November 28, 2024

Nancy Marconi
Registrar
Ontario Energy Board
2300 Yonge Street, P.O. Box 2319
Toronto ON, M4P 1E4

Dear Ms. Marconi,

RE: EB-2024-0063: Generic Cost of Capital – Reply Submissions of Energy Probe

Attached are the reply submissions of Energy Probe Research Foundation (Energy Probe) in the EB-2024-0063 Generic Cost of Capital proceeding.

Respectfully submitted on behalf of Energy Probe.

Tom Ladanyi Digitally signed by Tom Ladanyi Date: 2024.11.28 13:57:26 -05'00'

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cc. Parties to the Proceeding

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EB-2024-0063

Generic Cost of Capital

Energy Probe Reply Submissions

November 28, 2024

Introduction

The following are the reply submissions of Energy Probe Research Foundation (Energy Probe) in the EB-2024-0063 Generic Cost of Capital proceeding.

In this proceeding two groups of Ontario utilities are requesting that the OEB approve large increases in the deemed cost of capital that they recover in distribution or transmission rates or in payment amounts in case of OPG. One group consists of the members of the Electricity Distributors Association (EDA) representing the majority of municipally owned electricity distributors. The other group was comprised of the Ontario Energy Association and the Coalition of Large Distributors plus Ontario Power Generation (OEA). The EDA is proposing that the OEB increase the deemed return on equity (ROE) that utilities charge in their rates from the current 9.21% to 11.08%.[1] OEA is proposing that that the deemed ROE be increased to 10.0% and that the deemed equity ratio be increased to 45% for all Ontario utilities from the current 40% for electric utilities and 38% for Enbridge Gas.[2]

Reply Submissions of Energy Probe

Energy Probe will only comment on the proposals by the EDA and the OEA since they are proposing increases in the cost of capital. In its submissions Energy Probe will deal with them separately.

Electricity Distributors Association (EDA)

The large increase in ROE requested by the EDA is unjustified.
In support of its request for an increase in the cost of capital the EDA hired Nexus Economics as their cost of capital experts. Nexus report recommended that the OEB increase the return of equity for electricity distributors from the current 9.21% to 11.08%.[3] This is a large increase that will cost customers of Ontario electricity distributors $249.8 million per year.[4]

[1] EDA Closing Submissions, page 1
[2] OEA Argument, page 5
[3] EDA Closing Submissions, page 1
[4] SEC Final Argument, pages 8-9, para 1.4.3

Increase is not needed to attract investment capital.
The EDA claims that the increase is needed to attract capital for investment in future capital projects that will be necessary to deal with energy transition, climate change and cybersecurity. EDA claims that investors have options and that they would not invest in Ontario utilities if they do not have comparable returns as US utilities.[5]

EDA's consultant did not use any comparable US Utilities in its analysis
The EDA claims that many utilities in the US are comparable to utilities in Ontario.[6] Indeed many are such as many municipally owned utilities including Los Angeles Department of Water and Power, Sacramento Municipal Utility District and many others. Unfortunately, EDA's consultant Nexus did not include them as peers in its analysis.

Increased investment due to energy transition will result in greater utility earnings
The EDA claims that energy transition will not yield a windfall to utility investors.[7] That is because no matter how much is invested the deemed return remains the same. Of course it remains the same. The deemed return is set by the OEB and is imbedded in rates until the OEB approves a new deemed return. However, what does change is the actual return. Greater revenues due to energy transition will result in greater earnings which will produce a larger actual return on equity.

The EDA claims that more capital investment does not increase the return to investors.[8] Energy Probe agrees that the return to investors will not immediately increase but it will on rebasing and for utilities which have an ACM or ICM and can increase rates between rebasings.

EDA's interpretation of the FRS is too restrictive.
The EDA interprets the FRS as a blind test where the ownership of the utility or the identity of the investor do not matter. All that matters are comparable investments.[9]

The FRS has three branches, each themselves referred to as "standards". Each standard must be met, and none ranks in priority to the others.9 A fair return must:

(a) be comparable to the return available from the application of invested capital to other enterprises of like risk (the comparable investment standard);

(b) enable the financial integrity of the regulated enterprise to be maintained (the financial integrity standard); and

(c) permit incremental capital to be attracted to the enterprise on reasonable terms and conditions (the capital attraction standard).[10]

Energy Probe submits that this is interpretation is too restrictive. Investors base their investment decisions on information about the companies that are considering for investment including their

[5] EDA Closing Submissions page 34, para 84
[6] Ibid., page 3, para 8
[7] Ibid., page 4, para 9
[8] Ibid.
[9] Ibid., page 9, para 22, 23 and 24
[10] Ibid., pages 9 and 10, para 24

ownership. But even if one accepts the EDA's interpretation of FRS, then the selection of comparable investments is where there is a problem with the EDA's analysis. Energy Probe submits that comparable investments are utilities which have similar ownership structure and similar types of investors. EDA's consultant, Nexus, did not select a single municipally owned utility, nor one whose only investors are municipalities. Energy Probe submits that this is a fatal flaw in the analysis.

The EDA wants the OEB to ignore who the is the investor that would be investing in municipally owned electricity distribution utilities in Ontario.

It is noteworthy that the focus of the FRS is on the generic investor, without consideration of who is the investor.[11]

The fact is that there are no external investors in municipally owned utilities in Ontario, and that none are possible under the current tax laws[12] but the EDA wants the OEB commissioners to pretend that there are. The EDA wants the OEB commissioners to pretend that investors do not care if utilities have deferral and variance accounts, or three methods of setting rates, or ICM or ACM, or if they have promissory notes with municipalities, or if they use the MFIRS accounting system. The EDA wants the commissioners to pretend that investors are not aware that there are differences between US states and Canadian provinces or that there are differences between tax laws in US and Canada. The EDA wants the OEB to pretend that there are only generic investors looking to make generic investments in generic utilities in search of investment that will yield the greatest return.

The real world is very different from what the EDA wants the OEB to pretend. Electricity distributors in Ontario have mechanisms in place that allow them to reduce business risk: deferral and variance accounts, three rate setting methods, some with ICM and ACM to deals with major capital expenditures and have secure financing arrangements with municipalities.

<u>EDA wants a higher ROE because of the risk of mismanagement of Energy Transition by its members</u>.

According to the EDA, utilities will need to ramp up capital expenditures now to deal with energy transition and climate change at some time in the future.[13] The EDA claims that there is a risk that electricity utilities will overexpand in expectation of load growth due to energy transition, but the growth does not materialize.[14] The EDA claims that energy transition and climate change capital projects will be more risky than other capital projects of utilities. EDA believes that there is a risk that the energy transition and climate change projects will be over budget or behind schedule or not achieve their objectives resulting in rate base disallowance by the OEB as occurred with nuclear plant projects in the US in the 1970's.[15] The EDA claims that to attract investment capital for energy transition and climate change projects utilities need a

[11] Ibid., page 9, para 22
[12] AMPCO and IGUA Written Submissions, pages 5-6, paras 25-34
[13] Ibid. pages 12-13, paras 30, 31, and 32
[14] EDA Closing Submissions, page 40, para 98
[15] Ibid., pages 13-14, paras 33 and 34

higher deemed ROE because investors are expecting that utilities will mismanage these projects. Energy Probe submits that this is preposterous. The EDA wants ratepayers to prepay now to protect utilities from the risk of mismanagement of future projects. Energy Probe submits that the OEB should reject this claim.

Indeed, it is disappointing that EDA would hire a consultant like Nexus that has such low confidence in the ability of utility management to successfully manage capital projects that will be required to deal with energy transition and climate change. Energy Probe has been an intervenor in many OEB rate proceedings and believes that municipally owned Ontario electricity distributors are well managed and has confidence that they will be well managed in the future if and when they are faced with dealing with energy transition and climate change. Energy Probe hopes that the OEB commissioners have confidence in municipally owned electricity distributors in Ontario.

Ontario Energy Association, Coalition of Large Distributors and Ontario Power Generation (OEA)

Large increases in equity thickness and return on equity requested by OEA are not justified.

The OEA retained US based Concentric Energy Advisors (Concentric) to provide independent analysis and recommendations for each of the 22 issues identified by the Board for this proceeding. Concentric on behalf of the OEA is requesting an increase in the return on equity and of 10.0% and a minimum equity thickness of 45% for all Ontario electric and gas utilities.[16] These will cost Ontario ratepayers approximately $570 million each year.[17] The OEA claims that the current ROE and equity thicknesses of Ontario electricity and gas utilities do not meet the Fair Return Standard because they are lower than those of comparable utilities in the US. According to OEA a generic investor can earn more money by investing in US utilities. To attract those generic investors Ontario ratepayers will have to pay $460 million a year and if they don't then there will be no money to pay for unspecified capital investments required to deal with energy transition, climate change and cybersecurity at some unspecified time in the future. Energy Probe submits that the OEB should reject this threat from the OEA.

$460 Million per year is not required to meet FRS

The OEA explains[18] that the principles surrounding the concept of a "fair return" for a regulated company were established by the Supreme Court of Canada in *Northwestern Utilities v. City of Edmonton (1929):*

[16] OEA Argument, para 6, page 5
[17] SEC Final Argument, page 9
[18] OEA Argument, page 6, para 10

By a fair return is meant that the company will be allowed as large a return on the capital invested in its enterprise (which will be net to the company) as it would receive if it were investing the same amount in other securities possessing an attractiveness, stability and certainty equal to that of the company's enterprise.

OEA's consultant recommends that the return on equity be increased to 10% for all Ontario utilities based on its analysis of 25 proxy US and Canadian gas and electric utilities.[19] There were no US municipally owned utilities in the proxy group. Energy Probe submits that this is a significant deficiency.

Increase in Equity thickness of distributors to deal with Energy Transition is not justified

The OEA is requesting an increase in equity thickness for all Ontario utilities from 40% to 45% and for Enbridge Gas from 38% to 45% largely to deal with risks of energy transition. In the recent Enbridge Gas rebasing case[20], the OEB considered the risks of energy transition when it increased its equity thickness from 36% to 38%. That decision was issued in December 2023. There is no evidence in this proceeding that would justify increasing the equity thickness in less than a year.

The OEA claims that energy transition will result in *"unanticipated capital expenditure risk"* for Ontario distribution utilities and that *"growth of capital spending to meet increasing demand (such as that anticipated due to the Energy Transition) will put additional pressures on electric distributors' financial results and the perception of risk by both equity investors and credit rating agencies."*[21]

Energy Probe submits that it is highly unlikely that there will be *"unanticipated capital expenditures"* by Ontario distribution utilities because each utility is required to submit at rebasing its distribution system plan to the OEB. If a distributor has a large unanticipated capital expenditure it can apply for ICM funding prior to its next rebasing. Energy Probe agrees capital spending to meet increasing demand will put additional pressures on the distributors, but these will be positive pressures since distributors will have increased earnings.

The OEA claims that *"a reasonable deemed capital structure will ensure that distributors are able to attract equity and debt investment on reasonable terms amid growing capital needs to meet demand and improve resilience and reliability.*[22]*"* Energy Probe submits that the current capital structure is reasonable, but even if it were not, it would not matter since the 60 out of 61 distributors that are owned by municipalities are prevented from having outside equity investors.[23] There is no indication that municipal owners would base their investment decisions for capital expenditures by the distributors they own on the equity ratio.

[19] Ibid., page 29
[20] EB-2022-0200, Decision and Order, December 21, 2023, page 68
[21] OEA Argument, pages 68-69, para 213
[22] Ibid.
[23] AMPCO and IGUA Written Submissions, pages 5-6, paras 25-34

OEA claim for parity in equity ratio with investor-owned US utilities is not justified

The OEA is recommending that the OEB set 45% as the minimum equity ratio for all Ontario utilities and that this ratio should increase over time to achieve parity with US utilities[24] which are all well above 50%.[25] This recommendation assumes that investors can invest in all Ontario utilities, which is wrong, and if they can, that they would not take into account the many differences between US and Canadian political, tax and regulatory regimes.

OEA did not seek parity with municipally owned US Utilities

Even though there are many municipally owned utilities in the US, the consultants for the OEA did not include any in its proxy group. The OEA never explains why Ontario utilities must achieve parity with investor-owned US utilities but not with municipally owned US utilities. The consultants claim that ownership does not matter. If it does not, why did they exclude municipally owned utilities? Do municipally owned US utilities and investor owned US utilities have the same capital structure? This can not be determined from the evidence of OEA's consultants.

OPG should not be compensated for the risk that it will mismanage new nuclear projects

The OEA claims that the OPG is facing increased risk due to the possibility that its new nuclear project will cost more than budgeted and take longer than forecasted.[26] Energy Probe is confident that the OPG will not mismanage new nuclear projects and there is no need to compensate it for something that is unlikely to happen.

Enbridge Gas should not be compensated because its credit rating was lowered by S&P Global

The OEA claims that the equity ratio and the ROE of Enbridge Gas should be increased because S&P Global recently lowered its credit rating.[27] Standard & Poor was not a participant in this proceeding. There was no opportunity to challenge its opinions. For that reason, Energy Probe submits that the OEB should not assign much weight to what S&P Global thinks.

Conclusion

The proposal by consultants for the EDA to increase the equity return of electricity distributors would increase electricity rates in Ontario by $250 million[28] a year. The proposals by the

[24] OEA Argument, page 36, para 234
[25] Ibid., page 74, figure 36
[26] Ibid., page 11, para 29
[27] Ibid., page 12, paras 31 and 32
[28] SEC Final Argument, page 9

consultants for the OEA would increase rates of electricity distributors, transmitters and OPG by about $570 million per year[29]. Should the OEB approve these increases, it will make electricity even more expensive in comparison with gas than it already is. This will slow down the pace of energy transition from gas to electricity. The OEB should consider that when making its decision. The OEB should also consider that optics of siding with US consultants who claim that energy transition increases the business risk for Ontario utilities against a Canadian consultant who claims that it decreases it.

The very large increase in ROE requested by the EDA is unjustified. The increase is not needed to attract investment capital. EDA's consultant did not use any municipally owned US electricity distributors in its analysis of proxy utilities even though 60 out of 61 Ontario distributors are municipally owned. Because of that deficiency, the EDA's interpretation of the Fair Return Standard is wrong.

There is no evidence that energy transition is causing a significant increase in load by Ontario electricity distributors. The EDA claims that if it does, it will not result in any increase in earnings. It claims that distributors will be forced to expand their systems to provide increased capacity for new loads but their revenues will not increase. Energy Probe submits that this is not correct. Increased investment due to Energy Transition will result in greater utility earnings.

The EDA wants a higher ROE because of the risk of mismanagement of energy transition capital projects by its members. The EDA is saying that to attract investment capital for energy transition and climate change projects, utilities need a higher deemed ROE because investors are expecting that utilities will mismanage these projects. Energy Probe submits that this is preposterous. EDA wants ratepayers to prepay now to protect utilities from the risk of mismanagement of future projects. Energy Probe submits that the OEB should EDA's request for higher ROE.

The OEA claims that the current ROE and equity thicknesses of Ontario electricity and gas utilities do not meet the Fair Return Standard because they are lower than those of comparable utilities in the US. According to the OEA a generic investor can earn more money by investing in generic US utilities. To attract those generic investors Ontario ratepayers will have to pay about $570 million a year and if they don't then there will be no money to pay for unspecified capital investments required to deal with energy transition, climate change and cybersecurity at some unspecified time in the future. Energy Probe submits that the OEB should reject this threat from the OEA.

Energy Probe submits that it is highly unlikely that there will be "unanticipated capital expenditures" as the OEA claims by Ontario distribution utilities because each utility is required to submit at rebasing its distribution system plan to the OEB. If a distributor has a large unanticipated capital expenditure it can apply for ICM funding prior to its next rebasing. Energy Probe agrees capital spending to meet increasing demand will put additional pressures on the distributors, but these will be positive pressures since distributors will have increased earnings.

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[29] Ibid.

OEA claims that municipally owned Ontario utilities should have parity with investor owned US utilities to attract investment capital. Even though there are many municipally owned US utilities, the consultants for OEA did not include any in its proxy group. Energy Probe submits there is no reason why there should be parity in the equity ratio of Ontario utilities have to achieve parity with investor owned US utilities but not with municipally owned US utilities.