ONTARIO ENERGY BOARD

2024 Review of Cost of Capital Parameters and Deemed Capital Structure

**Association of Major Power Consumers in Ontario (AMPCO) &
Industrial Gas Users Association (IGUA)**

Written Submissions

A Dose of Common Sense

1. Regulated utility cost of capital discussions can be complicated. In the current review, a plethora of analytical frameworks and analyses have been presented by four external experts.

2. In respect of base cost of equity (ROE) in particular, multiple methodologies have been presented and deployed to come up with more than a dozen range estimates based on different data sets, and various combinations and weightings have been proposed to land on “a number” to apply in setting rates for Ontario’s rate regulated utilities.

3. The debate has been highly detailed, some might even say arcane.

4. In approaching consideration of all of this evidence, all of these calculations, all of the data sets, and the many, many expert judgements applied along the way, it is worth taking a step back to re-specify the overall nature and objective of this exercise.

5. The overall objective of determining an appropriate cost of capital for rate regulated utilities is to set rates that are “just and reasonable”. That is, the rates set should provide the utility and its shareholders with a reasonable opportunity to recover all of their costs reasonably incurred in the provision of regulated services. One such cost if the cost of capital.

6. The cost of capital has two basic components; the cost of debt, and the cost of equity.

7. The cost of debt is readily observable. While there are decisions to be made in respect of how to peg the cost of debt in determining a reasonable overall utility cost of capital, the topic is relatively more tractable.

8. The cost of equity is not readily observable. It must be divined. That is a more complicated and theoretical exercise and has been the focus of much of the evidence and debate in this proceeding. It is also the focus of these submissions.

9. That is not to say that the other cost of capital parameters, including the cost of debt and the derivation and application of an approach to periodic cost of capital adjustment, are not of interest to AMPCO and IGUA. They are. We have had the benefit of reviewing detailed draft submissions from CCC and SEC. These submissions address these other cost of capital parameters in significant detail, and very well. We agree with many of the points made by these intervenors, and need not replicate their good work.

10. CCC and SEC address the topic of determination of a base ROE in significant detail as well, and given the quality of those submissions there is no need for us to replicate that work either. On much of the detailed analysis in respect of the various inputs and analytic approaches to determining an appropriate ROE for Ontario's regulated utilities we agree with, defer to, and endorse those other consumer representative's submissions.

11. In these submissions we focus on discrete, framework level topics related to determination of the base ROE and deemed equity thickness. Overall, we advocate for a healthy dose of common sense in the exercise of this Board's discretion to determine an appropriate ROE, and deem an appropriate capital structure, for the purposes of determining a cost of capital to include in setting just and reasonable regulated Ontario energy utility rates.

Cost of Equity (Base ROE)

12. Various approaches and analytical techniques have been developed over the years and advocated in regulatory proceedings to divine "the" utility cost of capital. Each has its theoretical strengths and weaknesses, and regulators have often considered a number of these techniques and then applied their discretion in setting a cost of equity (ROE) within the range thereby defined.

13. While "a" cost of equity needs to be defined for the purpose of setting specific regulated energy utility rates, in reality most cost of capital evidence, including the evidence in this proceeding, indicates a range of reasonableness, rather than a clearly correct single number. Despite the impression of precision in the experts' math, there are a multitude of judgements and choices

made along the various analytical paths taken, and each expert takes a number of paths, all indicating that there is no single, multiple decimal point number that is "the" right answer. As in many aspects of economic regulation, the choice of "a" number to use for the purposes of setting rates is properly an exercise of informed regulatory discretion.

14. In the application of judgement and regulatory discretion to the choice of a particular cost of equity to define the ROE component of just and reasonable rates, it is important to bear in mind that the overall objective of this exercise is to determine an estimate of the cost of capital reasonably incurred by the utility.

15. In determining a reasonable estimate of the cost of capital for Ontario's regulated utilities, it should be noted that there is consensus among all experts that regulated utilities are less risky than average companies, and less risk drives a lower cost of capital.

16. Given the lower risk of regulated utilities relative to the market at large, it is axiomatic that long-term expected return on investment in regulated utilities should be lower than long-term expected average returns from the market as a whole.

17. Recommendations regarding an appropriate cost of equity for Ontario's regulated utilities are thus ***prima facie*** reasonable if they are lower than the long-term average returns expected from the relevant market as a whole, and ***prima facie*** unreasonable if they exceed the estimated long-run average market return.

18. Dr. Cleary, whose evidence is characterized by both a deep finance knowledge and experience, and by pragmatism, starts his analysis with this premise. In section 5.2.3 of his evidence (Exhibit M4) Dr. Cleary transparently derives an expected average Canadian equity market return[1], concluding that 7.5% represents an appropriate point estimate.[2]

19. We note that Dr. Cleary also examines U.S. equity market data, and while he generally takes the position that U.S. equity markets are not relevant in deriving a fair ROE for Canadian regulated utilities (a topic to which we return later in these submissions), in respect of overall market return expectations he finds little difference between U.S. and Canadian data.[3]

[1] Exhibit M4, pages 80-84.
[2] Exhibit M4, page 83, line 29.
[3] Exhibit M4, page 83.

20. In the result, Dr. Cleary emphasizes;

> ***It is important to recognize that this expected market return of 7.5% represents an upper bound for the cost of equity to regulated utilities (before adding 0.50% for flotation costs), since they are less risky than the average company in the market.***[4]

21. The table below sets out the ROEs recommended by each of the 4 experts in this proceeding[5], removing financing cost adjustments, and normalizing to (current) 40% deemed equity.

	Recommended ROE	**Difference from 7.5% Canadian Expected Market Return**
Concentric	11.01%[6]	+3.51 (+47%)
Nexus	10.58%	+3.08 (+41%)
LEI	8.95%	+1.45 (+19%)
Cleary	6.55%	-0.95 (-13%)

22. Starkly illustrated in this table is the fact that Dr. Cleary is the only expert whose recommended regulated utility return on equity is lower than the average expected market return on equity. That is, Dr. Cleary's recommendation is the only one that makes intrinsic sense, accepting, as all of the experts do, that regulated Ontario utilities are perceived by investors as less risky than the market as a whole.

23. There are various detailed methodological drivers for the differences in ROE recommendations from the various experts. CCC and SEC in their respective submissions have provided comprehensive analysis of these various drivers, their implications, and their veracity, and we defer to, and endorse, those analyses. The OEB should carefully consider those submissions in determining whether, at the end of the day, there is justification for the apparent inconsistency illustrated in the table above between the ROE recommendations by LEI, and to a greater extent Nexus and Concentric, on the one hand, and the expected overall market return evidenced by Dr. Cleary on the other hand. In our submission there is no such justification.

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[4] Exhibit M4, page 84, lines 2-5.

[5] To maintain analytical consistency, for the purpose of evaluating the appropriateness of the respective methodological approaches the table presents recommendations provided by the experts in their prefiled evidence, rather than their post-hearing updates by way of undertaking.

[6] September 27th transcript at page 110, lines 25 ***et seq.*** and October 5th transcript at page 159, lines 10-11.

24. Included among the drivers for the varying ROE results illustrated above are;

(a) The extent of reliance on US data.
(b) The extent of reliance on forecast, rather than observed actual market data.
(c) The choice of whether to use adjusted or raw "betas" as a measure of the difference in risk between the market as a whole and regulated utilities.

We address each of these essential analytical points of departure in turn.

Integrated North American Capital Markets?

25. In respect of the applicability of U.S. utility comparators and U.S. financial market data to determining the cost of capital for Ontario's regulated utilities, Dr. Cleary is an outlier among the experts. In Dr. Cleary's view, the reference for Canadian regulated utility cost of capital should be the Canadian financial market.

26. Nexus, Concentric, and to an extent LEI, on the other hand, emphasize that Ontario utilities must compete for capital in the North American equity market, and thus justify the inclusion, and in Concentric's and Nexus' cases the preponderance, of U.S. utility comparators.

27. These assertions that the OEB must consider U.S. utility ROEs and capital markets in assessing the ability of Ontario utilities to attract necessary equity capital ignore a fundamental feature of the Ontario utility context; the legislated municipal utility tax regime.

28. Commissioner Sardana noted this factor in some of his questions of the experts, and asked a number of times whether there was any evidence of Canadian regulated electricity utilities obtaining equity investment from the U.S. market. There is none. There is a simple reason for this. With the exception of Hydro One, Ontario's electric distribution utilities cannot practically accept significant amounts of equity from any 3rd party investors, Canadian, American or otherwise.

29. Section 149(1)(d.6) of the Federal ***Income Tax Act*** (***ITA***) renders operating utility companies tax exempt if they are 100% owned, directly or indirectly, by Canadian municipalities. Section 149(1)(d.5) of the ***ITA*** allows for no more than 10% non-municipal ownership at the utility holding company level before ***ITA*** tax exempt status is lost.

30. So long as the relevant corporation is tax exempt and a municipal electric utility, it makes Payments in Lieu of Taxes (PILS) to the Ontario government pursuant to the Ontario ***Electricity***

Act, 1998, effectively channelling what would normally be federal corporate tax revenue to Ontario. However, if any entity in the chain of ownership loses its ***ITA*** tax exempt status through the introduction of third party equity in excess of the minimal indirect amount permitted under the ***ITA***, there is a deemed disposition of all utility assets at fair market value, and a PILS regime departure tax becomes payable to Ontario.

31. In the result, if an Ontario municipally owned electricity distributor wants to raise non-municipal equity capital, it can only do so at a holding company level and only for up to 10% of the ownership of that company. Otherwise a prohibitively expensive departure tax is exigible.[7]

32. The fact is that there is a very limited practical ability of Ontario's municipally owned electric utilities to accept third party capital from anywhere, regardless of whether their need for capital will increase a result of the energy transition as the utility sponsored experts emphasize.

33. Until these tax laws change, it is a complete fabrication to suggest that Ontario municipally owned electricity distribution utilities must compete for capital in North American capital markets. They have not in fact done so, and simply cannot, as a matter of tax law and resulting affordability, do so.

34. If and when these laws change, the OEB may wish to revisit this question, but at the moment and for the foreseeable future, the issue of whether Ontario electricity distribution utilities, other than Hydro One, want to access US capital markets, or any capital markets, for third party equity is completely moot.

35. This is <u>not</u> a matter of treating utilities different from a cost of capital perspective depending on their ownership (as contemplated in issue 1.b) of the April 22, 2204 approved issues list). That issue goes to whether there is a fairness or social policy distinction for the purposes of divining a cost of capital on the basis of public versus private, or perhaps indigenous, ownership. Rather, this tax regime limitation on the ability of Ontario's municipally owned electricity distributors to access any significant amount of 3rd party equity capital is a fact centrally relevant to the OEB's determination of whether U.S. capital markets and utility comparators are relevant

[7] There is currently a limited exemption in place regarding taxation of any capital gains portion of such a deemed disposition. However, the departure tax payable on the recaptured utility asset base depreciation remains a determinative barrier to injection of any significant incremental third party equity into Ontario's municipally owned electricity distributors.

considerations in determining what an Ontario utility's reasonable cost of capital is assumed to be.

36. It is unreasonable to include in a cost of equity capital analysis of sources of capital which result in higher calculated ROEs, and thus higher "cost" recovery from customers, when those sources of capital are simply not accessible to the subject regulated utility and such "cost" would never in fact be incurred.

37. Hydro One Networks, which owns and operates the province's largest electricity distribution system, is not affected by this tax regime as it is not municipally owned. It is partly provincially owned, and partly publicly traded. Nonetheless, it does not raise equity in the U.S., and as late as August, 2024 issued $1.2 billion of notes in Canada.[8] There is no evidence that Hydro One, in fact accesses U.S. equity markets. (Of course, if that changes, Hydro One can bring evidence to that effect.)

38. In respect of Enbridge Gas Inc. (EGI) and Ontario Power Generation (OPG) it is legitimate to ask whether, for the purposes of divining what their reasonable cost of capital is, should the U.S. equity market be considered.

39. Concentric emphasized in its testimony that it is the use of funds that is the important consideration in divining a cost of capital, not the source of funds.[9] The use of funds that is relevant to the OEB's consideration of a just and reasonable cost of capital is use to fund, and risk associated with, Ontario's regulated utility business.

40. Mr. Coyne agrees that utilities in different jurisdictions may have different risk profiles, and setting lower returns for utilities in less risky jurisdictions does not violate the fair return standard.[10]

41. In their submissions CCC and SEC review in detail the multitude of supportive regulatory mechanisms that the OEB has developed over the last decade to de-risk the regulated utility businesses in Ontario. One of the driving forces for such mechanisms is to support the financial integrity of the regulated utilities, and this lowers their cost of capital.

42. Mr. Coyne, Mr. Goulding from LEI, and credit rating agencies agree that Ontario has a very supportive energy utility regulatory regime. (Nexus was not very familiar with it.)

[8] Transcript 5, page 144.
[9] Transcript 2, page 107, lines 15-22.
[10] Transcript 3, page 145, line 20 through page 146, line 9.

43. In their submissions CCC and SEC also review in detail the various utility comparators offered by Nexus and Concentric. Those submissions demonstrate the many questionable comparators, in many instances because the structure of energy utilities in many U.S. jurisdictions is different from the structure of Ontario's utilities.

44. Extensive reliance on U.S. comparators tilts the various analyses towards a higher ROE. For example;

(a) Appendix C of Dr. Cleary's evidence illustrates that over a long period of time, U.S. utility beta estimates have historically averaged almost double the comparable Canadian beta estimates.[11] There are two implications of this data;

(i) a market view that U.S. utilities have higher business risk than Canadian counterparts; and

(ii) use of U.S. utility beta estimates directly increases Capital Asset Pricing Model (CAPM) ROE results.[12]

(b) In deriving a risk free rate for input into its Capital Asset Pricing Model (CAPM) analysis, Nexus relies on 30 year U.S. Treasury yield forecasts and lands on a 4.06% risk free rate input, the highest of the 4 experts' derived risk free rates (the others use a Canadian risk free rate), in turn pushing Nexus' CAPM derived ROE up relative to the other analyses.[13]

45. Considering all of the foregoing, it is eminently reasonable for the OEB to exercise its discretion to conclude that, for the purposes of determining a reasonable cost of equity capital to include in setting Ontario regulated energy utility revenue requirements, U.S. comparators and inputs should not be used, or at the very least caution must be exercised in placing significant weight on U.S. capital market considerations.

46. Similar conclusions have been reached by the Alberta Utilities Commission[14] and the Régie De L'Energie.[15]

[11] Exhibit M4, pages 138-139.
[12] Exhibit KP1.4, pages 18 and 19.
[13] Exhibit KP1.4, pages 12 and 13.
[14] Exhibit M4, page 44, lines 28-30.
[15] RP-2022-0200, Exhibit K8.2, page numbered 52, paragraph 51.

Forecast Data versus Actual Data

47. The issue of the use of observable, historical data rather than forecast data is addressed by Dr. Cleary in two contexts.

48. The first context is derivation of a long-term debt rate. In this context, at section 3.7 (pages 23-24) of his evidence Dr. Cleary demonstrates that use of actual observed 30-year bond yields produces more accurate results than using forecast bond-yields. Dr. Cleary's analysis indicates an upward forecast bias relative to actuals of ~0.4%.

49. The second context in which this forecast bias arises is in the use of discounted cash flow (DCF) estimates to derive ROE. At Section 5.3.3. of his evidence (page 99) Dr. Cleary eschews the use of sell-side analyst growth forecasts, which he demonstrates are overly-optimistic, in DCF modelling. Dr. Cleary cites an Easton and Sommers study which estimates that such analyst "optimism bias" in growth forecasts inflates DCF cost of equity derivations by an average of 2.84%.

50. Further discussion of this point is presented by Dr. Cleary in Appendix D of his evidence, where he elaborates as follows (footnotes omitted):[16]

> ***This upward bias in analyst growth estimates is not surprising because the publicly available analyst estimates are almost always (if not entirely) those provided by "sell-side" analyst estimates, which are generally overly-optimistic, which is a well-known fact among finance professionals – i.e., by definition their job is to promote sales. For example, it is well-known that sell-side analysts rarely issue "sell" recommendations on stocks and tend to provide overly bullish stock price forecasts: with 60-65% "buy" recommendations; 30-35% "hold" recommendations; and, usually, less than 5% "sell" recommendations.***

51. Dr. Cleary endorses an alternative, and common, way of estimating company growth; determination of the company's sustainable growth rate by multiplying the earnings retention ratio (1-dividend payout ratio) by the earned ROE. This approach is included in the Chartered Financial Analyst (CFA) curriculum and academic textbooks, and in Dr. Cleary's experience is widely used in practice.

52. CCC in its submissions further discusses the merits of Dr. Cleary's actual versus forecast data approach in derivation of appropriate cost of capital parameters.

[16] Exhibit M4, page 140, lines 8-15.

53. As pages 20-22 of his presentation day materials (Exhibit KP1.4), Dr. Cleary summarizes his view that, in combination with heavy weighting of U.S. utilities, the use by the other experts of sell-side analyst growth forecasts rather than actual growth data in their DCF analyses results in inflated cost of equity derivations, as ultimately illustrated at page 23 of those materials.

54. Dr. Cleary's use of actual, observed market data is reflective of the informed yet practical approach that Dr. Cleary takes in these matters, much like his recommended, market based, Bond Yield Plus Risk Premium (BYPRP) approach to derivation of an appropriate regulated utility cost of capital, as discussed below.

Appropriateness of Adjusted Betas?

55. Betas represent estimates of the relative risk of a regulated utility as compared to the market as a whole, and are used in deriving a risk premium above a risk free rate to calculate an appropriate expected utility ROE.

56. Concentric and Nexus apply upward adjustments to their betas on the premise that, over time, the price of a stock gravitates towards the overall market average (i.e. "1"). That is, in the case of regulated utilities the assumption is that stocks becomes less risky.[17] The adjustments are premised on a 1970 study by a person named Blume. The Blume study examined beta estimates for a broad variety of industries and does not focus on any particular industry.[18] It is thus not surprising that the outcome of this study is an observation of beta adjustments towards the market average, over time.

57. Dr. Cleary and LEI use "raw" (i.e. unadjusted) betas, on the instinctive premise that an assumption that over time utility risk premiums approach the market average ignores the otherwise commonly accepted fact that utilities are less risky than the market average.

58. In addition to the basic sensibility of the assumption that utility betas do not gravitate towards one, Dr. Cleary cites strong evidence so demonstrating.[19]

[17] Transcript 3, page 141, lines 10-23.
[18] N-M2-10-AMPCO/IGUA-9.
[19] Exhibit M4, Appendix C. See also J4.5 and Exhibit M4, pages 97-98 and pages 77, lines 3-11.

59. Mr. Coyne estimated that the difference between using raw and adjusted betas is ~13-14 basis points in derived ROE.

60. Apart from this impact on derived ROE, the use of this "Blume adjustment" because ***"it's the industry standard"***[20] belies the sometimes counterintuitive result of following the math without considering the logic.

"Comparable Investment Standard" and Reliance on Awarded ROE Comparisons

61. In addition to exercising common sense in the appropriate application of complex statistical and mathematical analyses in determining a fair ROE to include in just and reasonable rates, caution is also warranted in judging a fair ROE or equity thickness for one utility based on what a regulator in another jurisdiction has been persuaded is a fair ROE or equity thickness for a utility there. There is a certain circularity to such comparisons, in particular when experts led by utilities habitually argue for significant cost of capital parameter increases.

62. As Dr. Cleary points out, and the Alberta Utilities Commission has found, ROEs awarded by other regulators are not market data.[21]

63. In February, 2023 Concentric filed evidence with the Alberta Utilities Commission (AUC) recommending an increase in Enmax's ROE to 9.5% and Enmax's equity ratio to 40%, parameters essentially in line with the OEB's current cost of capital parameters for Ontario utilities. Those recommendations to the AUC were premised by Concentric on bringing Enmax's cost of capital parameters into alignment with ***"the deemed equity ratios of comparable-risk electric utilities in Ontario and elsewhere across Canada"*** (emphasis added).[22]

64. Last month before this Board Mr. Coyne testified that Ontario utilities are comparable-risk utilities to Enmax, from an investor perspective.[23] Yet he recommends increasing Ontario ROE to more than 11% (adjusted for current equity thickness) and increasing equity thickness to 45%.

[20] Transcript 3, page 140, lines 17.
[21] 2018 GCOC Decision 22570-D01-2018, paragraph 39, in reference to the use of ROEs approved for U.S. utilities.
[22] N-M2-10-AMPCO/IGUA-17.
[23] Transcript 3, page 156, lines 7-8.

65. A year ago, in November, 2023, Concentric filed cost of capital evidence in Newfoundland Power proceedings before the Newfoundland PUB, recommending an allowed ROE of 9.85%, and an allowed equity ratio of 45%, very similar to Concentric's current recommendations for Ontario utilities of an ROE of 10% on the same 45% equity ratio. Concentric's recommendations in Newfoundland were premised on arguments that Newfoundland Power faces significant risks due to; i) its small size; ii) weak macroeconomic and demographic conditions in Newfoundland; and iii) potential issues with future demand and slow potential for customer growth.

66. Newfoundland Power is significantly smaller than Enbridge Gas and Hydro One, and a number of Ontario's larger electricity distribution utilities. Newfoundland's macro-economic and demographic conditions are clearly much more challenging that those in Ontario. Concentric cites as a risk to Ontario electric utilities significant growth in customers and customer demand. Yet despite these relative advantages to Ontario utilities ***vis a vis*** Newfoundland Power, Concentric advocates the same cost of capital parameters for Ontario as was the case within the last year in Newfoundland and based on starkly distinguishable considerations. Considering the parameters cited by Concentric before the Newfoundland PUB and accepting for the sake of argument Concentric's cost of capital recommendations for Newfoundland Power would indicate that Ontario's current cost of capital parameters are directionally right, and Concentric's current recommendations for Ontario are directionally wrong.

67. The point, as Dr. Cleary articulated, is that the fact that another regulator has been persuaded by an expert's or utility's advocacy does not directly reflect financial market parameters. Such comparisons should be approached with caution.

68. In section 5.1 of Exhibit M4 Dr. Cleary cites both empirical and academic evidence that despite reductions in government and utility bond yields that are inputs into various analyses used by experts to determine regulated utility cost of capital parameters, allowed ROEs in Canada and the U.S. have not decreased in line. This evidence of "downward stickiness" in awarded ROEs suggests that awarded ROEs are poor indicators of utility relevant financial market conditions, and may in fact result in excess compensation.[24] (It also suggests inflated derived utility betas.)

[24] See also summary provided at Exhibit KP1.4, pages 7-10.

69. Consideration of market determined price to book ratios, which at equilibrium should equal 1, also indicates that publicly traded utilities (including Hydro One with a price to book ratio of 2.04) are in fact earning excess economic rent.[25]

70. Nexus' Dr. Pampush spoke in his testimony to an interesting concept of specific jurisdictional or utility risk being "diversifiable", and thus cancelling out in a cost of equity analysis such as those presented by the experts in this proceeding.[26]

71. This concept indicates the weakness of relying on a range of comparators which, in Dr. Pampush's apparent view, would effectively nullify the risk differentials between various jurisdictions. This is precisely why it is important to go behind the mathematical averages and consider how a utility and its regulatory framework in the jurisdiction in question actually compare to those constituting the comparator group. CCC and SEC have included extensive discussion on this point in their respective submissions, which discussion we commend and endorse.

72. Dr. Pampush spoke of the diversification benefit to a utility portfolio investor. The OEB needs to be concerned with an appropriate cost of capital for Ontario's utilities. In considering the appropriate value of Ontario's utilities, from an investor perspective, FitchRatings notes that Ontario's strong and predictable regulatory framework offsets lower allowed equity thickness and lower allowed ROE compared to U.S. utilities.[27]

73. While on a different point, the analytical circularity apparent on the 50 basis point financing cost adder in use in Ontario and elsewhere in Canada also indicates that caution is warranted in non-critically applying regulatory cost of capital findings from other jurisdictions. The experts in this proceeding rely on the Canadian practice of allowing a 50 basis point ROE adder for financing costs, yet none could speak to where that practice originated or how the 50 basis points was derived. The evidence that was tendered indicated that the 50 basis points may be significantly too high, even where equity financing costs are incurred. In respect of Ontario's municipally owned electricity distributors, as already discussed, there are no equity raises and there should be no equity raise costs.

74. The point, again, is that while statistical, mathematical and comparative analyses can inform cost of capital considerations, common sense and a critical caution must also be brought to bear.

[25] Exhibit M4, section 5.5, as summarized at Exhibit KP1.4, page 10.
[26] Transcript 5, page 43, lines 18-24; Transcript 4, pages 161-162.
[27] Exhibit K5.1, page 41.

AMPCO/IGUA Recommendations on ROE: Dr. Cleary's Market Based Approaches

75. The opportunity cost of investment in regulated Ontario utilities is not the ability to invest in U.S. utilities. Rather it is return on investments of comparable risk to Ontario utilities (though for Ontario municipal electricity utility owners it also includes the opportunity to invest in other municipal programs or services).

76. As reviewed in detail by CCC in its submissions, Dr. Cleary provides two approaches that allow the OEB to establish a base ROE without the need to directly input financial information from companies included in a given proxy group, or using authorized returns from other jurisdictions. The first approach is Dr. Cleary's version of the CAPM, which uses a long-term historical average of the market observed raw beta for Canadian utilities[28]. The second is the Bond Yield Plus Risk Premium (BYPRP) approach, which uses observed yields on long-term A-rated Canadian utility bonds.[29] By focusing on actual market data and Canadian inputs Dr. Cleary produces results directly and appropriately applicable to determining the opportunity cost for investors in Ontario regulated utilities. As seen from the table set out at paragraph 21, above, Dr. Cleary's results are also consistent with the axiomatic observation that less risky utility investments should be expected to earn <u>below</u> average expected market returns.

77. Dr. Cleary's ROE recommendation as of the filing of his evidence was 7.05%, and was updated as of September 30th to 6.95% (both <u>including</u> a financing cost allowance of 0.5%). Depending on whether the OEB adopts a June or September effective date, AMPCO/IGUA endorse the appropriate one of these recommendations, <u>minus</u> the financing cost allowance, as a reasonable ROE for inclusion in regulated utility rates.

78. In respect of a financing cost allowance, we agree with Dr. Cleary, and Nexus and Concentric, that financing costs associated with equity issuances are a legitimate cost of capital that should be recoverable by shareholders. We disagree, however, that an automatic 50 basis point adder is appropriate. This figure has not been justified, and what evidence is available indicates that it is too high.

[28] Exhibit M4, page 92.
[29] Exhibit M4, pages 106 ***et seq.***

79. This apparently inflated financing cost adder has been recovered by Ontario's regulated utilities for some years. It would be reasonable for the OEB to assume that these recoveries have reasonably compensated the utilities for any historical equity financing costs.

80. Going forward, an allowance for reasonable and demonstrable actual financing costs should be recoverable through an appropriate mechanism, but not through an unsupported and apparently over-compensatory 50 basis point ROE adder. Where financing proceeds are associated with particular capital assets the associated raise costs may be appropriately capitalized to the cost of those assets. Where financing proceeds are for more general utility use associated raise costs, once validated as reasonably incurred, could be deferred for recovery over an appropriate time period. In order to be accepted for recovery, going forward these costs should be demonstrated, as are all other accepted utility costs, as having been reasonably incurred, and an appropriate recovery mechanism proposed.

81. In the result, AMPCO and IGUA endorse a base ROE for Ontario's utilities (subject to implementation considerations as discussed below) of;

(a) 6.55%, if effective June 30th; or
(b) 6.45%, if effective September 30th.

Equity Thickness: Ontario Electricity Distributors

82. Concentric is the only expert which has recommended a change to equity thickness for Ontario's utilities; from 40% to 45%.[30] This recommendation is made on the basis that the energy transition, and associated increases in customer demand, pose risks for Ontario's regulated electric utilities.

83. Dr. Cleary's view, with which AMPCO and IGUA agree, is that electricity demand growth is properly considered a business opportunity that would attract investment[31];

> ***… an expected increase in demand represents a growth opportunity for utilities and is a situation that most companies would happily embrace – far preferable to a forecast decrease in demand for their product. This is particularly true when the companies have***

[30] Nexus offers extremely summary observations focussed on other utilities, with no analysis and ultimately no recommended changes. Exhibit M3, page 84.
[31] Exhibit N-M4-CCC-9.

the opportunity to adequately plan for such increases in demand, and can pass through legitimate costs to consumers (as is the case for regulated operating utilities).

84. CCC and SEC review in detail the plethora of supportive regulatory mechanisms that the OEB has, and continues to, put in place to support Ontario's utilities through the expected energy transition related impacts on their businesses. In the case of electric utilities these mechanisms are intended to incent the utilities to adequately plan for increase in demand, and recover legitimate costs of meeting those demands. That is, these mechanisms de-risk the electric utility business in Ontario, and retain the protection of "the regulatory compact" for properly managed rate regulated electric utilities.

85. AMPCO and IGUA endorse CCC and SEC's submissions in this respect, and Dr. Cleary's finance expert opinion. There is no basis upon which to conclude that an increase in equity thickness for Ontario's electricity utilities is warranted.

Equity Thickness: Enbridge Gas Inc.

86. Less than a year ago, in a comprehensive rebasing determination that included, among other matters, a significant focus on energy transition related risks, the OEB increased EGI's equity thickness from 36% to 38%. In its decision the Hearing Panel stated (emphasis added) [32]:

> ***Considering both a decrease in business risk due to amalgamation, and an increase in business risk due to the energy transition, which is partially mitigated by this Decision and Order, the OEB concludes that there is a net increase in business risk that justifies a modest increase in the deemed equity thickness. The OEB is persuaded by the analysis of LEI and its recommended 38% equity thickness. Enbridge Gas has not met the onus to establish that its ultimate requested increase to 42% is reasonable. In the absence of the risk assessment evidence that Enbridge Gas is directed to develop for its next rebasing application, the OEB denies Enbridge Gas's request. The OEB approves an increase to the deemed equity thickness to 38% at this time. The approved increase in equity thickness will be applied to 2024 rates and will not be phased in.***

87. This excerpt highlights three things;

(a) the OEB has expressly and recently considered energy transition impacts on EGI's business risk, and made a determination regarding the appropriate equity thickness adjustment to recognize the net impact of that risk on the utility;

[32] EB-2022-0200, Decision and Order, December 21, 2023, page 68.

(b) that equity thickness adjustment was considered in the particular context of the balance of the EGI specific regulatory initiatives addressed and directed in that decision; and

(c) the OEB has directed EGI to do more work in assessing energy transition risk before making any further adjustments to EGI's regulatory framework, including cost of capital parameters, on that account.

88. The EGI specific business risk and equity thickness related evidence in that rebasing proceeding was extensive, and included a significant report from Concentric. There is no new information in the current review that would justify revisiting of this recent, EGI specific, cost of capital decision.

89. If anything, EGI's energy transition business risk has been decreased since the date of the 2024 rebasing decision by the introduction and passage by the Ontario government of Bill 165. Bill 165 restores the 40 year revenue horizon for new gas connections that the Hearing Panel in the rebasing decision would have done away with. Further, the OEB's more recent decision in the Panhandle expansion case[33] maintained the historical practice of socializing across Enbridge Gas' customer base transmission system related reinforcement costs, further de-risking EGI's business risk.

90. That equity thickness increase for EGI was determined in conjunction with affirmation by the OEB of the continued appropriateness for EGI of the OEB-approved 2024 ROE, as established through the existing formulaic approach.[34]

Equity Thickness: Hydro One

91. In addition to the applicability to Hydro One, as to all other regulated Ontario electricity utilities, of the OEB's supportive regulatory framework as discussed above, there is further evidence specific to Hydro One's business risk that indicates that the current deemed 40% equity thickness may be too high for Hydro One.

92. LEI has suggested that ***"the risk profile of electricity transmitters is similar, if not lower than that of electricity distributors."***[35]

[33] EB-2022-0157, Decision and Order, May 14, 2024.
[34] EB-2022-0200, Decision and Order, December 21, 2023, page 61.
[35] Exhibit M1, p. 143.

93. Given the preponderance of Hydro One in the Ontario utility sector, Dr. Cleary was asked to consider an appropriate capital structure for Hydro One in particular. In doing so, Dr. Cleary observed as follows[36]:

(a) Hydro One has strong, long-standing and stable third party ratings reflecting excellent business risk, very low industry risk and reasonable regulatory support.

(b) Hydro One shows strength in all key credit metrics[37];

(i) cash flow to total debt;
(ii) total debt in capital structure;
(iii) earnings before interest and taxes (EBIT) gross interest coverage; and
(iv) earnings before interest, taxes, depreciation and amortization (EBITDA) gross interest coverage.

(c) These credit metrics would continue to be strong with an equity ratio of 38%.

(d) Hydro One has a reasonably healthy balance sheet.

(e) Hydro One enjoys an extensive franchise area and customer base.

(f) While DBRS notes high levels of planned capital expenditure for Hydro One, DBRS also notes "good" cost recovery and a supportive regulatory regime.

(g) Hydro One expects significant rate base growth over the 2022-2027 period, leading to earnings growth.

(h) Hydro One enjoys stable and predictable cash flows with minimal regulatory lag.

(i) Hydro One's recent bond yields indicate that it is able to attract incremental capital on reasonable terms.

(j) Hydro One has consistently earned its allowed ROE, or higher, over the most recent six year period, strongly indicating low total risk.

(k) Hydro One's observed price to book (P/B) ratio is 2.04, compared to an average market determined price to book ratio of 1.45 for Canadian publicly traded utilities in 2023, ***"which suggests the market feels that it is comfortably earning a more than adequate return based on its current equity base, as discussed in Section 5.5."***[38]

94. In addition, we note that;

(a) Hydro One is of comparable size and breadth to EGI, though without the "energy transition" challenges of declining demand and customer numbers facing EGI and which was the basis for the OEB's recent increase of EGI's ROE from 36% to 38%.

[36] Exhibit M4, pages 116-121.
[37] See Exhibit M4, page 120.
[38] Exhibit M4, page 121, lines 7-10.

(b) Given the similar size, but lower energy transition business risk, of Hydro One, in the same strong regulatory jurisdiction, and arguably with an even more supportive and proactive overall regulatory framework in place for it, it is counterintuitive that Hydro One's equity thickness needs to be maintained at 2% above that of an arguably more risky utility business, let alone raised to fully 6% above that riskier utility as recommended by Concentric.

95. On the basis of his analyses, Dr. Cleary concludes:[39]

> ***… there is no reason that [Hydro One's] equity ratio could not be lowered to as low as 36% and still allow it to borrow and issue equity at attractive rates, as well as maintain solid credit metrics.***

96. AMPCO agrees.

Recommendations

97. AMPCO and IGUA recommend that:

(a) The base ROE for Ontario rate regulated utilities be reset. There is ample support for resetting that base ROE as low as 6.45% as at September 30, 2024, exclusive of a financing cost adder.

(b) Utilities be permitted to recover reasonable demonstrated actual financing costs through an appropriate cost recovery mechanism as they may propose.

(c) The deemed equity thickness for Ontario's regulated utilities, with exception of EGI, Hydro One and OPG be maintained at 40%.

(d) EGI's recently reset equity thickness be left at 38%, pending reconsideration at the time of its next rebasing in the context of the energy transition planning directed by the OEB in its ***Decision with Reasons*** in EB-2022-0200.

(e) The equity thickness for Hydro One be re-examined at the time of its next rebasing, and brought into better business risk alignment relative to that of other Ontario utilities, in particular EGI which is of similar size and significance to Ontario's regulated energy utility sector.

98. AMPCO takes no specific position on OPG's business risk at this time. We note, however, Mr. Dane's repeated assertions that OPG as a generator has greater risks and requires a higher ROE and/or greater equity thickness than Ontario's other electricity utilities. On the other hand, Mr. Coyne repeatedly asserted that, from an investor's perspective, regulated linear infrastructure and regulated generation infrastructure are the same. Concentric's testimony thus

[39] Exhibit M4, page 121, lines 11-15.

suggests that either OPG should not get a higher ROE than other Ontario regulated energy utilities (if Mr. Coyne is right), or that the proxies used by Concentric are inappropriate to apply to OPG (if Mr. Dane is right). Either way, the appropriate capital structure for OPG is best evaluated at the time of OPG's next payments proceeding.

Implementation

99. Commissioner Sardana's questions to Dr. Cleary reflected a concern of credit rating agencies might perceive a significant reduction in ROE for Ontario's rate regulated utilities relative to the current ROE level, and the resulting revenue reduction impact.

100. We acknowledge this concern.

101. One thing that the OEB should certainly not do is adopt the recommendations of Concentric or Nexus and increase deemed ROE or equity thickness for Ontario's rate regulated utilities. Such a determination would result in equally concerning impacts in the form of excess earnings at the expense of Ontario's energy customers.

102. We expect that most parties will recommend that any changes in deemed equity ratios or base ROE should be implemented for each regulated utility at the time of its rate rebasing (unless a particular utility's extant rate plan or settlement agreement provides otherwise). Such an implementation process would lend a certain gradualism to any changes determined through this proceeding.

103. If, however, the OEB concludes, given the magnitude of the changes that AMPCO and IGUA, CCC, SEC and perhaps others recommend, that more gradualism than staggered implementation is warranted, then the OEB could reasonably exercise its discretion to select a base ROE within a range of reasonableness. As commented throughout these submissions, there is no single, observable, point base ROE that is the correct one.

104. In this event, we submit that a range of reasonableness for the ROE to be included in Ontario regulated utility rates going forward is properly defined by a reasonably derived expected overall market return at the upper end, and Dr. Cleary's recommended base ROE (which is the lowest one recommended) at the lower end. While AMPCO and IGUA support Dr. Cleary's recommended 6.45% base ROE, re-setting the base ROE to 7.0% (about the middle of the range

of reasonableness defined by Dr. Cleary's work) would be a reasonable exercise of the OEB's discretion, pending the next cost of capital review.

105. Others (including CCC and SEC) will make principled recommendations on an appropriate and justifiable base ROE. Some parties may provide supportable derivations of an overall expected Canadian market return. It would be reasonable for the OEB to consider all of these recommendations, assess which are reasonable and properly evidenced and thus fall within a range of reasonableness, and then consider an appropriate point number within that range of reasonableness, with reference to the magnitude of potential change from the current cost of capital parameters, and considering another of its statutory objectives; maintaining the financial viability of Ontario's rate regulated utilities.

ALL OF WHICH IS RESPECTFULLY SUBMITTED by:

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GOWLING WLG (CANADA) LLP, per:
Ian A. Mondrow
Counsel to AMPCO & IGUA

November 7, 2024