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

BY EMAIL

November 7, 2024

Ms. Nancy Marconi
Registrar
Ontario Energy Board
2300 Yonge Street, 27th Floor
Toronto, ON M4P 1E4
Registrar@oeb.ca

Dear Ms. Marconi:

Re: Generic Proceeding – Cost of Capital and Other Matters
Ontario Energy Board (OEB) Staff Submission
OEB File Number: EB-2024-0063

Please find attached OEB staff's submission in the above referenced proceeding, pursuant to the deadline set out in the October 15, 2024 OEB letter.

Yours truly,

Fiona O'Connell

Digitally signed by Fiona O'Connell
Date: 2024.11.07 16:55:52 -05'00'

Fiona O'Connell
Senior Advisor, Regulatory Accounting, Operations Decision Support

Encl.

c: All parties in EB-2024-0063

ONTARIO ENERGY BOARD

OEB Staff Submission

Generic Proceeding – Cost of Capital and Other Matters

EB-2024-0063

November 7, 2024

Background

On March 6, 2024, pursuant to sections 36, 78 and 78.1 of the *Ontario Energy Board Act, 1998*, the OEB issued a Notice of Hearing on its own motion to initiate a generic proceeding.[1] This generic proceeding considers the methodology for determining the values of the cost of capital parameters and capital structure to be used to set rates for electricity transmitters, electricity distributors, natural gas utilities, and rate-regulated electricity generators. The OEB also noted that it will determine whether its current approach to setting the cost of capital parameters and capital structures continues to remain appropriate and if not, what approach should be used. Other matters are also being addressed in this proceeding, with 22 issues in total.

The OEB annually publishes its approved cost of capital parameters on its website.

Summary and OEB Staff Position on Key Issues

The following is OEB staff's summary of its position on the key issues in this proceeding. A detailed discussion, organized according to the Issues List and positions of the experts, follows.

- The two utility experts propose that Ontario should have the highest deemed return on equity (ROE) of any province in Canada; the ratepayer expert proposes that it should have the lowest. In OEB staff's view, the answer lies in between those proposals. More specifically, an ROE somewhere in the range of 8.79% and 9.32% would continue to meet the Fair Return Standard. The approved ROE of 9.21% for 2024 as well as the approved (interim) ROE of 9.25% for 2025 both fall within that range.
- OEB staff's recommended range does not include a 50 basis point "adder" for equity financing transaction costs. In OEB staff's view, the adder is no longer justified. Instead of embedding transaction costs in the ROE, utilities should be permitted to recover their actual transaction costs in a rate application.
- No changes are required to the deemed capital structure for utilities. The current equity ratios continue to meet the Fair Return Standard.
- Any changes in the cost of capital parameters and/or capital structure decided in this proceeding should be implemented at utilities' next rebasing proceedings, starting with utilities who will (or have) rebased for 2025 rates.

[1] EB-2024-0063

OEB Staff Submission

Issues List

A. General Issues

1. Should the approach to setting cost of capital parameters and capital structure differ depending on:
   a) The source of the capital (i.e., whether a utility finances its business through the capital markets or through government lending such as Infrastructure Ontario, municipal debt, etc.)?
   b) The different types of ownership (e.g., municipal, private, public, co-operative, not for profit, Indigenous / utility partnership, etc.)

OEB staff submits that the approach to setting the cost of capital parameters and capital structure should not depend on a utility's ownership and the source of funds. This view is consistent with the views expressed by LEI and other experts, and with the *Report of the Board on the Cost of Capital for Ontario's Regulated Utilities,* December 11, 2009 (OEB Report).[2] The focus should be on the use of funds. None of the four experts in this proceeding argued otherwise.

OEB staff agrees with LEI and Dr. Cleary that the OEB's existing methodology implicitly accounts for differences in sources of funding when approving rate applications and that this should be maintained.[3] This is because the OEB considers the actual long-term debt rates in most cases, thereby considering the source of funding. For example, certain ceilings may apply to the debt rate to embedded in base rates when a utility incurs debt from an affiliate.

Consistent with the status quo, LEI, Concentric, and Dr. Cleary stated that the approach to setting the cost of capital parameters and capital structure should not depend on a utility's ownership structure.[4] Nexus did not express an opinion on this issue. LEI believes that as long as utilities undertake business/investment activities of similar (or like) risk, the ownership type/structure should not matter.[5] Concentric stated that regulatory practice is to determine the cost of capital based on the use of funds and not

[2] EB-2009-0084
[3] LEI Expert Report, June 21, 2024, Revised September 23, 2024, p. 13; Dr. Cleary Expert Report, July 22, 2024, p. 4
[4] LEI Expert Report, June 21, 2024, Revised September 23, 2024, p. 13; Concentric Expert Report, July 19, 2024, p. 20; Dr. Cleary Expert Report, July 22, 2024, p. 4
[5] LEI Expert Report, June 21, 2024, Revised September 23, 2024, pp. 52 & 53

the source of funds when determining just and reasonable rates.[6]

A separate perspective was offered by the Three Fires Group Inc. and Minogi Corp. (TFG/Minogi) who stated that Indigenous groups and/or First Nations are increasingly becoming participants in Ontario's regulated utilities through partial equity ownership of individual regulated assets (such as individual transmission lines or electricity generating stations).[7] TFG/Minogi noted that the cost of capital can present unique challenges for First Nations interested in more active participation in Ontario's energy sector.[8] TFG/Minogi strongly believes that these perspectives have historically been disadvantaged or excluded from Ontario's most important policy conversations. In OEB staff's view, these are important questions, but any unique First Nations issues can be addressed in a rate application by a First Nations owned utility.

2. **What risk factors (including, but not limited to, the energy transition) should be considered, and how should these risk factors under the current and forecasted macroeconomic conditions be considered in determining the cost of capital parameters and capital structure?**

OEB staff submits that the following business risk factors should be considered in determining the cost of capital and capital structure, as well as financial risk factors. LEI stated that risks that can be grouped into the following business risk factors:[9]

1. Energy transition risk
2. Volumetric risk
3. Operational risk
4. Regulatory risk
5. Policy risk

This is the grouped list of risk factors in LEI's report.[10]

With respect to Energy Transition risk, OEB staff submits there was no evidence presented that energy transition impacts either timing or recovery for regulated utilities, particularly in the forthcoming regulatory period (2025-2029). LEI's view is that energy transition issues are not a large driver in reviewing the process of setting the cost of capital, and that is because, at least in the near term, they are not affecting cash

[6] Concentric Expert Report, July 19, 2024, p. 18
[7] N-M1-12-TFG/Minogi-1, August 22, 2024
[8] TFG/Minogi Letter, August 16, 2024
[9] LEI Expert Report, June 21, 2024, Revised September 23, 2024, pp. 54 & 55
[10] LEI Expert Report, June 21, 2024, Revised September 23, 2024, pp. 54 & 55

flows.[11] Thus, OEB staff recommends that the cost of capital policy be reviewed again in five years. When that happens, the impact of energy transition can be explored further. Until that time, any uncertainty from the energy transition can be addressed in utilities' respective cost-based rate applications or in applications made under the OEB's *Non-Wires Solutions (NWS) Guidelines for Electricity Distributors*, March 28, 2024. Lastly, OEB staff notes that outside of this proceeding there are other initiatives that appropriately address applications for energy transition investment.[12]

That said, OEB staff also notes Concentric's statements regarding energy transition:

- As more customers shift away from natural gas, gas distributors will face higher risks in recovering costs[13]
- Increased business risks arise from the implementation of alternative fuels[14]
- Increased capital spending, whether in response to climate change/electrification or for other customer or service/reliability needs adversely affects the risk profile of utilities[15]
- No adjustments to its ROE analysis have been made[16]
- It underscores the importance of setting the equity ratio appropriately for Ontario's utilities[17]
- Enbridge was put on negative credit watch by Standard & Poor's[18]

OEB staff acknowledges these statements made by Concentric, but submits that given OEB staff's submission above, the energy transition risk be better understood when the OEB reviews the cost of capital policy again in five years' time. Therefore, these points made by Concentric can be addressed further at that time, also because there is not enough evidence in this proceeding to warrant changes.

3. What regulatory and rate-setting mechanisms impact utility risk, and how should these impacts be considered in determining the cost of capital parameters and capital structure?

OEB staff submits that regulatory risks have generally decreased for utilities since the OEB's cost of capital policy was last reviewed in 2009 because of various regulatory

[11] Oral Hearing Transcript, September 25, 2024, pp. 90 & 91
[12] EB-2024-0118, Non-Wires Solutions Guidelines for Electricity Distributors, March 28, 2024, p. 6
[13] N-M2-2-SEC-33, August 22, 2024
[14] N-M2-2-SEC-33, August 22, 2024
[15] N-M2-CCC-2, August 22, 2024
[16] Oral Hearing Transcript, September 26, 2024, p. 90
[17] Oral Hearing Transcript, September 26, 2024, p. 92
[18] Oral Hearing Transcript, September 27, 2024, pp. 82 & 83

changes such as the OEB's introduction of fully fixed electricity distribution rates for residential customers and the advanced capital module. LEI observed that the five major OEB policy initiatives since 2006 reviewed by LEI have slightly reduced the risks for electricity distributors.[19] Concentric also concluded that certain regulatory and policy changes have somewhat reduced certain utility cost recovery risks on an absolute basis.[20]

OEB staff agrees with LEI and Dr. Cleary that any regulatory mechanism that can significantly impact the stability of future cash flows must be considered for review as part of regulatory risks.[21] OEB staff agrees with LEI that as the perceived stability of future cash flows is a key consideration for investors, a regulated utility's ability to recover its capital and operating costs profoundly relies on the available regulatory mechanisms.[22] As such, they play an outsized role in increasing or decreasing utilities' business and financial risks.

OEB staff concludes that the OEB's regulatory and rate-setting mechanisms have moderately reduced utility risk since 2009 (when the cost of capital policy was last reviewed). OEB staff's proposals on ROE and capital structure (Issues 10 and 12 below) reflect that.

B. Short-Term Debt Rate

4. **Should the short-term debt rate for electricity transmitters, electricity distributors, natural gas utilities, and OPG continue to be set using the same approach as set out in the OEB Report?[23]**
5. **If no to Issue #4, how should the short-term debt rate be set ?**

As noted in the OEB Letter July 26, 2024, the three-month bankers' acceptances that has underpinned these calculations has been phased out. The deemed short-term debt rate (DSTDR) was set on an interim basis for 2025 rates using the average of the three-month Canada T-bill rate for each business day in September 2024, as also noted in the OEB Letter, October 31, 2024.

The OEB concluded that the three-month Canada T-bill rate was a reasonable replacement for the three-month bankers' acceptance rate for the short period of time

[19] LEI Expert Report, June 21, 2024, Revised September 23, 2024, p. 14
[20] N-M2-3-SEC-34, August 22, 2024
[21] LEI Expert Report, June 21, 2024, Revised September 23, 2024, p. 14; Dr. Cleary Expert Report, July 19, 2024, p. 5
[22] LEI Expert Report, June 21, 2024, Revised September 23, 2024, p. 74
[23] OEB Report, pp. iii, 55-59

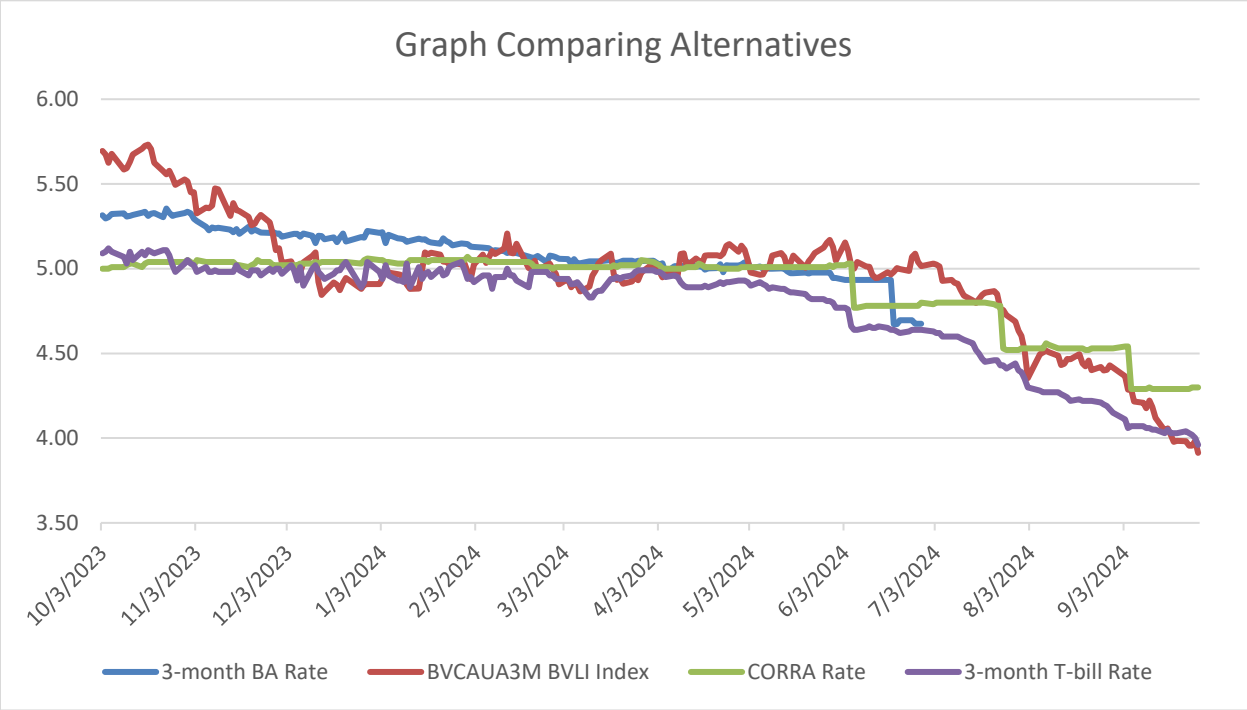
until the OEB makes a decision in the generic cost of capital proceeding on the appropriate methodology for calculating the DSTDR going forward.

Broadly speaking, there are three alternatives to the bankers' acceptance rate: (1) the Canadian Overnight Repo Rate Average (CORRA) reference rate published by the Bank of Canada (or possibly a CORRA futures rate); (2) the Bloomberg ticker BVCAUA3M BVLI Index (3-month), which tracks utility bond yields; or (3) the three-month Canada T-bill rate. A credit spread would need to be applied to (1) or (3) but not (2), which already has a credit spread built in. If (1) or (3) were selected, the spread could be based on a on a confidential survey of banks or a confidential survey of regulated utilities.

In OEB staff's view, any of these alternatives would be reasonable. However, option (2), has the advantage of being administratively simpler as it would not require the OEB to calculate a spread by means of a bank or utility survey. More precisely, OEB staff submits that regarding the average of the trailing 12-months as of September 30 for the Bloomberg ticker BVCAUA3M BVLI Index (3-month) should be used to develop the DSTDR. This DSTDR would be included in base rates for the subsequent rate year (i.e., either January 1 or May 1 rates). The disadvantages of using the Bloomberg ticker are that it is not freely available (it is only available to Bloomberg subscribers) and that it is not as well-known a benchmark as the CORRA or the T-bill. Still, in OEB staff's view, the ease of implementation outweighs those drawbacks.

In terms of the actual outcome for utilities (i.e., the impact on the actual DSTDR), OEB staff does not expect there to be a significant difference between the three alternatives. Table 1 below shows that the 3-month T-bill, the CORRA and the Bloomberg ticker all track similar paths historically – and all are comparable to the bankers' acceptance rate. The Bloomberg ticker is generally higher because it includes a spread.

Table 1 – Graph Comparing DSTDR Alternatives[24]



- *Use of the DSTDR as a Cap*

Further, OEB staff submits that the DSTDR should be applied as a cap for all utilities (and not just electricity distributors and transmitters), given OEB-regulated entities have similar credit ratings.[25] This may potentially incentivize utilities to improve their credit profile and/or negotiate better borrowing terms, if their actual rates are higher than the DSTDR.[26] Under this approach, the actual (and forecasted) short-term rates would be incorporated into rates if they are lower than the DSTDR, and the DSTDR would be incorporated into rates if the actual (and forecasted) short-term rates are higher than the DSTDR.

Different methods used in practice for Ontario utilities to account for differences between the deemed capital structure and actual capital structure. Enbridge Gas and OPG conduct true-ups, but electricity distributors and electricity transmitters do not conduct true-ups.

[24] In Table 1, note that the 3-month BA rate does not reflect data after June 30, 2024, given that this rate has been phased out. The source for the 3-month BA rate was from the Canadian Investment Regulatory Organization. The source for the BVCAUA3M BVLI Index rate was from Bloomberg. The sources for the CORRA rate and the 3-month T-bill rate were from the Bank of Canada.
[25] LEI Expert Report, June 21, 2024, Revised September 23, 2024, p. 176
[26] LEI Expert Report, June 21, 2024, Revised September 23, 2024, p. 82

An "unfunded portion" implies that the short-term debt portion should be considered as a plug in the capital structure only if deemed equity portion (%) and the actual long-term debt portion (%) add up to less than 100%.[27]

OEB staff agrees with LEI that the DSTDR should be applicable as a cap for the unfunded portion after deducting from the long-term debt and common equity portions for Enbridge Gas and OPG.[28] OEB staff is of the view that this is not practical to implement for the other Ontario utilities and there should be no true-up between the deemed and actual capital structure for such utilities.

C. Long-Term Debt Rate

6. **Should the long-term debt rate for electricity distributors, natural gas utilities, and OPG continue to be set using the same approach as set out in the OEB Report and as set out in the Staff Report for electricity transmitters?[29]**
7. **If no to Issue #6, how should the long-term debt rate be set?**

Under the OEB's current methodology, for the long-term debt rate, all utilities use the weighted average of embedded (actual) debt plus forecasted debt rate(s) of new debts in the test period. However, for electricity distributors and transmitters, a deemed long-term debt rate (DLTDR) serves as a ceiling in certain instances, as set out in the OEB Report and the OEB Staff Report, *Review of the Cost of Capital for Ontario's Regulated Utilities* (Staff Report).[30] As noted in the OEB Report and Staff Report, the DLTDR serves as a ceiling on affiliated debt at the time of issuance, on variable rate debt, on debt without a fixed term, or where an electricity distribution utility has no actual debt. All debt costs are subject to a prudency review in a cost-based rates application. OEB staff submits that these approaches should continue.

For the DLTDR, the OEB's methodology set in 2009 for electricity distributors and electricity transmitters is as follows.

$$LTDR_t = LCBF_t + UtilBondSpread_t$$

The DLTDR is based on the long (30-year) Government of Canada bond yield forecast (LCBF) plus the average spread between an A-rated Canadian utility bond yield and 30-year Government of Canada bond yield for all business days in the month (that is three

[27] LEI Expert Report, June 21, 2024, Revised September 23, 2024, p. 82
[28] LEI Expert Report, June 21, 2024, Revised September 23, 2024, p. 28
[29] OEB Report, pp. 50-55, 59; Staff Report, January 14, 2016, p. 3 Table 1
[30] OEB Report, pp. 53-54; Staff Report, January 14, 2016, p. 3 Table 1

months in advance of the effective date for the rate changes).

The LCBF rate is currently calculated as follows.[31] The average of the 3-month and 12-month 10-year Government of Canada bond yield forecasts is taken (as stated in the relevant issue of Consensus Forecasts), and then the average of the actual observed spreads between 10-year and 30-year Government of Canada bond yields, for each business day in the month corresponding to the most recent Consensus Forecast issue, is added.

Ideally 30-year Government of Canada bond yield forecasts would be derived from the publication Consensus Forecasts used by the OEB to update the LCBF. However, Consensus Forecasts only publishes the forecasts for 10-year Government of Canada bonds. This necessitates the calculation of spreads for 30-year versus 10-year Government of Canda bond yields.

The current LCBF formula is:

LCBF = 10-year Government of Canada bond yield forecasts plus yield spread of 30-year Government of Canda bonds over 10-year Government of Canada bonds

The current utility bond yield spread formula is:

Bond yield spread = average 30-year A-Rated Canadian Utility bond yield rate minus the 30-year Government of Canada bond yield rate

The table below is a summary of suggested approaches for the DLTDR.

[31] LEI Expert Report, June 21, 2024, Revised September 23, 2024, p. 84

Table 2 – Summary of Suggested Approaches for the DLTDR

Expert	LCBF	Utility Bond Spread
Status Quo (OEB Report)	10-year Government of Canada bond yield forecasts (from Consensus Forecasts) plus yield spread of 30-year Government of Canda bonds over 10-year Government of Canada bonds[32]	Average spread between a 30- year A-rated Canadian utility bond yield and 30-year Government of Canada bond yield for the month of September [33]
LEI	30-year bond yield forecasts from the seven major Canadian banks[34]	Average spread between a 30-year A-rated Canadian utility bond yield and 30-year Government of Canada bond yield for the trailing 12 months as of September 30[35]
Concentric	Average of:[36] • The forecast of the quarterly 30-year Government of Canada bond yield for each of the four quarters in the coming year from three Canadian investment banks – which receives a 75% weight; and • The current 90-day average 30-year Government of Canada bond yield, which receives a 25% weight	Average spread between a 30-year A-rated Canadian utility bond yield and 30-year Government of Canada bond yield for the trailing 90 days as of September 30[37]
Nexus	No comments made on the DLTDR[38]	
Dr. Cleary	Actual 30-year Government of Canada bond yield, as of September 30[39]	Actual spread between a 30-year A-rated Canadian utility bond yield and 30-year Government of Canada bond yield, as of September 30[40]

The approaches from each expert are set out in more detail below.

[32] OEB Report, p. I
[33] OEB Report, p. VIII
[34] LEI Expert Report, June 21, 2024, Revised September 23, 2024, p. 92
[35] LEI Expert Report, June 21, 2024, Revised September 23, 2024, p. 93
[36] Concentric Expert Report, July 19, 2024, p. 95
[37] Concentric Expert Report, July 19, 2024, p. 96
[38] Nexus Expert Report, July 19, 2024, p. 2
[39] Undertaking J5.3, October 16, 2024
[40] Undertaking J5.3, October 16, 2024

- *LEI's Suggested Approach (OEB staff's Suggested Approach)*

OEB staff submits that LEI's suggested approach should be adopted by the OEB. As set out in LEI's expert report, the base LCBF should be 3.19% and the base utility bond spread should be 1.385%, summing to a DLTDR of 4.58%.[41] Using updated data as of September 30, 2024, the base LCBF should be 3.127% and the base utility bond spread should be 1.427%, summing to a DLTDR of 4.554%.[42] OEB staff cautions against using the base utility bond spread in LEI's expert report, as it was based on the 30-days ended March 31, 2024, instead of the 12-month trailing data as of September 30, 2024.

OEB staff agrees with LEI that the term of debt to be used for the DLTDR (i.e., 30-years) is similar to that of most long-term bonds issued by utilities in Ontario[43] and that such a maturity is appropriate for deriving the DLTDR, given the useful life of utilities' property, plant, and equipment that underpin rate base, as set out in the OEB's Asset Depreciation Study.[44]

At a high level, the current approach to calculating the DLTDR should be maintained which uses the sum of the LCBF and an A-rated utility bond yield spread to develop the DLTDR. However, some modifications should be made to the OEB's existing approach to setting the DLTDR, as set out below.

Using reputable, publicly available, sources for 30-year bond yield forecasts from the seven major Canadian banks for the LCBF rate should be used, as it is simple to administer relative to the status quo.[45] LEI demonstrated that all major Canadian banks provide forecasts for 30-year Government of Canada bond yield on a quarterly or monthly basis.[46] This would address the above-noted problem that Consensus Forecasts does not publish 30-year Government of Canada bond yield forecasts.

Further, that current approach to developing the utility bond yield spread (i.e., the spread between an A-rated Canadian utility bond yield and 30-year Government of Canada bond yield) should continue, but with data for trailing 12-months ended September 30 instead of trailing one-month ended September 30.

[41] LEI Expert Report, June 21, 2024, Revised September 23, 2024, p. 123
[42] Undertaking J2.2, October 8, 2024
[43] LEI Expert Report, June 21, 2024, Revised September 23, 2024, p. 89
[44] Asset Depreciation Study for the Ontario Energy Board, Kinectrics Inc. Report, July 8, 2010, p. 17, Summary of Results
[45] LEI Expert Report, June 21, 2024, Revised September 23, 2024, p. 92
[46] LEI Expert Report, June 21, 2024, Revised September 23, 2024, p. 92, Figure 26

The Bloomberg ticker BVCAUA30 BVLI Index (30-year) is appropriate for considering the spread over the LCBF for an A-rated utility.[47] OEB staff submits that the average of the trailing 12-months as of September 30 for the Bloomberg ticker BVCAUA30 BVLI Index (30-year) should be used to develop the DLTDR to be included in base rates for the subsequent rate year (i.e., either January 1 or May 1 rates).

Lastly, OEB staff submits that the DLTDR be applied as a cap for all utilities in certain instances (not just electricity distributors and transmitters which is the OEB's current approach), given OEB-regulated entities have similar credit ratings.[48] This may potentially incentivize utilities to improve their credit profile and/or negotiate better borrowing terms, if their rates are higher than the DLTDR. In the OEB Report, the OEB recognized that the DLTDR would act as a proxy or ceiling for market-based rates by the OEB under certain circumstances (as also set out in the LEI report).[49] OEB staff submits that the OEB's historic approach is reasonable to continue.

8. How should transaction costs incurred by utilities be considered when setting the long-term debt rate?

OEB staff submits that the OEB's current methodology for the debt transaction costs should be continued. OEB staff supports the recommendations from Concentric, Nexus, and Dr. Cleary that transaction costs associated with long-term debt should continue to be recovered in rates through the embedded cost of long-term debt. OEB staff is of the view that this treatment would mitigate any potential intergenerational inequity issues resulting from the mismatch of when the cost is recovered from customers at the time it is incurred, rather than over the life of the relevant financial instrument.[50]

9. What are the implications of variances from the deemed capital structure (i.e., notional debt and equity) and how should they be considered in setting the cost of long-term debt?

Notional debt is the portion of deemed debt exceeding a utility's actual debt.[51] Notional debt can be either positive (deemed debt is greater than actual debt) or negative (deemed debt is less than actual debt).

OEB staff agrees with LEI and Dr. Cleary that the status quo approach (considering

[47] LEI Expert Report, June 21, 2024, Revised September 23, 2024, p. 93
[48] LEI Expert Report, June 21, 2024, Revised September 23, 2024, p. 176; Dr. Cleary Expert Report, July 19, 2024, p. 7
[49] LEI Expert Report, June 21, 2024, Revised September 23, 2024, p. 35, Footnote #71
[50] Nexus Presentation Day Slide Deck, September 5, 2024, p. 37
[51] Staff Report, January 14, 2016, pp. 6 & 7

deemed capital structure regardless of the actual capital structure) should be retained.[52] This ensures fairness to both utilities (by providing flexibility to optimize the capital structure based on their specific needs) and consumers (by limiting the deemed share of equity, which has a higher financing cost than debt).

In the Staff Report, it was noted that the OEB had determined in a number of cases that notional debt should attract the weighted average cost of actual long-term debt rate (rather than the DLTDR issued by the OEB).[53] An exception to this was where a utility is 100% equity financed and has no current debt or recent history of debt financing. In such a circumstance, the OEB noted that the deemed long-term debt rate would apply as a ceiling. OEB staff submits that the current approach should also be retained for 100% equity financed utilities.

D. Return on Equity

10. What methodology should the OEB use to produce a return on equity that satisfies the Fair Return Standard (FRS)?

Context

The OEB Report provides a good overview of the theory underlying the cost of capital. Key points include:

- the **Fair Return Standard "constitutes the over-arching principle** for setting the cost of capital, which is one input into the setting of rates"[54]
- the cost of capital "is equivalent to the **aggregate return on investment investors require in order to keep their capital invested in the utility and to invest new capital in the utility**"[55]
- In the long run, if a utility is unable to earn its cost of capital, **not only shareholders but also customers will be harmed**[56]
- Meeting the Fair Return Standard "is not optional; it is a **legal requirement**"[57]

[52] LEI Expert Report, June 21, 2024, Revised September 23, 2024, p. 100; Dr. Cleary Expert Report, July 19, 2024, p. 26
[53] Staff Report, January 14, 2016
[54] OEB Report, p. 19
[55] OEB Report, p. 20, citing *TransCanada PipeLines Limited v. National Energy Board et al.,* [2004] F.C.A 149.
[56] OEB Report, p. 20, citing *TransCanada PipeLines Limited v. National Energy Board et al.,* [2004] F.C.A 149
[57] OEB Report, p. 18

- The **rate impact on customers is "an irrelevant consideration"** in the determination of the cost of capital[58]
- The Fair Return Standard comprises three prongs, all of which must be met:
  - **the comparable investment standard:** the approved return must be comparable to the return available from the application of invested capital to other enterprises of like risk
  - **the financial integrity standard:** the approved return must enable the financial integrity of the regulated enterprise to be maintained
  - **the capital attraction standard:** the approved return must permit incremental capital to be attracted to the enterprise on reasonable terms and conditions
- The Fair Return Standard is a **prospective** rather than retrospective concept[59]
- "[t]he allowed **ROE is a cost** and is not the same concept as a profit"[60]

These general principles are well accepted. None of the four experts in this proceeding appear to take issue with them. OEB staff certainly does not. OEB staff would add, however, that one principle that was not expressly stated but implicit in the OEB Report is that a return that exceeds what is required to meet Fair Return Standard amounts to economic rent. As the Supreme Court of Canada put it in *Ontario (Energy Board) v. Ontario Power Generation Inc.*: "The just-and-reasonable approach to recovery of the cost of services provided by a utility captures the essential balance at the heart of utilities regulation: to encourage investment in a robust utility infrastructure and to protect consumer interests, utilities must be allowed, over the long run, to earn their cost of capital, no more, no less."[61]

Each of the four experts in this proceeding proposed a different ROE. Overall, in OEB staff's view, it is neither necessary nor advisable for the OEB to pick one of the four expert recommendations in this case, or to make a finding on which methodology (e.g., CAPM, DCF or ERP) or which inputs are superior. OEB staff's recommendation is that the OEB should triangulate between the expert proposals. Table 3 summarizes the ROE recommended in each expert report, and the updated calculation provided in response to a request from the Panel to update calculations with September 2024 data.

[58] OEB Report, citing *TransCanada PipeLines Limited v. National Energy Board et al.,* [2004] F.C.A 149
[59] OEB Report, p. 19
[60] OEB Report, p. 20
[61] 2015 SCC 44 (emphasis added).

Table 3: ROE Proposed in Expert Reports

	Dr. Cleary	LEI	Concentric	Nexus
Expert report	7.05%	8.95%	10.00%	11.08%
Updated by undertaking[62]	6.95%	8.88%	10.00%	11.08%

Notes: Concentric and Nexus both noted that their updated calculations produced slightly lower ROE values, but continued to support the value they had originally recommended (Undertakings J4.8 and J5.2).

Concentric made it clear that its recommendation of 10% was tied to its recommendation to increase the deemed equity ratios to at least 45%. It explained that if the equity ratios were to remain unchanged, its proposed ROE would increase to 11.38-11.63 with current equity ratios.[63]

LEI and Dr. Cleary proposed a single ROE for all Ontario utilities. Concentric's proposed ROE applied to all utilities except OPG, which would be able to apply for its own ROE. Nexus' recommended ROE only applied to electricity distributors; it did not consider other types of utilities.[64]

The four experts arrived at their recommendations using different methodologies. In brief, LEI relied on only the Capital Asset Pricing Model (CAPM). The other experts relied on a combination of three models: CAPM, the Discounted Cash Flow model (DCF) and the Risk Premium model.[65]

Applying each model requires the analyst to make choices using their professional judgment, and the four approaches varied in innumerable ways. Such choices include:

[62] LEI Undertaking Response J2.2, October 8, 2024; Concentric Undertaking Response J4.8, October 9, 2024; Nexus Undertaking Response J5.2, October 10, 2024; Dr. Cleary Undertaking Response J5.3, October 16, 2024
[63]. Concentric Expert Report, July 19, 2024, p. 71; Oral Hearing Transcript, September 26, 2024, p. 96 & 97
The 138 basis point adjustment applies to electricity distribution and transmission (assuming the status quo 40% equity ratio); the 163 point adjustment applies to gas distribution (assuming the status quo for Enbridge Gas of 38%). The adjustments were calculated based on the CAPM only, "as an indication of the degree of ROE adjustment that could be required if the Board were to retain existing equity ratios": Oral Hearing Transcript, October 1, 2024, p. 111
[64] Oral Hearing Transcript, October 3, 2024, p. 4
[65] Specifically, Dr. Cleary used a Bond Yield plus Risk Premium model

- Where multiple models are used, what weight to assign to each model[66]
- Where the DCF is relied on, whether to use a "single-stage" or "multi-stage" approach, as well as the utilization of varied growth factors[67]
- Within the CAPM, whether to apply the "Blume adjustment" to inflate utility beta values[68]
- Within the CAPM, where to source utility beta data from
- Within the Risk Premium approach, whether to consider approved ROEs in other jurisdictions[69]
- Which utilities should be used as comparators (US only, combination of US and Canada, Canada only)[70]

As Mr. Coyne put it at the oral hearing, the Commissioners face a "daunting task of sorting through thousands of pages of sometimes very technical evidence."[71]

When asked to provide some practical advice to the Commissioners, Mr. Coyne offered:

> So I think, going back to the wisdom of these court decisions from 100 years ago, I liked what they said in the Hope decision. And, in the Hope decision, one of the conclusions was: It's not about which input to the model or which model you use; it's about the end result and is it a reasonable one.
>
> And I really do think that's the high ground from which this Board best operates, and that's why we think it's important for the Board to consider – I think it would be a real shame if the Board was lost in the minor detail of determining whether or not beta should be adjusted and by how much, because you'll find various academic opinions from experts on those issues, and I don't think that's where the truth lies at the end of the day.[72]

In OEB staff's view, that is sensible advice. There is no single correct answer to the question of what ROE is needed to meet the Fair Return Standard, and no magic formula for deriving it. As Mr. Pampush of Nexus put it at Presentation Day, "models are to be used but not to be believed."[73]

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[66] Concentric and Dr. Cleary gave equal weight to each of the three models. Nexus applied a weighting based on the inverse of the variance of the results from the various models, which resulted in 49% CAPM, 38% DCF and 13% Risk Premium: Nexus Expert Report, July 19, 2024, p. 74-75
[67] Concentric used a multi-stage DCF; Nexus used a single-stage DCF; Dr. Cleary used variations of a single-stage and multi-stage models for the DCF.
[68] Concentric and Nexus applied the Blume adjustment; LEI and Dr. Cleary did not.
[69] Oral Hearing Transcript, October 3, 2024, p. 175
[70] Dr. Cleary looked only at Canadian comparators; the other experts looked at Canadian and US comparators.
[71] Oral Hearing Transcript, October 2, 2024, p. 94
[72] Oral Hearing Transcript, October 2, 2024, p. 94. In *Hope Natural Gas v. Federal Power Commission*, 320 US 591 (1944)
the US Supreme Court held that it is "the result reached, not the method employed, which is controlling."
[73] Presentation Day Transcript, September 5, 2024, p. 63

At the oral hearing, Mr. Goulding of LEI warned, "we need to be cautious about fallacies of misplaced precision. We should think in terms of a zone of reasonableness."[74] Mr. Goulding also suggested that, while "there are a variety of ways that reasonable people can look at all of the evidence and come to a conclusion," one way is "to average the recommendations of the experts."[75]

That is the approach the OEB used in the OEB Report. In the consultation that led to the OEB Report, the five experts applied various methodologies. For instance, Dr. Booth used the CAPM model, while Concentric used CAPM plus the DCF and ERP models.[76] The OEB did not make a determination on which model was best. To the contrary, it explained: "Although the Board maintains its view that each of the tests has empirical strengths and weaknesses, the diversity of approaches tabled and discussed in the consultation was helpful. As a result, the Board has given each test weight in the process to establish the initial ERP to be embedded in the Board's formula."[77] The OEB determined the base ROE by averaging the five expert recommendations.[78] It gave equal weight to all five.

In OEB staff's view, a broadly similar approach would be appropriate in this proceeding. It is neither necessary nor advisable for the OEB to pick one of the four expert recommendations in this case, or to make a finding on which methodology (e.g., CAPM, DCF or ERP) or which inputs are superior. OEB staff's recommendation is that the OEB should triangulate between the expert proposals.

Approaches to Triangulation

If we were to calculate the simple average of what each expert proposed in their expert report, the result would be an ROE of **9.27%**,[79] which is remarkably close to the approved ROE for 2024 of 9.21% and the approved interim ROE for 2025 of 9.25%.

However, in this case, that approach would be an oversimplification.

[74] Oral Hearing Transcript, September 25, 2024, p. 46
[75] Oral Hearing Transcript, September 25, 2024, p. 118
[76] OEB Report, p.38
[77] OEB Report, p.37
[78] More specifically, the OEB calculated the mean of the five experts' recommended equity risk premium. Where an expert had recommended a range, the low end of the range was used. The result (550 basis points) was added to the forecast Government of Canada long-term bond yield of 4.25% to arrive at the base ROE of 9.75%. OEB Report, pp.ii and p. 38;
[79] This is calculated by adding the four recommendations shown in Table 3 and dividing by four: (7.05 + 8.95 + 10.00 + 11.08) / 4 = 9.27. We used the recommendations in the expert reports rather than the updates provided by way of undertaking.

First, we acknowledge that Concentric's recommendation of 10.00% was tied to its recommendation to increase the deemed equity ratios. Concentric explained that if the deemed equity ratios were to remain at current levels, a higher ROE would be needed to meet the Fair Return Standard, somewhere between 11.38% and 11.63%, depending on the type of utility.[80] Later in this submission, OEB staff argues that the deemed equity ratios should stay the same. If the OEB were to agree, it would need to consider the context for Concentric's proposed 10.00%. If we were to take the midpoint between 11.38% and 11.63%, i.e., 11.51%, and use that as a composite Concentric recommendation instead of 10.00%, the simple average of the four expert recommendations would be **9.65%**.[81]

Second, in OEB staff's view, three of the four expert recommendations are inflated because they include a 50 basis point adder for transaction costs (sometimes referred to in this proceeding as flotation costs). Later in this submission we explain why this adder should be eliminated or at least reduced. If 50 basis points were factored out of the values recommended by Concentric, Nexus and Dr. Cleary, the simple average would be **9.32%** (using 11.51% as Concentric's recommendation instead of 10.00%).[82]

Third, taking a simple average might be seen as unfair in this case because the utility experts outnumbered the ratepayer expert two to one. Perhaps unsurprisingly, the ratepayer expert came in with the lowest recommended ROE while the two utility experts came in the with the highest.[83] OEB staff's expert was in the middle. Had there been another ratepayer expert the simple average might have been lower.

To correct for this, OEB staff could use a composite utility expert recommendation, i.e., the average between Concentric's 11.51% and Nexus' 11.08% (11.30%). That would

[80] Concentric Expert Report, p. 71; Oral Hearing Transcript, September 26, 2024, p. 97
[81] (7.05 + 8.95 + 11.51 + 11.08)/4 = 9.65
[82] Nexus and Dr. Cleary added 50 basis points to their baseline ROE recommendation; accordingly, for present purposes, OEB staff has simply subtracted 50 basis points from their recommended values: for Nexus, 11.08 - 0.50 = 10.58; for Dr. Cleary, 7.05 - 0.50 = 6.55. For Concentric it is more complicated, because Concentric only added the 50 basis points to two of its models (DCF and CAPM): Concentric report, p. 74. Concentric explained at the oral hearing that it was effectively an adder of 33 basis points that is reflected in its final recommendation: Oral Hearing Transcript, September 27, 2024, pp. 27 & 28. We have therefore subtracted 33 basis points from Concentric's composite ROE at 40% equity thickness, i.e., 11.51 - 0.33 = 11.18. The average, adjusted to remove the impact of the adder, is therefore: (6.55 + 8.95 + 11.18 + 10.58) / 4 = 9.32.
[83] Without meaning in any way to impugn the objectivity of any of the experts, who all signed the Acknowledgment of Expert Duty form, we note that Concentric has in several past OEB proceedings opined that the Fair Return Standard was not being met, while Dr. Cleary has typically urged that the cost of capital be lowered: …. Oral Hearing Transcript, October 1, 2024, p. 93; Oral Hearing Transcript, October 10, 2024, p. 32.

yield an overall average recommendation of **9.10%**.[84]

Adjusting further by factoring out the 50 basis point adder from the composite utility recommendation and the ratepayer recommendation would result in **8.79%** assuming no change in equity ratio.[85]

OEB Staff Recommended Approach - Overall Average ROE (Excluding Transaction Costs)

It can be seen from this analysis that there are a number of ways to triangulate. To summarize, assuming that (a) the 50 basis point adder will not be embedded in the ROE, and (b) the generic equity ratios are not increased in this proceeding, the average ROE would be **9.32%**. If we were to adjust for the fact that the utility experts outnumber the ratepayer expert, the average would be **8.79%**. Those two values define a reasonable ROE range.

OEB staff submits that the OEB should select an ROE from within that range as the "rebased" ROE for 2025. This generic ROE should apply to all utilities. Differences in risk as between different types of utility (e.g., electricity generators vs. electricity distributors) are already taken into account in the approved equity ratios.

As a feature of the policy, utilities should continue to be permitted to bring forward an application for a variance from the generic ROE, that is, a utility-specific ROE. The burden of proof would be on the utility to demonstrate that the default ROE would not meet the Fair Return Standard given the utility's particular circumstances.

OEB staff notes that at the oral hearing, the Panel asked each expert to update their ROE calculations based on more recent data to September 2024. In our triangulation calculations, OEB staff has relied on the ROE values originally recommended in the four expert reports. The revised numbers have not been tested by way of interrogatory or cross-examination. In any case the differences were generally negligible. We note, however, that directionally the updates suggest that all four expert recommendations were, if anything, slightly on the high side. The OEB could consider that when determining the final ROE from among the range we have proposed.

Stress-testing OEB staff's recommended range

It might be argued that this type of triangulation is not grounded in principle – it

[84] (7.05 + 8.95 + 11.30) / 3 = 9.10.
[85] (6.55 + 8.95 + [11.18 + 10.58 / 2]) / 3 = 8.79.

essentially accepts each recommendation at face value without picking one. OEB staff would respond that, as the OEB noted in the OEB Report, there is value in considering multiple expert perspectives (and multiple methodologies). Moreover, there are other reasons to believe a range of **8.79% to 9.32%** is reasonable.

1. It is in line with the status quo, which has worked well

The OEB-approved ROE for 2024 is 9.21%. For 2025 it is 9.25% (on an interim basis). That is near the upper end of OEB staff's proposed range, and within 50 basis points of the lower end of OEB staff's recommended range.

In OEB staff's view, the current ROE is working as intended. No evidence has been provided in this proceeding that Ontario utilities are currently failing to attract capital on reasonable terms, let alone that their financial integrity is compromised. Concentric acknowledged that it is "not aware of Ontario utilities failing to attract capital or being in danger of losing their financial integrity since the 2009 Decision."[86] Nexus said it had not looked at whether utilities were having difficulty attracting capital.[87] Dr. Cleary said, "The fact is that, despite these consistent assertions, none of the experts have provided evidence that Canadian utilities have had any issues attracting capital at reasonable terms through the years or currently, and in most cases Canadian utilities have done so at lower rates than their riskier US counterparts (e.g. according to bond yield spreads, etc.)."[88]

LEI wrote that it is "not aware of OEB-regulated entities facing notable issues in attracting equity and debt capital since 2009."[89] LEI added that S&P Global, a credit rating agency, classifies the Ontario regulatory regime as "most credit supportive" – the highest of five categories.[90] At the oral hearing, Mr. Goulding said, "continued investment in network utilities does strike me as being a fairly strong indicator that the FRS has been met", and that "the proof of the pudding is in the eating."[91]

Concentric says that many of the Canadian investors they work with (e.g., pension funds) have been investing in US utilities, and that there has been a "steady outflow of capital from Canada investing in US utilities",[92] but no one has demonstrated that such

[86], N-M2-10-CME-1, August 22,2024 See also. Oral Hearing Transcript, October 2, 2024, p. 67 &68
[87] "We have not interviewed EDA members regarding notable issues attracting equity and debt capital since this was not necessary for our analysis or conclusions regarding the cost of equity" N-M3-10-SEC-77, August 22, 2024
[88] N-M4-10-OEA-14, August 22, 2024, p.2 of 3
[89] LEI Expert Report, June 21, 2024, Revised September 23, 2024, p. 127
[90]. LEI Expert Report, June 21, 2024, Revised September 23, 2024, p 128 &129
[91] Oral Hearing Transcript, September 25, 2024, p. 111
[92]; Oral Hearing Transcript, October 2, 2024, p. 72. see also M2-AMPCO/IGUA-5,August 22,2024

cross-border investment has left Ontario utilities unable to raise the capital they need on reasonable terms. In other words, there is no evidence that investment in US utilities has come at the expense of Ontario utilities.

In OEB staff's view, the only reasonable inference is that, generally, US utilities are not actually comparable in risk to Ontario utilities.[93] Investors are willing to accept lower returns in Ontario because the risk is lower.

2. **It is in line with what other Canadian energy regulators have approved.**

OEB staff's proposed range of 8.79% to 9.32% would keep Ontario returns in line with what other Canadian utilities can earn. Again, since Canadian utilities are generally lower risk than US utilities, their authorized returns are a useful benchmark when assessing the comparative investment standard.

According to Concentric, the average approved ROE for electricity utilities in Canada is **9.16%** (the range is from 8.50% in Newfoundland and Labrador to 9.65% in BC). For natural gas utilities the average is **9.23%** (the range is from 8.90% for Energir to 10.65% for Eastward Energy).[94] As discussed below, several provinces embed transaction costs (typically 50 basis points) in the ROE.

In October 2023, following a generic hearing, the Alberta Utilities Commission rebased the ROE at **9%** (including a 50 basis point transaction cost adder), which has since been updated formulaically to **9.28**.[95] For context, the deemed equity ratio in Alberta is 37% for all distribution and transmission utilities except for one which is at 39%.[96]

3. **The utility experts' ROE recommendations are too high, and the ratepayer expert's recommendation is too low**

Leaving aside the 50 basis point adder for the moment, both the Concentric and Nexus reports include methodological choices that lead to an upward bias. For instance, Concentric and Nexus applied the "Blume adjustment" to inflate the utility betas in their CAPM analysis. The Blume adjustment is a mathematical adjustment that increases a given beta to reflect the notion that beta (an indicator of a security's risk relative to the

[93] Oral Hearing Transcript, September 25, 2024, p. 68
[94] Concentric Expert Report, July 19, 2024, p 79
[95] N.M4.10.OEA.15 ,August 22,2024; see also the AUC website (https://www.auc.ab.ca/rate-of-return/#:~:text=Starting%20in%202024%2C%20the%20return,rated%20Canadian%20utility%20bond%20yields) and Decision 27084-D02-2023 (https://efiling-webapi.auc.ab.ca/Document/Get/794577). According to the Decision, no party opposed the inclusion of the 50 basis point adder.
[96] AUC website (ibid.).

overall market) tends to revert to the market mean over time.

LEI argued at Presentation Day that there is insufficient empirical evidence for using the Blume adjustment, and OEB staff agrees. While Concentric notes that utility betas have risen in the last few years, OEB staff's view is that we should be cautious about drawing conclusions from short-term trends: over the long term, utility betas rise and fall in a cycle of peaks and valleys.[97] In any case, it defies logic to presume that utilities, which are inherently lower risk than the typical competitive enterprise, are inching inexorably towards the market-average risk level. Moreover, there is academic literature questioning the Blume adjustment.[98] The impact of the Blume adjustment is not huge in this case– Concentric says the adjustment added around 13 to 14 basis points to its recommended ROE.[99]

More significantly, Concentric and Nexus rely heavily on US utility comparators. These tend to have higher approved ROEs than Canadian utilities. OEB staff acknowledges that, as the OEB said in the OEB Report, "'like' does not mean the "same". The comparable investment standard requires empirical analysis to determine the similarities and differences between rate-regulated entities. It does not require that those entities be 'the same'". The OEB Report specifically rejected the suggestion that US data be ignored, finding instead that "the US is a relevant source for comparable data."[100] Still, legitimate questions have been raised about Concentric's and Nexus' choice of comparators. Indeed a significant portion of the oral hearing was spent scrutinizing those choices.

For instance, Concentric was asked to rerun its ROE calculations excluding utilities that own regulated generation, as well as companies with more than 10% of operating income from unregulated operations (both of which would be higher risk than the typical Ontario utility). Concentric's response shows that ROE would be about 40 basis points lower.[101]

Nexus' comparator group included many vertically integrated companies that own significant generation assets. Nexus acknowledged under cross-examination that one of

[97] See the chart showing historical utility betas since 1968 in LEI Presentation Day presentation, p. 11 (KP1.1).
[98] R.A. Michelfelder and P. Theodossiou, "Public Utility Beta Adjustment and Biased Costs of Capital in Public Utility Rate Proceedings," *The Electricity Journal*, November 2013 (Vol. 29, Issue 9) (filed as Undertaking J4.5). The abstract states that "an empirical analysis suggests that the commonly used Blume CAPM beta adjustment is not appropriate for electric and electric and gas public utility betas, and may bias the cost of common equity capital in public utility rate proceedings.
[99] Oral Hearing Transcript, October 1, 2024, p. 24
[100] OEB Report, p. 23
[101] Concentric Undertaking Response J4.2, October 7, 2024

its comparator companies (Alaska Power & Telephone Co.) earns most of its revenues from telecommunications and another (Otter Trail Corp.) earns most of its revenues from manufacturing. While "like" does not mean "the same", the inclusion of such companies, which bear little resemblance to Ontario electricity or gas utilities, calls into question Nexus' conclusions on ROE.

Dr. Cleary's analysis suffers from the opposite problem. His sample of comparators is too small. It comprises only five utilities, all Canadian. Dr. Cleary said that "Comparing apples to more oranges doesn't help."[102]

He later acknowledged, however, that imperfect comparators (even US ones) can be used, as long as adjustments are made for relative risk – as the AUC has done.[103]

Dr. Cleary makes a compelling point that a 7% return looks good if the expected total market return is 7.5%.[104] Nevertheless, the fact is that 7% would mark a steep reduction from the 2025 interim ROE of 9.25%. When asked by Commissioner Sardana whether that "could have a credit rating chill in the sector," Dr. Cleary acknowledged, "It's possible."[105]

Accepting Dr. Cleary's proposed ROE would make Ontario the lowest-ROE province in Canada, by a fair margin (recall that according to Concentric, Newfoundland and Labrador is currently the lowest, at 8.50%). It would also widen the gap between Ontario and the US. Dr. Cleary may be right that approved ROEs tend to be too high throughout North America and that there is a certain "circularity" in looking at what other regulators have done, but that is not something that the OEB can cure on its own. Dr. Cleary acknowledged that regulators are in a "prisoner's dilemma".[106] Unilaterally slashing the ROE – even if backed by sound theory – makes it harder to meet the comparable investment test.

Again, OEB staff does not mean to suggest that there is a single, ideal methodology for calculating the ROE – that the OEB should declare, for instance, that Concentric was wrong to include Duke Energy or Alliant Energy in its comparator group. The point, rather, is that the utility experts made certain methodological choices that supported a higher ROE, and the ratepayer expert made certain methodological choices that supported a lower ROE. While the ratepayer expert proposes to make Ontario the lowest-ROE province in Canada, the utility experts propose to make it the highest.

[102] N-M4-10-Staff-67, August 22, 2024
[103] Oral Hearing Transcript, October 10, 2024, p. 154-157
[104] Oral Hearing Transcript, October 10, 2024, p. 39.
[105] Oral Hearing Transcript, October 10, 2024, p. 185
[106] Oral Hearing Transcript, October 10, 2024, p. 158

As for OEB staff's expert, LEI – it was critiqued from both sides. That may be an indication that its recommended ROE lies in the "Goldilocks zone".[107]

10. Sub-Issue: Should 50 basis points be included as part of the ROE for transaction costs and financial flexibility?

The deemed ROE has included a 50 basis point adder for "transactional costs" since the OEB Report.[108] However, the OEB Report provides no rationale for embedding such costs in the ROE, nor for how the adder was set at 50 basis points.

In OEB staff's view, it is time to revisit this aspect of OEB policy. It became clear in the oral hearing that, whatever justification there may have been for the 50 basis point adder in 2009, it is not needed today.

OEB staff's recommendation is that the adder be eliminated and that instead, utilities be given an opportunity to recover their actual transaction costs in a rate application. This is the position LEI took in their report. A recent decision of the BCUC found that "the proposed flotation cost adder is too vague to be a just and reasonable expense recoverable from ratepayers. It is a very rough estimate of the actual flotation costs of shares issued by the parent when it issues its own shares to obtain the funds used to purchase the shares of its subsidiaries."[109] Instead of embedding transaction costs in the ROE, the BCUC allowed utilities to claim transaction costs "as part of each utility's Revenue Requirement process".[110]

The three other experts recommended that the 50 basis point adder be retained. However, they provided starkly different reasons.

According to Concentric's evidence, flotation costs for utilities are within a range from 2% to 10%, with an average of around 5%. A 5% average translates into about 25 basis points of ROE.[111] Concentric also opined that an additional cushion for "financial flexibility" is also needed: "The adjustment also takes into account the need for financial flexibility, meaning that utilities are capital intensive businesses and must be able to access capital markets at all necessary times regardless of conditions in capital markets

[107] Oral Hearing Transcript, September 25, 2024, p. 41
[108] OEB Report, p. 37
[109] BCUC Decision and Order G-236-23 (Generic Cost of Capital Proceeding – Stage 1), September 5, 2023, p. 128.
[110] Ibid., p. 129.
[111] Oral Hearing Transcript, October 2, 2024, p.81. in Undertaking J3.3, October 7, 2024, Concentric provided calculations showing that 5% flotation costs require 24 basis points of ROE.

or the economy."[112]

Concentric went on to cite the work of Roger Morin, who wrote that this cushion for financial flexibility is needed because, compared to non-regulated firms, utilities "have limited ability to time security issuances in order to avoid an adverse market break."[113] However Concentric was unaware of any instances where an Ontario utility actually had to go to market during a market break.[114]

Nexus argued that in addition to direct transaction costs such as a professional fees ("lawyers, accountants, rating agencies"), the ROE must also account for share dilution.[115] However Nexus was unaware of any other regulator that treats share dilution as a cost of equity recoverable from ratepayers.[116] OEB staff is not persuaded that share dilution should be reflected in the ROE. A fundamental principle is that the cost of capital is a cost. Share dilution is not a true cost to the utility. As Dr. Cleary noted, "I would say that that's probably more captured in the price offering, like the price that the consumer, the investor, rather, pays for it."[117]

OEB staff is not persuaded that utilities who do not actually incur transaction costs should get the benefit of the adder. Indeed, very few Ontario utilities depend (or have ever depended) on the public equity markets, and even then, it is typically the corporate parent that is listed, not the regulated utility itself (e.g., Enbridge Inc. rather than Enbridge Gas Inc., or Hydro One Limited rather than Hydro One Networks Inc.).[118] OEB staff fails to see why transaction costs should be considered to be part of the cost of capital for a utility that does not incur any. At the oral hearing, Concentric accepted that Hydro One, for example, earned around $4.8 million from the flotation cost adder in 2023 even though it had not issued public equity since at least 2019 and does not plan to do so in through 2027, but insisted that it was still reasonable for ratepayers to pay for that $4.8 million.[119] In OEB staff's view, it is difficult to justify such an outcome with the fundamental premise, stressed by Concentric, that "the cost of equity is a true cost of service".[120]

In sum, OEB staff agrees with LEI that a 50 basis point adder "is likely to overcompensate utilities".[121] There are two ways this could be remedied.

[112] Concentric Expert Report, July 19, 2024, p. 71
[113] N-M2-10-Staff-16, August 22, 2024
[114] Oral Hearing Transcript, October 2, 2024, p. 80.
[115] Oral Hearing Transcript, October 2, 2024, p. 138.
[116] Oral Hearing Transcript, October 2, 2024, p. 55.
[117] Oral Hearing Transcript, October 10, 2024, p. 168.
[118] Oral Hearing Transcript Vol. 3, September 27, 2024, pp. 184-187
[119] Oral Hearing Transcript, October 1, 2024, p. 26
[120] Oral Hearing Transcript, October 1, 2024, p. 44. Specifically in respect of the flotation cost adder, Mr. Dane said, "yes, it's intended to capture real costs": Oral Hearing Transcript, Vol. 3, September 27, 2024, p. 187.
[121] Presentation Day Transcript, September 5, 2024, p. 8

One option would be to follow the BCUC and remove the adder entirely from the ROE. Instead, utilities would be able to include transaction costs (or, as the BCUC, the transaction costs incurred by their corporate parent) in the revenue requirement they seek in a rate application. A deferral account could be established (either on a generic basis or on the application by a utility) to track any transaction costs incurred between rebasing applications.[122]

Another option that provides for simple administration would be to reduce the adder to more closely reflect actual transaction costs. As Mr. Goulding put it, "if there is an adder, I want it to be anchored in some kind of evidence about costs."[123] The evidence of actual cost is weak, but indicates that an adder of around 25 basis points would be more than sufficient to capture actual costs.

OEB staff recommends the first option. In OEB staff's views, none of the three experts who support the status quo provided a convincing reason. As a matter of principle, utilities should be entitled to recover their prudent transaction costs but no more or less than that. Reviewing such costs in a rate case would accomplish that. OEB staff submits that when a utility brings forward the deferral account for clearance in a future application, it must demonstrate that any transactions costs recorded in the deferral account are not double-counted elsewhere (i.e. not incorporated into the amount raised).

ROE Update Formula

LEI,[124] Concentric,[125] and Dr. Cleary[126] proposed similar ROE update formulas to be used beyond 2025, compared to that approved in the 2009 consultation, but with updated numbers included in the formula. The ROE formula in the OEB Report was as follows:[127]

ROE_t = 9.75%* + 0.5×($LCBF_t$−4.25%) + 0.5×($UtilBondSpread_t$−1.415%)

*including 50 basis point flotation cost adder

All three experts did not take issue with the OEB updating the above-noted ROE update

[122]. Presentation Day Transcript, September 5, 2024, p. 19
[123]. Oral Hearing Transcript, September 25, 2024, p. 138
[124] LEI Undertaking Response J2.2, October 8, 2024
[125] Concentric Expert Report, July 19, 2024, p. 98.
[126] Undertaking J5.3, October 16, 2024
[127] OEB Report, p. vi

formula, but with different comments on how to update the parameters in this formula as follows:

- An update to the base ROE from 9.75% - OEB staff's recommendation is a range of 8.79% to 9.32%, as discussed in the Issue #10 section above. The midpoint of this range is 9.06%.
- An update to the 0.5 adjustment factors – OEB staff's recommendation is an adjustment factor for the LCBF of 0.40 and an adjustment factor for utility bond spread of 0.33, as discussed below in Issue #10.
- An update to the base LCBF – OEB staff's recommendation is 3.127%, as discussed in Issue #7.
- An update to the utility bond spread – OEB staff's recommendation is 1.427%, as discussed in Issue #7.

In an undertaking response, Nexus suggested the following ROE update formula, which was similar to the above-noted formula, but utilized only US data.[128]

ROE = $Base\ ROE$ +0.26 (US 30−$Year\ Treasury$−$Base\ US$ 30−$Year$) +0.13 ($Moody's\ Baa\ Corp$−$Base\ US$ 30−$Year$)

OEB staff does not agree with Nexus' reliance solely on US data. OEB staff submits the following ROE Update Formula is appropriate, given OEB staff's analysis set out in this submission.

ROE_t = 9.06% + 0.40×($LCBF_t$−3.127%) + 0.33×($UtilBondSpread_t$−1.427%)

Adjustment Factors

There are two adjustment factors that were set in the OEB Report: LCBF and utility bond spread. The purpose of the adjustment factors is to refine the ROE adjustment formula to reduce its sensitivity to changes in government bond yields due to monetary and fiscal conditions that do not reflect changes in the utility cost of equity.[129]

The status quo LCBF adjustment factor is 0.5 and is applied to the difference between a LCBF updated as part of the OEB's annual ROE updates and the base LCBF set in 2009. The status quo utility bond spread adjustment factor is 0.5 and is applied to the difference between an A-rated Utility Bond Yield Spread updated as part of the OEB's annual ROE updates and the base spread set in 2009.

[128] Nexus Undertaking Response J5.2, October 10, 2024
[129] OEB Report, pp.ii

As noted above, OEB staff's recommended ROE Adjustment Formula is:

ROE_t = 9.06% + 0.40×($LCBF_t$−3.127%) + 0.33×($UtilBondSpread_t$−1.427%)

If the OEB accepts OEB staff's submission, for the LCBF, if the data updated as part of the OEB's annual ROE updates is greater than 3.127%, a higher adjustment factor than 0.5 would increase the allowed ROE. In the case where the data updated is less than 3.127%, a higher adjustment factor than 0.5 would decrease the allowed ROE. The same argument would apply to the utility bond spread.

OEB staff agrees with Concentric's adjustment factors: i,e., 0.40 adjustment factor for the LCBF and 0.33 adjustment factor for utility bond spread. Concentric recommended lowering the LCBF adjustment factor from the status quo 0.50 to 0.40 and the utility bond spread adjustment factor from the status quo 0.50 to 0.33.[130] Concentric stated that these changes recognize that the relationship between ROEs and government bond yields has weakened slightly over the past fifteen years, while still maintaining the formula's ability to be sufficiently sensitive to changes in interest rates and utility credit spreads.

While Concentric agreed with LEI that the coefficients have come down since 2009, its estimates indicate LEI's recommended adjustment factors are too low and provided reasons for its disagreement .[131] OEB staff agrees with Concentric and accordingly does not support LEI's suggested adjustment factors of 0.26 for LCBF and 0.13 for utility bond spread.[132] OEB staff submits that Concentric's recommended adjustment factors are similar to the average of the adjustment factors between the OEB Report and LEI's recommendations, as shown in Table 4 below.

[130] Concentric Expert Report, July 19, 2024, p. 98
[131] Concentric Expert Report, July 19, 2024, p. 105. Concentric found the following flaws with LEI's regression:

- It considers BBB-rated corporate bond yields rather than A-rated utility bond yields
- It considers the absolute level of corporate bond yields rather than spreads over government bond yields
- It suffers from multicollinearity issues

[132] LEI Expert Report, June 21, 2024, Revised September 23, 2024, p. 127

Table 4 – Adjustment Factors Comparison

Adjustment Factors	OEB Report (a)	LEI (b)	Average of (a) and (b)	Concentric
LCBF	0.50	0.26	0.38	0.40
Utility Bond Spread	0.50	0.13	0.31	0.33

Dr. Cleary also disagreed with LEI's recommended adjustment factors and noted that the existing adjustment factors of 0.50 would be preferable (if Dr. Cleary's suggested adjustment factors of 0.75 were not approved by the OEB).[133] Dr. Cleary stated that LEI's regression specification is flawed by design, since allowed ROEs in US jurisdictions do not have a direct relationship with changes in capital market conditions in Canada.[134] In Dr. Cleary's view the allowed ROEs in Ontario (and other jurisdictions) have not declined adequately in response to the reduction in the cost of capital that utilities have experienced, as long-term government bond yields and A-rated utility bond yields have declined significantly over the last two decades.[135]

Concentric stated that Dr. Cleary did not provide a historical regression analysis, which in its view, is the crucial step in determining the correct adjustment factors to use.[136] OEB staff suggests that this is a valid reason to reject Dr. Cleary's recommended adjustment factors of 0.75 for each of the LCBF and utility bond spread.[137]

Although Nexus did not offer an independent adjustment formula, Nexus noted that there was some merit to LEI's use of empirical analysis to establish its weights.[138]

OEB staff concludes that Concentric's adjustment factors are appropriate to use: i.e., 0.40 adjustment factor for the LCBF and 0.33 adjustment factor for utility bond spread. This is because the relationship between ROEs and government bond yields has weakened slightly over the past fifteen years. OEB staff does not agree with Dr. Cleary's position that the relationship has increased (as opposed to decreased), as he did not provide a historical regression analysis.

[133] Dr. Cleary Expert Report, July 22, 2024, p. 45
[134] Dr. Cleary Expert Report, July 22, 2024, p. 46
[135] Dr. Cleary Expert Report, July 22, 2024, p. 45
[136] N-M2-10-OEB Staff-9, August 22, 2024
[137] Dr. Cleary Expert Report, July 22, 2024, p. 46
[138] Nexus Expert Report, July 19, 2024, p. 79

11. Are the perspectives of debt and equity investors in the utility sector relevant to the setting of cost of capital parameters and capital structure? If yes, what are the perspectives relevant to that consideration, and how should those perspectives be taken into account for setting cost of capital parameters and capital structure?

OEB staff agrees with LEI and Dr. Cleary that the OEB's current approach to cost of capital determination (including the determination of deemed capital structure) sufficiently considers investor perspectives, i.e., the allowed cost is commensurate with the perceived risks associated with the sector.[139] LEI and Dr. Cleary believe that the existing approach meets the FRS.

OEB staff also agrees with LEI that market data included in the OEB's formula and risk assessment when determining the appropriate equity thickness, when considered appropriately, should reasonably reflect investors' perspectives.[140] LEI stated that the OEB can slightly modify the reporting requirements to enable better monitoring of the actual utility cost of capital. However, as noted in Issue #15, OEB staff disagrees that the OEB's reporting requirements need to be increased.

LEI stated that the OEB is among the few North American regulators to annually update the cost of capital parameters to ensure they align with the current macroeconomic environment.[141] LEI and Dr. Cleary are not aware of OEB-regulated entities facing notable issues in attracting equity and debt capital since 2009.[142] LEI and Dr. Cleary stated that this is also reflected in the utility credit ratings and the regulator assessments performed by the credit rating agencies.

LEI and Dr. Cleary noted the DLTDR and DTDSR formulae are devised considering OEB regulated entities' credit profiles.[143] Dr. Cleary stated that the approach of determining an appropriate estimate of the required ROE and appropriate estimates of DLTDR and DTSDR implicitly considers the perspectives of both debt and equity investors.[144] Determining an allowable ROE that satisfies the FRS in effect should ensure this is the case.

[139] LEI Expert Report, June 21, 2024, Revised September 23, 2024, p. 134; Dr. Cleary Expert Report, July 22, 2024, p. 48.
[140] LEI Expert Report, June 21, 2024, Revised September 23, 2024, p. 134
[141] LEI Expert Report, June 21, 2024, Revised September 23, 2024, pp. 127 & 128
[142] LEI Expert Report, June 21, 2024, Revised September 23, 2024, pp. 127 & 128; Dr. Cleary Expert Report, July 22, 2024, p. 47
[143] LEI Expert Report, June 21, 2024, Revised September 23, 2024, p. 16; Dr. Cleary Expert Report, July 22, 2024, p. 48
[144] Dr. Cleary Expert Report, July 22, 2024, p. 48

OEB staff agrees with Concentric's view that the perspectives of debt and equity investors in the utility sector are one of the most relevant considerations in setting the cost of capital parameters and capital structure.[145] They provide important feedback on the reasonableness of the authorized cost of capital and whether the financial integrity, capital attraction and comparable return standards are being met.

Concentric stated that relevant sources of information include credit reports on the utility industry, debt and equity investor rankings of Ontario's regulatory environment, and credit and equity analyst reports for individual utilities.[146] OEB staff agrees that these are relevant sources of information.

Nexus stated that the authorized returns on equity under the current OEB approach are substantially lower than those of comparables.[147] Nexus concludes that the OEB's current approach fails to adequately represent the interests of equity investors. OEB staff disagrees with Nexus and submits that the OEB's current approach to cost of capital determination sufficiently considers investor perspectives (as noted above).

E. Capital Structure

12. How should the capital structure be set for electricity transmitters, electricity distributors, natural gas utilities, and OPG to reflect the FRS?

The OEB Report affirmed the deemed equity ratio of 40% equity / 60% debt which has been in place since 2006.[148] The OEB Report said that for electricity transmitters, generators, and gas utilities, the deemed capital structure would continue to be determined on a case-by-case basis.[149] Since the OEB Report, the OEB has extended the deemed equity ratio of 40% to electricity transmitters. The equity ratio for gas utilities and OPG are still set on a case-by-case basis. Enbridge Gas's current approved equity ratio is 38%. EPCOR Natural Gas's is 40%. OPG's is 45%.

LEI opined that no changes to capital structure are required, and that the OEB should retain its current approach of permitting utilities to apply for a change in capital structure if they believe there has been an increase in the business or financial risks they face. OEB staff submits this is the most appropriate option for setting the deemed capital structure.

[145] Concentric Expert Report, July 19, 2024, p. 122.
[146] Concentric Expert Report, July 19, 2024, p. 122.
[147] Nexus Expert Report, July 19, 2024, pp. 82 & 83.
[148] OEB Report, p. 50 (citing the *Report of the Board on Cost of Capital and 2nd Generation Incentive Regulation for Ontario's Electricity Distributors*, December 20, 2006).
[149] OEB Report, p. 50

Dr. Cleary generally agreed with LEI that the generic equity ratios do not require resetting, except he suggested that the OEB should reduce the approved equity ratios for Hydro One Networks Inc. (from 40% to 38% or even, over time, to 36%) and Enbridge Gas (from 38% to 36%). Dr. Cleary added that while he did not conduct a detailed analysis of each Ontario utility, his view is that equity ratios are generally too high.

In its expert report, Nexus endorsed the status quo for electricity distributors, while noting that the approved equity thickness tends to be higher in the US than in Ontario. At the oral hearing, Dr. Pampush clarified that Nexus was "essentially neutral" on the equity thickness issue.[150]

Only Concentric recommended changes to the generic equity ratios. Specifically, it recommended that the deemed equity ratio be set at no lower than 45% for all utilities – both electricity and natural gas utilities – except OPG, which should continue to have its capital structure examined in each payment amounts proceeding.

Concentric recommended that each utility be authorized at its discretion to retain its current equity ratio and also have the ability to propose differences from the "generic" equity thickness in its rates application.[151]

OEB staff submits that no changes need to be made to the OEB's policy on capital structure in this proceeding. Concentric has not made out a persuasive case that a minimum equity ratio of 45% is required to meet the Fair Return Standard. OEB staff agrees with Concentric that OPG's equity ratio should be examined in each payment proceeding. OEB staff recognizes that OPG, as the only rate-regulated generator in the province, may have a unique risk profile and unique capital spending needs to fulfill its mandate. In the meantime, there is no need to reset OPG's equity ratio in this proceeding.

Concentric and Nexus are correct that equity ratios in the US are generally higher than in Ontario. But as LEI testified, it may be that US equity ratios are too high, not that Ontario equity ratios are too low.[152] Ontario equity ratios are in fact in line with the average equity ratios in other provinces.[153] A significant amount of hearing time was

[150] Oral Hearing Transcript, October 2, 2024, p. 39.
[151] Concentric Expert Report, July 19, 2024, p. 137.
[152] Oral Hearing Transcript, September 25, 2024, pp. 76 & 77: "The idea was to show that in our presentation day, we had made a point with regards to it is not necessarily the case that Ontario ROEs and equity ratios are low, but it is potentially possible that the US ROEs and equity ratios are high."
[153] Concentric Expert Report, July 19, 2024, p. 134; Exhibit N-M2-12-AMPCO/IGUA-20, August 22,2024

spent exploring the difference between Ontario and US utilities. As discussed above, US utilities tend to be riskier than Ontario utilities. The reasons include that many US utilities include generation and non-regulated assets. Concentric said that its recommended equity ratio of 45% "already has a built-in 7 percent discount off the capital structures of the sample of companies from which this group comes from. So, we are already treating Ontario's T&D [transmission and distribution] companies as a low-risk group of companies, otherwise the recommendation would be 52 percent, but it's 45 percent."[154]

Even with this 7% discount, Concentric's recommendation would bring Ontario well above the Canadian average equity ratio for both electricity distribution and transmission and natural gas.[155]

Concentric also opined that "risks for Ontario utilities have increased over time."[156] It points to, for example, climate risks, cybersecurity risks, energy transition risks.

OEB staff is not persuaded that the overall level of risk facing electricity distributors and transmitters is materially different than in 2009 when the current cost of capital policy was adopted or in 2016 when that policy was last reviewed. Several ratepayer groups suggested in the oral hearing that the energy transition actually represents a huge opportunity for those utilities. Moreover, there have been changes to the Ontario regulatory framework that have reduced risk, such as the implementation of fully fixed distribution rates for residential electricity distribution customers, which mitigates volume risk. In any case, any change in risk has already been reflected to some extent in the formulaic adjustments to ROE.

In OEB staff's view, it is telling that Nexus, which was retained by the EDA (a group of 50 electricity distributors[157]), did not recommend an increase in equity thickness. It is worth repeating that with the wide range of utilities that the deemed capital structure applies to and the OEB regulating more than 60 utilities in this regard, the ability for a utility to apply for a specific capital structure be maintained.

To repeat what Mr. Goulding said, the proof of the pudding is in the eating. As OEB staff explained above under Issue 10, the evidence shows that the OEB's current approach has been meeting the Fair Return Standard. Ontario utilities are not struggling to raise capital on reasonable terms, nor is their financial integrity at risk. While lower than the average equity ratios in the US, Ontario equity ratios are comparable to what other

[154] Oral Hearing Transcript, September 26, 2024, p. 169
[155] Ibid.
[156] Concentric Expert Report, July 19, 2024, p. 112.
[157] EDA Intervention Request, March 19, 2024.

Canadian energy regulators have approved.

Concentric's recommendation re Enbridge Gas

If Concentric's recommended 45% minimum equity ratio were adopted, the biggest beneficiary would be Enbridge Gas, whose approved equity ratio is currently 38%. In OEB staff's view, now is not the time to adjust Enbridge Gas's equity ratio. It was a contested issue in Phase 1 of Enbridge Gas's rebasing proceeding that was decided less than a year ago. Three of the experts in this case participated: Concentric on behalf of Enbridge Gas, Dr. Cleary on behalf of IGUA, and LEI on behalf of OEB staff. After hearing all the evidence, the Phase 1 panel decided to increase Enbridge Gas's equity ratio from 36% to 38% for 2024. That was less than the 42% Enbridge Gas had requested.[158] Enbridge Gas appealed that aspect of the Phase 1 decision to the Divisional Court; the appeal has not been heard. Enbridge Gas also brought a motion asking the OEB to review that finding, but later narrowed the scope of its motion, saying it would advance its position about the proper capital structure in this generic proceeding.[159]

The arguments Concentric makes in this generic proceeding for increasing Enbridge Gas's equity ratio are essentially the same as the arguments it made in the rebasing case – including the argument that Energy Transition has increased risk. The Phase 1 panel considered those arguments and unanimously decided that an increase to 38% would suffice. The Phase 1 panel had the benefit of vastly more evidence and argument on the matter than this panel has in this generic proceeding.

When Concentric was asked why it was recommending a higher equity ratio for Enbridge Gas in this proceeding than it had recommended in the rebasing application, Mr. Dane explained:

> I think this is an important point because we are using – or, in this proceeding, the Board is looking at cost of capital generally, it's looking at the ROE, and it's looking at capital structure.
>
> And so, in the Enbridge case, where we were looking at working within the Board's framework, looking at risks and then determining based on that assessment what an appropriate equity ratio would be, here, we are looking at the cost of capital generally. And, as Mr. Trogonoski described, there is interplay between ROE and cost of capital.
>
> So, whereas in the Enbridge case I might describe the analysis as being going from A to B, I think in this proceeding we are establishing whether A is the correct starting point to begin with.

[158] Decision and Order on Phase 1 of Enbridge Gas's 2024 Rebasing Application (EB-2022-0200), December 21, 2023.
[159] Enbridge Gas Fresh as Amended Notice of Motion (EB-2024-0078), May 29, 2024, pp. 11-12.

> And we understand the Board's prior approach about looking at business risk and requiring that utilities demonstrate a significant change in risk before equity thickness is determined, but we think it's very important that the Board in this proceeding begin by looking at a capital structure as a starting point and whether that meets the fair return standard and specifically the comparable component of that.[160]

That is a fair point. Moreover, it may appear somewhat incongruous for Enbridge Gas to have the lowest approved equity ratio of any Ontario utility. Still, in OEB staff's view, this generic proceeding should not provide an opportunity to take an end-run around a major OEB decision that is less than a year old. For the same reasons, OEB staff disagrees with Dr. Cleary's recommendation to lower Enbridge Gas's equity ratio. Likewise we disagree with Dr. Cleary's recommendation to revisit Hydro One's 40% equity ratio. The OEB approved a settlement on the equity thickness issue (for both distribution and transmission) in Hydro One's last rebasing case.[161]

Summary

In summary, OEB staff submits that no changes to the status quo in respect of capital structure are required. The equity thickness for Enbridge Gas and the other natural gas utility, as well as for OPG, should continue to be determined on a case-by-case basis. The default equity thickness should remain at 40% for electricity distributors and transmitters. OEB staff agrees with LEI that, as is the case today, a distributor or transmitter should be permitted to apply for a tailored equity ratio when it rebases. It would need to demonstrate that its particular risk profile justifies a departure from the applicable generic equity ratio.

13. Should the OEB take a different approach for setting the capital structure for electricity transmitters depending on whether they are a single versus multiple asset transmitter?

This issue relates to whether being a single asset electricity transmitter (i.e., other than Hydro One) increases its risk profile relative to Hydro One, and whether that warrants a higher allowed equity thickness in the capital structure.[162] OEB staff agrees with LEI that the current approach of allowing the same equity thickness to all electricity transmitters (and distributors) should be maintained, even if it is a single asset transmitter.[163]

OEB staff agrees with LEI that the reasoning provided by the OEB in 2006 to move

[160] Oral Hearing Transcript, September 26, 2024, p. 127.
[161] Decision on Settlement Proposal, November 29, 2022 (EB-2021-0110).
[162] LEI Expert Report, June 21, 2024, Revised September 23, 2024, p. 141
[163] LEI Expert Report, June 21, 2024, Revised September 23, 2024, p. 144

away from the size-based capital structure determination for electricity distributors also applies to electricity transmitters.[164] The risk profile of electricity transmitters is similar to, if not lower than, that of electricity distributors. As such, it is reasonable to consider the same approach to setting capital structure for electricity transmitters as that used for electricity distributors. Single asset transmitters do not necessarily have increased risk as compared to multi-asset transmitters as the one customer that these single-asset transmitters have is the IESO who is the Ontario market operator.[165] OEB staff also notes that it is not solely about having one customer, for single asset transmitters, it is about the lack of diversification, as per statements also made by Concentric (as noted below).

Concentric did not make specific recommendations regarding any risk premium that may be warranted for single-asset transmitters.[166] OEB staff agrees with Concentric that such a risk premium differential could be proposed in the context of utility-specific rates applications (and not in the current proceeding), with respect to the allowed ROE and equity ratio. OEB staff submits that there is no evidence in this proceeding to warrant a different approach to setting a different allowed ROE or equity ratio for single asset transmitters.

OEB staff is of the view that its submission in Issue #21 regarding the prescribed interest rate for CWIP and any concurrent cost recovery for certain projects, also applies to this Issue. Please refer to Issue #21 for OEB staff's further discussion on these topics.

F. Mechanics of Implementation

14. What on-going monitoring indicators to test the reasonableness of the results generated by its cost of capital methodology should the OEB consider, including the monitoring of market conditions?

OEB staff agrees with LEI and Dr. Cleary that consistent with the OEB's existing policy, the OEB should continue to monitor the cost of capital parameters and test their reasonableness in the context of prevailing macroeconomic conditions through the generation of a report.[167]

However, these reports should only be prepared annually (instead of quarterly as

[164] LEI Expert Report, June 21, 2024, Revised September 23, 2024, p. 143
[165] LEI Expert Report, June 21, 2024, Revised September 23, 2024, p. 144
[166] Concentric Expert Report, July 19, 2024, p. 140
[167] LEI Expert Report, June 21, 2024, Revised September 23, 2024, p. 148; Dr. Cleary Expert Report, July 22, 2024, p. 51

recommended by LEI and Nexus), as well maintained as internal OEB staff internal documentation.

OEB staff submits that an annual report should suffice. However, OEB staff submits that if there are acute changes in the capital markets in the intervening period between annual reports, then the OEB would take appropriate action, including the preparation of a report on an ad-hoc basis.

As aside from Australia, LEI was not aware of examples of ongoing public monitoring/ reporting by regulators regarding cost of capital in between major reviews.[168]

OEB staff agrees with LEI that ongoing monitoring of the cost of capital parameters enables the OEB to ensure the Fair Return Standard continues to be met.[169] It is also simple to administer.

OEB staff agrees with Concentric that periodic generic rate hearings remain the only reliable method for determination of utility ROEs that remain consistent with the FRS.[170] Given that short and long term debt rates are linked to market based data, ROE and capital structure should be the primary focus.

15. How should the OEB regularly confirm that the FRS continues to be met and that rate-regulated entities are financially viable and have the opportunity to earn a fair, but not excessive, return?

OEB staff agrees with LEI and Dr. Cleary that the OEB should continue to annually confirm that the FRS is being met, as it currently does through its cost of capital update letters.[171]

LEI and Dr. Cleary recommended that the OEB should direct utilities, as part of the annual reporting requirements, to provide credit ratings and details regarding new short-term and long-term debt and equity issued/borrowed during the year, as a further test of whether the FRS continues to be met.[172] LEI suggested that having actual data that allows for a check against the inputs that are being used in the cost of capital parameters.[173] LEI also proposed that utilities should provide details regarding any

[168] LEI Expert Report, June 21, 2024, Revised September 23, 2024, p. 147
[169] LEI Expert Report, June 21, 2024, Revised September 23, 2024, p. 148
[170] Concentric Expert Report, July 19, 2024, p. 142
[171] LEI Expert Report, June 21, 2024, Revised September 23, 2024, p. 151; Dr. Cleary Expert Report, July 22, 2024, p. 51
[172] LEI Expert Report, June 21, 2024, Revised September 23, 2024, p. 151; Dr. Cleary Expert Report, July 22, 2024, pp. 51 & 52
[173] Presentation Day Transcript, September 5, 2024, p. 17

failed attempts to secure debt and equity, or instances where the utility faced materially higher than expected costs to secure debt and equity.

Dr. Cleary further stated that utilities will have readily at hand debt and equity issuance information, as they have them in their investor presentations and they have to include them in annual reports and quarterly reports, if they prepare them.[174] Dr. Cleary did not see that it would be that onerous to provide them to the OEB, so that the OEB is as informed as can be.

Concentric disagreed with LEI's proposed reporting requirements, noting that the OEB is committed to reducing "red tape" and that there may be confidentiality concerns.[175] Concentric opined that the OEB performs a full discovery on the cost of debt at utilities' rebasing proceedings, which would be the appropriate time to look at debts that had been acquired and the related terms, as opposed to an annual reporting requirement.[176]

OEB staff's view is that, while there may be some value in annually gathering the information proposed by LEI, it would not justify the regulatory burden on utilities.

16. What should be the timing of the OEB's annual cost of capital parameters updates, including the timing, as required, of the underlying calculations?

OEB staff agrees with LEI that the OEB should continue publishing its annual cost of capital parameter updates in October or November, but use 12-month trailing data as of the end of September (i.e., from October of the previous year to September of the current year), for rates going into effect in the following January or May.[177] The status quo is to use 30 days of trailing data as of the end of September. Dr. Cleary agreed with the status quo.[178]

OEB staff also agrees with LEI that stakeholders are familiar with the OEB's existing cost of capital update schedule, and so continuing this approach would promote predictability and stability.[179]

Concentric generally agreed with LEI, but recommended the use of trailing 90-day averages (as opposed to 12-month trialing) where historical data are utilized, to avoid

[174] Oral Hearing Transcript, October 10, 2024, p. 186
[175] LEI Expert Report, June 21, 2024, Revised September 23, 2024, p. 151; N-M2-16-OEB Staff-23, August 22, 2024
[176] Oral Hearing Transcript, October 1, 2024, pp. 114 & 115
[177] LEI Expert Report, June 21, 2024, Revised September 23, 2024, p. 152
[178] Dr. Cleary Expert Report, July 22, 2024, p. 52
[179] LEI Expert Report, June 21, 2024, Revised September 23, 2024, p. 152

the inherent volatility in a single month's data.[180] The current timing for updates, in Concentric's view, represents a reasonable balance between the currency of the market data and sufficient advance notice to the regulated utilities and customers of the pending change to the rate of return.[181]

Concentric and Dr. Cleary suggested that it would not have any concerns if the OEB were to use market data as of October 31.[182] However, Concentric noted that from a timing perspective, the OEB should consider the administrative process and determine if a shift in data leaves sufficient time to make updates.[183] Dr. Cleary suggested that the OEB would need to determine that this change would not cause undue disruptions to its existing processes and procedures, but noted that the use of October data would provide more up-to-date capital market estimates and be consistent with the AUC approach.[184]

OEB staff concludes that the status quo of publishing the annual cost of capital parameter updates in October or November is appropriate, but instead using 12-month trailing data as of the end of September (rather than 30 days). LEI's report noted that considering a trailing 12-month period is consistent with the applicable duration of the LCBF (i.e., the 12-month period from January to December for the subsequent year).[185]

17. **What should be the defined interval (for example, every three to five years) to review the cost of capital policy (including, but not limited to, a review of the ROE formula and the capital structure)? Should the OEB adopt trigger mechanism(s) for a review and if so, what would be the mechanisms?**

OEB staff agrees with LEI and Concentric that the OEB should commit to reviewing the cost of capital policy every five years.[186] Nexus recommended that a review of the cost of capital occur every three years.[187] Dr. Cleary recommended intervals of ideally every three years, but never more than five years.[188]

OEB staff is of the view that the cost of capital policy should be reviewed with enough frequency to ensure alignment with prevailing macroeconomic conditions, so that

[180] Concentric Expert Report, July 19, 2024, p. 147
[181] Concentric Expert Report, July 19, 2024, p. 146
[182] N-M2-14-OEB Staff-24, August 22, 2024; Dr. Cleary Expert Report, July 22, 2024, p. 52
[183] N-M2-14-OEB Staff-24, August 22, 2024
[184] Dr. Cleary Expert Report, July 22, 2024, p. 52
[185] LEI Expert Report, June 21, 2024, Revised September 23, 2024, p. 91
[186] LEI Expert Report, June 21, 2024, Revised September 23, 2024, p. 158; Concentric Expert Report, July 19, 2024, p. 13
[187] Nexus Expert Report, July 19, 2024, p. 12
[188] Dr. Cleary Expert Report, July 22, 2024, p. 53

investors, utilities, and consumers have reasonable confidence in the OEB's decisions and outcomes. OEB staff submits that this issue is about balance and weighing the costs (i.e., the time and effort for stakeholders and the OEB) of performing an update of the cost of capital policy, against the benefits of incorporating more up-to-date capital market information and analysis in such policy. OEB staff is of the view that an appropriate balance is to review the policy every five years. This review could be in the form of a full generic proceeding, like this current case, or a review like the one conducted in 2016. OEB staff's view is that leaving flexibility on what type of review is required best balances the need for alignment with regulatory burden.

OEB staff submits that if there are acute changes in the capital markets then the OEB would take appropriate action at that time. No specific trigger needs to be adopted for major events such as the 2008-2009 financial crisis or the Covid pandemic – as LEI said, "we know it when we see it".[189]

18. **How should any changes in the cost of capital parameters and/or capital structure of a utility be implemented (e.g., on a one-time basis upon rebasing or gradually over a rate term)?**
19. **Should changes in the cost of capital parameters and/or capital structure arising out of this proceeding (if any) be implemented for utilities that are in the middle of an approved rate term, and if so, how?**

OEB staff agrees with LEI and Dr. Cleary that consistent with the OEB's existing policy, the OEB should continue to implement changes in the cost of capital parameters and capital structure upon rebasing.[190] The OEB reviews the capital structure only upon an application from the utility or other participants, generally during the review of the rebasing applications (cost of service applications or Custom IR applications).

Given that OEB staff's recommendations in Issue #10 and Issue #12 do not result in a significant change from the status quo, OEB staff finds no reason why any such changes could not wait until rebasing to be implemented. OEB staff submits that the revised cost of capital policy should apply to all utilities filing cost-based applications for 2025 and forward rates, even those where a decision for 2025 rates is expected or has been issued in advance of the OEB's decision in this proceeding. There may be a reasonable exception for the few cases for 2025 rates that have been concurrent with this generic proceeding, wherein parties have reached a settlement agreement on cost of capital matters and implementation.

[189] Oral Hearing Transcript, September 26, 2024, p. 82.
[190] LEI Expert Report, June 21, 2024, Revised September 23, 2024, pp. 159 & 160; Dr. Cleary Expert Report, July 22, 2024, p. 13

OEB staff submits that utilities should maintain the ability to apply to the OEB for their own utility-specific cost of capital parameters or capital structure if they believe their special circumstances require a departure from the generic approach in their own cases. OEB staff also notes that utilities can file a cost-based application earlier than scheduled, but distributors must justify, in its cost-based application, why an early rebasing is required.[191]

OEB staff submits that in the event that the OEB were to approve significant changes (i.e., to the cost of capital parameters and/or the deemed capital structure) from the status quo in this proceeding, another approach such as LEI's recommended two-factor test for parties to request implementation of such changes prior to rebasing would be appropriate and should be implemented, as necessary.[192] LEI's test states that (i) the utility should have more than 60% of its rate term remaining, and (ii) deviations in the cost of capital parameters should be material (100 bps or more).[193]

OEB staff notes that those utilities rebasing for January 1, 2025 rates can record the impacts of the generic proceeding outcomes in generic variance accounts (i.e., for each of the DSTDR, DLTDR, and ROE), as per the OEB's Letters and Accounting Orders.[194]

G. Other Issues

a) Prescribed Interest Rates

20. Should the prescribed interest rates applicable to DVAs and the construction work in progress (CWIP) account for electricity transmitters, electricity distributors, natural gas utilities, and OPG continue to be calculated using the current approach?[195]

21. If no to Issue #20, how should the prescribed interest rates applicable to DVAs and the CWIP account be calculated?

Overall Submission

[191] Filing Requirements For Electricity Distribution Rate Applications - 2023 Edition for 2024 Rate Applications, Chapter 2, Cost of Service, December 15, 2022, pp. 3 & 4
[192] LEI Expert Report, June 21, 2024, Revised September 23, 2024, pp. 162 & 163
[193] LEI Expert Report, June 21, 2024, Revised September 23, 2024, p. 162
[194] EB-2024-0063 OEB Letter and Accounting Order (DSTDR), July 26, 2024; OEB Letter and Accounting Orders (DLTDR and ROE), October 31, 2024
[195] OEB website; EB-2006-0117, OEB Letter, Approval of Accounting Interest Rates Methodology for Regulatory Accounts November 28, 2006; Accounting Procedures Handbook For Electricity Distributors, Issued: December 2011, Effective: January 1, 2012, Article 220, p. 200; Article 410, pp. 27 & 28

OEB staff's submission on prescribed interest rates and related matters is summarized as follows:

a) For the prescribed interest rate for all DVAs, the Bloomberg ticker BVCAUA3M BVLI Index (3-month) should be used, consistent with Issue #5.
b) For the prescribed interest rate for CWIP, a debt-based rate should be used, as per status quo, specifically the FTSE Canada (formerly DEX) Mid Term Bond Index All Corporate yield.
c) Instead of the OEB approving a WACC to CWIP on a generic basis, utilities with large multi-year capital projects can apply for a project-specific ROE to be included in CWIP, as per OEB policy.
d) TFG/Minogi's recommended approach of concurrent cost recovery for its projects is outside of the scope of this proceeding and any unique First Nations issues can be addressed in a rate application by a First Nations-owned utility.

Background

The OEB's *Report of the Board on Electricity Distributors' Deferral and Variance Account Review Initiative (EDDVAR),* July 31, 2009, addressed Group 1 DVAs and Group 2 DVAs.[196] This report stated that the OEB's two groupings (i.e. Group 1 and Group 2) are based on the required depth of the OEB's review and the process in which the account balances would be reviewed. Group 1 DVAs include accounts that do not require a prudence review, while Group 2 DVAs include accounts that do require such a review.

OEB staff submits that the OEB's current practice of reviewing the prescribed interest rates quarterly should be maintained. These rates should only be updated if the formulaic approach results in a change in interest rates of 25 basis points or more.[197] Otherwise, the previous quarter's prescribed interest rate should be maintained for the following quarter.

OEB staff also submits that the prescribed interest rates applicable to each of the DVAs and the CWIP account should reflect the respective data point at the end of the month that is one month prior to the start of the quarter (e.g., a November 30 data point for the quarter starting January 1). These rates should be published on the OEB's website shortly thereafter, effective for the next quarter (e.g., January 1 to March 31).

[196] EB-2008-0046
[197] Per the OEB's Prescribed Interest Rates webpage; EB-2006-0117, OEB Letter, Approval of Accounting Interest Rates Methodology for Regulatory Accounts November 28, 2006

OEB staff is of the view that its recommended accounting interest methodologies would be able to be updated mechanistically, while also being reflective of market rates and responsive to changes in market conditions.

Different alternatives for the prescribed interest rate methodology were also considered by the experts, including those set out in LEI's report and commented on by Concentric, Dr. Cleary, and OEB staff interrogatories.[198]

As also noted in Issue #5, broadly speaking, there are three alternatives to the bankers' acceptance rate: (1) the CORRA reference rate published by the Bank of Canada (or possibly a CORRA futures rate); (2) the Bloomberg ticker BVCAUA3M BVLI Index (3-month), which tracks utility bond yields; or (3) the three-month Canada T-bill rate. A credit spread would need to be applied to (1) or (3) but not (2), which already has a credit spread built in. For all of the remaining alternatives, if (1) or (3) were selected, the spread could be based on a confidential survey of banks or a confidential survey of regulated utilities.

An additional methodology was suggested by Concentric,[199] which was to apply the prescribed interest rate for DVAs to Group 1 DVAs and the WACC to Group 2 DVAs.

In OEB staff's view, any of these alternatives would be reasonable, except for Concentric's recommendation about using different rates for Group 1 and Group 2 DVAs. However, option (2), has the advantage of being administratively simpler as it would not require the OEB to calculate a spread by means of a bank or utility survey. More precisely, OEB staff submits that the Bloomberg ticker BVCAUA3M BVLI Index (3-month) should be used to develop the prescribed rate for DVAs. The disadvantages of using the Bloomberg ticker are that it is not freely available (it is only available to Bloomberg subscribers) and that it is not as well-known a benchmark as the CORRA or the T-bill. Still, in OEB staff's view, the ease of implementation outweighs those drawbacks.

In terms of the actual outcome for utilities (i.e., the impact on the prescribed interest rates for DVAs), OEB staff does not expect there to be a significant difference between the three alternatives. Table 1 in Issue #5 shows that the 3-month T-bill, the CORRA and the Bloomberg ticker all track similar paths historically – and all are comparable to the bankers' acceptance rate. The Bloomberg ticker is generally higher because it includes a spread.

[198] LEI Expert Report, June 21, 2024, Revised September 23, 2024, pp. 79 & 80
[199] N-M2-21-OEB Staff-27, August 22, 2024

- *Concentric's Position*

OEB staff disagrees with Concentric that a WACC rate should be applied to the OEB's Group 2 DVAs. Concentric stated that applying the prescribed interest rate to Group 1 DVAs and the WACC to Group 2 DVAs would provide a reasonable approximation of the short-term versus long-term distinction that Concentric has drawn in its report.[200]

Concentric also stated that amounts in DVAs could be tied up for a number of years and funded by a mix of debt and equity, so this supports the use of a WACC, even if certain DVAs reflect operating expenses.[201] OEB staff submits that if there is a multi-year deferral account that records purely operating expenses, but if the WACC were to apply, the utility would in effect be making a return on equity on a portion of the amounts, even though there is no equity.[202] OEB staff is not clear on Concentric's statement at the oral hearing that "the company would be earning its weighted average cost of capital on what's effectively become an asset at that point because it's deferred expense and, yes, under the weighted average cost of capital a component of that is the equity."[203]

If there is a DVA that is 100 percent capital, the revenue requirement impact is recorded in that DVA (and not the gross amount of the capital spend).[204] The revenue requirement is the total cost for a utility to provide energy service. It includes the cost of salaries, equipment, capital projects, depreciation, taxes, interest and a return on the equity invested by shareholders.[205] The revenue requirement is used to set rates for customers.

OEB staff submits that the revenue requirement impact already reflects the WACC and does not agree with Concentric's proposal to layer on another WACC to the principal balance. Concentric stated that the use of the deferral account then recognizes that deferral of the recovery of that amount.

In sum, OEB staff is of the view that the status quo prescribed interest rate for DVAs should be sufficient to capture the impact of the deferral of the recovery.

- *Prescribed Interest Rates Applicable to CWIP*

The current methodology for the prescribed interest rate for CWIP equals the FTSE

[200] N-M2-21-OEB Staff-27, August 22, 2024
[201] Presentation Day Transcript, September 5, 2024, pp. 52 & 53
[202] Oral Hearing Transcript, October 1, 2024, pp. 85 & 86
[203] Oral Hearing Transcript, October 1, 2024, pp. 85 & 86
[204] Oral Hearing Transcript, October 1, 2024, pp. 86 & 87
[205] Handbook to Utility Rate Applications, October 13, 2016, p. vii

Canada (formerly DEX) Mid Term Bond Index All Corporate yield.[206]

In general, for the prescribed interest rate for CWIP, OEB staff supports the continued use of the FTSE Canada Mid Term Bond Index All Corporate yield, as also recommended by LEI.[207] This is because OEB staff agrees with VECC that the construction cycle for most electricity distributors' capital projects is within one year, therefore a WACC would not be required.[208] Dr. Cleary also supported maintaining the current approach for the prescribed interest rates applicable to CWIP.[209]

Instead of the OEB approving a WACC to CWIP on a generic basis, OEB staff submits that utilities with large multi-year capital projects (which may include those related to the First Nations) can apply for a project-specific ROE to be included in CWIP, as discussed further below, as per OEB policy.

OEB staff notes that the FTSE Canada Mid Term Bond Index All Corporate yield rate has a credit spread built in. This rate should continue to be applied to all projects under construction, regardless of the construction period. OEB staff also agrees with LEI's recommendation to continue the current CWIP accounting procedures as set out in the OEB' Accounting Procedures Handbook (APH).[210] OEB staff submits that if a utility is not using the OEB's prescribed interest rate for CWIP and uses its own actual borrowing rate in the situations allowed in the APH, utilities should continue to use a debt-based rate, as opposed to a WACC.

- *The OEB's Treatment of CWIP and WACC*

In the January 15, 2010, *Report of the Board, The Regulatory Treatment of Infrastructure Investment in Connection with the Rate-regulated Activities of Distributors and Transmitters in Ontario* (Infrastructure Investment Report) the OEB suggested that an equity component could be applied for CWIP. The Infrastructure Investment Report also noted that the OEB could also consider applying a cap on the CWIP amount allowed, noting the following (emphasis added):[211]

[206] LEI Expert Report, June 21, 2024, Revised September 23, 2024, p. 164
[207] LEI Expert Report, June 21, 2024, Revised September 23, 2024, p. 168
[208] Oral Hearing Transcript, September 27, 2024, p. 207
[209] Dr. Cleary Expert Report, July 22, 2024, p. 56; N-M4-20-TFG/Minogi-8, August 22, 2024
[210] LEI Expert Report, June 21, 2024, Revised September 23, 2024, p. 168; Accounting Procedures Handbook For Electricity Distributors, Issued: December 2011, Effective: January 1, 2012, Article 220, p. 200; Article 410, pp. 27 & 28
[211] EB-2009-0152, *Report of the Board, The Regulatory Treatment of Infrastructure Investment in Connection with the Rate-regulated Activities of Distributors and Transmitters in Ontario*, January 15, 2010, p. 15

> The Board will allow utilities to apply to include up to 100 percent of prudently incurred CWIP costs in rate base. **This approach allows utilities to recover the interest costs on debt and a return on equity (i.e., the weighted cost of capital) during the construction period**. The depreciation or return of the investment will continue to be recovered once the project goes into service. **The Board may also consider: a) applying a cap on the CWIP amount allowed** or b) allowing the CWIP amount into rate base on a staged basis as construction proceeds. The Board will also allow utilities to apply to expense prudently incurred pre-commercial costs.

In the Infrastructure Investment Report, the OEB also states the following (emphasis added):[212]

> When projects compete for capital in infrastructure investment planning, return on equity ("ROE") incentives may encourage investment by making certain projects more attractive and therefore more likely to proceed. More specifically, **ROE incentives may encourage appropriate proactive investment**, especially in those cases where the project is perceived to be particularly risky. Even when a project can be a mandated project, the investment may entail certain risks and challenges, and a project-specific ROE may provide regulatory flexibility commensurate with any demonstrable risks and challenges being faced by the applicant.
>
> **The Board will therefore allow utilities to apply for a project-specific ROE**. Where a utility applies for a project-specific ROE in relation to a project for which other alternative mechanisms are also requested, the Board will take the risk-mitigating impact of those other mechanisms into account in its determination of an appropriate ROE for the project.
>
> As noted above, the Board will remain mindful of stakeholder concerns that project-specific ROEs can make some projects more attractive than others to a utility, and therefore have the potential to skew utility decision-making.

The Infrastructure Investment Report also stated that this alternative mechanism (e.g., allowing a ROE on CWIP) is likely to be most suitable in relation to the construction of capital intensive multi-year projects. This mechanism will provide greater up-front regulatory predictability, rate stability and improved cash flow for utilities.

Concentric's Positions

OEB staff disagrees with Concentric and TFG/Minogi that a WACC rate should be applied to the CWIP account on a generic basis. The position being taken by OEB staff is despite LEI's statements in the oral hearing that particularly for longer projects, there is nothing that says applying the WACC would violate the FRS. This is because OEB staff is of the view that the FRS does not relate to a WACC, rather it is related to the

[212] EB-2009-0152, Report of the Board, The Regulatory Treatment of Infrastructure Investment in Connection with the Rate-regulated Activities of Distributors and Transmitters in Ontario, January 15, 2010, pp. 17 & 18

allowed ROE or equity ratio.[213]

Concentric stated that the current approach that applies the cost of debt to CWIP balances has the potential to significantly understate the cost of capital for utilities.[214] Excluding the cost of equity borne by utilities during construction deprives the utilities of the opportunity to recover their full costs of financing, including the cost of equity over the life of the investment. A debt-only approach also places the Ontario utilities out of step with their utility peers. Concentric stated that Ontario is an outlier in this regard.[215]

Concentric recommended that the carrying costs on CWIP reflect the cost to the utilities of financing those assets, including a mix of debt and equity, which is a WACC.[216]

VECC stated that for most of the traditional investments for electricity distributors, the construction cycle is less than a year, and any CWIP that is on their balance sheets at the end of the year goes into service by the end of the following year.[217]

At the oral hearing, Concentric agreed that in Ontario CWIP is not included in rate base. However, OEB staff remains concerned that if a utility was to apply the WACC to CWIP, CWIP would be treated the same as capital additions to rate base, even though the asset under construction is not yet used and useful.[218] Concentric noted that it is focused on the carrying charge associated with construction projects and including the carrying costs on those as the costs are spent and accrued, but not that they be recovered in real-time or factored into the revenue requirement.

Under IFRS, CWIP carrying charges are recorded using a debt-based rate but US GAAP is more flexible in that regard. In the oral hearing, when asked questions by OEB staff about IFRS versus US GAAP, Concentric noted that OEB staff was addressing an accounting construct, but Concentric's focus is on a cost recovery construct.[219] OEB staff submits that there might be an administrative burden whether utilities might need to maintain two separate sets of books (i.e., regulatory records and financial reporting records). Concentric noted that there may be some amount of calculations that would be required and did not see that as an administrative burden.

TFG/Minogi's Positions

[213] Oral Hearing Transcript, September 25, 2024, pp. 162 & 163
[214] Concentric Expert Report, July 19, 2024, pp. 153 & 154
[215] Oral Hearing Transcript, September 26, 2024, p. 116
[216] Oral Hearing Transcript, September 26, 2024, p. 92
[217] Oral Hearing Transcript, September 27, 2024, p. 207
[218] Oral Hearing Transcript, October 1, 2024, pp. 88 & 89
[219] Oral Hearing Transcript, October 1, 2024, pp. 89 & 90

TFG/Minogi stated that the current approach for the prescribed interest rate for CWIP effectively blocks most First Nations from investing in regulated assets during construction.[220] That is because most First Nations must borrow funds at a cost that is often higher than the prescribed interest rate for CWIP, in order to invest in large utility projects. This shortfall puts First Nations in an immediate loss position, at a minimum, for the duration of the construction period. Applying the WACC to CWIP would overcome the immediate shortfall position. Equity capital is often employed in construction, particularly for large, multi-year construction projects.[221]

Instead of the OEB approving a WACC generically to CWIP, OEB staff submits that utilities can apply for a project-specific ROE to be included in CWIP, consistent with the Infrastructure Investment Report.

TFG/Minogi were also concerned that investors do not receive payment during the construction phase and must wait until a new facility is in service before they can receive payment.[222] TFG/Minogi argued that the OEB could also consider adopting an approach of concurrent cost recovery for these projects, at least with respect to First Nations' equity investment.[223]

Dr. Cleary noted that there could be a separate proceeding to consider costs of capital implications for First Nations, and that the outcomes of such proceeding then would be a starting point for additional conversations.[224]

OEB staff submits that an approach of concurrent cost recovery for such projects is outside of the scope of this proceeding. In OEB staff's view, any unique First Nations issues can be addressed in a rate application by a First Nations utility.

b) Cloud Computing Deferral Account

22. Should carrying charges and/or another type of rate apply to the Cloud Computing deferral account? If so, what rate should be applied?[225]

[220] Oral Hearing Transcript, September 25, 2024, pp. 7 & 8
[221] Oral Hearing Transcript, September 25, 2024, p. 16
[222] Oral Hearing Transcript, September 25, 2024, p. 16
[223] Oral Hearing Transcript, September 25, 2024, p. 19
[224] Oral Hearing Transcript, October 10, 2024, pp. 19 & 20
[225] Please refer to the OEB's Accounting Order (003-2023) for the Establishment of a Deferral Account to Record Incremental Cloud Computing Arrangement Implementation Costs, issued November 2, 2023.

In November 2023, the OEB issued an accounting order establishing a generic Cloud Computing deferral account allowing utilities to "record cloud computing implementation costs when utilities first transition from on-premise solutions to cloud computing solutions". The Accounting Order further states that:

> At the utility's next rebasing rate proceeding, a utility may propose the regulatory treatment for any material cloud implementation costs expected during its rate-setting term. The proposal could include consideration of a new deferral account or other approaches that take into account the timing and duration of the contract term.

It is clear from the above that the Cloud Computing deferral account is not expected to be an on-going generic account. On the contrary, it is expected that utilities are to propose the regulatory treatment of any material cloud implementation costs expected during its rate term in cost-based applications.

According to the Accounting Order, "carrying charges at the OEB's prescribed rates for deferral and variance accounts will apply to the account unless otherwise directed by the OEB." The Accounting Order further states that "if the OEB determines that carrying charges other than the prescribed rates will apply to the account, any carrying charges that have accrued will be reversed in favour of the final approach".

Only two experts (LEI and Concentric) commented on this issue.

LEI recommended that the OEB employ a deemed capital additions approach, which would apply a deemed WACC on the unamortized portions of the cloud computing contracts.[226] LEI argued that this would incentivize utilities to transition to cloud computing solutions.

Under this approach, LEI explained that:[227]

> …the OEB can allow the prescribed interest rate for the DVAs on the incremental operating costs. The recorded incremental operating costs and the relevant costs allowed during IRM proceedings (if any) can be treated as amortized costs of the cloud computing contract. The OEB can treat the balance unamortized portion of the cloud-based contracts (contract value minus amortized costs) as deemed capital additions to incentivize the transition to cloud-based software solutions.
>
> The onus should be on the utilities to justify the claimed costs during rebasing...
> … In addition, if the recorded incremental capital costs are not yet capitalized, the OEB may consider allowing the prescribed interest rate for the CWIP account on the recorded incremental capital costs until it is capitalized and added to the rate base.

[226] LEI Expert Report, June 21, 2024, Revised September 23, 2024, p. 175
[227] LEI Expert Report, June 21, 2024, Revised September 23, 2024, pp. 173 & 174

Concentric stated that it agreed with LEI's recommendation to allow a deemed WACC on the unamortized portion of cloud-based contracts, but disagreed with LEI's recommendation to continue the use of the prescribed interest rate to long-term DVAs (whether reflective of O&M costs related to cloud computing contracts or other costs).[228]

In OEB staff's view, the Cloud Computing deferral account should be treated like any other deferral account: the carrying charge should be the prescribed interest rate for DVAs. OEB staff is not persuaded that a departure from the usual approach is warranted. In OEB staff's view, the establishment of the Cloud Computing account was in itself sufficient incentive for utilities to transition to the cloud; an additional incentive by means of a higher carrying charge is not needed. In any case, the additional incentive would be small, as under LEI's proposal the WACC would only apply to the unamortized portion. Moreover, LEI's suggested approach (using three potential rates for different components of the recorded amounts -- prescribed interest rate for DVAs, WACC, and CWIP rate) would be administratively complicated.[229]

In sum, OEB staff submits that the OEB should continue to use the prescribed interest rate for DVAs to the entire balance in the Cloud Computing deferral account.

~All of which is respectfully submitted~

[228] N-M2-22-OEB Staff-30, August 22, 2024
[229] LEI Expert Report, June 21, 2024, Revised September 23, 2024, pp. 173-175. LEI's layered approach is to reflect the deemed WACC on the unamortized portions of the cloud computing contracts, the prescribed interest rate for the CWIP account on the recorded incremental capital costs until it is capitalized, and the prescribed interest rate for the DVAs on the incremental operating costs.