19.1 Please identify the Canadian utilities used in: i) Figure 6 (pages 130-131) and ii) Charts 20 & 21 (pages 132-133).

19.2 In Figure 6 and Charts 20 & 21, were the betas used for each company the actual company betas or were they unlevered and then re-levered (per description on page 135) to a common capital structure?

19.2.1 If the actual company betas were used what was the range of equity thickness for the various companies used in Figure 6 and Charts 20 & 21?

19.2.2 If the betas were "unlevered" and "re-levered" to a common equity thickness, what was the equity thickness used.

19.3 In Dr. Cleary's view, is it appropriate to unlever and re-lever the actual betas for each company (as done by LEI) in order to calculate the value for beta to be used in the CAPM?

20.0 Reference: Exhibit M4, pages 36 and 95

Preamble: The Report states:
"*Similar to my response regarding debt financing transaction costs provided in Section 3.8, I believe the current practice of adding 0.5% to Ke estimates seems reasonable, since it embeds the actual costs of equity financing related to new equity issues into the cost of equity, as they should be*." (page 36)
And
"*Finally, I add 50 bp for financial flexibility (or flotation costs), consistent with previous OEB practice, and consistent with long-term estimates*." (page 95)

20.1 Is financial flexibility the same as flotation costs?

20.1.1 If not, please explain the difference and how the 50 bp accounts for both.

21.0 Reference: Exhibit M4, pages 96-97
Exhibit M2 (Concentric Report), pages 57-58

Preamble: The Report uses the following formula to calculate the required return using the single-stage DCF Model:

$$K_e = (D_0/Price)\times(1 + g) + g$$

The Concentric Report uses a different formula:

$$K_e = (D_0/Price)\times(1 +0.5 \times g) + g$$

21.1 Please comment on the two approaches and why Dr. Cleary considers his approach to be more appropriate.

22.0 Reference: Exhibit M4, pages 81 and 97

Preamble: The Report states:
"*Table 1 showed that real GDP growth has averaged 2.3% over the 1992 to 2022 period, which provides one potential estimate of long-term growth that could be used in the single-stage model, since one might expect long-term growth for the overall market to gravitate towards this figure*." (page 97)

22.1 Please explain why a 30 year period is used as opposed to a longer historical period such as those in Table 7 (page 81).

23.0 Reference: Exhibit M4, page 97

Preamble: The Report states:
"*The dividend yield for the S&P/TSX Composite Index as of December 31, 2023 was 3.19%. This is the "lagged" dividend yield (i.e., D_0/Price) since it is estimated using dividends over the most recent 12-month period*."

23.1 What was the basis for the stock price used in the calculation (e.g., was it the stock price as of December 31, 2023 or the average stock price over the 12 months ending December 31. 2023)?

23.1.1 Please explain why the approach used is appropriate.

23.2 Why was December 31, 2023 selected as the reference point as opposed to a more current date?

24.0 Reference: Exhibit M4, pages 105-107
Exhibit M1 (LEI Report), pages 113-114
Exhibit M2 (Concentric Report), pages 74-79

24.1 LEI and Concentric both appear to use a different approach for the ERP method than Dr. Cleary and, indeed, the approaches used by LEI and Concentric are themselves different. Please comment on the differences between Dr. Cleary's ERP analysis and that of LEI and Concentric and provide Dr. Cleary's view on the appropriateness of each.

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